Changes in the Depository Industry in Tenth District States

By William R. Keeton and Anne D. McKibbin

Recent developments in Congress and the courts have focused attention on the relative roles of commercial banks, thrifts, and credit unions. As concern mounted last year about the state of the thrift deposit insurance fund, Congress required commercial banks to share the burden of recapitalizing the fund. In return, Congress promised to come up with a plan for merging the bank and thrift charters, a move the banking industry has long favored. About the same time, a federal appeals court ruled against a major source of credit union growth since the early 1980s—the acceptance of new members with a common bond different from the original members. The Supreme Court later agreed to hear the case, sparking a renewed debate in Congress about the proper role of credit unions in the financial system.

These recent actions by Congress and the courts follow a decade and a half of dramatic changes in the depository industry in Tenth District states. Some of these changes have been due to shifts in laws and regulations. Others have resulted from shocks to the regional and national economy and long-run financial trends such as the growth of secondary loan markets. While the changes to the district depository industry have been many and varied, four stand out. First, there has been a significant decline in the number of district depository institutions—a decline in which banks, thrifts, and credit unions have all shared. Second, total deposits have declined when adjusted for inflation or measured relative to economic activity. Third, the share of thrifts in total deposits has plummeted relative to that of banks and credit unions. And fourth, while banks, thrifts, and credit unions still specialize in different loans and investments, the three types of institution do not look as different today as at the beginning of the 1980s.

Such changes are important because they affect the thousands of depository institutions in the district and the supply of credit and other financial services to district households and businesses. With those effects in mind, this article shows how the district depository industry has changed since 1979, explains the factors behind each change, and suggests what further changes may lie ahead. The first section documents and explains past changes. The second section discusses future changes, focusing on three forces that loom large in the period ahead: the merger of the bank and thrift charters, the debate over the proper role of credit unions, and the growth of secondary loan markets.

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I. MAJOR CHANGES IN THE DISTRICT DEPOSITORY INDUSTRY SINCE 1979

The period from 1979 to 1996 was one of dramatic change in the district depository industry—both for the industry as a whole and for each type of depository institution. By way of background, this section reviews the basic features of the three institutions at the start of the period. The section then documents and explains the four major changes in the industry over the period—the decline in the number of institutions, the decrease in total deposits, the decline in the deposit share of thrifts relative to banks and credit unions, and the narrowing of differences in asset composition.

Basic features of the three institutions

At the start of the period, the district depository industry consisted of three types of institutions that differed in ownership, tax status, and lending and investment powers. First were commercial banks, which were owned by their shareholders and subject to federal and state income tax. Commercial banks were prohibited from holding common stocks or junk bonds, but otherwise faced few restrictions on their loans and investments. Most banks took advantage of this freedom to diversify their portfolios, holding both a wide mix of loans and substantial amounts of securities.

Second were thrifts, which in Tenth District states consisted entirely of savings and loan associations.[1] Some associations were stock associations owned by their shareholders, but most were mutuals, which meant that they were legally owned by their depositors. Despite their different form of ownership, mutual associations were subject to federal and state income tax, just like commercial banks and stock associations. Having been created to promote the housing industry, thrifts were required to hold most of their assets in the form of residential real estate loans. In return, they received certain tax benefits and the right to borrow at favorable terms from the Federal Home Loan Banks (FHLBs), a system of lenders owned by thrifts but sponsored and supervised by the federal government.

The last group of depository institutions were credit unions, organizations designed to enable individuals with a "common bond" (e.g., a common employer or area of residence) to borrow from and lend to each other. Credit unions were mutual organizations owned by their members and, unlike commercial banks and thrifts, were not subject to federal or state income tax. They could make either consumer loans or home mortgage loans. But because the authority to make home mortgage loans had been granted only recently, credit unions still specialized heavily in consumer loans at the beginning of the 1980s—especially loans for the purchase of automobiles.

Despite their differences, banks, thrifts, and credit unions shared four important characteristics that distinguished them from other financial institutions. First, banks, thrifts, and credit unions earned most of their profits through financial intermediation—they collected deposits from households and businesses and then loaned those funds to borrowers at higher interest rates. Second, the deposits of all three institutions were federally insured, with each institution covered by an insurance fund built up through annual premiums. Third, all three institutions enjoyed access to the payments system, in the sense that they could clear payments directly through accounts held at the Federal Reserve.[2] And finally, all three institutions were regulated and supervised by the federal government, partly because of their access to the payments system and partly because the federal

Table 1

NUMBER OF DEPOSITORY INSTITUTIONS

Tenth District states, end of year

	1979	1996	Percent change
Banks	2,767	1,854	-33
Thrifts	379	126	-67
Credit unions	1,140	845	-26
All	4,286	2,825	-34

Note: Data are for institutions headquartered in Tenth District states.

Source: Reports of Income and Condition for banks, Thrift Financial Reports for thrifts, and Statement of Financial Condition for credit unions.

government stood behind the deposit insurance system. These common characteristics, which banks, thrifts, and credit unions continue to share today, provide the main justification for treating the three institutions as a single industry.

Decline in the number of depository institutions

The first major change in the district depository industry since 1979 has been a significant decline in the number of depository institutions—a decline in which banks, thrifts, and credit unions have all shared. From the end of 1979 to the end of 1996, the total number of depository institutions headquartered in Tenth District states fell by about a third—from a little less than 4,300 at the start of the period to just over 2,800 at the end (Table 1). The biggest proportional decline was in the number of thrifts, which fell by 67 percent. But there were also sizable declines in the other two institutions—33 percent for banks and 26 percent for credit unions.

The main cause of the decline in institutions was the large number of mergers (Table 2). Over the period as a whole, 1,140 banks and 126 thrifts were lost through mergers. Bank mergers increased over the period and were especially high in the 1990s. Three-fifths of bank mergers were with banks in the same holding company, while the rest were with banks in other organizations. In contrast to bank mergers, thrift mergers were concentrated in the first half of the 1980s. All thrift mergers in the 1980s were with other thrifts, but a quarter of thrift mergers in the 1990s were with commercial banks. Data are not available on the number of credit unions mergers in the district. For the nation as a whole, however, mergers were the main factor behind the decline in credit unions, and there is no reason to believe the district experience was different (Amel).

Several factors contributed to the high number of mergers in the district.[3] First, geographic barriers to consolidation were relaxed substantially during the period. All seven states moved to some form of statewide branching in the late 1980s and early 1990s, encouraging both the consolidation of banks within the same holding company and mergers among banks in different holding companies. Legislation enacted by

Table 2

LOSS OF BANKS AND THRIFTS THROUGH MERGERS AND FAILURES

Tenth District states, 1980-96

	1980-84	1985-89	1990-96	Entire period
1. Number lost through mergers				
a. Commercial banks	46	351	744	1,141
i. Mergers with affiliated banks	34	238	428	700
ii. Mergers with unaffiliated banks	12	113	316	441
b. Thrifts	75	11	40	126
i. Mergers with other thrifts	75	11	29	115
ii. Mergers with banks	0	0	11	11
2. Number lost through failures				
a. Commercial banks	15	225	44	284
b. Thrifts	12	28	91	131

Note: Data are for institutions headquartered in Tenth District states. Failures exclude failed institutions succeeded by new institutions.

