Short-Run Structural Solutions to the Problems of Thrift Institutions

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I. Introduction

The discussion over the current problem of thrift institutions has centered on two categories of possible solution. In one camp are those who argue for giving thrifts aid, generally or individually, through one of several devices, until short-term interest rates drop sufficiently to cause the problem to disappear. In the opposing camp are those who argue that thrifts are an anachronism and that they should be merged out of existence, or possibly liquidated, perhaps with the merger/liquidation process facilitated by aid from the appropriate federal insuring agency. As this paper is being drafted at least one Congressional committee is holding hearings on the subject and by the time the paper is presented before its intended audience, one of these two opposing solutions may well have been chosen, although it still is possible that no action at all will be taken. One thing seems certain, however—the number of persons arguing that nothing need be done, because the problem is of insufficient consequence, is rapidly diminishing.

Proponents of the "short-run aid until things get better" school of thought argue that such aid is less expensive to the federal insuring agencies and ultimately to the taxpayer than the alternative of federally assisted mergers of troubled institutions. This conclusion is based on several assumptions, including a crucial one that short-term interest rates are bound to fall soon, thus eliminating the need for all but a minor amount of aid until the problem is rectified by the fallen rates. Even if rates should not fall, intermediate to longer-term assistance might be preferable to merger since the presumption is that troubled thrift institutions, especially the larger mutual savings banks, are not particularly salable items. Then too, the opponents of assisted or unassisted mergers concern themselves with possible social diseconomies stemming from the disappearance of several large thrift institutions, especially where such disappearance is accomplished through the device of mergers with commercial banks. It is argued that thrifts are essential, as separate specialized institutions, in order to assure a sufficient supply of loanable funds to finance new housing and in order to meet the needs generally of household savers and borrowers. Widespread mergers between commercial banks and thrifts, on the other hand, are thought to reduce competition, possibly lead to an undue concentration of

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resources in the hands of commercial banks, and, if sufficiently widespread, could cause an undermining of public confidence which could lead to "runs" on financial institutions in general. Thus, short-run assistance aimed primarily at keeping troubled thrift institutions intact is thought to be preferred to solutions which result in fewer thrifts. The proponents of the merger route, of course, believe that such transactions are less costly to the insuring agencies and have little or none of the public costs attributed to them by the proponents of short-run aid.

Section II below analyzes the conditions under which assisted mergers are less expensive (or more costly) to the insuring agency than open-bank subsidies aimed at bridging the gap until interest rates decline; the circumstances under which a commercial bank would be interested in taking over a troubled thrift; and the effect on the insuring agencies of permitting closed-bank mergers between commercial banks and thrifts, on either an intrastate or interstate basis.

Section III provides a discussion of the public costs and/or benefits—apart from the cost to the insuring agencies—of assisted mergers; and Section IV provides a summary and conclusion. Note that, in order to simplify the analysis, the discussion below is carried out with respect only to the FDIC's responsibility as insurer of mutual savings banks and, in the examples given, the data are for large New York City mutual savings banks in excess of $500 million in total assets. Nonetheless, the analysis would apply to both mutual savings banks (MSBs) and savings and loan associations (S&Ls) of varying sizes in any location, and whether insured by either the Federal Deposit Insurance Corporation (FDIC) or the Federal Savings and Loan Insurance Corporation (FSLIC).

II. Open Bank Subsidies versus Merger Assistance

Two somewhat related questions must be answered before we proceed with the analysis: When does "failure" occur? What are the costs of averting such "failure"? Technically, an institution becomes insolvent when it cannot meet its obligations either through the generation of revenues, the maturation of existing assets, or through new borrowing. Thus, technically, a thrift institution could have negative book equity but as long as it enjoys sufficient growth in new liabilities, it could sustain negative earnings, theoretically at least, forever. This is why thrift institution executives often refer to their plight as being a "liquidity" problem, whereas the rest of us typically would refer to their plight as an "earnings" problem. As a practical matter, nevertheless, the determination of when an institution is insolvent lies with its chartering agency—in the case in question the State Superintendent of Banks. It is quite likely that the chartering agency would place a troubled thrift institution in receivership well before the point at which book equity turns zero and/or well before the point at which current obligations cannot be met through any normal procedures for generating new cash. For example, in New York State the Superintendent has wide discretion as to when to place a banking organization in receivership. The Superintendent may close a banking organization on the grounds it "is in an

unsound or unsafe condition ... (or) cannot with safety and expediency continue business." [1]

It is difficult to tell with any precision when a superintendent would "pull the plug" on a troubled thrift. Certainly, the state agency, in constant touch with the federal insuring agency, would monitor the situation on a day-to-day basis. However, it is reasonable to assume that very rough rules-of-regulatory-thumb exist on such matters as book capital-to-asset ratios which, if violated, would create a presumption of imminent failure. For example, an agency might worry that an MSB's creditor (other than the Fed or the FHLBB) would bring about technical insolvency—by not rolling over some debt obligations of the institution. Since the outside creditors do not have access to the agencies' sophisticated balance sheet and income statement data, they (the creditors) would tend to make their judgments on rather imprecise grounds (e.g., on remaining book equity levels, recent earnings or loss performance, etc.). These "gross" measures of safety and soundness then become important in the agencies' determination of when "failure" should properly occur.

Thus, a reasonable operating assumption on which to base our analysis might be that the amount of yearly open-bank subsidy needed to avert "failure" would equal MSBs' yearly pretax net operating losses. If MSBs did not grow (they have, in fact, been shrinking in recent months) and if the chartering agencies literally set a "book" equity level below which insolvency would occur, then the amount of subsidy would be that which was necessary to avert any further losses, i.e., any further declines in bank equity.[2]

Just how much assistance—presumably under section 13(c) of the Federal Deposit Insurance Act—would be needed to avert further losses for large New York MSBs? The answer cannot be given with any precision without having access in some detail to the balance sheets and income statements of each of these mutual savings banks. But for purposes of our analysis we may use the aggregated balance sheet and income statement of large New York City mutual savings banks (see Table 1). Through the first seven months of 1981 pretax net operating losses for these institutions, on an annualized basis, have been on the order of $1 billion per year. Thus, if the FDIC were able to make a finding of "essentiality" under section 13(c)[3]

[1]New York Banking Law, S. 606.1.

[2]Although we ignore them, taxes are especially important in New York State where a "franchise" tax bases the New York tax on level of assets, not level of earnings. Thus, large New York City MSBs paid $43 million in New York taxes during the first seven months of 1981 while receiving $30 million in federal tax rebates. Assuming that federal tax carrybacks will be soon exhausted, the insuring agencies must worry not only about replacing MSBs' operating losses but also the New York "franchise" taxes when calculating the size of the needed subsidy.

[3]Under Section 13(c) of the Federal Deposit Insurance Act, the Corporation, before it can assist an open bank in order to *prevent* its closure, must find the institution to be "essential" to the financial community of which it is a part. The FDIC apparently must believe it is unlikely that it could make such an "essentiality" finding in the case of even a large New York City mutual savings bank or it would not have asked the Congress to liberalize the conditions under which it could give 13(c) assistance, as per the recently introduced, so-called Regulators Bill.

Table 1
Key Balance Sheet and Income-Expense Items for NYC MSBs with Total Assets of $500 Million or More
(March 31, 1981) (Millions)

Assets		Liabilities	
Cash & Due	$ 622	Total Deposits	$54,758
Real Estate Loans (Net)	33,867	Other Liabilities	2,597
Securities[1]	21,187	"Capital"[2]	3,349
Other Assets	5,028		
Total Assets	$60,704	Total Liabilities & Capital	$60,704

[1]Securities include U.S. governments, corporate bonds, state and local securities, "other" bonds, and corporate stock.
[2]"Capital" equals surplus, undivided profits and other surplus reserves.

Income/Expense Statement
through July 31, 1981
(Millions)

Interest Income	$3,029
Interest Expense	3,186
Net Noninterest Expense	410
Operating Income (before penalties, taxes,/ securities gains and losses)	(567)

SOURCE: FDIC

the yearly cost to the Corporation of keeping these institutions afloat—if, as a group, they were now at the minimum acceptable book equity level—would be roughly $1 billion. Of course, such a rough estimate of insuring agency cost under open bank assistance may grossly underestimate the true cost to the extent the aggregated numbers contain some institutions with positive earnings, to the extent transactions and other costs are ignored, and to the extent that MSB funds' cost may rise either through a general rise in rates or through an accelerated runoff of lower-cost deposits. Conversely, FDIC costs would be substantially lower if rates in general moved downward in the near term or to the extent that assets presently underwater mature or otherwise reprice themselves. These possibilities are discussed in greater detail below.[4] However, the $1 billion per year figure is simply a benchmark against which to measure the attractiveness of 13(c)

[4]In any case, the costs being discussed here do not include the social costs of the federal government being involved in an active manner in the management of an ongoing institution in the process of protecting its claim under a 13(c) type assistance package. For example, FDIC staff regularly sit in on director meetings and make personnel and other management decisions in the course of protecting the Corporation's investment in First Pennsylvania. Issues such as the appropriateness of public ownership of financial institutions, as would be possible through the exercise of warrants in the First Pennsylvania case, also are beyond the scope of this paper.

assistance (open-bank assistance) against that of 13(e) assistance (i.e., assistance to effect a merger of an open or closed institution).[5]

The major alternative to Section 13(c) assistance is for the FDIC to assist a buyer in taking over an open or closed institution (under Section 13(e) of the Act).[6] The present value of FDIC costs under Section 13(e), say, through a typical purchase of assets and assumption of liabilities (P&A) agreement, would equal the amount of negative true net worth of the troubled institution less the amount of premium paid by the purchasing institution (ignoring transactions and other costs). But why would anyone *buy* an institution that has (a) negative true net worth, and (b) negative earnings? The answer is—for the same reason some institutions pay premiums in excess of book value for other institutions with positive earnings—because such deals represent good investments yielding returns higher than other investments. In fact, one can easily construct an example in which the FDIC need not expend any of its own funds in order to effect the purchase of assets and assumption of liabilities of a troubled institution with negative earnings and assets that are underwater by more than the amount of book equity.

