

Eleventh District Savings and Loans Outperform Industry Nationwide

By Kenneth J. Robinson

While the larger banking industry grabbed most of the attention, U.S. savings and loans (S&Ls) also felt the strain of the recent financial crisis. Major institutions such as Countrywide Financial and Washington Mutual failed.

Thrifts, as S&Ls are also called, became a particular source of concern at the onset of the downturn. The industry experienced “disproportionate losses during the financial crisis,” according to a 2010 congressional study on the housing and financial industry collapse.¹ Citing figures from the Federal Deposit Insurance Corp. (FDIC), which guarantees the safety of deposits at U.S. banks and thrifts, the study noted that 95 percent of failed-institution assets in 2008 were attributable to thrifts regulated at the time by the federal Office of Thrift Supervision (OTS). The failed-asset figure was 73 percent from 2008 to April 2010, “even though the agency supervised only 12 percent of all bank and thrift assets at the beginning of this period,” the study said.

The Dodd-Frank Wall Street Reform

and Consumer Protection Act of 2010 introduced a number of changes to the thrift industry. Specifically, the law abolished the OTS, transferring supervision over S&L holding companies (SLHCs) to the Federal Reserve. The new regulatory structure was a response to concerns about thrift losses and questions about the efficacy of regulatory efforts.²

Since the financial crisis, the S&L industry has recovered in the Eleventh Federal Reserve District and across the nation. In fact, like banks in the district, thrifts here are outperforming their counterparts nationally. This likely reflects the relative health of the regional economy.³

What’s Different About Thrifts?

Thrifts are generally smaller than banks—in quantity and size. The number of S&Ls peaked at 3,677 in 1986, when assets totaled \$1 trillion; commercial banks reached a high of 14,470 in 1984, when assets totaled \$2.5 trillion.⁴ These kinds of differences have persisted even as the

number of institutions has declined. At the end of 2011, the nation had 1,067 thrifts with assets of \$1.1 trillion, and 6,278 banks with assets of \$12.6 trillion.

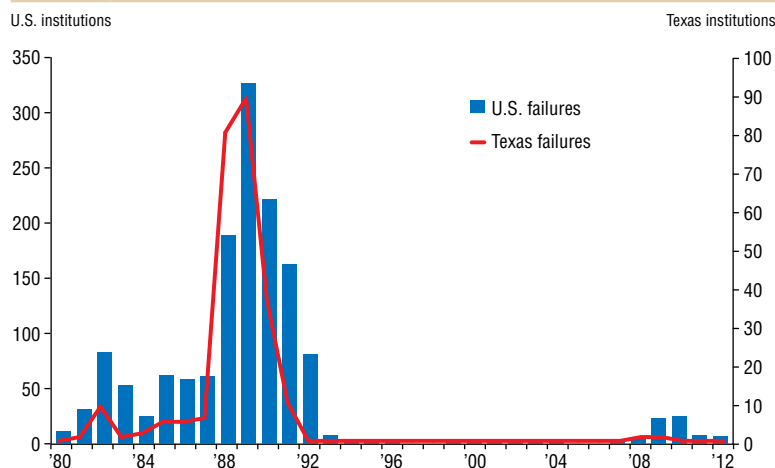
Savings and loans have their origins in the public-policy goal of encouraging home-ownership at a time when banks didn’t lend money for residential mortgages. The first S&L was established in Pennsylvania in 1831. Thrifts were originally organized by groups of people wishing to buy their own homes but lacking sufficient resources to do so. Group members pooled their savings, lending money back to a few members to finance home purchases. As the loans were repaid, funds were lent to other members.

States initially oversaw the thrift industry, but the federal government later assumed a role similar to the one it plays in the dual banking system of state and federally chartered banks. Federal regulation of savings and loans began with the Federal Home Loan Bank Act of 1932. It established the Federal Home Loan Bank system to provide a source of liquidity to the industry. The Home Owners’ Loan Act of 1933 authorized Home Loan Banks to charter and regulate federal savings and loans. The National Housing Act of 1934 created the Federal Savings and Loan Insurance Corp. (FSLIC), the savings-and-loan counterpart to the FDIC, to insure thrift deposits.

Reflecting their role in housing finance, thrifts historically concentrated more on mortgage lending than banks did, though that focus has shifted somewhat over time. In 1985, mortgage loans accounted for 43 percent of thrift assets, compared with 7 percent at commercial banks. At year-end 2011, mortgages accounted for 32 percent of assets at thrifts, versus 16 percent at banks.

