Chapter 6

The Mutual Savings Bank Crisis

Introduction

The first major crisis the FDIC had to confront in the 1980s was the threatened insolvency of a large number of mutual savings banks (MSBs). Historically, state laws had restricted these thrift institutions to investing in long-term, fixed-rate assets; and traditionally, the majority of MSB liabilities were in passbook savings accounts paying a low rate of interest. Until the 1970s, this manner of operating had enabled mutual savings banks to prosper throughout most of their history. However, in the 1970s the combined forces of rising interest rates, increased competition for deposits, and legal restrictions on diversifying the asset side of the balance sheet quickly overwhelmed many thrift institutions. During the first three years of the 1980s the mutual savings bank industry sustained operating losses of nearly $3.3 billion, an amount equivalent to more than 28 percent of the industry's general reserves at year-end 1980. Losses at some individual MSBs were even higher, and these institutions experienced a rapid depletion of capital. This chapter describes the relatively unique development and history of mutual savings banks in the United States and the causes of the crisis that peaked in the early 1980s; it also discusses the regulatory and congressional responses to the problem.

Background

Mutual savings banks in the United States date to 1816, when the Philadelphia Saving Fund Society began operations on a voluntary basis and the Provident Institution for Savings in Boston was granted the first savings bank charter.[1] Originally MSBs were organized to help the working and lower classes by providing a safe place where the small saver, then shunned by commercial banks, could deposit money and earn interest. Unlike savings and loan associations (S&Ls), whose purpose was to facilitate the home ownership of members

[1] For a more complete discussion of MSB history, see Franklin Ornstein, *Savings Banking: An Industry in Change* (1985), 16–26; Alan Teck, *Mutual Savings Banks and Savings and Loan Associations: Aspects of Growth* (1968), 4–55; and Weldon Welfling, *Mutual Savings Banks: The Evolution of a Financial Intermediary* (1968), 8–69.

by pooling their savings and allocating housing loans, the early mutual savings banks were largely the result of a philanthropic impulse: wealthy, public-spirited individuals contributed start-up capital and served as trustees of the bank, overseeing operations without the benefit of remuneration.[2] Initially the investment of MSB funds was restricted to federal and state government bonds. Although depositors in a mutual savings bank technically own the institution's assets and share in its profits, they are neither stockholders nor members, and have no voting rights or influence over how their money is invested.

Soon after the early success of the Philadelphia and Boston banks, MSBs were chartered in a number of states, primarily in the Mid-Atlantic region and the industrial Northeast, where there were large numbers of wage earners seeking a safe haven for their savings. In contrast, demographic and economic conditions in the South and the expanding West favored the development of commercial banks and stock savings associations. Although eventually MSBs were chartered in 19 states, historically more than 95 percent of total deposits in mutual savings banks were accounted for by only 9 states—Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, and Washington.[3]

The earliest MSB charters contained no restrictions on investment powers. In practice, however, the trustee system of savings bank operations fostered conservative management, and this was reflected in most state laws governing mutual savings banks.[4] These statutes specified the types of investments permitted; set ceilings on the percentage of assets or deposits permitted in each type; and laid out detailed criteria for evaluating eligibility. Originally confined to investing in government securities, MSBs were soon permitted to invest in high-grade municipal, railroad, utility, and industrial bonds; blue-chip common and preferred stocks; first mortgage loans on real estate; and other collateralized lending. The expanded investment powers went hand in hand with the rapid growth in both the number of mutual savings banks and their deposits. Between 1820 and 1910, the number of MSBs in the United States grew from 10 to 637, while total deposits grew from $1 million to more than $3 billion.[5]

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[2] As savings banks expanded, management was delegated to professionals appointed by the trustees.

[3] The other ten states in which MSBs were chartered were Alaska, Delaware, Florida, Indiana, Maryland, Minnesota, Ohio, Oregon, Vermont, and Wisconsin. MSBs were also chartered in Puerto Rico and the U.S. Virgin Islands (National Association of Mutual Savings Banks, *1980 National Fact Book of Mutual Savings Banking* [1980], 17).

[4] Ornstein, *Savings Banking*, 21. Notable exceptions were Delaware and Maryland, which left the investment of funds to management's discretion. Ornstein notes, however, that savings banks in these states were "subject to exhaustive examinations by the respective banking departments" (18). Traditionally, investment powers were relatively broad in the New England states and very restricted in New York and Pennsylvania.

[5] John Lintner, *Mutual Savings Banks in the Savings and Mortgage Markets* (1948), 49; and FDIC, *Annual Report* (1934), 112–13.

The considerable success of mutual savings banks during the first century of their history has been attributed to lack of competition for small deposits and to the rapid industrial and economic growth of the areas they served. In addition, mutual savings banks traditionally enjoyed a reputation of providing a high level of safety for depositors.[6] (An FDIC study conducted in 1934 suggested that this reputation might have been exaggerated; nevertheless, during the 1930s MSBs were far less prone to bank runs than either commercial banks or savings and loan associations.[7] Indeed, nearly every year during the 1930s MSBs experienced a net savings inflow.)[8] Although interest in chartering new MSBs diminished after 1910, existing institutions continued to prosper during and long after the Depression. In 1975 the average MSB had more than $250 million in assets, compared with approximately $66 million for commercial banks and $69 million for savings and loan associations (see table 6.1).

The increased demand for housing after World War II meant that a greater proportion of MSB assets were invested in mortgage loans, with the remainder invested primarily in permissible securities. Mortgage loans as a proportion of total assets peaked at more than 75 percent during the mid-1960s, but in the late 1970s mortgage investments (including mortgage-backed securities) still accounted for approximately two-thirds of mutual savings bank assets (see table 6.2). In comparison, in 1975 savings and loan associations, whose primary purpose was to provide funds for housing, held more than 82 percent of their assets in mortgage loans, while commercial banks held only 14 percent.[9]

Until the mid-1960s, savings banks, like other financial institutions, operated in a relatively stable economic environment. By investing in fixed-rate mortgages and high-quality, long-term bonds, MSBs were able to provide an acceptable return on deposits (which were primarily passbook accounts) and build a comfortable capital base. Average reserve ratios at year-end 1975 ranged from 6 percent of assets in New Jersey and Pennsylvania to

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[6] For example, see Ornstein, *Savings Banking,* 154; and Teck, *Mutual Savings Banks*, 118.

[7] FDIC, *Annual Report* (1934), 111–13. For a more detailed discussion, see Arthur Castro et al., *Public Policy toward Mutual Savings Banks in New York State: Proposals for Change* (1974), 86–91.

[8] Ornstein, *Savings Banking*, 54; and Welfling, *Mutual Savings Banks*, 84. As a result of both the paucity of bank runs and the savings inflows, mutual savings banks were generally reluctant to join the FDIC in its infancy and, when the permanent deposit insurance fund began operations in August 1935, only 56 MSBs—less than 12 percent of the total number—were members. Several states organized their own deposit insurance funds, but over the years these were largely abandoned as state laws came to require federal deposit insurance. By 1975, approximately 70 percent of the mutual savings bank industry was FDIC-insured; the remaining 30 percent consisted of Massachusetts savings banks insured by the Mutual Savings Central Fund, Inc. In 1985, as a result of the private insurance crises in Ohio and Maryland, all the Massachusetts savings banks insured by the Mutual Savings Central Fund applied for federal deposit insurance. By late 1986, all those applications had been granted (see Ada Focer, "Savings Banks Get FDIC Protection," *American Banker* [October 27, 1986], 1).

[9] U.S. League of Savings Associations, *S&L Fact Book 1976*, 81.