Assume a "troubled" MSB has the following balance sheet:

Example 1
($)

Assets	*Liabilities*	
Loans, etc.	$100	Total Deposits	$ 97
		"Capital"	3
Total Assets	$100	Total Liabilities & Capital	$100

Suppose the MSB in question earns an average 8 percent on assets whereas a typical commercial bank earns 12 percent. Both the MSB and the commercial bank have similar average cost of funds (10 percent) such that the commercial bank earns a positive 2 percent pretax ROA, whereas the MSB earns a negative 2 percent pretax ROA. Further assume (rather unrealistically) that the average remaining maturity on the MSB's assets is one year. Then under these assumptions, ignoring taxes, as is our custom, and assuming that any further losses would cause "failure," the FDIC's cost for keeping the institution in business for one year under Section 13(c) is

[5]Under Section 13(e) of the Act, the Corporation may assist the surviving institution in a closed or open bank merger, under the condition that such assistance would "reduce the risk or avert a threatened loss to the Corporation. . . ."

[6]To keep the discussion reasonably concise we ignore the possibility of liquidation of assets and payoff of insured deposits as an alternative. The "hit" to the FDIC under such circumstances is simply the market value of assets less insured deposits (although this simple formulation is complicated somewhat by the fact that some insured depositors may legally be paid off by offsetting the book value of their loans outstanding against their deposits). It is likely, however, that a liquidation would have adverse publicity effects—especially in the case of a multi-billion dollar MSB in a large metropolitan area—and, therefore, may not be desirable even if less costly to the FDIC than other alternatives.

$2. If the Corporation, upon the direction of the chartering agency, were to put the institution up for sale, however, it would have not a loss, but, in fact, a gain which can be computed in the following manner. Since the MSB portfolio has an average yield of 8 percent whereas the average market yield (which, in our example, is assumed to be the yield on the CB portfolio) is 12 percent, then the $100 of assets averaging one year in remaining maturity would have a present market value of $96.43.[7] Since liabilities equal $97, the FDIC would inject cash of 57 cents to balance the balance sheet and would put up the "clean" balance sheet for bids.

How much could the FDIC reasonably expect to receive in bids? As a rule of thumb, I am told, the answer historically has been between 4 percent and 15 percent of deposits. One can confirm this estimate in either of two ways. First, a commercial bank typically would be willing to pay at least book for another commercial bank that had a 5 percent equity-to-asset ratio and was yielding (in our example) a pretax ROA of 2 percent. Thus, in the example given, a viable financial institution would be willing to pay at least $4.85 for the "clean" balance sheet of the failed MSB (i.e., .05 • $97 = $4.85). An alternative approach is to use a targeted rate of return on investment. Let's assume a potential buyer wishes to have his investment yield 40 percent on a pretax basis. Then the "clean" balance sheet of the failed MSB will yield:

$$0.02 \cdot (\$97) = \$1.94$$

and

$$\frac{\$1.94}{x} = .40 \text{ or "target" rate of return}$$

$$x = \$4.85 \text{ "premium"}$$

Therefore, under a bid for the "clean" balance sheet that typically could be expected, the FDIC actually would make money ($4.85 − $.57 = $4.28). Of course, in this rather artificial example, the FDIC would be faced with the problem of what to do with this "excess premium."[8] But the essential point to be made is that the Corporation is a lot better off, in this example, by assisting the purchasing institution under Section 13(e) of the Act than it is by subsidizing the institution under Section 13(c) for the one year before its asset portfolio reprices itself at going market rates.

[7]That is,

$$.12 = \frac{\$108}{x} - 1$$

$$x = \$96.43$$

Where x is the present value of a security yielding $108 one year from now in a market where the general rate equals 12 percent.

[8]If the institution in our example were a stock institution, the excess premium would be rebated to the shareholders. But, under the circumstances, that would cause the shareholders to wonder whether the authorities were correct in the first place in placing the institution in receivership. In the discussion that follows we assume that no such thorny issue would arise in the case of large, troubled MSBs.

Mutual savings banks, of course, typically don't have average remaining maturities of one year in their portfolios; their average remaining maturities are more like 10 years. Thus, portfolio depreciation in today's market is likely to be quite substantial and the insuring agency can be expected to take a substantial "hit" if it were to effect an assisted merger. The relevant question, however, is whether such a hit is greater than or less than, on a present value basis, the subsidies necessary to keep a troubled institution ongoing and intact. Let's look again at the large New York City mutual savings banks (whose balance sheet is represented in Table 1) as if they were a single organization (again ignoring the pitfalls of aggregation, and ignoring taxes, etc.). What would be the present value of the FDIC's cost if it were to effect a purchase and assumption for all of the New York mutual savings banks whose assets exceed $500 million?

Conversations with experts yield estimates of MSB portfolio depreciation under current market rates ranging from 20 percent to over 30 percent. Looking at the aggregate balance sheet and income statement of the large NYC MSBs tends to confirm an estimate of portfolio depreciation in the 30 percent range. To see this, begin by converting MSB average asset yields to a tax-equivalent basis; through mid-year 1981, large NYC MSBs were earning approximately 8.7 percent (tax-equivalency) on average assets. Now, assuming that the MSBs have an average remaining maturity on their portfolio of 10 years, we can roughly compute portfolio depreciation by comparing this 8.7 percent yield with a current market yield of, say, 15 percent (which was approximately the average yield on 10-year Treasury instruments in the week ending October 2, 1981). Assuming no growth in the MSB's portfolio over the 10 years of its average remaining life of assets, the portfolio (with its 8.7 percent yield) may be treated as a fixed-coupon instrument with a current market price determined by the standard formula for repricing a fixed-coupon asset based on a current yield to maturity of 15 percent.[9] This calculation yields a market price of 68.4 percent of book value of MSB assets; that is, the MSBs' portfolio is underwater by approximately 31.6 percent.

Using this estimate of the degree to which large New York City MSBs' portfolios, in the aggregate, currently are underwater, we can approximate the present value of the "hit" the FDIC would take if it assisted closed-bank takeovers of these institutions under Section 13(e). The purchasing organization(s) would take over the assets at market value and the liabilities at book value, the FDIC would inject cash into the new organization(s) equal to the amount of portfolio depreciation less book equity. This cash injection would be roughly $15.9 billion. That is,

[9]If current yield on a 10-year instrument is 15 percent, then a $100 bond yielding $8.70 per year has a current market value of

$$P = \frac{8.7}{(1+.15)} + \frac{8.7}{(1+.15)^2} + \cdots + \frac{8.7}{(1+.15)^{10}} + \frac{100}{(1+.15)^{10}}$$

$$P = 68.4$$

asset depreciation = .316 • ($60.7) = $19.2
market value of assets = $60.7 − $19.2 = $41.5
cash injection = liabilities minus market value of assets
= $57.4 − $41.5 = $15.9

Then, the FDIC would receive a premium from the purchaser which can be estimated under one of several methods, as in our simple example above. First, a viable institution may be willing to pay at least book value of equity for a "clean" financial institution that had book equity and earnings similar to that of a "typical" commercial bank. During 1980, the average CB had pretax earnings of 1.1 percent of average assets. But the "clean" MSB under our assumptions of a P&A would be generating a net pretax yield of 4.7 percent! That is, the clean balance sheet taken over by the purchaser would have an average asset yield of 15 percent and an average cost of liabilities of 10.3 percent.[10] Assuming that a commercial bank would pay book for another CB with equity equal to 5 percent of liabilities and pretax earnings of 1.1 percent of assets, the CB should be willing to pay approximately 20 percent of liabilities for the higher-earning "clean" MSB.[11] Thus, a commercial bank or banks should be willing to pay

$$.20 \qquad (\$57.4) = \$11.5$$

Alternatively, we may assume the buyer wishes to attain a "target" pretax return on 25 percent on his investment. Then,

$$\text{premium} = \frac{.047\ (\$57.4)}{.25} = \$10.8$$

These estimates of a premium to be paid for MSBs, under the stringent assumptions we use, could be on the low side. After all, CBs often pay *multiples* of book for other CBs earning not much in excess of 1 percent pretax ROA. Also, the MSBs' *average* tax rate is an effective 28 percent (see discussion below) implying a post-tax return on investment of more than 20 percent if the CB pays $11 billion for the clean MSBs' $57.4 billion in assets. Thus, it is possible that premiums for the large MSBs, under the as-

[10]For the large NYC MSBs, interest plus *net* noninterest expense as a percentage of average assets was running at approximately 10.3 percent through mid-year 1981. Currently, interest plus net noninterest expense is running in excess of 11 percent, suggesting that FDIC costs under either Section 13(c) or 13(e) would be substantially greater. This net funds cost for MSBs compares with a ratio for CBs (nationwide) of approximately 8.9 percent during 1980. The difference may be attributable to several factors: the demonstrably greater interest-elasticity of NYC MSB depositors vis-à-vis that of U.S. bank customers in general; greater CB reliance on regular checking account funds; higher fee incomes for CBs (which reflect in lower *net* noninterest expense).