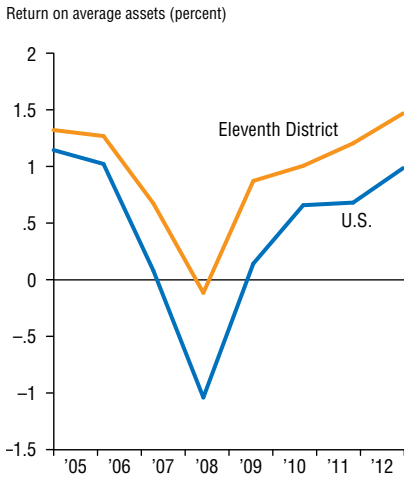
The relatively greater concentration of mortgage lending, however, made savings institutions vulnerable to interest rate increases and housing price declines. During times of stress, thrift failures have moved higher (*Chart 1*).

Chart 1 Thrift Failures Soar in 1980s



NOTE: Includes failures and assisted transactions; failures are through June 15, 2012.
SOURCE: Federal Deposit Insurance Corp.

Chart 2 Thrift Profitability Stronger in District than U.S.



NOTE: Data are through March 31, 2012, annualized.
 SOURCES: Thrift Financial Report, Office of Thrift Supervision; Report of Condition and Income, Federal Financial Institutions Examination Council.

When rates began rising rapidly in the late 1970s, many S&Ls suffered extensive losses. Their earning assets tended to be in long-term, mostly fixed-rate mortgages, but because they held mostly short-term deposits, their cost of funds increased dramatically when interest rates rose. When housing prices nationally turned sharply downward in the recent crisis, thrifts again suffered losses as mortgage defaults mounted.

While particularly vulnerable to interest rate and housing price movements, thrifts have faced other economic stressors. Beginning in the early 1980s, thrift woes were tied to factors that included the shock of an oil-price collapse in energy-rich Texas. The regional economy fell into recession, deeply impacting residential and commercial real estate. In 1988, more than 40 percent of thrift failures nationwide occurred in Texas.

S&L difficulties spread to other parts of the country, ultimately bankrupting the FSLIC and forcing taxpayers to cover liabilities estimated at as much as \$124 billion.⁵ In response, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 to restructure the industry and establish the Office of Thrift Supervision. Simultaneously, commercial banking suffered from its own problems, in Texas and elsewhere.⁶

The 1990s and early 2000s were relatively tranquil for the thrift and banking

industries. However, with the onset of financial turmoil in 2007–09, thrift failures again increased. While the total was substantially lower in the recent crisis than in the prior downturn, the industry was also significantly smaller. Slightly more than 1,000 thrifts remained at the end of 2011, reflecting the failure since 2007 of 71 S&Ls with assets of \$594 billion.

Dodd–Frank specifically addresses the thrift industry in Title III, which abolished the OTS, effective July 21, 2011. While the thrift charter was left intact, the regulatory and rulemaking authorities of the OTS were transferred to the Federal Reserve, the Office of the Comptroller of the Currency (an independent agency within the Treasury) and the FDIC. The Federal Reserve assumed responsibility for S&L holding companies and their nondepository subsidiaries, while the Comptroller of the Currency gained oversight of federally chartered savings associations. The FDIC assumed the OTS's duties over state-chartered savings associations. On the July 21 transfer date, the Federal Reserve became responsible for about 430 SLHCs, 23 of them based in the Eleventh District. One is the largest Texas-based financial institution—USAA of San Antonio.

S&L holding companies, like their banking counterparts, can engage in activities other than taking deposits and making loans. These include insurance and broker/dealer services. For most SLHCs, however, the main line of business is the underlying thrift

institution. A total of 126 holding companies nationally filed regulatory statements for first quarter 2012, reporting consolidated assets of \$959 billion.⁷ Of those holdings, 58 percent were in thrift subsidiaries.

Performance Measures

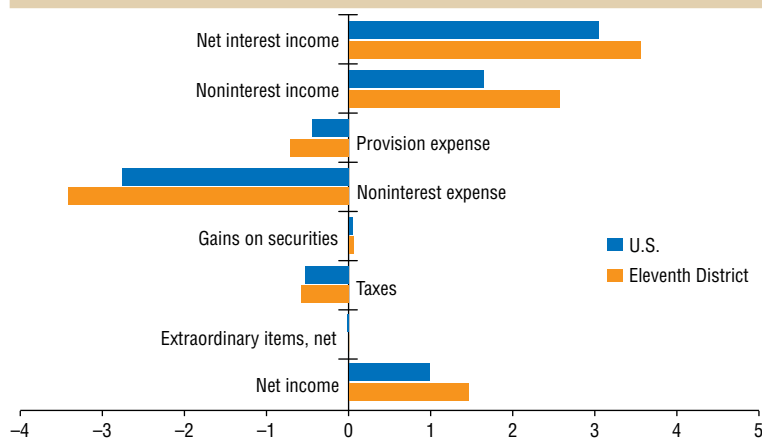
In contrast to circumstances in the 1980s, Eleventh District thrifts have outperformed S&Ls nationwide during the recent crisis. This comparatively strong showing has also occurred among district banks.⁸ The relative strength of regional thrifts is evident in key performance measures.

