THE TRANSFORMATION OF THE COMMERCIAL BANKING INDUSTRY
THE MOVEMENT TOWARD SAVINGS AND LOANS

Jerry Belloit, Clarion University of PA
Sarah Bryant Bower, Shippensburg University of PA

ABSTRACT

Since deregulation of the commercial banking industry in the 1980s and 1990s, commercial banks have radically changed the asset side of their balance sheets. This paper will examine the evidence of the movement of the commercial banking industry asset structure toward that of the Savings and Loan Industry. It will also examine how the commercial banking and the savings and loan industries are managing interest rate risk, and potential dangers in their not doing so.

INTRODUCTION

Deregulation of the financial services industries has had a profound impact upon commercial banks, savings and loans, and mutual savings banks. During the late 1970s and early 1980s, interest rates were at historic highs and financial institutions were struggling with disintermediation and pressure on profits. All financial institutions began to lobby for less restrictive regulations and more freedom to pursue additional profit opportunities. As the legislature began to respond to those lobbying efforts by deregulating the industries, many thought that the thrift industry, made up of savings and loans and savings banks, would move toward the asset structure more similar to commercial banks and that commercial banking industry would move toward the assets structure of thrifts. In other words, the expectation was that the industries would move to some middle ground between the two segments. This paper compares and contrasts the asset structure of the thrift industry and the commercial banking industries in Pennsylvania.

LEGISLATIVE HISTORY

Savings and loan institutions (S&Ls) were organized originally as financial institutions designed to promote thrift and home ownership. The original principle was simple—encourage people to place their surplus capital into savings accounts that paid some interest and then pool those savings and lend them to those wishing to buy a home at a little higher interest. S&Ls were distinct and separate from commercial banking, as S&Ls were required by law to lend almost exclusively in mortgage markets. Commercial banks had broader, more diversified lending authority.

Following WWII, the S&L industry enjoyed a prolonged period of financial stability and prosperity. Regulatory restrictions (Regulation Q) limited the maximum interest that could be paid on savings accounts, and there were legal limits on interest rates that could be charged on home loans.

After the economic recovery from the Great Depression and until the 1970s, commercial banks and S&Ls had little concern with interest rate risk. These financial institutions had well delineated roles in the financial markets and fixed interest rate margins between their assets and liabilities. In other words, there was little risk in their portfolios. Strict government laws and regulations helped hold this almost certain world in tack.

However, changes in the economy caused by changes in government spending and Federal Reserve monetary policy during the 1970s, as well as oil price shocks, led to inflationary pressures and corresponding stresses on interest rates. Volatility in interest rates, or interest rate risk, became the new threat to financial institutions. They had to learn new methods of operations to avoid financial distress. Over the next 15 or so years, thousands of financial institutions, primarily S&Ls, failed or were taken over by other financial institutions that were able to adapt faster. The federal government had to set a course of deregulating interest rates, and changing the well-delineated roles of these institutions. As a consequence, events have forced continual change in financial markets since that time.

In the early 1970s, inflationary pressures pushed market rates on investments above the maximum rates that could be paid by the commercial banks or S&Ls on savings accounts. Smaller investors needed, and found, newly created mutual funds, which were investment vehicles that were basically unregulated and allowed market rates of return. Deposits were withdrawn from financial institutions to be redeposited in mutual funds.

S&Ls suffered the most in this environment.[xxv] They were restricted by law to originating and holding almost 100 percent of their portfolio in long-term mortgages. Most were at fixed rates. At the time variable-rate loans were not well accepted by the public. Almost all S&L funding came by way of small deposits that also had fixed interest rates. As interest rates rose and became more erratic, S&Ls scrambled to adjust their portfolios.

One way the government sought to mitigate the decrease in loanable funds was by increasing S&Ls' access to a secondary mortgage market, increasing the roles of the Federal National Mortgage Association and by creating the Federal Home Loan Mortgage Corporation. This provided vehicles for additional funds through the sale of mortgage assets. This step was not enough to counter the serious outflow of funds from the institutions, as portfolio re-adjustment is a longer-term endeavor. Significant disintermediation continued, and political pressure to remove the interest rate cap on savings accounts succeeded in 1980. The 1980 Depository Institutions Deregulation and Monetary Control Act (DIDMCA) initiated the phase-out of Regulation Q.

