

# FRBSF WEEKLY LETTER

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## Crises in the Thrift Industry and the Cost of Mortgage Credit

During the thrift industry crises of the 1980s, the preferred policy in dealing with undercapitalized or insolvent thrift institutions was one of capital forbearance. For example, legislation enacted in the early 1980s substantially reduced the capital requirements imposed on thrifts. Furthermore, regulatory accounting principles introduced during that period masked the insolvency of many institutions. Broad consensus among industry analysts suggests that delays in the closure of insolvent institutions led to substantial increases in both the direct and indirect costs of thrift resolution.

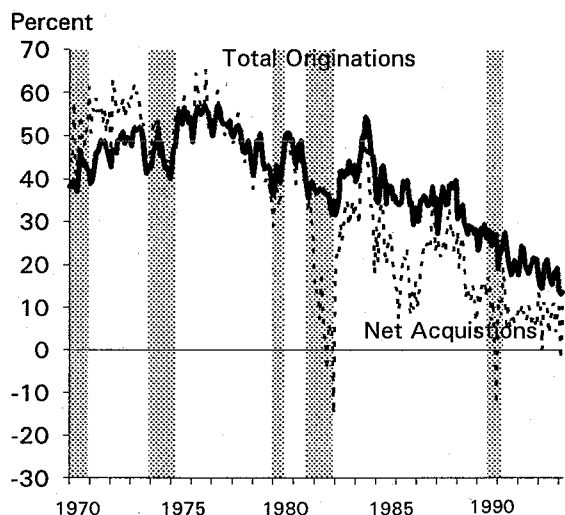
This *Weekly Letter* explores an issue that may not be well-appreciated, namely, that the immediate closure of all insolvent thrifts during the early 1980s would have imposed a different set of costs on the economy, in the form of higher mortgage interest rates and concomitantly reduced levels of housing activity. The results show that those adverse effects would have all but disappeared by the late 1980s, owing in large measure to the proliferation of nonportfolio mortgage lenders and the expanded coverage of secondary mortgage markets. Looking back, those larger economic costs associated with immediate resolution of troubled thrifts may have provided some justification for a policy of regulatory forbearance during the early 1980s. By late in the decade, however, there remained little detectable mortgage rate effect associated with thrift industry operation, providing further credence to a policy of immediate resolution of troubled institutions, rather than forbearance.

### Adverse developments in the thrift industry

Historically, thrifts have been specialized mortgage lenders with considerable expertise in evaluating potential borrowers, establishing long-term relationships with customers, and designing loan agreements that reduce adverse selection. Such expertise, along with tax incentives, gave thrifts a prominent role in providing housing finance. During the mid-1970s, thrifts accounted for as much as one-half of all home mortgage originations in the United States.

In recent decades, the relative advantage thrifts enjoyed in housing finance has diminished. As shown in Figure 1, thrifts' shares of mortgage acquisitions and mortgage originations have declined since the late 1970s. The downward trend can be traced to a number of developments. One is intermittent industry crises. During the early 1980s, the run-up in interest rates, along with the mismatch in the maturities of thrift assets and liabilities, contributed to a high level of disintermediation and a large number of thrift failures. As a result, the thrift share of mortgage credit fell back sharply. Furthermore, regulatory and technological changes—including the removal of Regulation Q—have eroded the relative advantages of thrifts in mortgage lending. Those changes also have permitted the separation of mortgage origination, servicing, and holding functions, facilitating the flow of capital into mortgage markets from general capital markets and other sources. Hendershott (1989) and others have argued that the distinguishing characteristic

**Figure 1**  
Thrifts' Shares on the Decline



\*Source: U.S. Department of Housing and Urban Development and Office of Thrift Supervision

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of thrifts—that of holding mortgages in portfolio—may no longer be economically viable. They point to a decline in the spread between rates earned on mortgage assets (adjusted for the values of the default and prepayment options imbedded in the mortgage contract) and the all-in thrift cost of funds.

It is not surprising then that over the course of the past decade, the development of secondary mortgage markets has supported the proliferation of a large number of competitors. Nor is it surprising that lenders in primary markets now often base their credit decisions on underwriting guidelines set forth by secondary market institutions such as Fannie Mae and Freddie Mac.

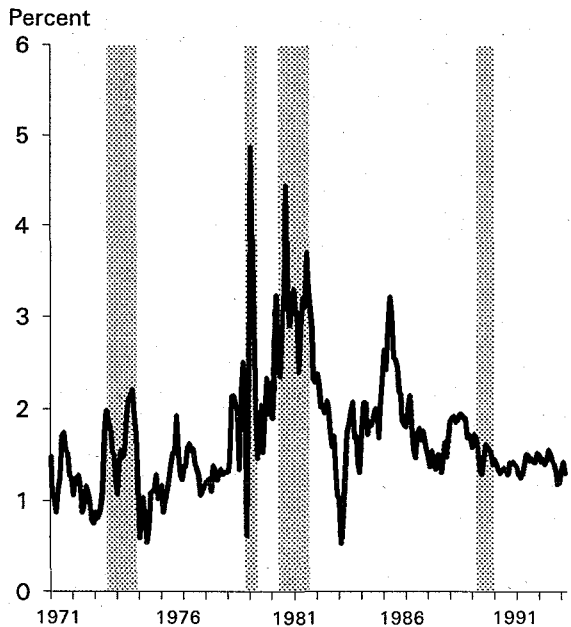
While many individual thrifts remain economically viable, these developments have raised questions about the future of specialized federally insured institutions to promote housing finance. Analysts and policymakers alike also have expressed concerns about the larger economic effects of crises in the thrift industry. These issues take on greater significance in the wake of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), which imposed much of the ultimate burden of resolving troubled institutions on the taxpayer.