Thrift profitability as calculated by return on assets declined sharply both regionally and nationally beginning in 2007 as the housing bust hit and the ensuing financial crisis spread (*Chart 2*).

S&Ls suffered losses in 2008 but began recovering in 2009. District thrifts earned an annualized return on assets of 1.5 percent in first quarter 2012, compared with the national performance of 0.98 percent. The biggest contributor to profitability was net interest income, or the difference between interest earned on loans and interest paid on deposits (*Chart 3*). This component was more important to profitability for regional than national thrifts.

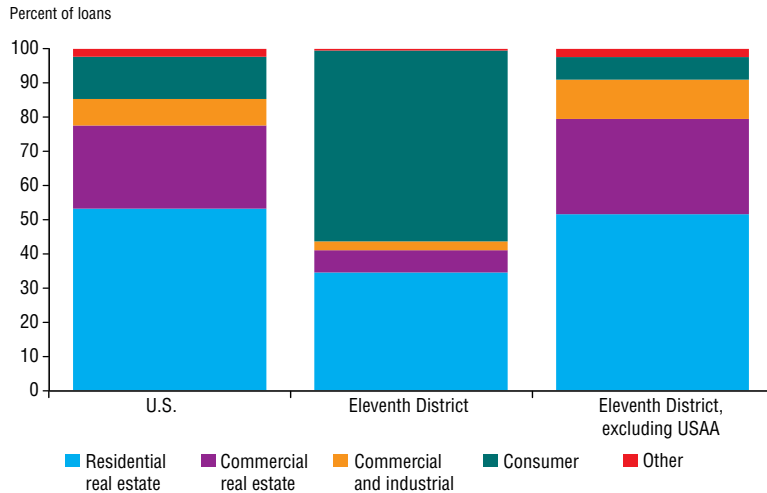
Noninterest income, or what is sometimes referred to as fee income, was also a relatively more important contributor to regional thrift profitability. Noninterest expense, including salaries and benefits, was

Chart 3 Net Interest Income a Key Profitability Component (Percent of average assets, annualized)



NOTE: Data are as of March 31, 2012.
 SOURCE: Report of Condition and Income, Federal Financial Institutions Examination Council.

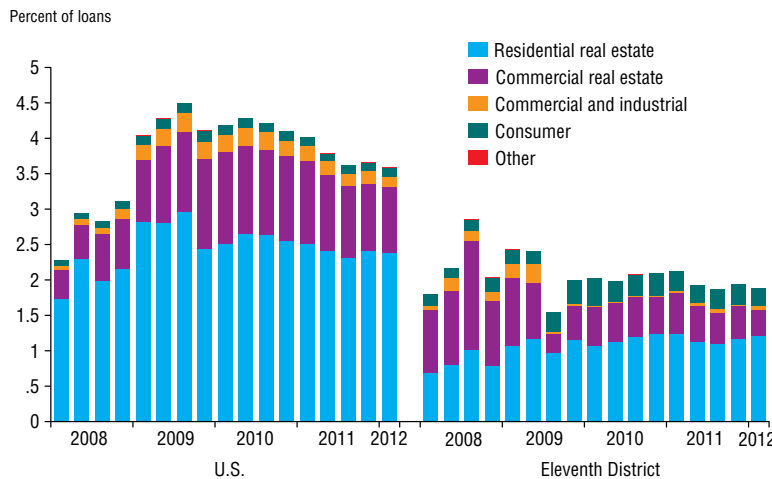
Chart 4 Bulk of Thrift Lending Is in Mortgages



NOTES: Data are as of March 31, 2012. District results are presented with and without USAA to account for the effect of the large thrift's somewhat unique focus on consumer lending.

SOURCE: Report of Condition and Income, Federal Financial Institutions Examination Council.

Chart 5 Noncurrent Loans Lower in District than U.S.