Source: National Information Center Database, Office of Thrift Supervision, RTC press releases.

Congress in 1980 had a similar effect on thrift mergers, by permitting statewide branching by all federally chartered thrifts.[4] Second, the heavy loan losses suffered by banks and thrifts in the 1980s focused attention on reducing credit risk through geographic diversification—for example, by combining banks or thrifts from different economic regions of the same state. Third, increased competition from outside the depository industry, a factor discussed in the next section, encouraged institutions in the same market to merge with each other to eliminate overlap in branches and backoffice facilities and thereby cut costs. Finally, credit union mergers were spurred by two special factors—the large number of credit unions that were too small to be economically viable, and new regulations adopted in 1982 that allowed credit unions with different common bonds to merge.[5]

Besides mergers, the other reason for the decline in district depository institutions was the large number of failures. Over the period as a whole, 284 banks and 131 thrifts were lost through failures.[6] Most bank failures were in the second half of the 1980s, while most thrift failures were in the 1990s. While smaller than bank failures in absolute terms, thrift failures were much more important in proportional terms. Specifically, thrifts lost through failures were 35 percent of thrifts operating at the start of the period, while banks lost through failures were only 10 percent of banks operating at the start of the period.

The high rate of bank failures in the 1980s resulted from a severe downturn in the district economy. Simultaneous slumps in agriculture and energy in the mid-1980s led to heavy loan losses at farm and energy banks. Later in the decade, overbuilding and the removal of tax incentives contributed to a collapse in commercial real estate prices, causing some urban banks to suffer heavy losses on their commercial real estate loans. While the deteriorating economy was the main cause of the increased bank failures, excessive risk-taking also played a role. In an effort to win business, some banks lowered their credit standards during the previous boom, causing them to suffer especially heavy losses when the economy turned downward (Keeton and Morris).

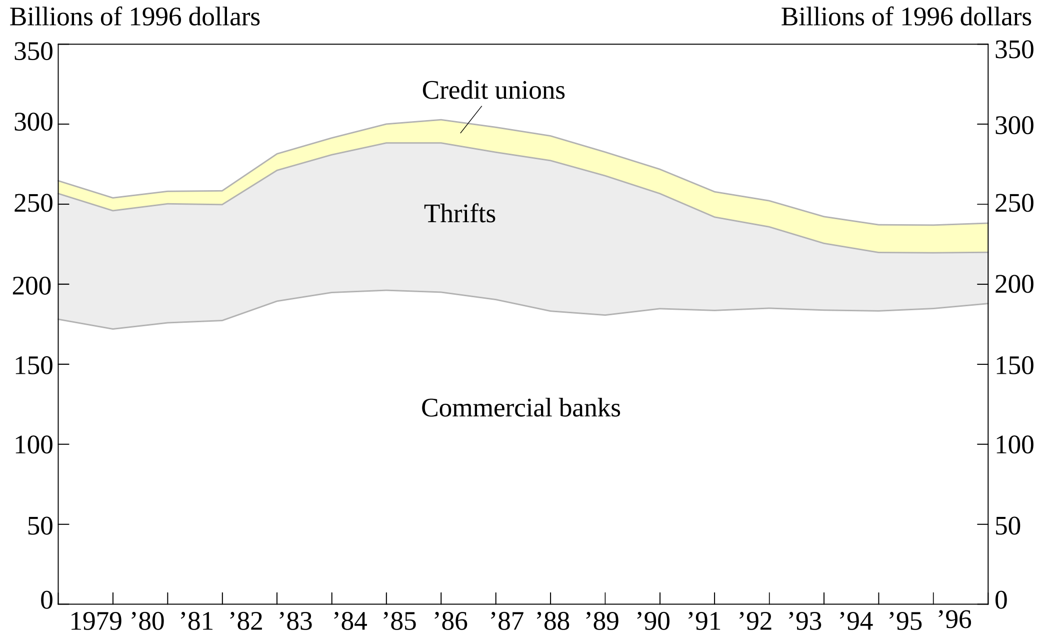
While most thrift failures were in the 1990s, the seeds of these failures were sown in the 1980s (Brumbaugh, White, National Commission). The debacle began with a sharp hike in short-term interest rates at the start of the 1980s. The liabilities of thrifts consisted mainly of short-term deposits, while their assets consisted mainly of long-term mortgages. Thus, when short-term interest rates climbed, thrifts' interest expense rose much more than their interest income, causing heavy losses and eroding capital. Legislators tried to help by allowing thrifts to make a wider variety of loans and investments. It was widely believed that thrifts had gotten into trouble due to their heavy dependence on long-term mortgages and that some diversification into other assets would make them less vulnerable to future interest swings. Acting on this belief, Congress passed laws in 1980 and 1982 that expanded the authority of federally chartered thrifts to invest in consumer loans, business loans, and commercial real estate loans.[7] Not wanting to be left behind, a number of states also expanded lending and investment powers for their state-chartered thrifts, sometimes going well beyond the federal legislation.

Instead of becoming safer, many thrifts used the new powers to grow rapidly and make risky loans and investments. Thrifts whose net worth had been reduced below zero by the jump in short-term interest rates had a strong incentive to gamble. If the gambles failed, these thrifts would be no worse off because they were already insolvent. And if the gambles succeeded, the thrifts would be able to stay in business and recoup their owners' investment.[8] Most experts also agree thrift regulators exacerbated the problem by lowering capital requirements, encouraging the use of questionable accounting methods, and failing to adequately supervise troubled thrifts. The thrifts that took excessive risks ended up suffering heavy losses in the second half of the 1980s, especially after the commercial real estate market collapsed. They were not closed until the 1990s, however, because the thrift insurance fund was quickly depleted and Congress delayed in providing new funds until August 1989.[9]

Decline in total deposits

The second major change in the district depository industry since 1979 has been a decline in total deposits adjusted for inflation or measured relative to economic activity. Expressed in 1996 prices, the total deposits of banks, thrifts, and credit unions operating in Tenth District states fell from $261 billion in mid-1979 to $237 billion in mid-1996, a decline of 9 percent (Chart 1 and Table 3). Since the district economy was growing over most of the period, deposits declined even more sharply relative to economic activity. For example, from 1979 to 1994, the last year for which data are available, the ratio of deposits to gross state product fell from 0.62 to 0.49, a

Chart 1
BANK, THRIFT, AND CREDIT UNION DEPOSITS
Tenth District states, midyear



Source: Summary of Deposits for banks and thrifts; Statement of Financial Condition for credit unions.

decline of 21 percent. The fact that deposits have declined does not necessarily mean the district depository industry has become less important, because depository institutions could be providing increased services off the balance sheet (Boyd and Gertler, Kaufman and Mote).[10] The decline does suggest, however, a shrinkage in the industry’s traditional role of funding loans with deposits.