[11]In fact,

$$\frac{.047}{.011} \cdot (.05) = .214$$

sumptions used in our calculations, would range from approximately $11 billion to, say, $13 billion or more.

Based on an $11 billion premium, the total "hit" taken by the FDIC under a 13(e) assistance package would be equal to the cash injection of $15.9 less the premium of $11. Thus, the net FDIC exposure would be on the order of $4.9 billion. Admittedly, this estimate is exceedingly rough but it is not intended to be a precise estimate of FDIC losses in solving the MSB problem. Rather, the estimate is intended as a basis to compare with the presumed $1 billion per year in cost to the Corporation if it were to assist the NYC MSBs on an open-bank basis for the full 10 years of the average remaining maturity of their portfolio (and presuming, of course, that rates did not change in the interim and that no other changes in asset or liability composition occurred). The present value of $1 billion per year for each of 10 years, assuming a discount rate (for present value calculation) of 15 percent, is approximately $5 billion.[12] Thus, under the stringent assumptions laid out in this analysis, the FDIC would save, on a present value basis, between $100 million (if the premium for the clean MSBs were $11 billion) and $2.1 billion (if the premium were $13 billion) by merging the New York City mutual banks as opposed to protecting them from further declines in book equity through short-term subsidies.[13]

For the reader who may be uncomfortable with the notion of a 20 percent premium for a "clean" thrift, especially since premiums historically have ranged much lower, there is an alternative way of viewing the P&A transaction. Suppose that the assets of the thrifts are "marked to market" in a slightly different manner, one which would result in a balance sheet yielding a net return more nearly equal to that of an average, clean commercial bank—one yielding 1.1 percent pretax on average assets. This implies a much lower depreciation in the value of assets than the 31.6 percent used in our calculations above, and would more nearly approximate the amount of depreciation in assets that occurred during the early 1970s when the buying institutions were paying premiums in the 8 percent range for FDIC-sanitized, failed institutions. Nevertheless, if the calculations are carried out in this manner, we will see that the "hit" to the FDIC is on the same order of magnitude as (but somewhat lower than) our analysis above.

Begin by noting that, on a full tax-equivalent basis, MSBs were earning a negative (1.6 percent) on assets during the first seven months of 1981 while CBs earned (during 1980 for which such figures are available in the aggregate) a positive 1.3 percent on assets, pretax. Although part of this difference in returns is due to higher *net* noninterest expense at thrifts, let

[12]While large NYC MSBs were losing approximately $1 billion per year (pretax net operating losses) through the first seven months of 1981, the annualized loss during July was $1.29 billion per year. This performance, if continued, implies a present value cost of FDIC 13(c) assistance of approximately $6.5 billion.

[13]If the FDIC were to liquidate these institutions, then the "hit" would be approximately the difference between the market value of assets and the amount of insured deposits. Assuming insured deposits comprised 90 percent of total deposits, the FDIC would have to pay out .90 (54.7) = $49.2 on deposits, and would get $41.5 back on assets (the assumed market value), for a "hit" of $49.2 − 41.5 = $7.7.

us assign all of this difference to the asset side. In other words, thrift assets would have to be yielding 11.6 percent, on average, instead of 8.7 percent, in order for thrifts to enjoy the 1.3 percent pretax, tax-equivalent spread CBs enjoyed in 1980. This implies that thrift assets have to be devalued by approximately 17 percent.[14] The resulting balance sheet would yield 1.3 percent tax-equivalent pretax, for which the buyer, if he wished to attain a "target" pretax return of 25 percent on his investment, would pay:

$$\text{premium} = \frac{.013\ (\$57.4)}{.25} = \$3$$

or roughly 5 percent of large NYC MSB assets. Thus, the FDIC "hit" would be calculated as follows:

$$\text{market value of assets} = .83\ (\$60.7) = 50.4$$
$$\text{cash injection} = \$57.4 - 50.4 = \$7$$
$$\text{"hit"} = \$7 - 3 = \$4$$

The value of this exercise is to show that the "hit" to the FDIC, as well as the size of the "premium," depends critically on the way in which the supervisors and accountants choose to devalue the MSBs' portfolio. The more the portfolio is devalued, the greater will be the premium offered (because this will drive up resulting effective asset yields). However, greater devaluation implies greater FDIC cash injections which will offset the greater premiums.

Of course, the above analysis takes as a given the level of mutual savings bank assets over the near term, assumes no changes in the composition of assets or liabilities, therefore, assumes no changes in the cost of funds or in the average maturity of assets. Also, the analysis ignores taxes and any future changes in noninterest costs or fee incomes. On the basis of no other information it is difficult to say whether these factors, if not ignored, would argue more in favor of 13(c) assistance rather than 13(e) assistance. One factor that is almost certain to change, however, is average funds costs. That is, even if the general level of interest rates remains constant, average funds costs for MSBs are likely to rise as more and more households switch out of low-cost passbook accounts to higher cost CDs and/or withdraw their funds completely. This factor necessarily will be taken into account by potential purchasers as they calculate their bids; similarly, it will influence the cost to the FDIC of open-bank assistance, since MSB operating losses can be expected to rise. Assume, for the sake of exposition, that another $4.3 billion in low-cost deposits at the large NYC MSBs (or 25 percent of savings

[14]If current yield on a 10-year instrument is 11.6 percent, then a $100 bond yielding $8.70 per year has a current market value of

$$P = \frac{8.7}{(1+.116)} + \frac{8.7}{(1+.116)^2} + \cdots + \frac{8.7}{(1+.116)^{10}} + \frac{100}{(1+.116)^{10}}$$
$$P = \$83$$

deposits as of 7/31/81) runs off in the near term. Further assume these funds cost 9 percent per annum more to replace. This adds to operating losses at the rate of $387 million per year or roughly .6 percent of average assets per year. The present value of FDIC costs under open-bank assistance would rise from approximately $5 billion to $6.8 billion.[15] Similarly, the net spread on the resulting "clean" balance sheet (after the FDIC cash injection) would decline from a pretax 4.7 percent of average assets to 4.1 percent. This implies, under our assumptions, a premium of about 16 percent of assets or so—roughly, $9.4 billion.[16] Thus, the FDIC "hit" under Section 13(e) would be on the order of $6.5 billion—the $15.9 billion cash injection minus the $9.4 billion premium. In all probability, the actual premiums paid for the clean balance sheets would be less than our rough estimate, and the hit to the FDIC correspondingly greater—because potential purchasers are likely to be conservative in their estimates of future low-cost deposit runoff. Of course, a projected increase in MSB average funds cost would increase FDIC costs under *either* 13(c) open-bank assistance or 13(e) merger assistance.

Still, two chief difficulties remain with respect to using 13(e) assistance on a large scale for large troubled savings institutions. First, what if rates do, in fact, decline over the near term? If the FDIC were to assist the large savings institutions via the closed-bank merger route, the Corporation will have lost $4.9 billion (if we assume no runoff of low cost deposits) to $6.5 billion (if we assume a future runoff of $4.3 billion in savings deposits) or more in vain, by our calculations. Second, 13(e) assistance typically requires an enormous cash outlay and a corresponding booking of the loss to the FDIC associated with the purchase and assumption. Under our calculations, the FDIC would have to book approximately a $4.9 billion loss (or more), up front, whereas under section 13(c) its loss is paid on an "installment" plan, so to speak. That is, the Corporation's loss appears as an opportunity cost; it loses earnings as it makes below-market rate loans to the troubled institutions.