While the DIDMCA reduced the pressure from disintermediation for all financial institutions, it created a new problem by exposing them to significantly more interest rate risk. This interest rate risk was two-fold for the institutions. First, the removal of the interest cap on the interest rate paid on savings and the threat of disintermediation if the institution did not adjust its rates to market, eliminated an inexpensive source of loanable funds, thus squeezing the profit margin on loans. This placed the institutions in the difficult position of having their assets (loans) earning less than the liabilities (savings accounts), thus creating a negative profit margin. This problem peaked during the early 1980s when mortgage interest rates on new loans topped 18 percent. Loan rates did decline from their peak in 1981, so the problem began to subside. Likewise, new mortgages funded after the peak in 1981 have not posed a problem with negative profit margins over the last 24 years, since interest rates have continually fallen. Still there was significant fallout from the unbalanced legislative approach to deregulation, as cost of funds was deregulated two years before returns on loans.

The second problem the institutions faced was the problem of unmatched maturities between the long-term assets and the short-term liabilities. While this problem was not new, prior to this period, it was of little concern because the interest cost of the liabilities was held artificially low because of the interest rate cap, even when short-term rates rose. After the caps were removed, this problem of unmatched maturities became problematic during the decade of the 1970s. Interest paid on savings rose from two percent to three percent early in the decade to more than twelve percent by the end of the decade. During that period, mortgage interest rates rose from six percent to 18 percent, but fewer loans were originated at those high rates.[xxvi] The problem was that loans originated with 20 to 30 years to maturity in earlier years were still outstanding with interest rates lower than the cost of short-term funding.

During the decade of the 1970s and moving into the 1980s, three other significant transitions in the industry occurred. First, in an effort to reduce interest rate exposure on new loans, institutions began to take advantage of selling their loans into the secondary market. The secondary market had both opportunities and challenges. On the positive side, the use of the secondary market reduced the problem of unmatched maturities, since the institution had the loans in portfolio only for a short period of time. It also allowed the institutions access to more capital for funding loans, since the institution was no longer limited to lending from its own deposit base. On the negative side, loan sales were expensive, as institutions gave up between 1percent to 2 percent of its origination fee as transactions costs. Also, the institutions no longer had long-term assets earning profits.

A second transition that occurred during the period of the 1970s and 1980s was the massive conversion of the institutions from mutual ownership to stock ownership. Fundamentally this led to a difference in the management philosophy of the institutions. Stock ownership of the institutions fueled an increased concern with strategies that promoted an increase in shareholder wealth rather than promoting the security and interest return for the depositors.

A third transition that occurred during the 1980s was a fundamental change in competition among all types of financial institutions. Due to the problems S&Ls faced under strict regulations in a dramatically changing economic environment, Congress passed legislation to help increase portfolio flexibility in S&Ls through the before-mentioned

DIDMCA of 1980, the 1982 Garn-St. Germain Depository Institutions Act, and subsequent acts. Business barriers between financial institutions were phased out. This allowed S&Ls to enter into the consumer credit business, insurance, and other business lines even beyond those formally exclusive to the realm of commercial banks.

Over time, federal and state governments relaxed laws and regulations to allow assets to be from a broader base than mortgages only. However, even to this day, savings institutions and other mortgage banks must hold 65 percent of their assets in mortgages or mortgage-backed securities. Changes were too late to help many institutions survive. Over time, in response to increased investment capabilities and increased awareness of continued volatility in financial markets, regulators issued strict guidelines concerning management of interest rate risk.[xxvii]

METHODOLOGY

One of the difficulties in this analysis is the availability of data from the 1970s and 1980s for individual commercial banks, savings banks, and savings and loans. Because of the Financial Institutions, Reform and Recovery Act of 1990 and provisions that effectively consolidated the regulatory authority of the FSLIC into the FDIC, data before 1998 is not readily available. Consequently, this study examines the balance sheets from the commercial banks' Call Reports and the thrift industries' Thrift Financial Reports available from the FDIC.[xxviii]