One reason for the decline in total deposits was increased competition from mutual funds. Households came to view mutual funds as an attractive alternative to deposits because they paid open-market returns, were easy to purchase and liquidate, and provided check-writing privileges. In the early 1980s, most of the mutual fund competition came from money-market mutual funds (MMMFs), which had grown rapidly ever since their introduction in the early 1970s (Chart 2). By the middle of the decade, however, depository institutions were also facing increased competition from stock and bond mutual funds. These funds became more popular partly due to the rising share of the population between ages 35 and 55—the age group most concerned about saving for retirement and therefore most willing to make investments with high short-term risk but high long-term returns (Morgan). Stock and bond funds also benefited from an increased willingness of people in the 35-55 age group to invest in mutual funds (Laderman). As doubts arose about the health of social security, these

Table 3

DEPOSITS IN CONSTANT DOLLARS

Tenth District states, midyear
(billions of 1996 dollars)

	1979	1996	Percent change
Banks	175.9	187.7	7
Thrifts	77.6	31.7	-59
Credit unions	7.9	18.0	128
All	261.4	237.4	-9

Note: Bank and thrift data are for all institutions with offices in Tenth District states, including institutions headquartered outside the district. Credit union data are for institutions headquartered in Tenth District states.

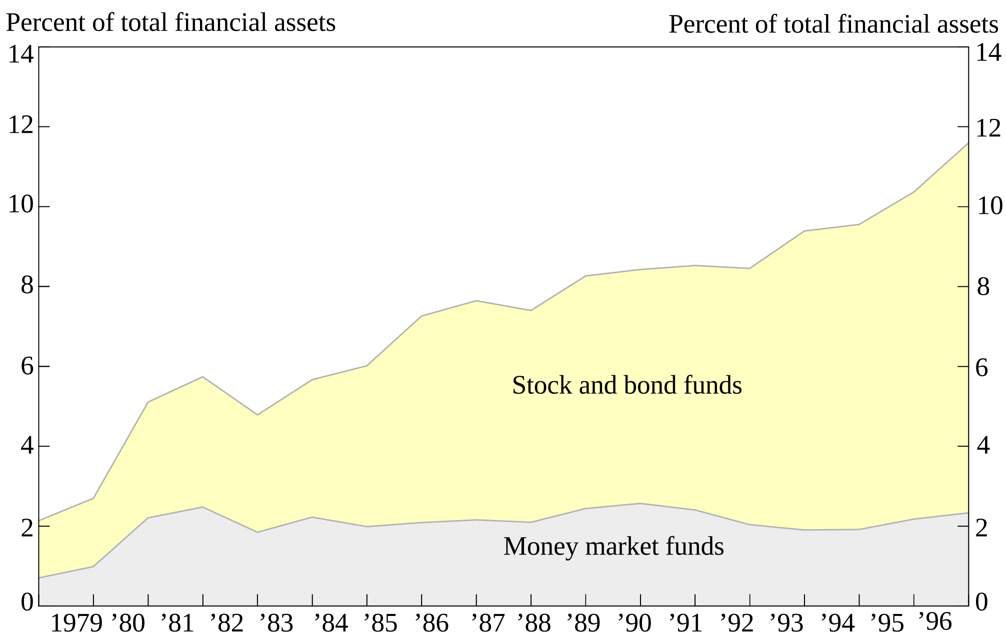
Source: Summary of Deposits for banks and thrifts; Statement of Financial Condition for credit unions.

individuals became more concerned about saving for retirement. And as the runup in stock prices persisted, they became more inclined to view stocks as good long-term investments.

A second reason for the decline in total deposits was an increased supply of credit to households and businesses from nondepository sources. The increase in supply was especially great for mortgage borrowers due to rapid growth in the secondary mortgage market (Chart 3). During the 1980s, home mortgage loans were increasingly pooled and sold to investors in the form of mortgage-backed securities (MBSs). Housing credit agencies owned or sponsored by the federal government played a key role in promoting this market, both by issuing MBSs directly and by providing guarantees that made it easier for private parties to issue them.[11] Another important factor was the introduction of collateralized mortgage obligations, which were attractive to many investors because they had more predictable cash flows or different effective maturities than the underlying pool of mortgages. These developments caused MBSs to become increasingly popular with investors such as mutual funds and life insurance companies, significantly increasing the supply of funds to the mortgage market. The increased supply of mortgage funds pushed mortgage rates down, reducing the profitability of funding mortgages with deposits and causing depository institutions to become less aggressive in bidding for deposits (GAO 1991a, Cotterman, McNulty).[12]

Nondepository sources also supplied increasing amounts of credit to consumer and business borrowers, although the change was less dramatic than for mortgage borrowers. In the case of consumer credit, the key development was the emergence in the late 1980s of a market for securities backed by pools of credit card loans and automobile loans. This market grew rapidly in the 1990s, increasing the supply of credit from