Table 6.1
Number, Total Assets, and Average Assets of Selected Types of Financial Institutions, Selected Years, 1900–1975
($Millions)

Year	Mutual Savings Banks			Commercial Banks			Savings and Loan Associations		
	Number	Total Assets	Average Assets	Number	Total Assets	Average Assets	Number	Total Assets	Average Assets
1900	626	$ 2,328	$ 3.7	12,427	$ 9,059	$ 0.7	5,356	$ 571	$ 0.1
1910	637	3,598	5.6	24,514	19,324	0.8	5,869	932	0.2
1920	618	5,586	9.0	30,291	47,509	1.6	8,633	2,520	0.3
1930	592	10,496	17.7	23,679	64,125	2.7	11,777	8,829	0.7
1940	540	11,919	22.1	14,534	67,804	4.7	7,521	5,733	0.8
1945	532	17,013	32.0	14,011	160,312	11.4	6,149	8,747	1.4
1950	529	22,446	42.4	14,121	168,932	12.0	5,992	16,846	2.8
1955	528	31,346	59.4	13,716	210,734	15.4	6,071	37,533	6.2
1960	515	40,571	78.8	13,472	257,552	19.1	6,276	71,314	11.4
1965	506	58,232	115.1	13,804	377,264	27.3	6,185	129,459	20.9
1970	494	78,995	159.9	13,686	576,242	42.1	5,669	176,076	31.1
1975	476	121,056	254.3	14,633	964,900	65.9	4,931	338,233	68.6

8.9 percent in New Hampshire, while the ratio for all mutual savings banks nationwide was 7 percent (see table 6.3).[10]

Economic and Legislative Developments in the 1970s

Inflationary pressures in the middle to late 1960s caused interest rates generally to rise throughout the 1970s until, in 1979, they reached unprecedented highs. But already in 1966, 1969–70, and 1973–74, thrift institutions had experienced financial disintermediation and earnings pressures.[11] In 1966 the regulatory agencies tried to help thrift institutions by extending deposit interest-rate ceilings to them, to reduce their cost of liabilities and protect them from deposit rate wars; nevertheless, the ceilings on deposits (although somewhat

[10] Table 6.3 also illustrates the effect of different state laws governing permissible investments, particularly the "other loans" category, which reflects not only differences in consumer lending powers but also the leeway provisions incorporated in many state savings bank statutes. It should be noted that states whose MSBs had the lowest levels of total loans, such as New York, New Jersey, and Pennsylvania, also had the highest concentrations of corporate (and other) bonds—and (as discussed below) produced several of the earliest failures.

[11] Disintermediation is the withdrawal of funds from interest-bearing accounts at banks or thrifts when rates on competing investments, such as Treasury bills or money market mutual funds, offer the investor a higher return.

Table 6.2

Composition of Assets of Mutual Savings Banks, Selected Years, 1900–1980

($Millions)

Year	Mortgage Investments		Securities			Other Loans	Cash and Other Assets	Total Assets
	Mortgage	GNMA Mortgage-Backed	U.S. Gov't	State and Local	Corporate and Other			
1900	$ 858	$ 0	$ 105	$ 567	$ 462	$ 169	$ 167	$ 2,328
1910	1,500	0	13	765	906	194	220	3,598
1920	2,291	0	783	650	1,213	336	313	5,586
1930	5,635	0	499	920	2,278	312	520	10,164
1940	4,836	0	3,193	612	1,429	82	1,764	11,916
1945	4,202	0	10,650	84	1,116	62	849	16,962
1950	8,039	0	19,877	96	2,260	127	1,047	22,446
1955	17,279	0	8,463	646	3,364	211	1,382	31,346
1960	26,702	0	6,243	672	5,076	416	1,463	40,571
1965	44,433	0	5,485	320	5,170	862	1,962	58,232
1970	57,775	85	3,151	197	12,791	2,255	2,741	78,995
1975	77,221	3,367	4,740	1,545	24,626	4,023	5,535	121,056
1980	99,865	13,849	8,949	2,390	25,433	11,733	9,344	171,564
			(Percentage Distribution)					
1900	36.9	0.0	4.5	24.4	19.8	7.3	7.2	100
1910	41.7	0.0	0.4	21.3	25.2	5.4	6.1	100
1920	41.0	0.0	14.0	11.6	21.7	6.0	5.6	100
1930	55.4	0.0	4.9	9.1	22.4	3.1	5.2	100
1940	40.6	0.0	26.8	5.1	12.0	0.7	14.8	100
1945	24.8	0.0	62.8	0.5	6.9	0.4	4.7	100
1950	35.8	0.0	48.5	0.4	10.1	0.6	4.6	100
1955	55.1	0.0	27.0	2.1	10.7	0.7	4.4	100
1960	65.8	0.0	15.4	1.7	12.5	1.0	3.7	100
1965	76.3	0.0	9.4	0.6	8.9	1.5	3.3	100
1970	73.1	0.1	4.0	0.2	16.2	2.9	3.5	100
1975	63.8	2.8	3.9	1.3	20.3	3.3	4.6	100
1980	58.2	8.1	5.2	1.4	14.8	6.8	5.5	100

Source: Ornstein, *Savings Banking*, 260.

Table 6.3
Percentage Distribution of Assets and Liabilities of Mutual Savings Banks, by State, Year-end 1975

Item	Total	NY	MA	CT	PA	NJ	WA	NH	ME	RI	MD	All Other States
ASSETS												
Cash and due from banks	1.9	2.0	1.2	2.0	1.7	2.6	3.2	2.2	2.0	1.3	2.1	3.1
U. S. government obligations	3.9	3.6	4.9	3.2	3.0	5.0	2.8	4.8	5.8	3.7	8.9	5.5
Federal agency obligations	2.3	1.6	4.1	1.8	2.7	3.6	2.8	3.3	2.9	4.9	2.1	2.1
State and local obligations	1.3	1.6	0.7	1.0	1.6	0.9	0.4	0.5	0.9	0.1	0.5	1.2
Mortgage-backed securities	2.8	3.2	1.3	0.8	4.0	6.4	3.0	1.1	1.2	2.4	1.7	0.9
Corporate and other bonds	14.5	15.4	12.3	7.4	27.6	15.3	8.6	5.2	8.5	4.9	7.9	13.6
Corporate stock	3.6	3.1	4.7	6.5	2.4	1.8	2.5	6.0	5.5	4.3	1.7	3.0
Total loans	67.1	66.8	68.8	74.2	54.8	62.2	72.7	74.6	70.9	74.6	71.4	67.9
Mortgage loans	63.8	64.3	64.3	68.4	52.8	59.8	68.2	67.0	65.2	68.8	60.0	64.8
Other loans	3.3	2.5	4.5	5.8	2.0	2.4	4.5	7.6	5.7	5.8	11.4	3.1
Bank premises owned	0.9	0.8	0.9	1.0	0.6	1.1	1.3	1.3	1.4	1.7	0.7	1.2
Other real estate	0.4	0.3	0.3	0.8	0.1	0.1	1.4	0.3	0.1	0.2	*	0.3
Other assets	1.4	1.6	0.9	1.3	1.6	1.1	1.1	0.8	0.7	2.1	3.1	1.2
TOTAL ASSETS	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
LIABILITIES												
Total deposits	90.8	90.0	90.3	89.7	92.1	91.7	91.9	89.0	90.8	89.1	88.8	90.5
Ordinary savings	57.5	58.2	57.1	58.2	55.7	55.2	56.4	59.0	65.0	47.9	70.7	48.3
Time deposits	32.7	32.3	33.1	31.3	35.8	34.1	35.2	29.7	25.5	41.1	15.0	41.1
Other deposits	0.5	0.4	0.1	0.2	0.6	2.3	0.3	0.2	0.3	0.2	2.6	1.1
Borrowings	0.5	0.4	0.1	0.8	0.2	0.7	1.1	0.4	0.2	1.2	-	1.8
Other liabilities	1.8	2.0	1.7	1.6	1.7	1.6	0.9	1.7	1.0	2.1	3.3	1.3
TOTAL LIABILITIES	93.0	93.3	92.1	92.0	94.0	94.0	93.9	91.1	92.0	92.4	92.1	93.6
Capital notes and debentures	0.2	0.1	*	0.4	0.6	0.3	0.2	0.2	*	-	-	0.4
Other general reserves	6.8	6.6	7.9	7.6	5.5	5.7	5.9	8.7	8.0	7.6	7.9	6.0
TOTAL GENERAL RESERVE ACCOUNTS	7.0	6.7	7.9	8.0	6.0	6.0	6.1	8.9	8.0	7.6	7.9	6.4
TOTAL LIABILITIES AND GENERAL RESERVE ACCOUNTS	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: National Association of Mutual Savings Banks, *1976 National Fact Book of Mutual Savings Banking.*