Four groupings of Pennsylvania financial institutions were examined: Large Commercial Banks, Small Commercial Banks, Large Thrifts, and Small Thrifts. Large Commercial Banks are defined as those that had assets in excess of $183 million in 1998. Small Commercial Banks are defined as financial institutions with under $112 million. Intermediate size institutions were not included. Large and small thrifts are defined by the same limits. The division into these groupings was made first, to discover if there were differences in the management of assets between thrift institutions and commercial banks and second, if there were differences due to the size of institutions. There are sixteen large commercial banks and fifteen small banks and twelve large and twelve small thrifts. One of the difficulties with the analysis was finding financial institutions that existed in 1998 and were still in existent in 2006. Mergers and closures significantly limited the sample sizes. In fact, there were only 270 active financial institutions during this period in Pennsylvania that reported to the FDIC.[xxix] To illustrate the problem of closures and mergers, from 1970 through June of 2006, 699 institutions ceased to be active out of the 969 institutions existing in 1970 . [xxx]

Data were collected for each of the financial institutions, including total assets, mortgage securities, real estate mortgage loans, deposits exceeding $100,000, total and net derivative values. A percentage of the institution's total assets was computed for each of these dollar amounts in an effort to standardize the measures for analysis.

For most of the analyses, the null hypothesis tested was that the underlying populations of commercial banks and thrifts were the same. The confidence level was set at 95%. For significant differences, an asterisk (*) is used. For most of the analysis, a two-tailed two-sample t-test assuming unequal variances was used. For the analysis of changes in the institutions from 1998 to 2006, a paired t-test was used.

RESULTS

Percentage of Total Assets

The first factor analyzed was the percentage of total assets held in real estate loans. The thrift industry was originally organized to encourage home ownership by lending to persons wishing to purchase a home. As previously mentioned, commercial banks generally did not lend money for home purchases. Before deregulation, the largest portion of a thrift institution's asset portfolio was held in real estate loans. Today, commercial bank's are much more heavily involved with real estate lending. The difference between thrift institution lending and commercial bank lending is still significant, although the difference is closing as is indicated by the following table:

% Mortgage	1998	2006
Banks **Thrifts**	44.76% 62.49%	41.11% 57.40%
Banks vs. Thrifts **t-statistic**	 .0001*	 .001*
	Δ% '98-'06	**Paired t**
All Banks	-8.15%	.308
All Thrifts	-8.15%	.309
Large Banks	-9.41%	.231
Small Banks	-4.06%	.460
Large Thrifts	-19.29%	.012*
Small Thrifts	3.53%	.645

An analysis of the micro data indicates two interesting occurrences. Mellon Bank and Park View Savings Bank radically cut the amount of real estate loans held in portfolio. Mellon Bank cut their loans from almost $7 billion in real estate loans in 1998 to just over $250,000 in 2006. Likewise Parkview Savings Bank reduced their real estate loan portfolio from 54.52 percent in 1998 to 12.72 percent in 2006.

Purchases of Mortgage Backed Securities

Some of the decrease in the amount of real estate loan holdings is the result of a shift from direct lending to indirect lending through the purchase of mortgage backed securities. Thrifts increased the percentage of their assets held in mortgage backed securities from 9.29 percent in 1998 to 11.3 percent in 2006, while commercial banks increased their percentage of assets held in mortgage backed securities from 8.63 percent in 1998 to 11.63 percent in 2006. The only significant change in the percentage of mortgage backed securities held was by the large commercial banks, as seen below:

% Mtg. Backed Sec.	1998	2006
Banks **Thrifts**	8.63% 9.29%	11.66% 11.30%
Banks vs. Thrifts **t-statistic**	 .846	 .912
	Δ% '98-'06	**Paired t**
All Banks	35.13%	.314
All Thrifts	21.67%	.501
Large Banks	62.04%	.019*
Small Banks	3.24%	.888
Large Thrifts	33.36%	.229
Small Thrifts	-6.36%	.776