Chart 2
MUTUAL FUND SHARES HELD BY HOUSEHOLDS
United States, end of year

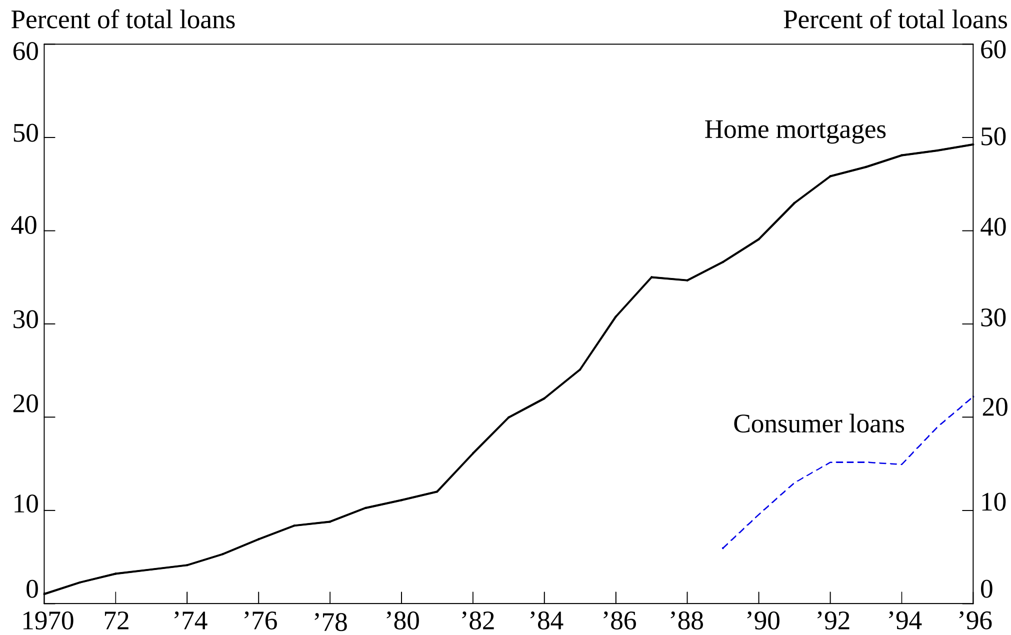


Source: Board of Governors, Flow of Funds

outside investors and reducing the profitability of funding consumer loans with deposits.[13] By 1996, however, securitization had still progressed only half as far for consumer loans as home mortgages, limiting the impact on deposit growth. In the case of short-term business credit, depository institutions had to compete against finance companies for small business loans and against the commercial paper market for large business loans. Competition from both sources increased during the 1980s. Compared to home mortgages and consumer loans, however, the secondary market for business loans remained much less developed, allowing depository institutions to hold their own during the 1990s.[14]

A third reason deposits declined was that failures imposed substantial costs on surviving institutions, reducing their profits and dulling their appetite for deposits. The most obvious cost of failures was the higher insurance premium paid by surviving institutions to replenish the deposit insurance funds. The thrift insurance premium was increased in 1989 and was not lowered until the fall of 1996, when Congress imposed a substantial one-time assessment to recapitalize the thrift insurance fund to the mandatory target of 1.25 percent of insured deposits.[15] The bank insurance premium was raised in 1991, after a jump in failures at large banks had depleted the bank insurance fund. The higher bank premium remained in effect

Chart 3
SECURITIZED LOANS
United States, end of year



Source: Board of Governors, Flow of Funds

until mid-1995. By that time the fund had reached the 1.25 percent target, helped by an unexpectedly strong banking recovery that reduced failures to virtually zero.

Some analysts argue that surviving institutions also had to bear indirect costs in the form of tighter supervision and regulation, although this point is more controversial. In an effort to limit deposit insurance losses, Congress enacted a new system of regulation in 1991 that penalized poorly capitalized banks and rewarded well-capitalized banks.[16] The new system came on top of risk-based capital requirements, adopted two years earlier as part of an international effort to harmonize capital standards. Those analysts who blame tighter regulation for the decline in total deposits argue that such measures forced banks to hold too much capital, putting them at a disadvantage relative to unregulated financial institutions (Golembe). Other analysts disagree, arguing that higher capital requirements merely corrected the disincentive to hold capital due to deposit insurance (Litan).[17]

Finally, while not the main cause of the decline in deposits, the large number of failures may have allowed the depository industry to adjust faster to its new equilibrium size. Over time, an industry with declining profits can be expected to shrink until it is small enough to become profitable again. That process may take

Table 4

DEPOSIT SHARES

Tenth District states, midyear
(percent)

	1979	1996	Change
Banks	67	79	12
Thrifts	30	13	-16
Credit unions	3	8	5
All	100	100	0

Note: Deposit data are the same as in Table 3.

considerable time, however, if the industry's human and organizational capital cannot be easily transferred elsewhere—-for example, if managers and employees have skills that are highly specific to the industry. In such a situation, an increase in failures due to other factors may hasten the adjustment process by forcing human and organization capital to exit the industry more quickly. In the depository industry, for example, the rapid growth of secondary mortgage markets reduced the profitability of funding home mortgages and MBSs with deposits. Much of the decline in this activity did not occur until the 1990s, however, when the thrifts that took excessive risks in the 1980s were finally closed. If the thrift debacle had never occurred, the adjustment of the depository industry to the securitization of home mortgages might have taken even longer.

Decline in thrift deposit share

The third major change in the district depository industry has been a steep decline in the thrift deposit share relative to that of banks and credit unions. The contraction in total deposits from 1979 to 1996 was not shared equally by the three institutions. Adjusted for inflation, deposits fell 59 percent at thrifts but rose 7 percent at banks and more than doubled at credit unions (Chart 1 and Table 3). As a result of these differences in deposit growth, the deposit shares of the three institutions changed radically. Specifically, the thrift share plummeted from 30 percent to 13 percent, the bank share jumped from 67 percent to 79 percent, and the credit union share rose from 3 percent to 8 percent (Table 4). By the end of the period, commercial banks were by far the dominant institution, and thrifts held only a small lead over credit unions.

At first glance, an obvious explanation for the sharp decline in the thrift deposit share was that large numbers of thrifts failed due to excessive risk-taking in the 1980s. The decline in the thrift deposit share occurred entirely in the 1990s, the same period during which most high-flying thrifts were closed. Furthermore, the deposits of these failing thrifts totaled $36 billion in 1989, an amount equal to two-thirds of the total decline in thrift deposits during the 1990s. Such evidence would seem to suggest

Table 5

SOURCES OF CHANGE IN THRIFT DEPOSITS

Tenth District states, June 1989 to June 1996

	Billions of 1996 dollars
1. Failing thrifts	
RTC payoffs	-3.0
Assumption of deposits by healthy thrifts	-5.3
Assumption of deposits by banks	-17.2
Deposit outflows before closure	-10.3
Net change	-35.8
2. Healthy thrifts	
Assumption of deposits from failed thrifts	5.3
Absorption of deposits by banking industry	-8.4
Charter conversions	-2.4
Mergers	-2.5
Branch purchases	-3.4
Deposit outflows	-15.6
Net change	-18.6

Source: Authors' calculations.

that the decline in the thrift deposit share was mainly due to failures.

There are two problems with this explanation for the decline in the thrift deposit share. First, it begs the question why the deposits of failed thrifts did not stay in the thrift industry. In principle, the many healthy thrifts that remained in business could have acquired the deposits of the failed thrifts, limiting the decline in total thrift deposits. In fact, however, healthy thrifts ended up directly acquiring only $5 billion of the deposits of failed thrifts (Table 5). The remaining $30 billion of deposits were paid off by regulators, assumed by commercial banks, or withdrawn by depositors while the thrifts were waiting to be closed. Second, healthy thrifts not only refrained from assuming the deposits of failed thrifts but also lost a substantial amount of deposits of their own. Specifically, healthy thrifts lost $16 billion through deposit outflows and gave up another $8 billion in deposits to the banking industry through mergers, charter conversions, and branch purchases.

