CHAPTER 17

THRIFT INSTITUTIONS AND MORTGAGE BANKS

Topics Covered in Chapter

- Thrift Institutions
  - Savings Associations
  - Savings Banks
  - Credit Unions
- Finance Companies

Historical Development of Thrift Institutions

- Mutual Savings Banks were developed in the 1800s because commercial banks did not serve the needs of small savers.
- Eventually Mutual Savings Banks invested most of their deposits in mortgage loans.
- Mutual Savings and Loan Associations and Building Societies were also started in the 1800s by groups of people who pooled their savings so that each would eventually be able to acquire a house.

Historical Development of Thrift Institutions (concluded)

- Stockholder-owned savings and loan associations were relatively uncommon until the late 1970s and 1980s when pressure to attract more capital encouraged many mutual S&Ls to convert to the stock form of ownership.
- Stockholder-owned S&Ls outnumber mutuals today.
- The assets of stock S&Ls are many times as large as the assets of mutual S&Ls.

Assets of Thrift Institutions

- The major assets of savings banks and S&L's are mortgage-oriented assets.
  - Mortgage loans and mortgage-backed securities comprise over 60% of assets for S&Ls.
  - The federal tax laws still encourage the industry to participate in mortgage lending.
  - Mortgage-backed securities have become popular as S&Ls and MSBs have swapped mortgage loans with government agencies in return for agency securities.

Assets of Thrift Institutions (continued)

- Investment securities (especially mortgage derivatives) represent the second largest category of assets.
- Consumer and commercial loans have expanded slightly since deregulation, but these loans are only a little over 7% of assets.
- Cash and noninterest bearing deposits are held to meet reserve requirements and other liquidity needs.

Liabilities and Net Worth of Thrifts

- Time and savings deposits are the primary funding source.
  - Savings accounts, the S&L industry's traditional primary sources of funds, have become less important.
  - Certificates of deposit (consumer and large money market).
  - Checkable deposits (NOW accounts and MMDA accounts).

Liabilities and Net Worth of Thrifts (continued)

- Borrowing includes both short- and long-term financing.
  - Advances from the Federal Home Loan banks (short and long term).
  - Federal funds purchased.
  - Reverse repurchase agreements.
  - Mortgage-backed bonds.

Liabilities and Net Worth of Thrifts (concluded)

- Thrifts improved their capital adequacy ratios substantially in the 1990s.
  - Conversion from mutual to stock charters and the sale of stock have provided a means of increasing net worth.
  - Thrift assets shrank as institutions failed or sold assets.
  - With more capital and fewer assets, capital ratios improved.

S&L and Savings Banks Income Statements

- Interest revenue and interest expense are the largest revenue and expense categories, respectively.
  - Interest revenue minus interest expense is called net interest income or net interest spread.
  - The net interest income divided by average assets is called the net interest margin, which is low compared to commercial banks.
  - Most of the losses suffered by the S&L industry in the early 1980s were due to narrow spreads.

S&L and Savings Banks Income Statements (continued)

- Operating expenses per average assets increased through the 1980's as new types of assets and deposits that were expensive to offer were introduced.
- The major cause of losses in the mid-1980s were loan losses.
  - Provision for loan loss expense (debit) creates a reserve or allowance for loan losses (credit or contra-asset against loans).
  - When a loan is charged off, the loan is removed (credit) and the reserve is reduced (debit).

S&L and Savings Banks Income Statements (concluded)

- Savings Institution profitability improved substantially in the 1990s and early 2000s.
  - As interest rates fell during the decade, deposit rates fell faster than mortgage rates.
  - Rates on adjustable rate mortgages adjusted upward after initial low teaser rates.
  - Thrifts made more relatively high-rate commercial and consumer loans.

Thrifts have earned their returns by:

- spreading risk over a large number of assets.
- spreading information, acquisitions and transaction costs over a high volume of transactions.
- pooling funds to provide liquidity for depositors while obtaining high yields on long-term assets, called maturity intermediation.

Credit Unions

- Mutual institutions organized much like a club with each member (share owner) having a vote to elect the board of directors.
- Membership requires a common bond (e.g., same employer, church, trade association).
- Credit Union Assets have grown steadily in recent years.

Credit Union Assets and Liabilities

- Credit union member loans constitute over 60 percent of total CU assets.
- Other assets include cash and investments.