In fact, the FDIC can structure a purchase and assumption so that it requires no initial cash outlay from the Corporation and so that the FDIC's "hit" is booked over a period of, say, five to ten years. Furthermore, the level of the FDIC's loss can be reduced to insignificance if rates turn

[15]That is, the MSBs would be losing $1.36 billion instead of $1 billion per year, and the present value over a 10-year horizon, using a 15 percent rate of discount, of $1.36 billion per year in operating losses is

$$P = \frac{\$1.36}{(1.15)} + \frac{1.36}{(1.15)^2} + \cdots + \frac{1.36}{(1.15)^{10}}$$

$$P = \$6.8$$

[16]Assuming a 25 percent pretax "target" rate of return on investment:

$$\text{premium} = \frac{.041\ (\$57.4)}{.25} = \$9.4$$

around sufficiently in the short run, even *after the fact* of a P&A. Probably several methods can be used to accomplish this result, but one scenario is as follows: After the troubled institution is placed in receivership, the purchasing institution takes on the assets and liabilities at book from the FDIC. The purchasing bank immediately marks the asset to market, but in the process creates a separate depreciable asset in the amount of the difference between the book and market value of the assets purchased. In essence, the actual "premium" booked by the purchasing bank equals a "normal" premium plus the excess of book over market value of assets. Then, the FDIC promises to make yearly payments to the purchaser, over the number of years for which the "super premium" is depreciated, in an amount equal to each year's depreciation (plus a market rate of interest on that amount), thus leaving the purchaser with no effect on his pretax income.[17] In effect, the FDIC is making its cash injection into the balance sheet of the failed institution on the "installment plan." Moreover, the buyer promises to rebate to the FDIC each year any gains in market value (as a result of interest rates declining) of the assets it took over and had originally marked to market. Similarly, the FDIC promises to make good on any losses the buyer incurs from future rises in interest rates. Since the FDIC cannot know what its yearly cost would be under this scheme, it books no actual liability to the buyer but, instead, the Corporation has a contingent liability under which it must make a yearly payment to the purchaser in an amount determined by future interest rates. Thus, under this scheme the FDIC has *no* initial cash outlay. In fact, it receives an initial cash inflow in the amount of the premium, and its future cash outlays could be reduced to zero if interest rates were to fall far enough fast enough. Thus, the FDIC is in no worse position than it would be by making yearly contributions under Section 13(c) to a troubled institution in the amount of its pretax losses, but the Corporation has gained the benefit of a cash premium from the purchaser.

Such a scheme has still other variations. For example, the buyer could agree, in return for a lower premium, to take on all of the downside risk and not receive increased payments from the FDIC if rates were to move even higher. This sort of scheme is not too dissimilar to the indemnification process under a typical FDIC P&A and is probably quite similar to the indemnification clauses (as reported in the press) in the recent FDIC-assisted takeover of West Side Federal S&L in New York and Washington S&L in Miami Beach by Citizens S&L in San Francisco.

III. Public Benefits and Costs of Thrift Mergers with Commercial Banks

A major benefit of permitting commercial banks to bid for the assets and liabilities of closed thrifts is that the premium to be paid the insuring

[17]The FDIC must make interest payments on the "super premium" (assuming the buyer has based his "normal" premium on taking over a "clean" balance sheet) because the buyer is receiving a market return on the depreciated assets but no return on the "super premium." That is, the FDIC, in this scenario, has made no initial cash injection which would permit the buyer to earn a market return on all $57.4 billion of MSB liabilities.

agency is maximized. Offset against this gain, however, are potential costs to commercial bank-thrift affiliations which include: the loss of thrifts as specialized housing lenders; the potential for an undue concentration of resources in the hands of commercial banks; a decline in competition at the local market level as thrifts and banks merge. Each of these issues is discussed in turn below.

A. The premium is maximized and the insuring agency costs are minimized when commercial banks are permitted to bid for troubled thrifts.

In the previous section the case is made that the problems of U.S. thrifts can, under proper circumstances, be worked out at least cost by effecting mergers between viable institutions and troubled thrifts. In effect, such a policy would properly place the cost of the workout, at least partially, on the ultimate owners of the institution to be aided—not on taxpayers in general as would be the case with, say, general bailouts through tax schemes and other devices. Under Section 13(e) assistance, the workout is paid for both by the premium of the purchasing institution and by the "hit" taken by the insuring agency, which is, in turn, reflected in the insurance premiums paid by all insured institutions.[18] Since, as has been argued elsewhere[19] federal deposit insurance is probably underpriced, this sharing of the burden as between an individual purchasing institution and all other viable institutions in general seems eminently fair. The issue remains, however, as to how the eventual purchaser and the rest of its financial institution colleagues ought to split the cost of the workout.

The economist will argue that the eventual purchaser of a troubled institution should pay his true opportunity costs, that is, the return on an alternative investment of equal risk. Moreover, a price which reflects such opportunity costs is most likely to come about only in the circumstance of sufficient competition among bidders. As a practical matter, however, nothing resembling competition among bidders may be possible if potential bidders are restricted only to other thrift institutions. First, commercial banks may be the only depository institutions in the short run with the necessary minimum capitalization levels to permit them to take over large troubled thrifts without the resulting institution being judged unsafe and unsound in the eyes of the regulators (although other financial entities such as insurance companies, broker-dealers, and others may be interested and able to purchase thrifts). Put another way, the premium to be paid the insuring agencies will depend on just how much commercial bank leverage the regulators are willing to tolerate. Large troubled thrifts, of course, can be broken up by the insuring agencies and sold to other smaller thrifts

[18]Added FDIC expense associated with assistance to troubled thrifts would be reflected in reduced rebates to insured institutions, thereby increasing their effective premium.

[19]Some have argued that FDIC insurance is both underpriced and *improperly* priced by not varying with risk. See John H. Kareken, "Deregulatory Commercial Banks: The Watchword Should Be Caution," *Quarterly Review*, FRB Minneapolis, Vol. 5, No. 2, 1981; also see S. A. Buser, A. H. Chen and E. J. Kane, "Federal Deposit Insurance, Regulatory Policy, and Optimal Bank Capital," *Journal of Finance*, Vol. 34, No. 1, March 1981.

and/or commercial banks, but this process has several costs including extra transactions cost to the agencies as well as foregone scale and marketing economies to the purchaser. These costs would result in the aggregate premium paid among several purchasers being less than a single premium paid by one large purchaser. Moreover, enough large commercial banks in this country are in sufficiently good shape to permit mergers with very large thrift institutions, absent political considerations and/or other externalities discussed below. For example, Bank of America could pick up the largest mutual savings bank in New York (totaling assets in excess of $5 billion) and cause not a ripple in Bank of America's equity-to-assets ratio—B of A's capital-asset ratio would decline by only .2 of a percentage point, from 3.5 percent to 3.3 percent, based on year-end 1980 data.

Not only might commercial banks be among the few viable bidders for large troubled thrifts, but the prospect of acquiring thrift operations, especially across state boundaries, may cause commercial bank bids to be higher than the bid of even a large, sound, and profitable thrift institution. Unlike many thrifts that have run out of tax carry-backs, most commercial banks are in the position of looking for ways to reduce effective taxes. The special treatment afforded thrift institutions through Section 593 of the Internal Revenue Code should be especially attractive to commercial banks. Specifically, S&Ls are permitted, for tax purposes, to deduct 40 percent of taxable income for bad debt reserves, if a specified percentage of assets is held in mortgages or other qualifying assets. To qualify for the 40 percent deduction, 82 percent of the total assets of an S&L must be held in qualifying assets; 72 percent of the assets of a mutual savings bank must be in qualifying assets. Most bank holding companies could incorporate separate thrift subsidiaries which could easily meet the Section 593 requirements for portfolio mix and therefore be eligible for the 40 percent deduction. Specifically, Section 593 defines loans secured by an interest in residential real property, cash, Treasury securities, and some other assets as eligible assets for purposes of receiving the deduction. In fact, S&Ls now hold about 95 percent of their assets in qualifying form for purposes of the Tax Code, and so a commercial bank could operate a thrift subsidiary in a substantially different mode than it is currently operated and still have the subsidiary qualify for the tax deduction.

A critical issue facing a potential commercial bank purchaser of a thrift is the degree of deposit runoff that can be expected post-acquisition. While some runoff can be expected in any merger or acquisition situation, the runoff potential can be minimized, and its impact on earnings cushioned by several factors. First, the CB purchaser can be expected to obtain permission to pay higher thrift rates on household deposits involving a bank-thrift differential. Second, the CB would be likely to operate the acquired thrift either as a separate division of the bank, or more probably, as a separate stock subsidiary[20]—thereby preserving the value of the thrift's

[20]Under current state and federal law it may not be possible for a commercial bank to operate a thrift as a separate stock subsidiary in New York. However, the proposed Regulators Bill apparently would permit such an arrangement.

name and market presence. Third, the acquirer is likely to be able to depreciate, for tax purposes, the value of the core deposits of the acquired institution. Nevertheless, the effects of a runoff are likely to be somewhat greater for a CB purchaser of a thrift than for another thrift purchaser—if only because some thrift deposit customers consciously attempt to avoid using banks.