*Less than .05 percent.

higher for thrifts than for commercial banks) caused outflows from financial institutions into higher-yielding investments such as capital market instruments, government securities, and—later—money market mutual funds.[12]

From a public policy perspective, disintermediation had several undesirable consequences. Most important, it both restricted the availability of credit to consumers and increased its cost, particularly for home mortgages; the same consequences affected small and medium-sized businesses that did not have access to the commercial paper market. In addition, because normal cash outlays increased to meet deposit withdrawals while cash inflows decreased as new funds were diverted to alternative investments, disintermediation slowed the growth of financial institutions and caused them liquidity concerns. To have the cash available to meet withdrawal demands, banks and thrifts were often forced either to borrow money at above-market interest rates or to sell assets, often at a loss from book value. The former had a negative effect on earnings, the latter on book value capital.

As early as 1971 these problems were widely recognized at the federal level. In that year the President's Commission on Financial Structure and Regulation, better known as the Hunt Commission, issued its report recommending additional powers for commercial banks and thrifts; it also recommended a variety of other reforms on the liability side of the balance sheet, including a lifting of interest-rate ceilings. These recommendations subsequently received widespread support and, in both 1973 and 1975, were introduced as proposed legislation. The Senate passed the 1975 bill, but the House Committee on Banking, Currency and Housing instead commissioned its own study, *Financial Institutions in the Nation's Economy (FINE)*, which resulted in a set of discussion principles and the drafting of the Financial Reform Act of 1976—but again no legislation was passed.

The failure to enact financial reform during the 1970s can be attributed to conflicting public policy concerns, a lack of consensus among financial institutions, and the successful efforts of special-interest groups to block legislation they perceived as harmful.[13] One example of conflict was the attitudes of different groups toward interest-rate deregulation and expanded powers for thrifts: housing groups and many members of Congress feared that both would adversely affect the cost and availability of mortgage credit; thrifts, too, feared

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[12] Commercial banks had been subjected to interest-rate ceilings on deposits since the Banking Act of 1933. The extension of Regulation Q to thrift institutions was accompanied by a differential allowing a higher ceiling for thrifts than for commercial banks, in order to encourage depositors to keep their savings at thrifts (which were not allowed to offer checking accounts). The differential, originally 75 to 100 basis points, was reduced to 50 basis points in 1970 and to 25 basis points in 1973.

[13] See Donald D. Hester, "Special Interests: The FINE Situation," and James L. Pierce, "The FINE Study," both in *Journal of Money, Credit and Banking* 9 (November 1977): 652–61 and 605–18; and Kenneth A. McLean, "Legislative Background of the Depository Institutions Deregulation and Monetary Control Act of 1980," in Federal Home Loan Bank of San Francisco, *Savings and Loan Asset Management under Deregulation: Proceedings of the Sixth Annual Conference in San Francisco, California, December 8–9, 1980*, 17–30.

the loss of the differential, and they were reluctant to compete directly with banks; and commercial banks supported expanded powers for thrifts only if the differential on deposit rate ceilings was immediately removed.[14] In addition, the regulatory agencies were concerned over the FINE Study's proposal to consolidate regulatory authority. Without a unified constituency, Congress was unable to find a formula for financial reform and abandoned such efforts at the end of 1977.[15]

In the following year Congress turned its attention to other matters of regulatory concern: insider transactions and several highly publicized bank failures in the mid-1970s led to passage of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRIRCA). In addition to placing restrictions on insider lending, this legislation significantly strengthened regulatory enforcement powers by authorizing the agencies to issue cease-and-desist orders against individual bank officials, impose civil money penalties, remove directors of financial institutions, and disapprove changes in control. FIRIRCA also extended for two years the banking and thrift regulatory agencies' ability under Regulation Q to set interest-rate ceilings on deposits and, by allowing existing mutual savings banks to convert from state to federal charters, extended the dual banking system to all types of depository institutions.[16]

In response to the problems caused by disintermediation, regulatory efforts during the late 1970s and early 1980s were aimed at providing the means for commercial banks and thrift institutions to compete more effectively with money market mutual funds. Thus, regulators authorized a greater variety of time deposit instruments with ceilings that varied with market rates. The most important of these instruments was the six-month money market certificate of deposit (MMCD), which was introduced on June 1, 1978. These certificates required a minimum deposit of $10,000, and thrift institutions were permitted to pay a maximum rate of interest equivalent to the Treasury auction discount rate on six-month Treasury bills plus 25 basis points. The introduction of the six-month MMCD was a dramatic change for the savings bank industry. In his remarks to the Savings Banks Association of Massachusetts in October 1978, Saul Klaman, then-president of the National Association of Mutual Savings Banks, noted that June 1, 1978, "will be recorded as the day when the philosophy of fixed deposit interest rate ceilings was shattered" and the industry was "permitted to slug it out toe to toe with high-flying money market instruments."[17] Although this new instrument helped slow deposit outflows at mutual savings banks, it also served to raise the institutions' average cost of funds, since a large proportion of these certificates represented

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[14] Andrew S. Carron, *The Plight of the Thrift Institutions* (1982), 8.

[15] McLean, "Legislative Background," 18.

[16] For a detailed summary of FIRIRCA's provisions, see *Encyclopedia of Banking and Finance*, ed. Charles J. Woelfel, 10th ed. (1994), 452–55.

[17] Saul B. Klaman, "The Changing World of the Savings Bank Industry," *American Banker* (October 23, 1978), 41.

transfers from low-cost passbook accounts. Less than two years after the certificates were introduced, more than 30 percent of MSB deposits were in money market certificates.[18] By curbing deposit outflows, bank regulators had been able to forestall thrift failures due to liquidity pressures, a problem that was particularly acute at mutual savings banks because most were not members of the Federal Home Loan Bank (FHLB) System and therefore did not have access to that source of liquidity.[19]

In March 1980, as interest rates rose to record levels, Congress returned to efforts at bank reform and enacted the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA). Among the legislation's major provisions were the six-year phaseout of Regulation Q interest ceilings, nationwide authority for all institutions to offer negotiable order of withdrawal (NOW) accounts,[20] and an increase in the federal deposit insurance limit from $40,000 to $100,000. DIDMCA also preempted state usury laws for mortgage loans and provided expanded lending powers for federally chartered S&Ls. Finally, the act authorized federal savings banks to invest up to 5 percent of their assets in commercial loans and to accept demand deposits from businesses to which credit had been extended.

Although DIDMCA enacted many of the financial reforms that had been debated for more than a decade, in many respects these changes came too late for MSBs. At the time of enactment, all of them were still operating under state charters, and many states restricted their ability to diversify their asset structure or to invest in higher-yielding assets. Some actions were taken at the state level to liberalize asset powers of thrifts and to alleviate the burden of restrictive usury ceilings, but these measures, like those at the federal level, came too late.