SOURCES: Thrift Financial Report, Office of Thrift Supervision; Report of Condition and Income, Federal Financial Institutions Examination Council.

the largest expense category affecting first-quarter profitability, again more so in the district than the nation. Provision expense, or what thrifts set aside to cover potential bad loans, was slightly higher for regional thrifts in the quarter. This expense peaked in the recent crisis at about 2 percent of assets both regionally and nationally in 2008 and has steadily declined.⁹

Given that S&Ls were originally chartered to provide mortgage loans, it stands to reason that real estate lending represents the bulk of thrifts' loan portfolios (*Chart 4*).

Nationwide, residential mortgages accounted for more than half of all loans outstanding, with commercial real estate loans making up 24 percent of all loans. In the district, residential mortgages were only 35 percent of the loan portfolio, with commercial accounting for 6 percent. However, district numbers are affected by USAA's heavy concentration of consumer lending. Excluding USAA, the district's numbers are similar to those of the nation, with district thrifts exhibiting a slightly higher concentration of commercial and industrial loans

and a lower concentration of consumer loans.

The S&L industry's overall real estate loan portfolio tends to resemble that of community banks (those with less than \$10 billion in assets). Nationally, real estate lending accounted for 78 percent of all loans at thrifts, compared with 68 percent at community banks. The difference reflects thrifts' greater involvement with residential mortgages.

Asset quality, as measured by noncurrent loans, worsened at thrifts regionally and nationally as the recent crisis unfolded (*Chart 5*). Noncurrent loans are defined as those in which payment is 90 days or more past due, plus those not accruing interest.

Before the crisis, the noncurrent loan rate was similar for thrifts in the district and the nation. However, starting in 2009, the national rate has significantly exceeded the district figure. The noncurrent loan rate for thrifts nationally peaked at 4.5 percent in third quarter 2009, while it topped out regionally at 2.9 percent in third quarter 2008.

Not surprisingly, most of these loans have been in the real estate category. Noncurrent residential and commercial real estate loans accounted for 92 percent of all noncurrent loans nationally and 83 percent regionally in first quarter 2012.

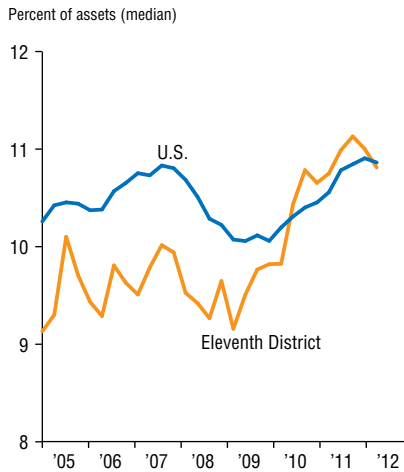
Charge-Offs Improve

The percentage of loans charged off—the proportion of loans in a thrift's portfolio that have been written off as uncollectible, net of any recoveries—has improved. These loans amounted to 1.5 percent of S&L assets regionally and 1.2 percent nationally in the first quarter—down from a regional peak of 1.9 percent in 2010 and a national high of 1.8 percent in 2009.

One important measure of the state of the thrift industry is equity capital relative to assets. Capital represents the cushion available to absorb losses. Equity capital ratios declined during the crisis at thrifts regionally and nationally (*Chart 6*).

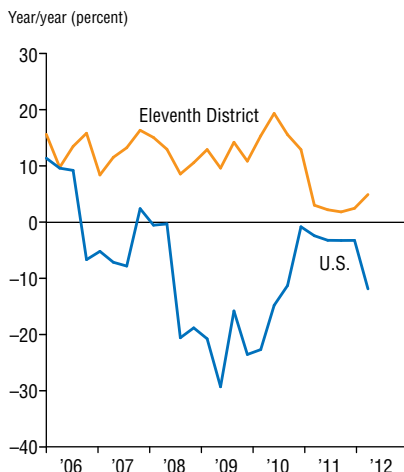
Before the crisis, thrifts nationally had higher capital ratios than those in the district, but more recently, the situation has reversed. The good news: 98 percent of district thrifts and 97 percent of U.S. S&Ls were considered well capitalized as of first quarter 2012.¹⁰ Another important cushion, the reserve coverage ratio—or the amount set

Chart 6 Equity Capital Ratios Strengthen in District



SOURCES: Thrift Financial Report, Office of Thrift Supervision; Report of Condition and Income, Federal Financial Institutions Examination Council.

Chart 7 District Sees Total Loan Growth; U.S. Contracts



SOURCES: Thrift Financial Report, Office of Thrift Supervision; Report of Condition and Income, Federal Financial Institutions Examination Council.

aside to cover bad loans—was at 110 percent of noncurrent loans regionally, compared with 42 percent nationally.