Another reason why commercial banks may be able to bid more for troubled thrifts than other thrifts is the commercial banks' comparative advantage in the provision of transaction account services. Thrift institutions, especially savings and loan institutions, are relatively new to the transaction account business (i.e., the providing of NOW account services). Although functional cost analysis data on a comparative basis for both commercial banks and thrifts are not available, it is likely that, in the short run at least, the cost to thrifts per dollar of assets of providing transaction accounts is somewhat higher than that of commercial banks. NOW accounts, since their introduction in the mid-1970s, have risen to only 2 percent of mutual savings bank total deposits, for example, yet noninterest expense as a percentage of average assets has grown by approximately 28 percent at MSBs since 1975, (compared with only a 3 percent growth in noninterest expense/average assets for CBs). This relative growth in noninterest expense at MSBs suggests some leeway for the introduction of cost savings procedures which commercial banks could bring to an affiliation with thrift institutions. Thus, other things equal, commercial banks could be expected to pay more for a thrift acquisition than would another thrift—to the extent the commercial bank can expect to reduce the noninterest cost associated with servicing transaction accounts at the thrift.

Still other reasons exist why commercial banks may be willing to pay higher premiums for troubled thrifts than would other thrift institutions. In states where banks cannot freely branch as can thrift institutions, the banks could view the acquisition of thrift institutions as the ability to penetrate new markets. This ability would be substantially lessened, however, by a provision of the so-called Regulators Bill which would confine the further branching operations of a thrift, once purchased by a CB, to those branch locations permitted for commercial banks. Similarly, acquisitions of thrifts across state lines would permit both thrifts and commercial banks to penetrate new geographic markets which, absent a regulatory change in stance, they could not now enter.[21] The potential for cross selling of products by commercial banks also should appear attractive to them. For example, a commercial bank with a well-established and well-run trust department could expect to expand marketing of its trust services in the offices of the

[21]Under current law, the Federal Reserve can now permit bank holding companies to purchase thrift institutions across state lines, and operate such institutions as "nonbank" subsidiaries. The Federal Reserve, so far, has hesitated to generally permit such acquisitions on the grounds that it is Congress's decision whether commercial banks should be permitted to affiliate with thrift institutions. Similarly, the FHLBB now has the power to permit interstate branching by S&Ls. As a matter of regulatory choice, however, the FHLBB has permitted interstate operations of thrifts only in special circumstances such as the recent takeover of troubled thrifts in New York and in Florida by a California-based S&L.

thrift institution it acquires. Also, any institution can expect to reduce risk, in general, through geographic diversification of its operations. Finally, any financial institution would be willing to pay something for the enhanced marketing power that comes with being represented over a wider geographic area. That is, the institution will be able to promote its ability to service the "convenience and needs" of its customers who could now cash their checks across political boundaries, have access to greater numbers of branches to conduct their business, etc.

It is difficult to tell how much more a commercial bank would pay for a troubled thrift institution than would another thrift institution. One clue is the current "bidding war" for other commercial banks in states that have recently liberalized their bank holding company and/or branching rules. Although little hard evidence exists, it appears that many organizations are willing to pay up to 1½ or 2 times book value for sound, profitable commercial banks with capital-asset ratios of approximately 5 percent or so and pretax earnings on average assets only slightly in excess of 1 percent. It is not unreasonable to expect, therefore, given the tax advantages associated with purchasing a thrift institution and taking into account the possibility of a future runoff of low cost deposits, that a commercial banking organization would be willing to pay 15 percent or more of liabilities for a "clean" thrift institution yielding initially over 4 percent on a pretax basis. If this assumption is correct, then as per our analysis under Section II, the aggregate premium that the FDIC could obtain for assisting in the merger of all large NYC MSBs could be on the order of $9.4 billion or more, with the upper bound determined by just how much over "book" value commercial banks are willing to pay. This suggests that opening the bidding war for troubled thrift institutions so as to include commercial banking organizations as bidders, may lead to a savings for the insuring agencies of several hundreds of millions of dollars in extra premiums.

The simple conclusion to be derived from this analysis is that a regulatory stance which permitted commercial banks to purchase troubled thrift institutions both in-state and across state lines would maximize the benefit to the insuring agencies. Unfortunately, the legislation currently being considered by the Congress (H.R. 4603) is not drafted in a way which would guarantee the maximum premium to the agencies. In Section 8 of the proposed legislation, the FSLIC is permitted to merge insured thrifts with commercial banks, if necessary, and is advised that "the need to minimize financial assistance required of the Corporation shall be the paramount consideration." In the next sentence, the proposed legislation says "the Corporation shall also make a reasonable effort to authorize transactions under this subsection" which give preference, in order of priority, to institutions of the same type within the same state, institutions of the same type in different states, institutions of different types in the same state, and finally, between institutions of different types in different states. In other words, according to the proposed legislation, the FSLIC should be willing to accept a somewhat lower bid, if the bidder is another thrift in the same state as the troubled institution. Thus, in one sentence the legislation ap-

pears to tell the FSLIC to maximize its premium and in the next sentence it is told not to do so. In still another section of the proposed legislation (Section 15), the FDIC is empowered to solicit bids on an FDIC-insured commercial bank or MSB from out-of-state banks or thrifts but only after giving preferred treatment in the bidding process to in-state banks and thrifts and, next, to banks and thrifts in contiguous states to the state in which the troubled institution resides. This section of the proposed legislation is drafted in a somewhat less ambivalent fashion than Section 8. It permits the FDIC, in fact, to maximize the premium it receives—that is, the FDIC can allow an out-of-state nonthrift to win the bid if no in-state thrift institution is willing to match the outsider's high bid.

B. Bank-thrift mergers will not significantly affect the supply of available mortgage money

Thrifts are specialized mortgage lenders that hold approximately three-quarters of their assets in real estate loans as compared with 14 percent for commercial banks. Therefore, the argument is often advanced that housing finance will be irreparably damaged by the loss of any significant number of thrift institutions through their merger with commercial banks. This argument is seriously flawed, however, because it looks only to the *average* holdings of thrift institutions, not to actions they may take at the margin, and only to thrifts' *permanent* holdings of mortgages, not their specialized role as mortgage originators and servicers.

In fact, from now on thrifts will have to act, at the margin, a good deal more like commercial banks in order to survive the high and variable interest rates of the 1980s. This view has been recently expressed in the *Report of the Interagency Task Force on Thrift Institutions.*[22]

> The Task Force believes there is a pressing need for longer run change in the thrift industry. Thrift asset and liability structures must adapt to the evolving financial environment. . . . It is no longer prudent for institutions to borrow short and lend long to the degree they have in past years.

That is, the asset and liability composition of thrift institutions must begin to look more closely like that of commercial banks if thrifts are going to be as relatively successful as the banks have been in surviving periods of high and volatile interest rates. One of the ways in which thrifts might change is to become "real estate related associations with a mortgage banking function" as suggested by the Task Force study. Under this model, thrifts would become more like mortgage bankers, originating mortgage loans, but selling a significant portion of them in the secondary market, thus avoiding significant interest rate risk associated with holding fixed rate, long-term mortgages in their permanent portfolios.

[22]A report submitted at the direction of the Depository Institutions Deregulation and Monetary Control Act of 1980, Department of the Treasury, June 30, 1980.

It is not likely that a significant shift by thrift institutions out of the permanent holding of mortgages will have a substantial effect, in and of itself, on the cost of mortgage money or the equilibrium amount of mortgage credit outstanding. This is because, whether in a mortgage warehousing mode or in a permanent lender mode, thrift institutions must necessarily pay more attention than they ever have in the past to the pricing of mortgage assets at rates reflecting true market rates of interest. In the past, thrift managers may have been able to subsidize mortgage lending through their ability to raise funds cheaply (under Regulation Q), but that luxury is no longer available to them, given the increased interest sensitivity of household depositors and the corresponding interest sensitivity of thrift liabilities. Thus, the equilibrium mortgage rate and the amount of mortgage credit available will be determined by general interest rate levels, the risk characteristics of household mortgage borrowers, and the risk preferences of permanent investors. The appropriate pricing of mortgage assets will have increasingly less to do with whether "specialized" thrift institutions exist or do not exist. Incidentally, thrift institutions should continue to specialize in the origination and servicing of home mortgages, because that is where their comparative advantage lies. No profit-oriented commercial banking organization, in turn, would ignore such comparative advantage and, therefore, it is unlikely that, post-affiliation with a bank, the originating and servicing functions of a thrift would be changed much from that of its status as an unaffiliated thrift.