More important, however, the federal tax code continued to provide a strong disincentive for S&Ls and MSBs to diversify their assets. Although the Revenue Act of 1951 had changed the tax-exempt status of thrifts, these institutions could still deduct up to 100 percent of taxable income through the establishment of a bad-debt reserve, whether or not losses actually occurred. Under the provisions of the Tax Reform Act of 1969, the maxi-

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[18] U.S. House Committee on Banking, Finance and Urban Affairs, *The Report of the Interagency Task Force on Thrift Institutions,* 96th Cong., 2d sess., 1980, 6.

[19] The Federal Home Loan Bank System was established in 1932 to provide a central credit system for mortgage lending institutions. The System makes advances to member institutions at interest rates lower than those in the commercial market and thus provides members with an important source of liquidity during periods of disintermediation.

[20] In April 1979 the U.S. Court of Appeals for the District of Columbia had ruled that federal regulators exceeded their authority when they approved automatic transfer (ATS) accounts for commercial banks, share draft accounts for credit unions, and remote service units for savings and loans. All of these accounts were the functional equivalent of interest-bearing checking accounts. At that time, NOW accounts were permitted only in the six New England states. The ruling gave Congress one year to validate the regulations; otherwise, financial institutions would be required to terminate the services and disrupt millions of account holders (McLean, "Legislative Background," 19).

mum deduction for additions to bad debts was allowed only if a mutual savings bank had 72 percent (or an S&L 82 percent) of its total assets in certain qualifying assets (generally mortgages and government securities), and the deduction was lost entirely if less than 60 percent of the institution's assets met the investment standard. Moreover, once an institution failed the qualifying asset test, it was required to recapture some of the previous deduction and incur what might be a substantial tax liability. Therefore, even in states that did expand consumer lending powers during the 1970s, there was no dramatic shift of MSB funds into consumer and other nonmortgage loans.[21] It should be noted, however, that this situation must also be attributed to the fact that prudently building up a portfolio of such loans would have been a difficult and lengthy process.

The FDIC's Response

Although no one could predict the future course of interest rates, it was fairly apparent throughout the 1970s that MSBs (the only thrifts insured by the FDIC) were at risk in a rising rate environment. The FDIC's monitoring of industry trends and surveillance of individual institutions increased during 1977–78, when short-term interest rates rose from approximately 4.5 percent to more than 9 percent (see figure 6.1). The FDIC began a monthly survey of large mutual savings banks and also received periodic reports from the National Association of Mutual Savings Banks (NAMSB). The agency used the surveys to judge the rates of both internal disintermediation (from traditional savings accounts to MMCDs) and external disintermediation and to project the effect of increased interest expense on future earnings. Although in mid-1978 the outlook for savings banks appeared favorable barring a significant increase in interest rates, FDIC staff nevertheless began exploring options available to the agency in the event a large savings bank were to fail.

Because of an accelerating inflation rate in 1978 and a shift in monetary policy in October 1979, interest rates rose almost continuously until the spring of 1980. Mutual savings banks, particularly those located in New York City and Boston, sustained 13 consecutive months of external disintermediation from March 1979 to April 1980, when a record $10.7 billion in deposits left MSBs.[22] In addition to closely monitoring deposit flows and earnings, FDIC staff participated in an interagency task force on thrifts and evaluated a variety of measures proposed by the industry that were designed to permit MSBs to earn market rates of interest on assets. These proposals included expanded powers, mortgage warehousing programs, and reinstatement of the differential on six-month MMCDs which DIDMCA had removed.

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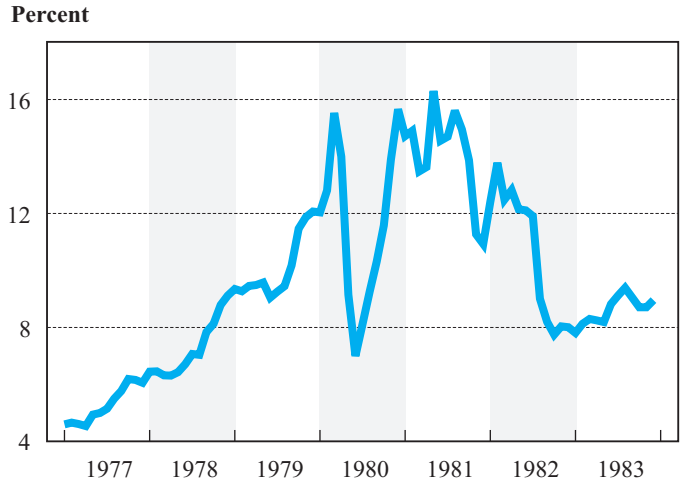
[21] U.S. Senate Committee on Banking, Housing, and Urban Affairs, *Deposit Interest Rate Ceilings and Housing Credit: The Report of the President's Inter-Agency Task Force on Regulation Q,* 96th Cong., 1st sess., 1979, 37–45.

[22] NAMSB, *1980 National Fact Book*, 7.

Figure 6.1

Monthly Treasury Bill Rate (3-Month), 1977–1983



Source: Haver Analytics.

An internal FDIC interdivisional task group, known as the Mutual Savings Bank Project Team, was formed in 1980 to develop plans to handle the possible failures of a large number of savings banks. Among other things, the group developed estimates of the potential magnitude of the problem under various economic scenarios, developed and evaluated options for handling the situation, and developed a strategic plan for each contingency. The recommendations prepared by this group shaped the structure of the ensuing assisted savings bank transactions (discussed below).

Mutual Savings Bank Failures, 1981–1982

Savings bank earnings, which had exceeded $1 billion in 1979, deteriorated very rapidly as the cost of funds began to exceed the yield on asset portfolios. The industry sustained losses of $123 million in 1980, the first year since World War II that it reported a negative income. In 1981, operating losses escalated to nearly $1.7 billion.[23] By early 1982, aggregate annual losses at FDIC-insured savings banks were running at approximately 1.25

[23] NAMSB, *1981 National Fact Book of Mutual Savings Banking* (1981) and *National Fact Book of Savings Banking* (1982).

percent of assets. The problem was more severe in New York City, where some of the weaker institutions were experiencing losses of 3.5 percent of assets, a devastating trend considering that at year-end 1981 total reserves for all MSBs in New York State had been only 4.8 percent.[24]

The plight of New York's mutual savings banks was discussed in a public forum as early as 1979, when Anita Miller of the Federal Home Loan Bank Board, in an address before an annual conference on the savings and loan industry, termed their condition "particularly worrisome."[25] New York's MSBs were constrained by limited lending powers, a restrictive usury ceiling, and unfavorable tax treatment at both the state and city levels.[26] Additionally, deposit growth and asset turnover were lower than average in New York City because of a high degree of competition from large money-center banks and money market funds and a heavy concentration of long-term bonds in the portfolios of many mutual savings banks. The MSBs could not sell these bonds without incurring a severe loss. Given the market value of the securities portfolios of the ten largest MSBs in New York City, Harry V. Keefe, Jr., chairman of Keefe, Bruyette & Woods, Inc., declared in December 1980 that "the nation's mutual savings banks, as an industry, are in fact bankrupt and Congress should act immediately to rescue them from eventual collapse." Keefe further warned that the problems of Chrysler and Lockheed were "peanuts compared to those of the mutual savings banks" and that if they were to fail, "the liability facing the Federal Deposit Insurance Corp. would exceed the $10 billion now in the fund."[27]

The FDIC's dilemma, from the standpoint of potential exposure of the deposit insurance fund, was very different from any the agency had faced earlier in its history. Unlike the situation with most commercial bank failures, asset quality was not a problem. However, as Keefe noted, a large number of MSBs were facing "book" insolvency, with the market value of their assets actually 25 to 30 percent below outstanding liabilities. If the FDIC had been forced to absorb this market depreciation, the deposit insurance fund would have incurred enormous losses. Resolutions that used either a purchase-and-assumption transaction or a deposit payoff probably would have entailed such absorption. Payoffs would also have entailed large cash outlays up front, since almost all MSB liabilities consisted of fully

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[24] FDIC, *Federal Deposit Insurance Corporation: The First Fifty Years* (1984), 99; and NAMSB, *1982 National Fact Book.*

[25] *Washington Financial Report* (October 22, 1979), A-22.