The main factor behind the decline in the thrift deposit share was not the large number of failures but the rapid growth of the secondary mortgage market, which reduced the profitability of funding home mortgages with deposits. This change affected all three types of depository institutions but had an especially large impact on thrifts. Thrifts invested a much higher proportion of their funds in home mortgages than banks or credit unions. And because most of their expertise was in home mortgage lending, thrifts could not easily shift out of home mortgages into business or consumer loans. Thus, healthy thrifts could not invest their funds profitably enough to hold on to their existing deposits, much less acquire the large amounts of deposits released by failed thrifts during the early 1990s.

While failures were not the main reason for the decline in the role of thrifts, they still contributed to that decline. If commercial real estate losses had not led to the closure of so many thrifts, the impact of the secondary mortgage market on the thrift deposit share might have taken longer to show up, as thrifts earning subpar profits only gradually contracted or exited the industry. The large number of failures also contributed to the decline in the thrift deposit share by imposing an especially heavy financial burden on those thrifts that survived. Bank and thrift insurance premiums were increased by similar amounts to rebuild the two insurance funds. But because the thrift insurance fund was in much worse condition, it was widely expected that thrifts would have to pay the higher premium for many more years than banks. This expectation tended to slow deposit growth at healthy thrifts even before 1995, when the bank premium was reduced to zero and the thrift premium left unchanged.

The steep decline in the thrift deposit share was mirrored by increases in both the bank deposit share and the credit union deposit share. The rise in the bank deposit share was mainly a reflection of the problems in the thrift industry. While bank deposits did increase over the period after adjustment for inflation, they increased only modestly (Table 3). And relative to the size of the district economy, bank deposits fell slightly.[18] The increase in the credit union deposit share was a different matter, resulting more from the strong growth in credit union deposits over the period than the weak growth in thrift deposits.

One reason credit unions grew so rapidly was that they began offering a wider array of services to their members. In 1977, Congress had authorized credit unions to make home mortgage loans and credit card loans. Further increases in mortgage powers came in 1982, when Congress authorized the refinancing of first mortgages and extended maturity limits on second mortgages, and in 1988, when regulators allowed credit unions to invest in mortgage-backed securities. During the 1980s, credit unions took advantage of these powers to offer a wider variety of loans, increasing their attractiveness to potential members. The opportunity to make a wider variety of loans and investments also boosted profitability, enabling credit unions to pay higher returns on their deposits. Finally, credit unions were helped in their effort to attract members and deposits by 1980 legislation authorizing them to offer transactions accounts, a move that put them on a par with banks and thrifts.

The other factor behind the rapid growth in credit union deposits was a significant relaxation in credit union membership requirements. In 1982, regulators allowed credit unions to have members with different common bonds—for example, an occupational credit union could accept groups of members from different firms than the credit union's original or "core" members. The purpose of this change in membership requirements was twofold—to make it easier for financially troubled credit unions to merge with healthy credit unions, and to expand total credit union membership. The change in policy was attacked in the courts by the banking and thrift industries, which argued that credit unions were deviating from their original purpose by accepting unrelated groups of members. Until mid-1996, however, these legal challenges met with little success.

Table 6

COMPOSITION OF ASSETS AT DISTRICT DEPOSITORY INSTITUTIONS

End of year (percent)

	1979			1996			Change		
	Banks	Thrifts	Credit unions†	Banks	Thrifts	Credit unions	Banks	Thrifts	Credit unions
Loans	54	85	69	59	66	67	5	-18	-3
Residential RE	7	71	5	14	54	17	7	-17	12
Commercial RE	6	11	__	11	8	__	5	-4	__
Consumer	14	2	65	13	4	49	-1	2	-15
Other	27	*	*	21	1	1	-7	1	1
Investments	30	11	26	31	30	29	1	19	2
Mortgage-backed	__	3	0	9	23	4	__	19	4
Other	__	8	26	22	7	25	__	-1	-2
All other assets	16	5	4	10	4	5	-6	-1	0
Total	100	100	100	100	100	100	0	0	0
Memo: Real estate assets	13	85	5	35	84	21	21	-1	16

* Less than 0.5 percent.

† Data are for 1980.

Note: Data are for institutions headquartered in Tenth District states. Consumer loans for 1996 include home equity loans. Real estate assets are the sum of residential real estate loans, commercial real estate loans, and mortgage-backed securities (if available).

Source: Reports of Income and Condition for banks, Thrift Financial Reports for thrifts, and Statement of Financial Condition for credit unions.

Narrowing of differences in asset composition

The last change in the district depository industry is that the three institutions do not look as different in the composition of their assets because banks and credit unions have shifted into real estate loans and securities (Table 6). At district thrifts, the shares of commercial real estate loans and residential real estate loans fell from 1979 to 1996, while the share of mortgage-backed securities rose. Total real estate assets changed only slightly, however, edging down from 85 percent to 84 percent. In contrast, the share of real estate assets in bank and credit union portfolios increased substantially over the period. Bank holdings of mortgage-backed securities were not reported in 1979 but were probably negligible. Assuming this to be the case, the share of real estate assets jumped from 13 percent to 35 percent at commercial banks and from 5 percent to 21 percent at credit unions.

Thus, by the end of the period, thrifts were still far more dependent on real estate assets than banks or credit unions, but the difference was not as great as at the start of the period.

In the case of banks, the main impetus for the shift into real estate assets was a reduction in the attractiveness of farm and business lending following the agriculture and energy slumps of the mid-1980s. The heavy losses suffered by banks on their farm and business loans in the second half of the 1980s made such loans appear riskier. Farms and businesses also became more reluctant to take on debt, reducing the demand for bank loans. As a result, the amount of farm and business loans held by district banks declined sharply.[19] This decrease in farm and business lending naturally lead district banks to look for alternative investment opportunities.

Why did banks turn to real estate assets as a substitute for farm and business loans? Commercial real estate loans were a natural choice because they were similar in some respects to business loans and because slow growth in the secondary market had limited the supply of credit from nondepository sources. To be sure, many banks suffered losses on their commercial real estate loans in the late 1980s and early 1990s. Once commercial property prices began to rebound in the early 1990s, however, commercial real estate lending became profitable again. The motives for banks shifting into home mortgages are less clear. It was argued above that securitization reduced the profitability of funding home mortgages with deposits, contributing to both the shrinkage in total deposits and the decline in the deposit share of thrifts. In such circumstances, banks might have been expected to cut back on their home mortgage holdings instead of increasing them.

There are several reasons banks may have shifted into home mortgages, even as securitization was lowering the average return on such investments. First, investing in mortgages was a way for banks with few such assets to diversify their loan portfolios, reducing the variability of profits.[20] Such diversification may have seemed especially attractive to banks in the 1980s in view of their heavy loan losses on other types of loans. Second, banks with few mortgage holdings may not have fully exploited their inherent advantages in attracting and identifying creditworthy mortgage borrowers. These advantages included the opportunity to cross-sell mortgages to existing customers and the ability to identify good risks based on customers' checking accounts and consumer loan histories. Finally, large amounts of home mortgages became available to banks in the 1990s when failed thrifts were closed and healthy thrifts agreed to be acquired. Some of these thrifts may have been earning healthy profits on their mortgages but gone out of business for other reasons—for example, because of losses on commercial real estate loans. In such cases, banks would have had an incentive to acquire the mortgages.