It has been argued (as in the recent Federal Reserve staff study on bank holding company acquisition of thrift institutions) that only limited potential exists for thrift institutions to diversify out of permanent holdings of mortgages. The argument is made that portfolio limitations (the recent liberalizations of the Depository Institutions Deregulation and Monetary Control Act of 1980 notwithstanding) limit the ability of thrifts to engage in commercial lending and other kinds of nonmortgage lending. Also, it is argued that Section 593 of the Tax Code effectively prohibits thrifts from diversifying into nonmortgage areas, because they would lose the benefit of a significantly lower marginal tax rate if they did not hold a specified portion of their portfolio in qualifying mortgages and related instruments. These constraints to thrift portfolio diversification are probably not important ones, especially in the short run, however. There is some likelihood that the Congress will pass legislation that will broaden thrifts' power substantially so as, for all practical purposes, to allow thrifts to operate on the asset side as if they were commercial banks. Also, while Section 593 of the Internal Revenue Code may represent quite a disincentive to diversify *at the margin*, as indicated above, very few thrifts are so diversified already that a significant decline in their holdings of qualifying assets (under Section 593) in the short run would cause them to lose their tax benefits. In fact, even if an individual thrift already were at the statutory minimum level of mortgages and related instruments needed in order to preserve its preferential tax treatment, the thrift still could reduce its holdings of permanent long-term mortgages by replacing them instead with other assets

which qualify for the preferential tax treatment but which do not subject the institution to an unacceptable interest rate risk. For example, Treasury instruments are a qualifying asset for purposes of Section 593 of the Tax Code.

Thus, current portfolio restrictions and tax codes notwithstanding, thrift institutions should be able to substantially diversify their permanent portfolio in the near term. The extent to which they do will be determined by the acumen of their individual managers, and those that intend to survive over the longer run will have no choice but to diversify or otherwise protect themselves against interest rate risk. As a general rule, then, it is unlikely that affiliation with bank holding companies would tend to speed up that diversification process.[23] In short, the argument that the level of housing finance would be adversely affected by bank/thrift mergers is not a powerful one on its face.

C. Concentration of resources will not significantly affect competition

One would have difficulty in arguing that mergers of large thrift institutions with other thrifts or with commercial banks would lead to a *significant* diminution of direct competition in local financial markets, even if the mergers took place between institutions in the same market. Especially in the markets where the larger mutual savings banks are located, the disappearance of one or more thrift institutions cannot reasonably be expected to alter the competitiveness of the market. For example, in Manhattan there are 92 commercial banks, mutual savings banks, and S&Ls, operating 651 offices that offer retail services to the public. By way of demonstration, Table 2 lists each of these organizations, their total deposits, and number of offices. Banking structural characteristics in New York indicate it is among the most competitive banking areas in the country; e.g., population per office is low (2,178) and the three-institution concentration ratio is 39.33 percent based on June 1980 data. Of course, the data provided in Table 2 present only a bare bones sketch of the structural characteristics of Manhattan as a competitive area. Moreover, structural data generally are imperfect indicators of economic competitive performance. Nevertheless, one can see that merging even very large mutual savings banks with very large commercial banks in Manhattan still would leave an area that exhibits structural characteristics which imply vigorous competition. For example, merging the three largest mutual savings banks with the three largest commercial banks would result in only a small increase in the three-institution concentration ratio from 39.33 percent to 44.71 percent (based on total domestic deposits of all CBs, MSBs and S&Ls in Manhattan), and would leave a total of 89 institutions remaining as competitors in the Manhattan area. These data demonstrate, incidentally, why the FDIC would have trouble—under

[23]In fact, commercial banks may reap some tax advantages by selling their underwater mortgages to their thrift affiliates at market prices. Thus, affiliated thrift institutions would have higher growth rates, other things equal, than nonaffiliated institutions and correspondingly higher growth rates of permanently held mortgages, but with a neutral effect on the originations of new mortgages.

Table 2
Deposit Shares of Financial Institutions, New York County (Manhattan)

	Number of Offices	Total Domestic Deposits (Manhattan) ($000)	June 30, 1980 Share of Total Deposits (%)
Commercial Banks[1]			
Chase Manhattan Corp. — The Chase Manhattan Bank, N.A.	64	$ 23,179,714	15.99%
Manufacturers Hanover Corp. — Manufacturers Hanover Trust Co.	62	18,674,472	12.88
J. P. Morgan & Co., Inc. — Morgan Guaranty Trust Co. of NY	4	15,163,281	10.46
Citicorp — Citibank, N.A.	73	15,058,162	10.39
Chemical New York Corp. — Chemical Bank	78	14,656,512	10.11
Bankers Trust New York Corp. — Bankers Trust Co.	25	11,163,911	7.70
Irving Bank Corp. — Irving Trust Co.	14	5,793,101	4.00
The Hong Kong and Shanghai Bank — Marine Midland Bank, N.A.	12	3,071,953	2.12
The Bank of New York Company — The Bank of New York	9	2,966,195	2.05
The Bank of Tokyo, Ltd. — Bank of Tokyo Trust Co.	5	1,872,553	1.29
European-American Bancorp — European-American Bank and Trust	13	1,670,483	1.15
Saban, S.A. — Republic National Bank of New York	13	1,566,451	1.08
United States Trust Corp. — United States Trust Co. of New York	1	1,111,607	.77
Trust-Otzar Hityashuuth Haye (Tel Aviv) — Bank of Leumi Trust Co. of New York	5	693,659	.48
Schroders Limited — J. Henry Schroder Bank and Trust Co.	1	586,234	.40
The Fuji Bank, Ltd. — The Fuji Bank & Trust Co.	2	564,741	.39
The Daiwa Bank, Ltd. — Daiwa Bank and Trust Company	1	440,298	.30
Amalgamated Clothing and Textile Union — Amalgamated Bank of New York	2	424,155	.29
The Industrial Bank of Japan Trust Co. — Industrial Bank of Japan Trust Co.	1	422,674	.29
National Westminster Bank Ltd. — National Bank of North America	15	$ 330,271	.23

[1]Commercial banks are excluded if no retail business is conducted. Excluded institutions are: noninsured depository institutions, U.S. branches of foreign banks, foreign-owned banks with savings deposits of less than $1 million.

Table 2
(cont'd.)

	Number of Offices	Total Domestic Deposits (Manhattan) ($000)	June 30, 1980 Share of Total Deposits (%)
Commercial Banks (cont'd.)			
National Bank of Greece, S.A. — Atlantic Bank of New York	2	317,315	.22%
Bradford Trust Company	1	308,065	.21
Sterling Bancorp — Sterling National Bank & Trust Co. of NY	4	302,584	.21
Financial General Bankshares — Bank of Commerce	7	175,623	.12
The Royal Bank of Canada — Royal Bank and Trust Co.	1	173,710	.12
The Merchants Bank of New York	5	162,557	.11
Barclays Bank Ltd. — Barclays Bank of New York	5	133,017	.09
Fiduciary Trust Co. of New York	1	95,721	.07
Century National Bank and Trust Co.	1	83,352	.06
Chinese American Bank	1	82,990	.06
First Empire State Corp. — Manufacturers and Traders Trust Co.	1	65,191	.04
Banco De Posce	4	59,695	.04
Banco Union C.A. (Caracas) — Union Chelsea National Bank	4	59,890	.04
Mizrahi Holding Association (Tel Aviv) — UMB Bank and Trust Company	1	56,502	.04
Freedom National Bank of New York	1	50,114	.03
Banco Popular De Puerto Rico	3	47,377	.03
Central State Bank	1	33,165	.02
Hartford Trust Company of New York	1	27,583	.02
Golden Pacific National Bank	2	23,986	.02
United Americas Bank	3	21,885	.02
Capital National Bank of New York	1	13,257	.01
First Woman's Bank	1	13,240	.01
Banco De Santander (Puerto Rico)	1	8,234	—
Lincoln First Banks, Inc. — Lincoln First Bank, N.A.	2	7,453	—
Global Union Bank	1	7,326	—
Bessemer Trust Co., N.A.	1	6,662	—
Litco Bancorp of New York — Long Island Trust Company	1	600	—
Total for Commercial Banks	457	121,747,521	83.99

Table 2
(cont'd.)

	Number of Offices	Total Domestic Deposits (Manhattan) ($000)	June 30, 1980 Share of Total Deposits (%)
Mutual Savings Banks			
The Bowery Savings Bank	12	$ 3,533,251	2.44%
The New York Bank for Savings	17	2,339,043	1.61
Emigrant Savings Bank	13	1,933,609	1.33
The Greenwich Savings Bank	9	1,625,721	1.12
Dry Dock Savings Bank	10	1,518,040	1.05
Manhattan Savings Bank	8	1,312,085	.91
The Seaman's Bank for Savings	5	1,258,742	.87
East River Savings Bank	8	1,055,219	.73
Union Dime Savings Bank	4	908,322	.63
Central Savings Bank	5	687,738	.47
The Dime Savings Bank of New York	3	645,172	.45
Harlem Savings Bank	6	616,893	.43
Franklin Savings Bank of New York	8	616,076	.43
Empire Savings Bank	9	591,583	.41
The East New York Savings Bank	5	382,124	.26
United Mutual Savings Bank	5	369,931	.26
American Savings Bank	4	295,087	.20
The Lincoln Savings Bank	5	272,831	.19
The Greater New York Savings Bank	4	227,461	.16
The Williamsburg Savings Bank	2	179,088	.12
Anchor Savings Bank	4	178,046	.12
Dollar Savings Bank of New York	1	169,142	.12
Metropolitan Savings Bank	3	146,890	.10
Jamaica Savings Bank	2	62,940	.04
Independence Savings Bank	1	31,908	.02
North Side Savings Bank	1	23,373	.02
Total for mutual savings banks	154	20,980,315	14.47

Table 2
(cont'd.)