[26] Banking institutions in New York were taxed at the higher of two alternative tax methods, one based on net income and the other based on a percentage of deposits. Despite aggregate negative earnings, therefore, MSBs operating in New York City were burdened by a significant tax liability to both the city and state governments, a liability that exacerbated the problem of declining surplus accounts.

[27] Gary M. Hector, "Keefe Warns on State of Savings Bank Industry; Urges Federal Assistance Now," *American Banker* (December 9, 1980), 1.

insured deposits. The FDIC's principal concern was therefore to keep the cost of handling failing savings banks at a reasonable level without undermining the public's confidence in the industry or in the agency.[28] The FDIC also sought to ensure that any financial institution resulting from a merger with a failing savings bank would be financially sound, would have the ability to compete effectively in its market, and would continue to serve the credit needs of its community free of excessive government control.

Pressure on the industry and on the FDIC mounted during 1981, as the growing volume of losses (particularly at the ten largest New York City mutuals) was disclosed. In mid-August it was reported that at least four mutuals with total assets of almost $9 billion were "said to have approached the FDIC with applications or proposals for aid to boost their flagging net worth."[29] Losses were most severe at the 148-year-old Greenwich Savings Bank, which was forced to turn to the Federal Reserve's discount window to borrow more than $100 million after a group of foreign banks refused to roll over approximately $75 million in collateralized Eurodollar notes.[30] On October 28 it was reported that state and federal bank regulators had met behind closed doors with representatives from a number of major banks to discuss Greenwich's fate. The next day this story was picked up by *The New York Times* and major wire services, while a New York radio station mistakenly announced that Greenwich had failed. These reports prompted heavier-than-usual activity at the bank and led the FDIC to issue a press release reassuring Greenwich's depositors that their money was safe. This statement, possibly unprecedented in the agency's history, acknowledged that the FDIC was seeking a buyer for Greenwich Savings Bank and that it would arrange "an orderly transaction which will insure that no depositors—whether insured or uninsured—will experience any loss of any principal or interest."[31]

On November 4, 1981, the FDIC announced the assisted merger of the Greenwich Savings Bank into Metropolitan Savings Bank, New York—a transaction effected under Section 13(e) of the Federal Deposit Insurance Act, which authorizes the agency to reduce or avert a threatened loss to the insurance fund by providing assistance to facilitate a merger between a failing insured bank and another insured bank. Although the FDIC had always had this authority and had used it frequently in the early years, it had used it only once in

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[28] It should be noted that no FDIC-insured mutual savings bank had failed since 1938.

[29] Karen Slater, "Mutuals Ask for Capital Aid; FDIC Resisting Action," *American Banker* (August. 14, 1981), 1.

[30] Although DIDMCA authorized thrifts to borrow from the discount window, Greenwich was one of the earliest institutions to borrow under the Federal Reserve's new program to provide extended credit to banks and thrifts that were under sustained liquidity pressures.

[31] Laura Gross and Gordon Matthews, "FDIC Assures on Greenwich; Tells Depositors Funds Are Safe; Seeks Buyers," *American Banker* (October 30, 1981), 1.

the decade before 1981, largely because the agency was reluctant to provide financial assistance that would benefit the stockholders and management of a failing institution.[32]

Assisted mergers had frequently been used by the Federal Savings and Loan Insurance Corporation (FSLIC) in handling S&L failures, and the FDIC had concluded that, under appropriate circumstances, assisted open-bank mergers could be a desirable way to handle failing MSBs. Two important considerations were that Section 13(e) assistance required neither new legislation nor a finding by the FDIC's Board of Directors that the institution was essential to its community. Other advantages to this approach over a closed-bank transaction were that it preserved tax-loss carry-forwards,[33] gave the acquiring institution greater flexibility to continue leases and other contractual arrangements, and received greater cooperation from state supervisors. In addition, it was thought that depositors in other mutual savings banks would react more favorably if the failing institutions were not officially closed. The Greenwich/Metropolitan transaction was notable for several reasons. With more than $2.5 billion in assets, Greenwich at that time was the third-largest bank failure in the FDIC's history.[34] More important, the initial estimated cost of the transaction—$465 million—was more than the reported cost of handling *all* previous failures of insured banks. Finally, as the first assisted merger, this transaction served as a prototype for subsequent assisted mergers in its basic structure and procedures.

The primary strategy developed by the Mutual Savings Bank Project Team was to structure assistance around what was called an Income Maintenance Agreement (IMA).[35] Under an IMA, the FDIC agreed to make periodic payments to the acquiring institution on the basis of the difference between the yield on the declining balance of acquired earning assets and the average cost of funds to savings banks, plus a spread to cover administrative and overhead expenses associated with these assets. This structure allowed the agency to fund long-term assets at short-term rates, resulting in a significant cost saving relative to the cost if the bank were to be liquidated. Additionally, it provided protection against the possibility that a windfall gain would accrue to the acquirer if market rates fell. Conversely, an IMA exposed the FDIC to increased costs in a rising interest-rate environment. From the acquirer's perspective, acquired assets were completely insulated from interest-rate risk,

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[32] U.S. House Committee on Banking, Finance and Urban Affairs, *Report*, 173–74. In all assisted mergers of failing mutual savings banks, the FDIC insisted that senior management and most trustees would not be able to serve with the surviving institution. In cases where the failing MSB had subordinated debt outstanding, the note holders were required, as a condition of the transaction, to take a substantial "hit," in the form of either a lower interest rate or an extended maturity.

[33] Tax-loss carry-forwards allow previously incurred taxable losses to be applied to future taxable income, thereby reducing tax liability in profitable years.

[34] In 1980, the FDIC provided open-bank assistance to prevent the failure of the nearly $8 billion First Pennsylvania Bank, N.A. The largest bank failure before that had been Franklin National Bank of New York, with assets of $3.6 billion, in 1974.

[35] Both the FSLIC and the FDIC had previously provided assistance along these general lines in a limited number of cases (FDIC, *First Fifty Years*, 100).

whereas the benefits of the reinvestment spread on the cash flow from existing assets provided an increasing source of income. Income maintenance agreements were used in 10 of the 17 assisted mergers of failing savings banks between 1981 and 1985 (see table 6.4).[36]

With respect to the "cost of funds" used to compute IMA payments, the FDIC was reluctant to use a measure that was under the control of the resultant institution. Thus in the case of a surviving savings bank, the index normally used was based on a group of peer institutions; in the two instances when the resulting institution was a commercial bank, a market-based index was used. As part of the assistance agreement, a schedule of remaining asset balances and average yields was agreed upon for the term of the IMA, and payments were based on this fixed schedule. This arrangement made it unnecessary for the bank to maintain separate records and for the FDIC to perform periodic audits, and allowed the acquiring institution to hold or sell a particular asset on the basis of considerations other than assistance payments.

