

Do Thrifts Matter?

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Are the tribulations of the thrift industry a matter for serious concern on the part of the home building industry? The historical relationship between thrifts and housing, and the continuing dominant role of thrifts in mortgage originations, suggest that it is a critically important issue. But the development of the secondary mortgage market and the entry of new types of investors suggest otherwise.

Figure 1 compares housing starts with the flow of deposits into thrifts over the preceding year. It shows that, until the mid-1980s, every movement in housing starts has been preceded by flows of deposits in and out of thrifts.

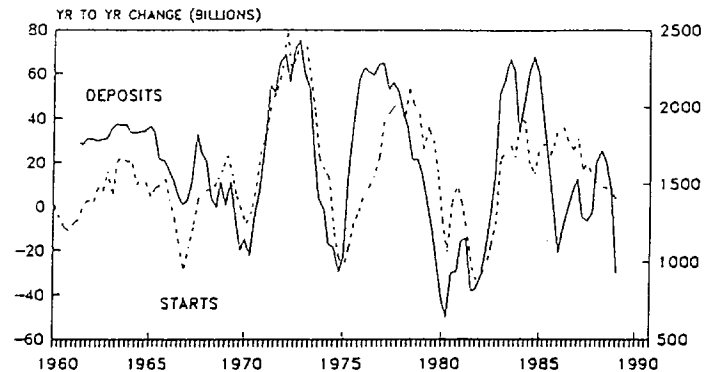
In the 1960s and 1970s, thrifts had little control over their deposit flows. The interest rates they were able to pay depositors were regulated. Even their freedom to give away toasters was controlled. When yields on competing investments rose, they lost deposits. It was then common for them to refuse applications for loans from qualified borrowers just because they didn't have enough money.

After deregulation, thrifts had more active control over the inflow of funds. They could "buy" more deposits. Also, more thrifts took advantage of the opportunities to make loans and fund them through secondary market sales. Those changes weakened the link between deposit flows and mortgage availability.

The proposed new capital requirements for thrifts and increased premiums for deposit insurance will restrain thrifts' growth and erode their competitive position relative to banks. Even though thrifts will remain involved in housing finance, their share will inevitably shrink because their total assets will grow more slowly.

S&L's continue to be the primary originators of mortgage loans. In 1988, S&L's and mutual savings banks originated 50% of the long-term loans on 1 to 4 family homes. The thrifts' share of mortgage originations was about the same a decade ago.

Figure 1 Change in Real Deposits at Thrifts vs Starts, 1960-89



Y-Quarter change in deposits in 1982 dollars (deflated using CPI)

Sources: Deposits—Federal Home Loan Bank Board, Starts—WEFA

To maintain their share of originations, thrifts have acted more like mortgage bankers. They originated loans, but sold much of that originations volume into the secondary market. In terms of net acquisitions (originations minus net sales), thrifts accounted for only 31% of 1988 volume of 1 to 4 family long-term loans. In addition, however, thrifts have purchased a substantial volume of mortgage-backed securities.

The tenuous financial condition of the thrifts in the 1980s and the deregulation of financial institutions in the late '70s and early '80s—which lifted interest ceilings on deposits and allowed thrifts more freedom to invest in areas other than home mortgages—might have been expected to make mortgage loans more expensive. Figure 2 shows that single family mortgage rates are not much higher relative to Treasury bonds than in the 1970s, despite the higher overall level of rates and greater uncertainty about future rates and prepayments. (When lenders or investors perceive increased risk of adverse prepayments, they demand a higher premium for holding mortgages or mortgage-backed securities.)

Single Family Lending

Single family long-term mortgages would probably be about equally available and equally priced if thrifts were to gradually disappear. That's especially true for FHA and VA loans, few of which are originated by thrifts. Conventional fixed-rate conforming (i.e., below \$187,600 and eligible for purchase by Fannie Mae or Freddie Mac) loans would also be relatively unaffected, because most such loans are packaged in mortgage-backed securities and sold to the general investment community.

It has been suggested that rates on those types of mortgages may be elevated because of the threat that thrifts will dump their large holdings of mortgage-backed securities in order to raise cash. Moreover, if demand for mortgage-backed securities from thrifts contracts, yields will need to be higher in order to attract other investors. The capital markets, however, have extremely elastic demands, and the additional return required may be so small as to be imperceptible.

Rates on "jumbo" fixed-rate mortgages (i.e., those over \$187,600) tend to be about 3/8 % over rates on otherwise-equivalent conforming loans. Many of those loans currently end up in mortgage-backed securities in the secondary market; but without guarantees from Ginnie, Fan-

nie, or Freddie, they require some alternative credit enhancement, such as over-collateralization or the assumption of risk by an issuing lender (often a thrift). Because any such guarantees will have to be backed by additional capital under proposed thrift capital rules, new means of funding jumbo loans may be required, and the effect may be to make such loans slightly more expensive relative to conforming loans.

Adjustable rate mortgages have not been widely traded in the secondary market, in part because many thrifts have priced ARMs so aggressively that other secondary market investors have found the yields inadequate. One effect of the thrifts' deposit losses and of proposed new regulations has been to discourage the deep initial discount (teaser) rates offered on ARMs by thrifts. Expect ARM rates to be higher and underwriting standards to be tighter (e.g., qualification based on the maximum second year rate).

Multifamily Finance

Thrifts have been even more important for long-term loans on multifamily (5 or more unit) properties than for single family loans. The thrifts' 1988 share of multifamily originations was 54%. More important, most of those loans were retained in portfolio, because the secondary market is limited and secondary market sales are generally in the form of whole loans rather than mortgage-backed securities (except for FHA-insured loans).

Thrifts are especially important for small multifamily property owners. Large, well-established owners and developers are able to directly access life insurance companies and other large institutional investors or government agencies. The thrifts' share of loans on newly-built multifamily structures is much smaller than their share of loans on existing properties.

One of the reasons that the secondary market is so limited for multifamily mortgages is that there is not uniformity in the terms of multifamily loans. There are wide variations in the length of loans, prepayment penalties, underwriting standards, and other features.

The risk-based capital rules adopted for commercial banks and those proposed for thrifts place all multifamily mortgages in the same risk class as commercial loans, rather than in the lower risk class designated for well-secured single family mortgages. That will discourage multifamily lending and make multifamily loans more expensive relative to single family loans. The capital rules encourage lenders to convert their multifamily mortgages into mortgage-backed securities.

AD&C

Another area where thrifts have been an important source of housing finance is in the provision of loans for land acquisition development and construction (AD&C). Even more than the other types of loans discussed above, AD&C loans are not traded in the secondary market. Thrifts have a smaller share—and commercial banks have a larger share—of these loans than they do of longer term residential loans. For many builders, however, thrifts have been the key source of financing, and

the possible disruption of long-standing relationships is worrisome.

AD&C loans are by their nature not well-suited to secondary market sales. The short-term nature of AD&C loans is, however, attractive to banks, although many banks have been wary of such loans. The likelihood is that commercial banks will become the dominant source of AD&C loans. Underwriting standards will become a little tighter, with loan to value ratios kept relatively low. It will become harder to get financing for projects that are not carefully researched and presented, but perhaps that's just as well. Haphazard lending has poisoned too many markets.

So?

In conclusion, then, it appears that thrifts do matter for housing. They matter most for types of lending that get the least public attention. The tie between thrifts and housing has weakened over the past decade, however, and the housing industry can learn to adapt—at some cost—to further reduction in the number and asset growth of thrifts.

Figure 2 Mortgage Rate vs 10 Year T-Bond