	Number of Offices	Total Domestic Deposits (Manhattan) ($000)	March 31, 1980 Share of Total Deposits (%)
Savings and Loan Associations			
West Side Federal S&L of New York City[1]	4	$ 825,814	.57%
Franklin Society Federal S&L Association	2	272,720	.19
Washington Federal S&L Association	3	157,682	.11
New York and Suburban Federal S&L Association	1	138,882	.10
Central Federal S&L of Nassau County	2	105,842	.07
Bankers Federal S&L Association	3	93,113	.06
First Federal S&L Association of NY	7	80,256	.06
Edison S&L Association	1	72,561	.05
Fourth Federal S&L Association of NY	2	72,163	.05
County Federal S&L Association	2	69,294	.05
Ninth Federal S&L Association	2	66,585	.05
Carver Federal S&L Association	2	49,205	.03
Serial Federal S&L Association of New York City	2	44,108	.03
Knickerbocker Federal S&L Association	1	39,433	.03
Union Federal S&L Association of New York	1	35,998	.03
American S&L Association	1	32,811	.02
Columbia S&L Association	1	26,999	.02
Yorkville S&L Association	1	24,859	.02
Dollar Federal S&L Association	2	19,040	.01
Total for Savings and Loans	40	2,227,365	1.54
Total for all commercial banks, mutual savings banks and savings and loans	651	144,955,201	100.0%

[1]Acquired by Citizens Saving and Loan Association of San Francisco, September 15, 1981.
SOURCES: *Branch Directory and Summary of Deposits, 80–81*—New York, June 1980; FDIC *Operating Banking Offices*, December 31, 1980.

current law—justifying Section 13(c) assistance to large New York mutual savings banks on the grounds that they are "essential" to the provision of financial services to the local community.

Another concern often expressed over the affiliation of thrift institutions with commercial banks is the potential for an "undue concentration of resources" in the hands of commercial banks. This concern is not grounded in any economic theory of competition, but rather relates to the notion that concentration of resources at either the state or national level (i.e., at other than the local market level) might enable a large institution or institutions to wield social or political power to the detriment of the community. This concern is not analytically based, but represents, instead, an assertion—"bigness is badness." Yet, the large institutions have demonstrated anything but an ability to control the legislative process; indeed, the track record of very large banking institutions in obtaining desirable legislation has been abysmal. Witness the length of time it took to pass legislation phasing out Regulation Q (and indeed deposit interest rate ceilings are not yet gone) and the lack of success in obtaining interstate banking powers or expanded financial service powers such as underwriting powers for commercial banks. More to the point, acquisition of even large thrift institutions by large commercial banking organizations would not significantly alter either the national or statewide shares of total deposits held by the acquiring institutions. For example, if Bank of America were to acquire the largest New York mutual savings bank, B of A's share of total nationwide deposits of all depository institutions would rise only slightly from 2.37 percent to 2.64 percent. Similarly, if Citicorp were to acquire that mutual savings bank, Citicorp's *statewide* share of total deposits of all depository institutions would rise from 7.64 percent to 9.32 percent. It would be difficult for even the proponents of the notion of "undue concentration of resources" to read much significance into such increases in nationwide or statewide share of deposits.

IV. Summary and Conclusions

If the decision is made to aid troubled thrift institutions through the use of the insuring agencies (FDIC and FSLIC), then the choice essentially is between two modes of financial assistance—open bank assistance (as in Section 13(c) of the Federal Deposit Insurance Act), or merger assistance (as in Section 13(e) of the FDI Act). The analysis above deals with these two choices in the context of large troubled mutual savings banks whose insurer is the FDIC; however, the analysis could apply as well to all troubled thrift institutions and to the FSLIC.

Before a choice can be made between open bank assistance and merger assistance, several important questions need to be answered. First, when does "failure" occur? What does it cost to prevent such failure? What will it cost the insuring agency if such failure is not prevented? How can assisted mergers between commercial banks and thrift institutions be expected to reduce costs for the insuring agency?

In analyzing these and related questions, several conclusions can be drawn:

- Under certain circumstances, the FDIC can save money by effecting a purchase of assets and assumption of liabilities of a closed, troubled MSB. The amount of the savings to the FDIC will vary with the condition of the troubled institution's portfolio and with the circumstances surrounding the bids for the balance sheet of the closed institution made by competing purchasers. On a present value basis, the savings to the FDIC may range from very minor to several hundreds of millions of dollars.
- Furthermore, the costs to the FDIC of effecting a P&A can be "amortized" by choosing various accounting processes. Such processes can avoid the FDIC having to book a "hit" immediately, while reducing substantially the FDIC's cash outlay. Indeed, the P&A can be structured in such a way as to reduce the FDIC's *yearly* cost to a level equal to or less than the cost under Section 13(c) assistance, no matter what course future interest rates take.
- The argument is sometimes made that the advantage of Section 13(c) assistance is that it is only temporary assistance—until interest rates decline and the troubled institution is made sound. However, the analysis above shows that a P&A, with appropriate indemnification clauses, can also cost the FDIC nothing in future time periods if rates decline. In effect, the indemnification clauses will require the purchaser to rebate to the FDIC any future gains on its portfolio resulting from falling interest rates.
- The premium to be paid the FDIC under a purchase and assumption can be maximized if the number of bidders is maximized, and this implies permitting commercial banks to bid for the assets and liabilities of closed thrift institutions. Including commercial banks in the bidding process may be especially important in minimizing FDIC cost, since CBs may be the only depository institutions in some circumstances that can afford to make reasonable bids. Of course, the higher the premium under a P&A, the lower the cost to the insuring agency.
- Commercial banks especially may be willing to make reasonably high bids for the balance sheet of a mutual savings bank which has been "sanitized" by the P&A process, because, among other reasons:
  - CBs may be able to take advantage of preferential tax treatment of thrift institutions;
  - CBs may be willing to pay for the chance to break into new geographic markets which are precluded to them directly under current law;
  - CBs may be able to reduce the unit costs of thrift institutions post-affiliation.

- Widespread mergers between commercial banks and thrifts would *not* reduce the flow of loanable funds to finance housing. In the current rate environment, surviving thrift institutions necessarily will price mortgage loans at market rates, such rates depending on risk and maturity characteristics. Thus, while thrifts have been specialized in the past, at the margin they can be expected to greatly diversify. At the least, those thrifts that expect to do well in periods of volatile interest rates will have to take significant measures to reduce interest rate risk. Thus, affiliation with banks or bank holding companies is not likely to change the marginal portfolio choices of thrifts. Note that this conclusion speaks to the issue of *permanent* holdings of mortgages, not to mortgage originations. In fact, thrifts—whether affiliated with banks or not—are likely to continue to exercise their comparative advantage, which is in the originating and servicing of mortgages. However, whether affiliated with banks or not, thrifts are not likely to hold mortgages permanently in their portfolios to the extent they had in the past.
- Other considerations, such as competition and the concentration of economic resources, are not seen to be importantly influenced by bank-thrift mergers. The bulk of assets of troubled MSBs, for example, are at institutions in large, vigorously competitive financial markets. And mergers between even the largest commercial banks in this country and the largest thrift institutions would not significantly increase the nationwide share of deposits of the resulting institutions.

Discussion

Garth Marston*

Frank, you and Bob are to be complimented for assembling this very lively group. The discussions have produced some light in the last few days. I was particularly pleased to see that you included a number of us former regulators, although, judging by the discussions, we are ipso facto "bad guys." I was talking with Frank Wille last night and asked, "Frank, why are they beating on us? Things were in pretty good shape when we left Washington." I have commented to a couple of people that if they don't think that the regulators foresaw to some extent the problems with fixed rate mortgages, I would invite them to look at some of the testimony from the early, mid and late 1970s. Those of us who were involved in that and those of us now involved on the other side of the fence have learned again the truism that fighting your regulator, like fighting Senator Proxmire and Congressman St. Germain, is like making love to a Montana gorilla. You only stop when the gorilla wants to stop. Ken Rosen, I should send you a copy of my testimony from last May because I had the temerity to suggest some of the things you talked about. Further, I suggested that we should reduce the tax incentive for all types of consumer borrowing including housing and switch it to savings and investing of whatever kind. Harrison Schmidt asked me if I didn't foresee a few political problems with this idea. And I said, "Yes, Senator, but let me set the policy, you work out the details."

This paper is worth reading, especially sections III and the conclusion section. I have divided my comments into three parts. First, the specific comments on the paper; second, some gratuitous comments; and finally some conclusions of my own. In the spirit of this conference, let me warn you in advance that I don't necessarily advocate or believe my own suggestions or alternatives. They are worthy of consideration and debate. This modesty is a characteristic that I share with Harry Keefe. The fact that neither of us believes our own stuff to any great extent is what makes people like Harry and me so endearing and eternally lovable. We hope to challenge the "business as usual" syndrome.