In the 12 months from November 1981 through October 1982, the FDIC consummated 11 assisted mergers of mutual savings banks with total assets of nearly $15 billion, more than the total assets of all failed commercial banks since the FDIC's inception. The cost of these failures was approximately $1.8 billion, or approximately 12 percent of assets. Most of the acquiring institutions were other MSBs, although for the first time in FDIC history commercial banks were the winning bidders—for Farmers and Mechanics Savings Bank (F&M), Minneapolis, Minnesota, and for Fidelity Mutual Savings Bank, Spokane, Washington. The merger of F&M, with assets in excess of $980 million, into the $350-million-asset Marquette National Bank created the fourth-largest commercial bank in the state of Minnesota. In this case the bidding process was facilitated by the passage of emergency legislation in Minnesota permitting an out-of-state bank holding company to acquire F&M as a commercial bank. This legislation was thought to have saved the FDIC $50 million.[37] The merger of Fidelity Mutual into First Interstate Bank of Washington, N.A., Seattle, Washington, also involved an interstate bidding process that saved the FDIC an estimated $20 million.[38]

The drastic drop in interest rates that occurred in the second half of 1982 significantly reduced the earnings pressure on the industry and brought most savings banks to or above the break-even level. However, even in the late-1982 interest-rate environment several large banks were still losing money. The Garn–St Germain Depository Institutions Act of

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[36] Other forms of assistance generally included cash, notes, and the assumption of Federal Reserve or Federal Home Loan Bank debt.

[37] William M. Isaac, "Depository Institutions—The Challenge of Today's Problems and Tomorrow's Opportunities" (address to the 52d annual convention of the Independent Bankers Association of America, Sheraton-Waikiki Hotel, March 16, 1982), 2.

[38] FDIC, *Annual Report* (1982) , 4.

Table 6.4
Failed and Assisted Savings Banks, 1981–1985

Date	Failed Bank/Acquirer and Location	Assets ($Millions)	Outcome
11-04-81	Greenwich SB/Metropolitan SB New York City	$2,475	Renamed Crossland, FSB, in 1984. Converted to stock in 1985. Failed in 1992 (pass-through receivership).
12-04-81	Central SB/Harlem SB New York City	910	Renamed Apple Bank for Savings in 1983. Converted to stock in 1985.
12-18-81	Union Dime SB / Buffalo SB New York City	1,453	Renamed Goldome Bank for Savings in 1983. Converted to FSB in 1984; to stock in 1987. Converted back to state charter in 1988. Failed in 1991 (purchased by KeyCorp and First Empire State Corporation).
01-15-82	Western NY SB/Buffalo SB Buffalo, NY	1,028	See Goldome (12-18-81).
02-20-82	Farmers & Mechanics SB/Marquette NB Minneapolis, MN	1,010	Renamed Marquette Bank of Minneapolis, NA, in 1985. Acquired by First Bank, NA, in 1993.
03-11-82	U.S. SB/Hudson City SB Newark, NJ	688	Hudson City SB is a state-chartered MSB.
03-11-82	Fidelity Mutual SB/First Interstate NB Spokane, WA	696	First Interstate Bank of Washington, NA
03-26-82	The New York Bank for Savings/Buffalo SB New York City	3,504	See Goldome (12-18-81).
04-02-82	Western Savings Fund Society/ Philadelphia Saving Fund Society Philadelphia, PA	2,126	PSFS converted to stock in 1983. Renamed Meritor SB in 1985. Failed in 1992 (purchased by Mellon Bank Corp.).
09-24-82	United Mutual SB/American SB New York City	833	Converted to FSB in 1983. Converted to stock in 1985. Converted back to state charter in 1989. Failed in 1992 (acquired by eight different banks).
10-15-82	Mechanics SB/Syracuse SB Elmira, NY	55	Syracuse SB failed in 1987 (acquired by Fleet Bank).
02-09-83	Dry Dock SB/Dollar SB New York City	2,452	Renamed Dollar–Dry Dock Savings Bank. Renamed Dollar–Dry Dock Bank in 1988. Failed in 1992 (acquired by Emigrant SB and Apple Bank for Savings [one branch]).
08-05-83	Oregon Mutual SB/Moore Financial Corp. Portland, OR	266	Renamed Oregon First Bank. Renamed West One Bank in 1989.
10-01-83	Auburn SB/Syracuse SB Auburn, NY	133	Syracuse SB failed in 1987 (acquired by Fleet Bank).
09-28-84	Orange SB/Hudson City SB Livingston, NJ	513	Hudson City SB is a state-chartered MSB.
10-01-85	Bowery SB/Ravitch Investor Group* New York City	5,277	Sold in 1988 to H. F. Ahmanson & Co. Renamed Home Savings of America, FSB, in 1992.
12-31-85	Home SB/Hamburg SB Brooklyn, NY	414	Retained the Home SB name. Acquired by H. F. Ahmanson & Co. in 1990.
	Total—17 assisted mergers	**$23,835**	

* The FDIC provided financial assistance to recapitalize the Bowery SB and merge it into a newly chartered stock savings bank that was then acquired by the Ravitch Investor Group.

1982 enabled the FDIC both to adopt a "wait-and-see" approach and to be more flexible in dealing with these institutions. For mutual savings banks, one of the most important provisions of this legislation was contained in Title II, which authorized the FDIC to establish a Net Worth Certificate Program.

Net Worth Certificate and Voluntary Merger Programs

On December 7, 1982, FDIC Chairman William M. Isaac announced details of the Net Worth Certificate (NWC) Program, in conjunction with a voluntary merger plan designed to induce savings banks to create their own proposals for assisted mergers. The NWC Program was intended to allow savings banks with capable management and good-quality assets a chance to recover if interest rates should drop from the high levels they were at when Garn–St Germain was passed in October 1982. Recognizing that "a few firms may have to be merged almost irrespective of what happens to rates" and that "mergers may be the only practical longer-range solution" for others, the agency's voluntary merger plan provided tangible financial assistance to encourage mergers involving savings banks when one of the participants was eligible for aid under the NWC Program.[39]

To qualify for assistance under the NWC Program, an institution was required to have (1) net worth equal to or less than 3 percent of assets, (2) losses incurred during the two previous quarters but not as a result of transactions involving mismanagement, and (3) investments in residential mortgages or in securities backed by such mortgages aggregating to at least 20 percent of loans. Institutions were required to apply by letter with a comprehensive business plan that included a strategic plan, lending and investment policies, plans for managing liquidity positions and rate-sensitivity gaps, plans to reduce expenses, and a two-year budget. Additional restrictions were placed on bank operations, particularly employment contracts with senior management; and participating banks were not permitted to change charter, convert to stock form, merge, or otherwise change the nature of their business or ownership without the prior approval of the FDIC. Conversely, however, MSBs that applied for assistance were required to sign a restrictive covenant obligating them to convert to stock form at the request of the FDIC.

Essentially, the FDIC increased or maintained the capital of participating institutions (for regulatory purposes) by purchasing NWCs in an amount equal to a percentage of operating losses over the preceding six-month period, in exchange for promissory notes under exactly the same terms as the NWC. The certificates counted as surplus for regulatory purposes but had no effect on the net cash flows or income of the institution.[40] Therefore, the

[39] FDIC Press Release PR-99-82 (December 7, 1982).

[40] However, some institutions did benefit from the exemption from state and local franchise taxes that was granted in Title II of Garn–St Germain.

NWC Program was basically a form of capital forbearance. The certificates remained outstanding until the institution became profitable. At that time, repayment was at a rate of one-third of net operating income and was accomplished through the retirement of an equal amount of promissory notes. Additionally, the FDIC could notify any institution that still held certificates seven years after issuance that it would have to repay all or a portion within six months.

A total of 29 savings banks with assets of approximately $40 billion participated in the original NWC Program (see table 6.5).[41] Nearly $720 million in net worth certificates were issued between 1982 and 1986, and the total amount outstanding at any one time peaked at $710.4 million at year-end 1985.[42] The decline in interest rates during the middle and late 1980s allowed the majority of participating banks to return to profitability. All but three institutions had retired their certificates by year-end 1988, and the last certificate was retired in 1992.

