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VIRGINIA S&L SURVEY RESULTS - SUMMER, 1981

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E.C.R.S.B. 81-5

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The current difficulties of the nation's thrift industry are mirrored in the results of a recent survey of the member organization of the Virginia League. The survey indicated that Savings & Loan Associations in Virginia are undergoing a financial squeeze of unprecedented intensity, a squeeze that is exceeding earlier expectations. The Survey also showed that coming to terms with this crisis is proving to be difficult.

During the summer of 1981, 88 member Associations of the Virginia League were asked to respond to a questionnaire relating to profitability, asset and liability management, and policy alternatives. The response rate was excellent--with 53 Associations answering the questions in some detail. A summary of responses to the various questions was given in a presentation before the fall Management Conference of the League. The present article seeks to provide a broad interpretation of the Survey results.

The Profit Picture

Bleak, of course, is the operative word here.

But, the important modifying phase is "worse than previously expected", as indicated in the table below.

Table 1

Profit Expectations: 1981
(Percent of All S&L's Expecting Profit/Loss

	As of August, 1981		As of March, 1981	
	Profit	Loss	Profit	Loss
Profit/Loss Range				
Less than $50,000	5.9%	9.8%	NA	3.2%
$50,000-$150,000	5.9	3.9	NA	3.2
$150,000-$300,000	-	11.8	NA	12.9
$300,000 or more	1.9	60.8	NA	32.3
	13.7%	86.3%	48.4%	51.6%

This profit squeeze reflects, of course, the negative spread shown in Table 2.

Table 2

Distribution of S&L's Experiencing Positive/Negative Spread 1/

S&L Asset Size
($Million)

Basis Points	Under $50		$50-$150		Over $150	
	Positive	Negative	Positive	Negative	Positive	Negative
1 - 50	28.6%	14.3%	0%	18.8%	5%	25.0%
50 - 100	0%	14.3%	0%	25.0%	0%	15.0%
100 - 150	14.3%	14.3%	0%	12.5%	0%	20.0%
150 - 200	0%	0%	0%	25.0%	0%	15.0%
Over 200	7.1%	7.1%	0%	18.7%	0%	20.0%
	50.0%	50.0%	0%	100.0%	5%	95.0%

1/ Spread is defined as the difference between percentage yield on earning assets and the percentage cost of funds including deposits and borrowings.

Another set of statistics also illustrates the problem of the adverse spread. Of the fixed-rate mortgages held by associations, some 60% yield less than 10% while one-half of the Associations have half of their liability portfolio in money market certificates yielding (obviously) well over that 10% figure for 1981. Even more ominous (and a statistic considered later in this article) is the fact that approximately 80% of the fixed rate mortgages yield less than 12%.

Need for Flexibility

The figures on profitability well illustrate the unhappy and deteriorating environment for all but the newest and most insulated Associations. The question obviously arises as to what can be done to meet this challenge.

One answer would seem to lie in the attainment of more flexibility. Data from the Survey indicate that Associations are making some progress in this direction but losing ground in others. This is indicated in several ways.

First, loans processed by participating Associations in the second quarter of 1981 reflected that [illegible] [illegible] naturally, appeared to be restrained. Two-thirds of the Associations were doing at least some second mortgage lending. Few of the Associations, however, were making more than ten percent of their loans in this category, and consumer loans were being initiated by only a handful of firms.

Second, funds raised with money market certificates have been invested in such a way as to enhance liquidity of the Associations. Investments in short-term securities were reported by some two-thirds to three-fourths of the participating Associations. While this does not appear to be consistent with the longer run role of thrift institutions in our economy, it is a necessity for the time being.

Third, Associations are obtaining NOW accounts at a rapid pace. The number of NOW accounts increased by 30 to 40 percent in the second quarter of 1981, and average balances fell by relatively small amounts. Yet it must be noted, that these more expensive new accounts were not compensating by any means for the loss in passbook deposits experienced in that quarter. On a total-dollar basis for passbook plus NOW accounts, the drain was at a rate of over ten percent per year. This suggests these funds were being lost--certainly to higher yields and possibly to competing institutions. Retention of funds in these categories thus would appear to be a holding operation at best.