Knowing John's background and the fine organization he works with, it is not surprising that his answer to the short-term structural trouble with thrifts should turn out to be assisted mergers with *commercial banks*. But it did stimulate this thought as I read his paper. Shouldn't we be thinking in terms of regulated vs. *non*regulated institutions? It's been my observation that, in general, nonregulated institutions run circles around regulated institutions. In part III, *Public Benefits and Costs of Thrift Mergers with Commercial Banks,* John gives us some of the reasons why they should be

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merged. One, the premium is maximized and the insuring agency costs are minimized when commercial banks are permitted to bid for troubled thrifts. "Bank/thrift mergers will not significantly affect the supply of available mortgage money and finally competition and undue concentration of resources." Bleckk! (that's my word—he didn't say it). He did say that the mortgage lending concern is a bug-a-boo and that this type of merger would not really reduce competition and lead to undue concentration of resources. As I read these words I ask myself again why we should restrict mergers to FDIC-insured commercial banks? Why not include *non* regulated commercial banks such as Merrill, Shearson, Scudder and Sears Roebuck? John, perhaps you'd comment on that later on.

I certainly won't argue with your numbers. I'm going to leave that up to Dennis Jacobe and George Hanc and some of the other economists here. One criticism of the paper is that it did not adequately explain how the FDIC or the FSLIC would avoid a "hit" occasioned by a lump-sum payment. In other words, it seemed to me that the paper said that they have the choice of the installment plan which we are seeing now or a lump-sum payment. The problem with the lump-sum payment is that if interest rates do go down significantly, then the merged institution is the beneficiary. John suggested that perhaps they would agree to a pay-back. However, most institutions would ask for more if rates go up. I'm not sure that there's a significant difference, unless the FDIC could get the advantage both ways. If merger conditions are not sound, the FDIC might simply be postponing its problems.

Yesterday, it was alleged that one of our problems was we had not been very good at forecasting interest rates. Last December I hired four pretty good economists—Otto Eckstein, Alan Greenspan, Lawrence Klein, and Michael Evans. Since we had done a bad job in the past, we asked them to tell us what the prime rate was going to be at the end of the second quarter. And I got these answers: 13.8 percent, 13.5, 15.5 and 13.2. The *actual* rate turned out to be 18.75 percent. Making interest rate forecasts is very difficult, except of course for these experts whom we have hired at our bank. Please tell me who can do better in 1982.

I think your point about the benefit of reducing the transaction cost is well taken. Our NOW volume is not significant. It's 2 to 3 percent of deposits, and our transaction volume has gone up. What many of us failed to forecast, although some did, was the multiplicity of accounts today and also the transaction volume. In the good old days, whenever those were, we had savings accounts. Pretty easy to explain. Now we have a great variety of accounts. Even if they were simple, it would take a lot more people with expertise to explain all these accounts we have. In addition to variety, we have the transaction volume—great turnover in the accounts which the thrifts did not adequately anticipate. I think I agree with you this would be something that regulated and nonregulated commercial banks such as Scudder Stevens could bring to the thrift/bank merger table.

I have a question as to how attractive market expansion would be to how many commercial banks. Some commercial banks would be attracted

to interstate mergers but *how many*? Would it be a significant number, especially when they get into the profit aspects of it? Harry and I are old enough to remember World War II, when we had to buy three bottles of Canadian Club to get one bottle of scotch. Apparently, this is what happened to Tony Frank of Citizens S&L; he had to buy New York in order to get Florida. Publicly it is suggested that a lot of people from New York go to Florida in the winter and that's going to justify this particular merger situation. Privately, analysts are suggesting that the tax aspects are what makes the investment so attractive. Will this form of subsidy last?

You ask why anyone would buy an institution with a negative net worth and negative earnings. You suggest that one of the reasons is that it is a good solid investment. Probably that is right. There's another factor that augers well for the insuring institution. That is *ego*. No *good* reason. There is an ample supply of fat-headed CEOs who want to brag about mergers. That accounts, I believe, for a lot of mergers not only in the financial field but in other fields, as well.

Impact on the mortgage market. I'm not as sanguine, John, as you are about the ability of commercial banks as opposed to, say, insurance companies taking up the slack. Banks had a lot to do with REITs in the mid-70s. Their record of managing the mortgage companies which they purchased has not been outstanding. *Permanent holdings of Adjustable Mortgage Loans (AMLs)*? I would hope to hear that discussed in some papers. You raised a question about permanent mortgages. Are AMLs going to be held in thrift institution and commercial bank portfolios? I'm not sure. It's very difficult to answer that question now because interest rates are so high, no mortgage plan is particularly attractive.

Now—gratuitous remarks—fewer thrifts. Harry Keefe made a good point. Maybe there are simply too many thrift institutions and commercial banks around. Talking last night with a couple of former regulators here, we wondered if past policy to keep all thrifts and all commercial banks alive hindered the whole financial industry. If we try to keep everybody alive, including the poor performers, that means we have to protect everybody. Everyone is slowed down to protect the weakest. In retrospect, it might have been a lot better to let some of us go out of business, through the merger route, rather than trying to keep everyone alive. I say that with 20–20 hindsight, thinking in terms of how well the natural selection and evolution function works. Perhaps this is what we should have done more in the past. This is what's happening today and it will happen more in the future. When I arrived in Boston, friends of mine said that the good old Provident Institution for Savings has been around since 1816. But who needs it today? And that's the question each of us must answer. Who needs us today?

Next, I agree with what you say in the early part of your paper that the problem is serious. I mean it's really serious. These days, the public doesn't take economic writers very seriously. But this Doonesbury strip is *serious*. In the *Boston Sunday Globe* on October 25, this Doonesbury comic strip appeared showing a couple trying to get a loan. The couple is glancing at 19

percent—20 percent rates and the loan officer says, "O.K., think about it, but don't take too long, we're about to go belly up ourselves." Now that is serious. People read and believe Doonesbury.

The problem with the aggregate figures that we've been talking about is that they don't take into account particularly critical areas such as New York. The Wednesday *American Banker* had a very fine article written by Laura Gross that talked about a closed door meeting focused on the ailing Greenwich Savings Bank. These sources say that Greenwich will shortly have difficulty generating enough cash to pay outstanding bills including interest credited and withdrawn on deposits. The aggregate figures would not reveal this kind of a problem, which makes it a public policy concern when there is an inadequate cash flow in New York. Even though we in Massachusetts are in generally good shape, we are concerned about the domino effect of any adverse publicity from massive failures in New York City. The FDIC and FSLIC can probably handle 5 or 10 or 15 basket cases, but they are not set up even at full strength to handle 50 or 100 or 1500. If this came to pass, the impact on the rest of the financial system would be horrendous.

Finally, and this is a gratuitous remark, again, John, it's not stimulated by your paper. I've said it in the past, and I say it again. One of my big objections in this whole problem of the thrift industry and to some extent commercial banks is that essentially the states play for free. Who picks up the tabs? I haven't heard anybody here mention the cost to the state insuring agency (although we have one in Massachusetts). We're talking about the Feds aren't we? The FDIC, FSLIC (federal). The states play for free. In this same issue of American Banker which reports on Greenwich, STATE GROUPS FIGHT CRISIS MERGER BILL—CONFERENCE OF STATE BANK SUPERVISOR AND THE NATIONAL ASSOCIATIONS OF STATE SAVING AND LOAN ASSOCIATIONS ARE FIGHTING THE BILL. What gall! The states play for free. We heard yesterday about the impact they have had in New York State and I quote "Usury ceilings in New York State and idiots in Albany have continued this." There is a tax problem in New York State. We have a similar problem in Massachusetts. We have in essence a gross income tax. Right the wrong? Why should they? In effect the states point to their own problems. They suggest that the thrifts come back to see them in a year or two or three or maybe more. And why not? It's no skin off their noses. There should be ways, and there are ways, (having been a regulator I thought of a few ways myself), in which the states could participate in solving some of the problems that they have exacerbated. I'm not blaming the states for everything. I'm just saying that these people play for free while having a great impact on the health of financial institutions which they charter and someone else insures.

In conclusion, here are some things I expect to happen. First, I think that the situation is going to get worse, not better, unless the drop in interest rates is far greater than any of us expect. I'm talking in the neighborhood of 500 to 600 basis points over an extended period. The situation will continue to get worse. Second, I see continuing injections of net worth either in a lump sum or on the installment plan. Third, I see the need of re-

ducing the cost of funds for thrifts. This goes for the community banks, as you pointed out Harry, that have an asset and liability structure similar to thrifts. This will take the form of subsidized borrowing or tax incentives for savers. There is the problem of selectivity. This is one of the problems with the all-savers certificate, because it helps *all* institutions, not just the ones who need help.

Finally, I see more mergers coming, assisted and unassisted, intrastate and interstate, intraindustry and interindustry, regulated companies and nonregulated companies. A line from H. L. Mencken gives me a sense of balance, Frank, when I come to a conference like this with so many intelligent, stimulating people. The line was this, "Nothing is impossible, especially for the man who does not have to do the work."