After introduction of the Net Worth Certificate Program, interest-rate mismatch led to six mutual savings bank failures, including three in 1983, one in 1984, and two in 1985.[43] Five of these were resolved under the FDIC's voluntary merger plan. The sixth, Oregon Mutual Savings Bank of Portland, Oregon, was acquired by Moore Financial Group, Inc., of Boise, Idaho. This acquisition was made possible by newly enacted state legislation that allowed Oregon Mutual to convert to a stock-form, state-chartered commercial bank and be acquired by a bank holding company in a contiguous state. The assistance agreement between the FDIC and Moore Financial provided that Oregon Mutual's net worth certificates be prepaid.

Net worth certificates were also prepaid in the assisted merger of Orange Savings Bank with Hudson City Savings Bank, both in New Jersey. In the four other voluntary mergers, outstanding net worth certificates were retained, and the surviving institution remained in the NWC Program. One of these transactions was a financial assistance package to recapitalize the Bowery Savings Bank and merge it into a newly chartered stock savings bank in order to facilitate its acquisition by a private investor group. The Bowery and Dollar–Dry Dock eventually retired their certificates, whereas Syracuse Savings Bank and Home Savings Bank failed with net worth certificates still outstanding. These were retired as part of FDIC-assisted mergers with other institutions.

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[41] The NWC Program, as authorized by the Garn–St Germain Depository Institutions Act of 1982, was due to expire after three years. However, Congress granted two extensions, and the program expired on October 13, 1986.

[42] FDIC, *Report of Activities under Title II of the Garn–St Germain Depository Institutions Act of 1982* (1983–1987).

[43] A seventh failure (Syracuse Savings Bank) in May 1987 was attributable to a bankrupt real estate investment tax shelter. In this case the FDIC's assistance was limited to indemnifying the acquirer, Norstar Bancorp, against certain contingent liabilities.

Table 6.5
FDIC Net Worth Certificate Program
($Thousands)

Bank Name	City/State	Assets at Entry into Program	Certificates (Maximum Amount Held)	Date Retired
Auburn SB*	Auburn, NY	$ 125,646	$ 1,640	Retained by Syracuse SB in 1983—Assisted merger
Beneficial Mutual	Philadelphia, PA	1,628,630	18,862	1991
Bowery SB*	New York, NY	4,999,357	220,100	1992
Cayuga County SB	Auburn, NY	189,957	788	1986
Colonial Mutual SB	Philadelphia, PA	70,732	776	1984—Acquired
Dime SB of NY, FSB	New York, NY	6,393,743	72,120	1986
Dime SB of Williamsburgh	New York, NY	573,858	3,559	1987
Dollar–Dry Dock SB†	New York, NY	4,972,787	41,321	1986
Dry Dock SB*	New York, NY			See Dollar-Dry Dock SB‡
East River SB, FSB	New York, NY	1,777,519	26,430	1987
Eastern SB	New York, NY	785,962	13,712	1986—Merger
Elizabeth SB	Elizabeth, NJ	31,695	351	1983—Merger
Emigrant SB	New York, NY	2,968,586	90,037	1991
Greater NY SB	New York, NY	1,816,836	23,054	1987
Home SB*	White Plains, NY	427,402	5,628	1986—Assisted merger
Inter-County SB	New Paltz, NY	123,366	1,588	1986
Lincoln SB, FSB	New York, NY	2,090,289	65,865	1987
National SB of the City of Albany	Albany, NY	391,205	1,123	1985
Niagara County SB	Niagara Falls, NY	291,887	464	1986—Merger
Orange SB*	Livingston, NJ	531,087	3,509	1984—Assisted merger
Oregon Mutual SB*	Portland, OR	260,000	1,489	1983—Assisted merger
Rochester Community SB	Rochester, NY	1,371,335	4,993	1986
Roosevelt SB	New York, NY	858,852	5,757	1986
Sag Harbor SB	Sag Harbor, NY	203,612	1,412	1987
Savings Fund Society of Germantown	Bala Cynwyd, PA	1,373,089	17,706	1987
Seamen's SB, FSB†	New York, NY	1,825,504	31,320	1986
Skaneateles SB	Skaneateles, NY	136,092	524	1986
Syracuse SB*	Syracuse, NY	1,180,471	See Auburn SB§	1987—Assisted merger
Williamsburgh SB	New York, NY	2,215,133	63,945	1987—Merger
Total—29 institutions		**$39,614,632**	**$718,073**	

* Failed or was assisted while in NWCP.

† Failed after NWCP participation.

‡ Certificates issued to Dry Dock SB were retained when that institution was acquired by Dollar SB. Subsequently, Dollar–Dry Dock acquired additional certificates.

§ Certificates issued to Auburn SB were retained when that institution was acquired by Syracuse SB. Syracuse SB failed in 1987.

The Net Worth Certificate Program succeeded in providing 22 potentially failing savings banks with the opportunity to return to profitable operations. Although 7 of the participating institutions did require additional FDIC assistance, the cost of these transactions was less than $420 million, or approximately 4.1 percent of the $10.2 billion in total assets held by these 7 institutions at the time of their failures. This figure is substantially below the average loss rate of 12 percent for the savings banks that were resolved before the NWC Program, and it is certainly far less than what it would have cost the FDIC to close all 29 savings banks had there been no Net Worth Certificate Program. It should be noted that two institutions failed after having paid off their net worth certificates: the Seamen's Savings Bank (1990) and Dollar–Dry Dock (1992). These failures occurred more than four years after the banks had paid off their net worth certificates, and therefore were probably a result of actions the institutions took after leaving the NWC Program.

The success of the FDIC's Net Worth Certificate Program depended on interest-rate levels, which were beyond the agency's control. However, the program's success was also due to several of its key aspects. Stringent application requirements helped ensure that only banks with capable management, good-quality assets, and the ability to be profitable in a favorable interest-rate environment received assistance. Equally important, banks in the program were closely monitored and supervised, and were not permitted to attempt to grow out of their problems. In sum, the Net Worth Certificate Program minimized the FDIC's potential exposure to loss while providing capital forbearance to savings banks.[44]

Conclusion

In the early 1980s, many mutual savings banks failed because both macroeconomic forces and changes in the financial services marketplace were inhospitable to the industry's traditional mode of operating. By law and regulation, MSB assets were permitted to be invested primarily in fixed-rate mortgages and long-term bonds, but as short-term interest rates rose to historically high levels between 1979 and 1982, the market value of these assets plunged. At the same time, MSB liabilities were composed almost exclusively of short-term deposits paying rates of interest subject to deposit interest-rate ceilings—and as market rates rose, even small savers began to think like investors. MSB deposits were withdrawn and placed in higher-yielding investments. Regulators fought this disintermediation by permitting the introduction of a variety of time deposits paying market rates of interest. These certificates of deposit helped MSBs retain funds, but they also raised the industry's cost of funds. Yields on assets rose much more slowly, and net interest margins shrank and

[44] After so many mutual savings banks converted to the stock form of ownership, the industry is now collectively referred to as the savings bank industry.

became negative. Operating losses were so great that capital levels built up over a century or more of profitable operations quickly eroded.

MSB failures were predictable and, arguably, preventable. The problems facing the thrift industry were recognized early and were debated throughout the 1970s.[45] However, Congress's attempts to enact sweeping financial reform were stalemated by the competing interests of various industry groups, the overlapping layers of state and federal regulators, and the additional public policy concern of ensuring a continued supply of funds for home mortgage lending. Thus, despite years of studies and proposals, no consensus could be reached on how best to proceed with financial deregulation. As a result, changes were enacted on a piecemeal basis and only when a crisis was clearly evident.

From the FDIC's perspective, the problems of the mutual savings bank industry in 1980 were the most serious challenge the agency had faced since its inception in 1933. Potential losses to the deposit insurance fund were enormous. What made MSB failures particularly costly were the sizes of the institutions, the large percentage of fully insured deposits, and the low market value of otherwise good-quality assets. This potential cost prompted the FDIC to develop strategies to deal with MSB failures that were different from the traditional methods used to resolve commercial bank failures.

