If thrifts that are poorly capitalized (i.e., those having less than 3 percent GAAP net worth) are included, the financially weak segment of the thrift industry rises to a total of 1,300 institutions, or 41 percent of all FSLIC insured institutions. As of June 1985, six weak thrifts had assets of almost $433 billion, or nearly 43 percent of total industry assets. The GAO study also found that low net worth is correlated with low profitability. Thus, we can infer that lower interest rates have not improved the earnings of the weakest segment of the industry on any sustainable basis. Thifts have made significant strides to protect themselves. The duration of their assets today is shorter than it was during the 1981-82 recession, when they were a whole, however, have taken limited advantage of new asset powers under the Garn-St Germain and the DIDMCA Acts. Some observers are critical of the slow pace at which they are adjusting to their new powers. However, many thrifts apparently have adopted a more diversified pace because it allows them to become familiar with these powers more wisely and prudently.

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Concluding Remarks
It is evident that a large segment of the thrift industry has only marginally benefited from lower interest rates since 1983. Using the GAO's data, the financial condition of 471 thrifts, or 15 percent of the industry has, in fact, worsened or failed to improve, even as rates have fallen. It is still far from clear that marginally lower interest rates are eventually to ease their financial problems.

There is even a larger thrift industry group whose long-term viability depends on a sustained period of low interest rates in the future. This group comprises about 800 thrifts (26 percent of the industry) that are currently profitable, but that have negative or extremely low net worth under GAAP.

Setting Up Thrifts for a Crisis
The vulnerability of thrifts stems primarily from their traditionally narrow composition of assets and liabilities. Historically, thrifts specialized in offering savings deposits and mortgage loans. This special role was recognized in the 1930s with establishment of the FHLBB and the Federal Savings and Loan Insurance Corporation (FSLIC). During the 1960s and the 1970s, government policy encouraged thrift industry growth in an effort to stabilize the already capital-depleted thrifts in a situation of paying out more than they take in—and when interest rates rise.

During the 1981-82 recession, high interest rates sparked a financial crisis in the savings and loan (thrift) industry. A number of companies were liquidated; others required help from the Federal Home Loan Bank Board (FHLBB). Since then, the industry has shrunk from about 4,000 to 3,200 institutions. The FHLBB has begun taking steps to repeal liberalized thrift powers, but they have not yet materialized.

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Initial Adjustments in the 1970s and Early 1980s

Beginning in the late 1970s, rising interest rates and the stringent regulation of thrifts' lending and deposit-taking activities began to stress thrifts. To counter these problems, thrifts began changing their balance sheets to increase their net income. This move was made necessary by the tight regulatory environment. While the thrifts attempted to increase their yields on assets sold in the mortgage market, they also found themselves increasingly tied to capital-based standards that limited interest rate risk but imposed significant capital requirements. In response, thrifts began selling nonmortgage assets and repaying deposits with nonmortgage liabilities that provided a better yield.

A major consequence of the 1980 decontrol act is that the susceptibility of thrifts to fund-shifting increased. As a result of being able to offer money market deposit accounts (MMDAs) and other noninterest-bearing deposits such as savings deposits, thrifts had a way to attract funds. In 1980, thrifts reduced their mortgage portfolio by over 77 percent to approximately 61 percent of total assets. At that time, thrifts began replacing their mortgage assets with consumer loans and commercial paper. This change provided a more stable source of income for the thrifts, as the yield on consumer loans was higher than the yield on mortgage assets.

In 1980, thrifts were offering mortgages in the 9 percent to 10 percent range, while paying as much as 15 percent on their short-term, market-rate liabilities. Consequently, from 1980 to 1982, thrifts suffered severe losses (see chart 2). As high interest rates battered thrifts' earnings, and as uncertainty grew over the interest rate environment, some thrifts switched from low-yield, residential mortgage assets to higher-yielding, but riskier, commercial mortgage assets. This strategy adds high-yielding assets at a rapid pace by purchasing high-cost wholesale or brokered deposits. Many insolvent or near-insolvent thrifts viewed this as a way to stabilize their balance sheets and continue to operate. The acquisition of commercial loans, however, increased the risk of the thrifts. These loans were often made to borrowers with poor credit histories, and the thrifts were often not able to recover the full amount of the loan. This resulted in significant losses for the thrifts and contributed to the failure of many thrifts in the 1980s.

In 1984, thrifts were offering mortgages in the 10 percent to 12 percent range, while paying as much as 15 percent on their short-term, market-rate liabilities. Consequently, from 1984 to 1986, thrifts suffered severe losses (see chart 2). As high interest rates battered thrifts' earnings, and as uncertainty grew over the interest rate environment, some thrifts switched from low-yield, residential mortgage assets to higher-yielding, but riskier, commercial mortgage assets. This strategy adds high-yielding assets at a rapid pace by purchasing high-cost wholesale or brokered deposits. Many insolvent or near-insolvent thrifts viewed this as a way to stabilize their balance sheets and continue to operate. The acquisition of commercial loans, however, increased the risk of the thrifts. These loans were often made to borrowers with poor credit histories, and the thrifts were often not able to recover the full amount of the loan. This resulted in significant losses for the thrifts and contributed to the failure of many thrifts in the 1980s.

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