Despite the financial industry's general recovery from the crisis, lending activity remains a concern. Low profitability and asset-quality problems can make it difficult for institutions to supply credit. The recession, which ended in June 2009, also damped demand for loans—although there is now some evidence of strengthening demand.¹¹

Thrifts, like banks, don't report the amount of new loans extended but rather the total amount of loans outstanding. Using this measure, district loan growth has considerably exceeded the national pace (Chart 7). Almost 70 percent of S&Ls in the district reported a year-over-year increase in loans outstanding as of first quarter 2012. Fewer than half of S&Ls nationwide reported an increase.

District growth was mostly driven by increases in commercial and industrial loans, especially from 2008 to 2010, with consumer loans showing strength since early 2010.

It's the Economy

Like their commercial banking brethren, Eleventh District thrifts have outperformed their national counterparts, whether measured by profitability, asset quality or lending. The achievement by both banks and S&Ls suggests that the regional economy is an underlying factor.

Texas, by far the largest economy in the region, suffered less from the housing downturn and subsequent financial crisis than the nation as a whole. It entered the recession later, and its recovery has been more robust. In 2011, employment grew 2.2 percent in the state, compared with 1.2 percent for the nation.

Far from its volatile past, the regional S&L industry is progressing in key performance measures and can expect to continue its impressive run if the Eleventh District economy remains relatively healthy.

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Notes

¹ See Senate Committee on Banking, Housing, and Urban Affairs, Report 111-176, April 30, 2010, p. 25.

² Dodd-Frank contained important changes to the regulatory structure of the U.S. financial industry outside the thrift sector. One of the most prominent was establishment of the Financial Stability Oversight Council, composed of the heads of 10 major regulatory agencies, to oversee systemic risks to the U.S. economy emanating from banks, thrifts and other financial institutions. The Federal Reserve was charged with supervising what the council designates as systemically important financial institutions and developing enhanced prudential standards for these institutions. All banking organizations with consolidated assets of \$50 billion and

above are automatically considered to be systemically important. It takes a vote of two-thirds of the council (with the chairman's approval) for nonbank financial institutions to be designated as systemically important. For a description of enhanced prudential standards, see www.federalreserve.gov/newsevents/press/bcreg/20111220a.htm.

³ As used here, the term "thrift" encompasses federal and state savings associations, savings-and-loan associations and mutual savings banks. The Eleventh Federal Reserve District encompasses all of Texas, northern Louisiana and southern New Mexico. All thrift data for the Eleventh District have been adjusted for structure changes.

⁴ Consistent data for the thrift industry are available beginning in 1984.

⁵ See "The Cost of the Savings and Loan Crisis: Truth and Consequences," by Timothy Curry and Lynn Shibus, *FDIC Banking Review*, vol. 13, no. 2, 2000. For more on the difficulties at savings and loans during this time, see *The S&L Insurance Mess: How Did It Happen?* by Edward J. Kane, Washington, D.C.: The Urban Institute Press, 1989. For a perspective on the problems in Texas, see "The Texas Thrift Situation: Implications for the Texas Financial Industry," by Genie D. Short and Jeffery W. Gunther, Federal Reserve Bank of Dallas *Financial Industry Studies*, September 1988, pp. 1-11.

⁶ See *History of the Eighties—Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s*, Washington, D.C.: Federal Deposit Insurance Corp., 1997.

⁷ Only savings-and-loan holding companies with consolidated assets of \$500 million and above were required to file the Y9-C report in the first quarter.

⁸ For an account of how the banking industry in the Eleventh District performed during the crisis, see "Eleventh District Banking Industry Weathers Financial Storms," by Kenneth J. Robinson, Federal Reserve Bank of Dallas *Southwest Economy*, Second Quarter 2010. For more on the area economy, see "Texas Economy Shakes Off Rough Ride," by Laila Assanie and Pia Orrenius, Federal Reserve Bank of Dallas *Southwest Economy*, First Quarter 2010.

⁹ Consistent data on provision expense for thrifts were not available before 1987. The prior peak in provision expense in the Eleventh District occurred in 1987 and was approximately 4 percent of average assets.

¹⁰ To be considered well capitalized, a thrift needs to have a total risk-based capital ratio equal to or greater than 10 percent, a tier 1 risk-based capital ratio equal to or greater than 6 percent and a tier 1 leverage capital ratio equal to or greater than 5 percent.

¹¹ See the Senior Loan Officer Opinion Survey on Bank Lending Practices, Board of Governors of the Federal Reserve System, April 2012.