A recent trend in financial institutions insured by the FDIC, and evident in Pennsylvania, has been an increasing amount of uninsured deposits. Only the large banks have not seen significant increases of uninsured deposits, as seen below:

% uninsured deposits	1998	2006
Banks **Thrifts**	6.75% 6.19%	9.76% 9.52%
Banks vs. Thrifts **t-statistic**	 .478	 .847
	Δ% '98-'06	**Paired t**
All Banks	44.59%	.008*
All Thrifts	53.86%	.013*
Large Banks	15.08%	.353
Small Banks	71.39%	.0003*
Large Thrifts	62.74%	.003*
Small Thrifts	24.24%	.091

None of the small commercial banks and thrifts took positions with derivatives or swaps to hedge their interest rate positions. Only one thrift, Firstrust Savings Bank, took any derivative position. Of the seventeen large commercial banks, eight did not use derivatives in 1998 but did in 2006.

Profitability

Profitability of the institutions, as computed as a return on their total assets, was examined in 1988 and again in 2006. The average quarterly return on total assets in 1998 was .365%, while the average quarterly return on assets in 2006 was .627%. A paired t-test was conducted and determined that the difference was statistically significant, with a t-value of .002. It is possible that the increased profitability was due to other factors than improved risk management, possibly better overall management.

CONCLUSION

It is clear that since deregulation, commercial banks have dramatically increased their real estate lending portfolios, but this trend seems to be leveling off. In our sample of commercial banking institutions, the percentage of assets held as either real estate loans or mortgage backed securities from 1998 to 2006 held constant at about 53 percent. Thrifts have averaged about 70 percent.

There is evidence from our sample of large commercial banks that the banks are improving their capital risk management through the use of derivatives. All of the financial institutions except for the small thrifts increased their position in mortgage backed securities. In some cases, it seems that the institutions were substituting increases in mortgage-backed securities for real estate portfolio loans.

It is somewhat troubling that small thrifts have increased their holdings in mortgage loans without any apparent hedging with financial derivatives or swaps. (As commercial banks have increased their holdings in mortgage loans, there may be significantly less advantage for them to offer swaps.) It is also troubling that all of the smaller financial institutions and most of the larger thrifts do not appear to be contracting with larger institutions to hedge their interest rate risk or engaging in hedging activities themselves. With the recent increases in long-term interest rates and the softening of some real estate markets, there will be increasing pressure on profits.

ENDNOTES

[xxv] Commercial banks were allowed by law to hold more diversified portfolios, and thus did not experience as much of the effects of changes in interest rates, or interest rate risk.

[xxvi] Interest rates steadily climbed during this period for several reasons. Most prominent was the upward pressure due to the general inflation of the economy. Also increasing upward pressure on interest rates was the demand for mortgages due to the rise in the rate of home ownership in the country of almost 4% between 1981 and 1995. See http://www.freddiemac.com/news/finance/commentary/070703_homeown_rate.htm.

[xxvii] See Thrift Bulletin, TB 13a. First adopted in the early 1980s, TB 13, later revised to TB 13a, describes the definitions, sources, and limits of interest rate risk, stress testing, board of director obligations, and S&L examiner judgments and potential actions.

[xxviii] A searchable data base of Call Reports and Thrift Financial Reports from March 1998 through the present is available at: http://www2.fdic.gov/call_tfr_rpts/.

[xxix] Of the 270 active institutions, 69 were savings banks and 41 were savings and loan associations. The balance was commercial banks.

[xxx] A chart of the number of institutions that went inactive each year during that period is included at the end of the paper below.

Jerry D. Belloit is a professor of finance and real estate at Clarion University of Pennsylvania. He received his Ph.D. in Real Estate and Urban Analysis from the University of Florida. His other research interests are real property law, financial institutions, and urban analysis.

Sarah Bryant Bower is a professor of finance and real estate at Shippensburg University of Pennsylvania. She received her Ph.D. from University of South Carolina. She also has experience working in the financial institutions area as a government regulator and a consultant. Other research areas of interest include financial and economic markets development.

Pennsylvania Financial Institutions Ceasing Operations