Home mortgages held similar attractions for credit unions, although they were motivated more by a desire to attract members than by a need to find new investment outlets. Credit unions did not begin to shift into home mortgages until the mid-1980s, long after the 1977 law authorizing them to make such mortgages. Some observers have suggested credit unions were spurred to reduce their dependence on consumer loans by the Tax Reform Act of 1986, which ended the tax deductibility of interest payments on auto loans and unsecured consumer loans. Others have argued that increased competition from banks and finance companies reduced the attractiveness of consumer lending, encouraging credit unions to look for new ways to invest their rapidly growing deposits (GAO 1991b). While these factors may account for some of the shift, credit unions were probably more motivated by a desire to increase membership by becoming full-service financial institutions. The relaxation of the common bond requirement in the early 1980s greatly increased the potential for membership growth. Offering a wider array of services to members, including home mortgage lending, was an obvious way for credit unions to realize that potential.

II. THE DEPOSITORY INDUSTRY AT A CROSSROADS

Depository institutions in the district are at a crossroads, with major changes in store. Long-standing differences in bank and thrift powers are likely to disappear as Congress merges the two charters. And as credit unions become more like banks and thrifts, they may find it harder to retain their special privileges. Finally, the securitization trend is likely to continue, making it harder for all three institutions to earn profits by funding loans with deposits. This section briefly reviews these factors and discusses their implications for the district depository industry.

Merging the bank and thrift charters

Most analysts believe Congress will soon eliminate the separate thrift charter, requiring thrifts to operate under the same rules and regulations as banks. Such a change could affect both the ability of district banks and thrifts to compete against other financial institutions and the relative roles of the two institutions in the district depository industry. When Congress passed legislation to recapitalize the thrift insurance fund in the fall of 1996, it not only levied a substantial one-time assessment on thrifts but also required banks to share the burden of repaying past borrowings. In return, Congress promised to come up with a plan for merging the bank and thrift charters, a move the banking industry had long sought on grounds that thrifts enjoyed unfair advantages over banks. Reinforcing the push for charter merger was a growing sentiment among financial experts and regulators that a separate thrift industry was no longer needed to promote housing, thanks to the rapid growth of secondary mortgage markets (Greenspan).

The bank and thrift charters now differ in three principal ways (Congressional Budget Office, FDIC). First, most thrift holding companies can engage in virtually any activity, while bank holding companies can engage only in activities closely related to banking. For example, thrifts can be owned by insurance firms, securities firms, and commercial and industrial firms, while banks can be owned only by companies whose principal activity is banking. Second, thrifts can own subsidiaries that engage in activities such as real estate development and insurance that are restricted for banks.[21] And third, thrifts are subject to much stricter limits on the types of loans and investments they can make. Although these limits were loosened in the early 1980s, they were tightened again as the thrift debacle worsened. As a result, thrifts still have much less latitude to invest in business, consumer, and commercial real estate loans than banks do.[22]

How the first two differences in charters are resolved could affect the ability of banks and thrifts to compete with other financial institutions and, thus, affect the ultimate size of the depository industry. Two very different approaches have been suggested. Under the “chartering up” approach, banks and thrifts would be granted relatively broad holding company and subsidiary powers—powers similar to those that thrifts now enjoy. Under the “chartering down” approach, banks and thrifts would be given only narrow holding company and subsidiary powers—powers similar to those now available to banks. Chartering up would enable banks and thrifts to offer one-stop shopping for their customers—for example, providing businesses with underwriting services as well as short-term credit, and supplying households with insurance as well as consumer loans, home mortgages, and deposit services. On the other hand, chartering down would restrict the range of services banks and thrifts could offer, limiting their ability to compete with other financial institutions.

While merger proposals differ in their treatment of holding company and subsidiary powers, all of them would allow thrifts to make the same kinds of loans and investments that banks now do. Thus, besides affecting the size of the depository industry, a merger of the two charters could have profound effects on the relative roles of banks and thrifts in the depository industry. Specifically, some analysts argue that banks and thrifts will become indistinguishable once all legal and regulatory distinctions are removed, engaging in the same activities and holding the same loans and investments.

The large differences in asset composition that now exist between banks and thrifts are likely to narrow once the two charters are merged, but there are three reasons to believe the differences will not disappear altogether. First, while there are benefits from diversification, there are also advantages to specialization. A highly diversified lender is likely to have more stable profits than a specialized one, because the diversified lender can use profits on one type of lending to offset losses on another. But a specialized lender may be able to earn a higher average level of profits than a diversified one, because economies of scale may enable the specialized lender to do a better job of evaluating borrowers and serving customers. In the absence of any restrictions on loans and investment, some depository institutions would probably choose to specialize and some to diversify, just as retailers do. And since thrifts have already developed expertise in mortgage lending, it stands to reason that a higher proportion of thrifts than banks would end up specializing in such lending.

A second reason for believing thrifts will not abandon their specialization in home mortgage loans once a common charter is adopted is the fact that most thrifts now hold more home mortgage loans than required. In the nation as a whole, for example, four-fifths of all thrifts exceed the minimum share of housing-related assets established by Congress by more than ten percentage points (FDIC).[23] Looking at the other side of the coin, most thrifts also hold much smaller amounts of business, consumer, and commercial real estate loans than allowed. At the end of 1996, for example, district thrifts held only 1 percent of their assets in business loans and only 4 percent in consumer loans, well below the legal limits for those loan categories. District thrifts also held substantially fewer loans secured by nonresidential real estate and loans for residential construction than allowed. If thrifts could not earn profits investing in home mortgage loans, they would presumably have invested in these other types of loans to the maximum extent allowed.

The last reason for believing many thrifts will continue to specialize in funding home mortgages is that commercial banks have shown this activity can still be profitable. For example, one study examined the relative performance of commercial banks throughout the nation that held 40 percent or more of their assets in real estate loans for at least half of the period 1978-87 (Eisenbeis and Kwast). These banks were found to be both less risky and more profitable on average than a control group of similar-size banks not specializing in real estate loans.[24] Such evidence suggests that well-managed thrifts may still be able to earn healthy profits by specializing in home mortgages, even though securitization has made such profits harder to earn. This conclusion is subject to an important caveat, however. In the study just cited, banks specializing in real estate loans held an average of 45 percent of assets in such investments, much less than a typical thrift. Thus, while specialization in real estate loans may still be profitable for well-managed thrifts, it may be profitable only on a smaller scale, requiring greater diversification into consumer and business loans.