Fourth, adjustable mortgates were becoming a definite fixture in the mortgage picture in Virginia in the second quarter of 1981. About one-fourth of the participating Associations were offering "variable rate" mortgages exclusively. Nearly three-fourths were offering the variable rate in some degree. Here, again, certain cautionary notes should be sounded, as indicated in the following discussion.

Adjustable Mortgage Experience

Despite the indications--noted above--that the industry is moving into the realm of adjustable (i.e., market-sensitive) mortgage instruments, the facts are that the steps are somewhat tentative, are coming at possibly a rather late point in the interest-rate cycle, and may not be based on the best choice of variable rate index.

That the move to variable rate mortgages is less than vigorous is indicated by the fact that only a fourth of the Associations are exclusively in this category, and for a large portion of those offering both fixed and variable-rate paper, some 90 percent of all mortgages were in fixed rate instruments. That the policy of offering such mortgages may be coming late in the cycle is, of course, partially a matter of conjecture and projection of future interest rates. If mortgage rates have reached a peak, and there is some evidence to suggest this, then the addition of fixed rate mortgages at the currently high rates should be attractive. And that the preferred index is perhaps not optimal is indicated by the fact that some half the Associations prefer or use the FHLBB National Mortgage Contract Rate--hardly a rate that moves readily with changes in the cost of capital to savings and loan associations. The volatile Treasury Bill note is becoming widely used but is an equally questionable instrument for indexing mortgage rates. The use of indexes that are acceptable in the secondary market also suggests that many of the market-sensitive mortgages are being sold; therefore, they will offer little relief during future interest rate fluctuations.

The Virginia industry should be rated as moderately successful in the light of consumer resistance to, or perhaps lack of familiarity with, these new mortgages. Consumers by a heavy majority are seen as having "reluctant" to only "fair" acceptance of such terms. And the experience in Virginia is quite similar to that in the nation as indicated by a recent survey conducted by the American Mortgage Insurance Company.

Asset and Liability Management

It is self-evident that the management and matching of costs and maturities of assets and liabilities is the road to survival and ultimate profitability in the industry.This lesson was learned by commercial banks during the past 15 years and their experience and flexibility have assisted in maintaining profitability during a particularly adverse period. The question is one of which direction and at what pace management should proceed. The Survey indicated that the industry is proceeding cautiously to develop some answers.

Firms making positive efforts to reduce the low interest components of their mortgage portfolios constitute a sizeable percentage of the participating Associations. Most popular was the refinancing of the lower rate mortgages, with some attention to inducements for early payoff as well as to wraparounds.

On the liability side, some forty percent of the larger Associations contemplate the use of rated securities (backed by mortgage portfolio) to address the asset-liability management problem, associated with long term mortgage lending.

About one-third of the Associations are either studying or using futures trading to the extent recently permitted by more liberal rules from the FHLBB (i.e., trading in excess of 5%). This may not seem to be a large proportion, but it should be pointed out that futures trading is hardly a field that is included in the behavioral reportoire of most businesses anywhere so that the aura of mystery surrounding this activity must be dispelled before much use of this tool can be expected. Of course, more and more materials are appearing on this subject, e.g., the recent report from Chase Manhattan Bank. in its <u>Economic Observer</u>.

<u>Prospects and Policies for the Future</u>

The readings from our Survey constitute both a call for action and a recommendation for increased selectivity in policies to be adopted by the industry and by regulatory bodies.

Action is required because the portfolio problem of most Associations is indicated, by the Survey, to be more severe than generally realized outside the industry. Even if interest rates fall, for example, to the 12 percent range, firms will still experience portfolio problems. The situation is not, in other words, self-correcting in the short run.

Selectivity is emphasized because whatever measures are taken must be effective, and indeed one might say, powerful. Yet the indicated directions of change are into uncharted waters for savings and loan firms--i.e., new types of lending, futures trading, equity investment and similar ventures.

Part of the current difficulties are attributable to deregulation or the lack of regulation of competing institutions. Additional freedom from existing rules may be necessary for the thrift institutions if they are to adjust effectively to the new financial environment. Access to more profitable lending opportunities and new fund raising instruments will undoubtedly be required.

The attainment of such goals will, it is obvious to say, challenge the industry. If, however, a definite start can be made on achieving the necessary flexibility, and if inflation is brought under some measure of control by wiser government policies than some of those over the last decade, then there is still reason to believe that the 1980's can be a happier experience for the industry than might be projected from the experience of the last two or three years of extreme difficulty.