Credit Union Assets and Liabilities (concluded)

- Credit Union Liabilities
  - Member Regular Share Accounts.
  - Share certificates are time deposits like CDs, and have become a more important source of funds for credit unions.
  - Share drafts are CU interest-bearing checking accounts (similar to commercial banks' NOW account).

Credit Union Problems

- Disadvantages of Credit Unions
  - Small, unable to achieve economies of scale or offer sophisticated services.
  - Few employees—Difficult to attain separation of duties
  - High interest spread, but high costs of servicing small loans.

Credit Union Management roblems

- Credit Risk -- poor loan portfolio diversification gives credit unions an incentive to
  - Hold high capital to absorb losses.
  - Hold high liquidity.
  - Merge or relax common bond requirements to achieve greater diversification.
- Liquidity Risk -- minimized by investing a large portion of assets in investment securities.
- Interest Rate Risk -- increased mortgage-related lending has led to increased interest rate risk.

Other Developments for Credit Unions

- Small credit unions are merging or liquidating.
- Credit unions are adopting new technologies, especially at larger credit unions.
- Funds flows are becoming increasingly coordinated.

Finance Companies

- Lenders to businesses and consumers who are higher risk borrowers.
- Highly leveraged; borrowing funds from banks and the open market.
- Most larger finance companies are now subsidiaries of bank and financial holding companies (sale finance companies).
- Finance companies are diverse and adaptive to changing needs.

Finance Company Assets

- Investment securities, real assets, cash, and deposits represent a small percent of assets.
- Consumer receivables (loans)
  - Personal loans.
  - Automobile credit.
  - Mobile home credit.
  - Revolving Consumer Installment Credit.
  - Other Consumer Installment Credit.
- Real Estate Lending (second mortgages) is the fastest growing area of finance company lending.

Finance Company Assets, cont.

- Business credit -- area of growth in recent years
  - Wholesale paper -- loans to finance inventories. "Floor plan" is a type of wholesale paper.
  - Retail paper -- purchase of consumer sales (loan) contracts from retailers.
  - Lease paper -- leasing business equipment and consumer durables.
  - Commercial accounts receivable financing.
  - Factoring -- the purchase of accounts receivables.

Liabilities and Net Worth

- Net worth
  - Low relative to assets -- highly leveraged.
  - Net worth level directly related to riskiness of loan portfolio.
- Finance company debt -- mostly short and some long term
  - Bank debt -- continuous and seasonal use by smaller firms.
  - Commercial paper -- unsecured, issuance into money market.
  - Transfer credit from parent companies is an important source for some finance companies.

Liabilities and Net Worth (concluded)

- Deposit liabilities and thrift certificates
  - Small denomination certificates sold to the public
  - Some states charter FC as industrial banks that can accept deposits and compete with banks and thrifts.
- Long-term debt
  - Issued when interest rates are low.
  - Finance company borrows short when interest rates are high.

Income and Expenses of Finance Companies

- Revenues
  - Finance charges from loans.
  - Credit insurance premiums.
  - Other fees and charges.
- Expenses
  - Interest expenses.
  - Loan losses.
  - Other operating expenses.

Income and Expenses of Finance Companies (concluded)

- Small finance companies have high yields on loans and high operating expenses.
  - Higher net return on assets.
  - Lower financial leverage.
- Large firms with better, secured loans have lower yields and lower operating expenses.
  - Higher financial leverage.
  - Profitability varies with interest rates (costs of funds).

Regulation of Finance Companies

- Maximum rate ceilings on loans, but phased out in most states
- Creditor remedy regulation -- limitations on creditors in working with problem customers.
- Branching, chartering, and merger restrictions.

Management Problems of FC

- Management of interest rate risk
  - Maturity matching.
  - Manage maturity/duration of both assets and liabilities.
- Management of liquidity risk
  - "Roll over" risk of commercial paper, offset by maintaining back up lines of credit at banks.
  - Securitization of assets provides liquidity.
- Management of credit risk
  - Higher credit risk levels.
  - Usually well diversified by industry and geographically--flexible charters and located throughout the world.

New Developments in Finance Companies

- Shift toward business credit.
- Shift toward second mortgage lending.
- Growth of leasing.
- Growth of revolving credit, such as home equity lines.
- Decline in small finance companies.