Defining the proper role of credit unions

There is just as much uncertainty about the future role of credit unions in the depository industry as about the future role of thrifts. As noted earlier, the banking industry mounted many legal challenges to the relaxation of the common bond requirement in the 1980s and 1990s. These efforts finally met success in the summer of 1996, when a federal appeals court ruled in the case of the AT&T Credit Union that all members of an occupational credit union must work for the same employee. The credit union industry vigorously protested this decision, and the Supreme Court agreed in 1997 to consider the case. Meanwhile, banks and thrifts have stepped up efforts to persuade Congress to end the tax exemption for credit unions and subject credit unions to the Community Reinvestment Act (CRA)—the law requiring banks and thrifts to meet minimum standards of service to the local community (Murphy, Smale).

Banks and thrifts argue that credit unions have strayed from their original purpose of serving close-knit groups of members and that their special tax and regulatory treatment gives them an unfair advantage in competing for customers. According to this view, either the common bond requirement should be strictly enforced, or the tax and CRA exemptions should be eliminated. Credit unions counter that the relaxation of the common bond requirement allows them to serve the employees of small companies who would be unable to form credit unions on their own. Credit unions also argue they do not enjoy an unfair advantage because they are subject to special requirements that do not apply to banks and thrifts—for example, the requirement to lend only to members (Bickley, Stockeld).

The current debate stems from an inherent dilemma in the credit union movement. The acceptance of members from different occupation groups and the expansion of services make sense from an economic point of view. A credit union with a diversified membership and a wide array of services is less vulnerable to a downturn in a particular industry or sector of the economy. Furthermore, a credit union that can recruit a wide variety of members is more likely to grow large enough to exploit economies of scale in activities such as check-clearing and credit evaluation. But the broader the membership base of credit unions and the greater the extent to which they duplicate services provided by banks and thrifts, the harder it is to argue that credit unions should receive special tax and regulatory treatment.

Three outcomes to the debate are possible, each with different implications for the future role of credit unions. First, credit unions could be allowed to keep their tax exemption and other privileges and continue recruiting members with different common bonds. Under this outcome, which maintains the status quo, the market share of credit unions would probably continue to grow. Second, credit unions could be allowed to retain their special privileges but forced to accept members with a single common bond. Such a policy would deprive credit unions of their main source of growth during the 1980s and 1990s, causing their market share to stabilize or even decline. Finally, Congress could end the tax exemption for credit unions and subject them to the same rules and regulations as banks and thrifts, establishing a single charter for all depository institutions. What would happen under this outcome is less clear. Banks and thrifts claim that credit unions owe their success to the tax and CRA exemption and would shrink without it. But if credit unions are correct that they provide higher quality services than banks and thrifts, they should continue to hold their own even after their special privileges were eliminated.

Whatever the outcome of the debate, credit unions are likely to continue specializing in consumer loans and home mortgage loans. As long as credit unions retain their tax exemption, they will be required to lend to members, ruling out any move into business or commercial real estate lending. And if the tax exemption were ended and credit unions allowed to make the same loans as banks and thrifts, most would probably continue specializing in consumer and home mortgage lending because of their accumulated expertise in those areas.

Prospects for further securitization

While the merger of the bank and thrift charters and the outcome of the credit union debate may alter the structure of the depository industry, the growth of the industry will depend primarily on the progress of securitization. As noted earlier, depository institutions have lost considerable ground to mutual stock and bond funds in the competition for household savings. That loss in market share has been due partly to a shift in household preferences from safe investments to risky investments, as people have become more concerned about saving for retirement and less concerned about meeting sudden cash needs. The main threat to deposit growth, however, is not a further shift in household preferences from safe to risky investments. Rather, the main threat is that securitization will continue to increase the supply of credit from investors and nondepository financial institutions to borrowers who now obtain their funds from depository institutions. Such an increase in the supply of outside credit would lower the returns depository institutions can earn on their loans, preventing them from paying deposit rates high enough to compete with other safe investments such as shares in MMMFs.

How far is securitization likely to proceed? Some analysts believe securitization will extend beyond home mortgages to virtually all types of loans now made by depository institutions. For example, while securitization of consumer loans has grown rapidly since the mid-1980s, the percent of such loans that are securitized is still less than half as great as for home mortgages, suggesting considerable room for further growth. And while secondary markets are much less developed for commercial real estate loans and business loans than for consumer loans, some analysts believe it is only a matter of time before these loans are securitized as well. As these loans became more liquid, investors and nondepository financial institutions would become more willing to hold them, increasing the total supply of credit. Thus, rates on business loans would fall relative to market rates, reducing the profitability of funding loans with deposits. In such a world, banks, thrifts, and credit unions that were highly efficient at originating and servicing loans would continue to prosper. They would do so, however, by earning fees rather than attracting and investing deposits.

While such dramatic growth in securitization cannot be ruled out, it seems unlikely. One reason the securitization of home mortgages has progressed so far is because of the encouragement of the federal housing credit agencies, which are either owned by the federal government or viewed by investors as having the implicit backing of the federal government due to government sponsorship. Another reason is that home mortgage loans are highly standardized and backed by collateral whose value can be easily determined, especially when the loans are pooled in large groups. Federal credit agencies have not become as involved in the securitization of other types of loans. Furthermore, while auto loans are well-collateralized, other types of consumer and business loans are either unsecured or backed by collateral whose value depends on the success of the business. For some types of loans, such as small business loans, the performance of the borrower must also be monitored after the loan is granted—a task the lender may not perform properly unless it retains a substantial interest in the loan (Beshouri and Nigro). Thus, while further growth in securitization can be expected, the depository industry should still have an important role to play in funding loans.[25]

III. CONCLUSIONS

The period since 1979 has been one of dramatic changes in the depository industry in Tenth District states. First, there has been a substantial decline in all three types of depository institutions, a development due partly to the high number of failures but mainly to the high rate of mergers. Second, the industry as a whole has shrunk, with deposits falling both in real terms and relative the district economy. The main cause of this contraction was increased competition for loans and deposits from outside the industry, sparked by rapid growth of mutual funds and secondary mortgage markets. The high rate of failures acted as a catalyst, however, by speeding the exodus of resources from the industry and imposing substantial costs on surviving institutions. Third, the role of thrifts has declined sharply relative to that of banks and credit unions, because outside competition has increased more for home mortgages than other types of loans and because thrifts specialized heavily in home mortgages. Finally, the three institutions have become more similar in the composition of their assets, with banks and credit unions shifting into real estate loans to diversify their portfolios and exploit the potential demand for mortgages among their existing customers.