## Thrift lending activity and mortgage interest rates

One way to gauge the effects of thrift crises on the larger economy is to examine the movement in fixed rates on mortgages relative to other interest rates. In the early 1980s, the reduction in thrift provision of mortgage credit coincided with a sharp increase in the interest rate spread between fixed-rate mortgages and comparable maturity Treasury securities. For example, rates on fixed-rate mortgages averaged 16.36 percent in 1981–82, reflecting a 291 basis point markup over comparable maturity Treasury securities. This spread was about twice that recorded for the 1975–1980 period. On balance, then, the disruption to the thrift industry during that period may have reduced the aggregate supply of mortgage credit and resulted in relatively higher mortgage interest rates. Given the sizable and well-documented interest elasticity of housing demand, the disruption to the thrift industry during the early 1980s may have exacerbated the cyclical downturn in housing activity.

In recent years, the thrift share of mortgage originations has continued to trend down. By early 1994, thrift market share had declined to less

**Figure 2**  
Mortgage Rate–Treasury Spread



than 20 percent, off substantially from levels recorded during the mid-1980s. The most recent disruption in the thrift industry, a tightening of thrift regulation under FIRREA, and increased competition from non-thrift lenders all have served to reduce thrift presence in the market. The more recent decline in thrift market share, however, appears to have had little effect on the pricing of mortgages in the primary market.

Our recent research (Bradley, Gabriel, and Wohar forthcoming) takes a more systematic approach to evaluating the influence of periodic disruptions in the thrift industry on mortgage credit intermediation and housing activity. The research is based on an econometric model that analyzes the links between shocks to the thrift industry during the 1980s and the loss of thrift intermediation services. From these results, we evaluate the effects of contraction in thrift mortgage market intermediation on the price of mortgage credit.

The econometric analysis uses intertemporal fluctuations in net new deposits to proxy the effects of disruptions in the thrift industry on the ability or willingness of those institutions to provide mortgage credit. We use the deposit measure because it reflects the view prevalent in the early 1980s that thrift supply of mortgage credit moved in step with thrift deposit flows.

Furthermore, it also allows us to simulate and empirically distinguish between the intermediation effects of sizable declines in net new deposits during the early and late 1980s. The model first analyzes the influence of fluctuations in net new deposits on the thrift share of residential 1-4 family net mortgage acquisitions. Subsequent statistical analysis evaluates the effects of thrift market share on the interest rate spread between conventional fixed-rate mortgages and comparable maturity Treasury securities. In undertaking that analysis, we control for the values of the borrower prepayment and default options embedded in the mortgage asset. Risk borne by the mortgage holder for potential borrower default or loan prepayment serves to explain much of the upward adjustment in mortgage rates over comparable maturity Treasury securities.

Our research results indicate that during the late 1970s and the early 1980s, a sharp curtailment in thrift intermediation activities would have significantly reduced the supply of loanable funds and boosted mortgage interest rates. Our simulations suggest that if all institutions that became market-value insolvent in early 1982 had been immediately resolved by the thrift regulatory agency, interest rate spreads between mortgages and Treasuries would have moved up in that year by about 30 basis points. Such an effect is not inconsequential, given that the mean value of that interest rate spread was 150 basis points during the 1975-1980 period. However, our analysis also indicates that both the magnitude and the statistical significance of the thrift affect on mortgage-Treasury rate spreads declined rapidly during the latter part of the 1980s. More specifically, little home mortgage or housing market consequence is ascribed to immediate resolution of troubled thrifts during the more recent period.

### Conclusions

Results of our research suggest that the thrift crisis of the early 1980s imposed real costs on the economy by reducing the amount of mortgage credit intermediation. In particular, the interest rate spread between mortgages and comparable maturity Treasury securities during that period was considerably higher than it would have been if those disruptions had not occurred. Those higher mortgage interest rates served to damp

the demand for housing and in so doing exacerbated the decline in economic activity recorded during early years of that decade. In hindsight, then, the policy of regulatory forbearance followed by the thrift regulatory agency may have enabled other providers of mortgage credit to substitute for the credit provided by thrifts, thus reducing the disruption to mortgage markets. Research findings further suggest that the disruption to the mortgage market would have been significantly worse, if all thrifts had been immediately resolved in the early 1980s. Of course, such benefits of a policy of forbearance must be weighed against the substantial costs associated with the delays in closing troubled institutions.

Having said that, our research also clearly indicates a severing of the link between thrift provision of mortgage credit and mortgage interest rates during the post-recession years of the 1980s. This is attributable, in part, to developments in primary and secondary mortgage markets which permitted the mortgage product to be unbundled. Many thrifts remain viable providers of mortgage intermediation services in the evolved housing finance and regulatory environment. However, concerning the large number of troubled institutions that have been closed in recent years, our research suggests little effect of industry contraction on the price or availability of mortgage credit or more generally on the demand for housing.

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