As significant as these changes have been, still more appear in store. Congress has promised to merge the bank and thrift charters, allowing thrifts to make the same loans and investments as banks. And recent court decisions have tightened membership requirements for credit unions, threatening to slow their explosive growth. Finally, the securitization trend is likely to continue, making it harder for all three institutions to earn profits by funding loans with deposits. As these events play out, the long-standing differences among banks, thrifts, and credit unions are likely to narrow still further. Many of these institutions will continue to seek their own niches, however. And contrary to some predictions, securitization will not progress so far that depository institutions lose their inherent advantages over other lenders.

ENDNOTES

[1] In other parts of the country, thrifts included mutual savings banks, which had somewhat broader lending and investment powers than savings and loans associations.

[2] Commercial banks have always enjoyed this access. Thrifts and credit unions were granted access by the Depository Institutions Deregulation and Monetary Control Act of 1980, which also subjected them to the same reserve requirements as commercial banks.

[3] Further details on the causes and consequences of district bank mergers can be found in Keeton. Besides the mergers shown in Table 4, there were a substantial number in which different organizations merged but the banks in each organization retained their charters. Such mergers are not shown in the table because they did not reduce the number of banks.

[4] Two other developments contributed to thrift mergers. First, the thrift bailout legislation passed in 1989 authorized bank holding companies to acquire healthy thrifts and consolidate them with their subsidiary banks. And second, regulators authorized all thrifts to branch across state lines in 1992.

[5] Credit unions headquartered in district states had average assets of only $7 million in 1979 (1996 dollars), compared to $80 million for banks and $256 million for thrifts.

[6] The total number of banks lost through mergers and failures exceeds the total decline in banks shown in Table 1 by a substantial margin because about 420 banks were gained through new charters and 90 banks through conversions from thrifts or uninsured industrial banks.

[7] Specifically, the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Act of 1982 permitted federally chartered thrifts to invest up to 30 percent of their assets in consumer loans, up to 40 percent in commercial real estate loans, up to 11 percent in business loans and corporate debt securities, and up to 3 percent in "service corporations" set up to finance real estate ventures.

[8] Thrifts inclined to gamble were also helped by a substantial increase in the deposit insurance limit in 1980 and by the gradual phasing out of deposit rate ceilings beginning in 1978—two factors that made it easier for risky depository institutions to raise funds.

[9] Specifically, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) authorized $50 billion of government borrowing to pay for the cleanup and created a new entity called the Resolution Trust Corporation (RTC) to expedite the disposition of insolvent thrifts.

[10] Examples of these services include originating and servicing loans sold to other investors, supplying backup lines of credit, and providing derivative securities such as interest rate swaps.

[11] The two agencies that issued MBSs directly were FHLMC ("Freddie Mac") and FNMA ("Fannie May"). They were government-sponsored enterprises viewed by investors as having the implicit backing of the federal government. GNMA ("Ginnie May"), which was wholly owned by the federal government, promoted the secondary market by guaranteeing certain kinds of privately issued mortgage-backed securities.

[12] The reduced attractiveness of funding mortgages with deposits was reflected in a steep decline in the share of home mortgages held by the depository industry in the form of either whole loans or MBSs—from over 72 percent at the end of 1979 to only 47 percent at the end of 1996. It should be noted that improved secondary markets also made mortgage investments safer and more liquid for depository institutions. These positive effects were outweighed, however, by the decline in mortgage rates due to increased supply.

[13] The decreased attractiveness of funding consumer loans with deposits was reflected in the share of total consumer credit held by depository institutions. That share fell from 72 percent at the end of 1979 to 59 percent at the end of 1996, with all the decline occurring after 1988.

[14] The share of short-term business credit held by depository institutions (mainly commercial banks) fell from 63 percent at the end of 1979 to 51 percent at the end of 1996, with all but two percentage points of the decline occurring in the 1980s.

[15] The 1.25 percent target was established by Congress in the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. Another direct cost of failures to surviving thrifts was that FIRREA required FHLBs to contribute part of their net worth and annual earnings to the thrift bailout. This requirement acted as a tax on thrifts because the FHLBs were owned by their thrift members (White).

[16] Congress also required regulators to set detailed safety-and-soundness standards on such matters as management,

asset quality, and earnings, causing depository institutions to complain of "micromangement" by regulators. Most of the detailed safety-and-soundness standards ended up never being adopted, however—first because regulators could not agree on standards, and then because Congress decided to allow regulators to issue general guidelines instead of quantitative standards (GAO 1996).

[17] Through the examination process, regulators also pressured banks to avoid risky loans and investments in the early 1990s, contributing to a nationwide slowdown in lending commonly referred to as the "credit crunch." It is unclear, however, how much of the slowdown was due to regulatory pressure and how much to increased caution on the part of banks and borrowers. Furthermore, regulators quit pressuring banks to avoid risky loans and investments once the severity of the lending slowdown became evident.

[18] From 1979 to 1994, the ratio of bank deposits to gross state product fell from 0.41 to 0.38.

[19] Adjusted for inflation, farm loans fell a total of 28 percent over four years (1983-87), while business loans banks fell a total of 46 percent over eight years (1984-92).

[20] Since banks held mostly short-term assets, they could also increase their mortgage holdings substantially without having to worry as much as thrifts about interest rate risk.

[21] Recent actions by the courts and regulators may cause this difference in the two charters to become somewhat less important. Specifically, federal courts have expanded the authority of national banks to sell insurance, while the Comptroller of the Currency has ruled that subsidiaries of national banks can engage in some activities prohibited for the bank.

[22] For example, federally chartered thrifts are currently subject to limits of 20 percent of assets for business loans, 35 percent for consumer loans, and the greater of 5 percent of assets or 100 percent of capital for residential construction loans.

[23] This minimum is contained in the Qualified Thrift Lender test, which requires that thrifts invest at least 65 percent of their assets in housing-related instruments to retain their greater holding company powers and their access to credit from the FHLBs. The test was first imposed in the Competitive Equality Banking Act of 1987 and has undergone several changes since then.

[24] The banks specializing in real estate loans held about two-thirds of these loans in the form of residential real estate loans and the rest in the form of commercial real estate loans. Data for 1996 suggest that the relationship found in the study also holds for district banks, although results for a single year must be treated with caution. Among banks with less than $300 million in assets, return on assets was 1.57 percent for those with over 40 percent of assets in residential real estate loans, 1.39 percent for those with 20 to 40 percent of assets in real estate loans, and 1.22 percent for those with less than 20 percent of assets in real estate loans.

[25] Some analysts argue that the depository industry may contract even in the absence of securitization. According to this view, illiquid loans can just as easily be originated and held by finance companies that raise funds by selling commercial paper. A good argument can be made, however, that deposit insurance gives depository institutions an inherent advantage over finance companies in funding illiquid loans—-in contrast to finance companies, depository institutions do not have to worry their funding will unexpectedly dry up due to a sudden loss of confidence by investors.

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