The predictability of the failures benefited the agency by giving it some planning time. Moreover, the threat of deposit runs was greatly reduced because a large proportion of deposits held by the MSB industry were fully insured. Finally, unlike the bank crisis of the 1930s, this crisis was not compounded by a sense of public panic.

The principal strategy the FDIC used was to provide open-bank merger assistance with healthier institutions. This procedure was acceptable to the agency because, given the absence of stockholders in mutual savings banks, only depositors would have to be protected in the transactions. Moreover, the problems facing MSBs at this time were not the result of mismanagement or fraud but were caused by forces outside the banks' control. Another consideration was the desire to avoid cash outlays. This was a major concern not only to the FDIC but also to the U.S. Treasury Department because FDIC expenditures, although not charged to the Treasury, are reflected in the unified budget. Therefore, wherever possible the FDIC attempted to substitute notes and periodic income maintenance payments (which were dependent on future interest rates) for direct up-front cash assistance. The 1982 Garn–St Germain Act granted the agency additional time and flexibility and authorized the ensuing Net Worth Certificate Program.

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[45] This chapter covers only the FDIC's experience during the 1980s. Savings and loan associations also encountered problems of asset/liability mismatch early in the decade, but those institutions were regulated by the Federal Home Loan Bank Board and insured by the Federal Savings and Loan Insurance Corporation. For a discussion of that crisis, see Chapter 4.

Using all these procedures, the agency largely succeeded in managing the mutual savings bank crisis of the early 1980s. Between late 1981 and year-end 1985, the agency conducted 17 assisted mergers or acquisitions of mutual savings banks with total assets of nearly $24 billion. These MSBs accounted for more than 15 percent of the total assets of FDIC-insured mutual savings banks as of year-end 1980. At year-end 1995, the cost of these failures was estimated at $2.2 billion.[46] This figure is nearly equivalent to the estimated cost of these transactions when they were consummated, notwithstanding the variable nature of some of the components. Although the FDIC benefited from the effect of declining interest rates on eventual income-maintenance payments, in several transactions the agency incurred a greater-than-expected loss from the liquidation of assets it purchased. Nevertheless, the strategies that were used in these assisted mergers minimized both losses and cash outlays.

It should be noted that although a number of mutual savings banks were able to survive the crisis by the capital forbearance provided in the NWC Program and/or by virtue of being extremely well managed, a number of others failed between 1985 and 1994 (a list of these failures appears in the appendix to this chapter). For the most part, these institutions failed for reasons other than asset/liability mismatch and therefore are not discussed in this chapter. The question arises, however, whether the FDIC could have prevented these failures, many of which occurred as a result of the expanded powers granted by deregulation.

Notably, several of these post-1985 failures were from assisted mergers that had taken place in the early 1980s. American Savings Bank, CrossLand FSB (formerly Metropolitan Savings Bank), Dollar–Dry Dock Bank, Goldome Bank (formerly Buffalo Savings Bank), and Meritor Savings Bank (formerly Philadelphia Saving Fund Society) all failed in 1991 or 1992. These failures, occurring a decade after the institutions had participated in FDIC-assisted mergers, were attributable to activities in which the banks became involved after the introduction of expanded powers. Most of the institutions had long since stopped receiving any type of FDIC assistance and were operating profitably before they encountered the problems that led to failure. Estimates are not available as to what it might have cost the FDIC to resolve these institutions separately, nor can it be determined what might have happened to the institutions if they had not participated in FDIC-assisted mergers. Nevertheless, it should be recognized that not all of the assisted merger combinations were a total success. In addition, a number of savings banks in the New England region, which had largely been spared in the early 1980s, failed during the early 1990s. These banks, many of

[46] The figure was approximate because several cases were still listed as active on the FDIC's books.

which had converted to the stock form of ownership, failed after investing in the boom-to-bust New England real estate cycle (see Chapter 10).[47]

In conclusion, the mutual savings bank industry underwent a profound change between 1980 and 1994. The number of banks declined because of mergers, failures, and conversions to commercial banks. Approximately 30 percent (including many of the largest savings banks) converted to stock form. Many savings banks benefited from a favorable environment and returned to profitability. (Future success depends on the ability of these banks to adapt as the financial services industry continues to evolve.) As for the FDIC, in its handling of the MSB crisis in the early 1980s it gained experience that would prove valuable, for as the decade unfolded, this crisis turned out to be only the first of many the agency had to confront in rapid succession.

[47] Jennifer L. Eccles and John P. O'Keefe, "Understanding the Experience of Converted New England Savings Banks," *FDIC Banking Review* 8, no. 1 (1995): 1–17.

Appendix

Table 6-A.1

BIF-Insured Savings Banks That Failed, 1986–1994 ($Thousands)

Institution Name	City, State	Failure Date	Total Assets	Resolution Cost
American Savings Bank	White Plains, NY	06/12/92	$ 3,202,492	$ 469,713
Amoskeag Bank	Manchester, NH	10/10/91	937,259	190,355
Attleboro Pawtucket SB	Attleboro, MA	08/21/92	632,450	32,210
Banco de Ahorro FSB	Mayaguez, PR	05/30/86	33,961	6,985
Bank Five for Savings	Arlington, MA	09/20/91	386,572	99,306
Bank for Savings	Malden, MA	03/20/92	397,979	28,620
Bank Mart	Bridgeport, CT	12/13/91	578,220	97,785
Bank of Hartford Inc.	Hartford, CT	06/10/94	321,457	23,326
Beacon Co-op Bank	Boston, MA	06/21/91	31,806	4,210
Brooklyn Savings Bank	Danielson, CT	10/19/90	130,931	29,791
Burritt InterFinancial Bcorp.	New Britain, CT	12/04/92	523,850	76,931
Central Bank	Meriden, CT	10/18/91	654,715	246,047
Central Savings Bank	Lowell, MA	02/14/92	369,110	32,594
Colony Savings Bank	Wallingford, CT	02/27/92	35,664	6,107
Connecticut Savings Bank	New Haven, CT	11/14/91	1,044,990	206,959
Coolidge Corner Coop Bank	Brookline, MA	03/14/91	83,699	16,502
Crossland Savings FSB	Brooklyn, NY	01/24/92	7,431,636	547,864
Dartmouth Bank	Manchester, NH	10/10/91	877,159	224,749
Dollar Dry Dock Bank	White Plains, NY	02/21/92	4,028,368	356,622
Eastland Savings Bank	Woonsocket, RI	12/11/92	515,301	16,735
Eliot Savings Bank	Boston, MA	06/29/90	479,461	220,492
First American Bank for Savings	Boston, MA	10/19/90	526,176	137,203
First Constitution Bank	New Haven, CT	10/02/92	1,571,240	126,526
First Mutual Bank for Savings	Boston, MA	06/28/91	1,129,946	181,037
First Service Bank for Savings	Leominster, MA	03/31/89	880,658	292,365
Goldome	Buffalo, NY	05/31/91	9,890,866	847,933
Granite Co-op Bank	Quincy, MA	12/12/91	103,814	14,768
Heritage Bank For Savings	Holyoke, MA	12/04/92	1,288,435	21,566
The Howard Savings Bank	Newark, NJ	10/02/92	3,461,421	87,087
Iona Savings Bank	Tilton, NH	10/11/91	31,180	5,334
Landmark Bank for Savings	Whitman, MA	06/12/92	62,124	13,082
Lowell Institution for Savings	Lowell, MA	08/30/91	386,363	126,303
Ludlow Savings Bank	Ludlow, MA	10/21/94	222,671	16,681
Maine Savings Bank	Portland, ME	02/01/91	1,182,519	5,614
Mechanics & Farmers SB, FSB	Bridgeport, CT	08/09/91	1,083,920	323,197
MerchantsBank of Boston	Boston, MA	05/18/90	392,219	96,581
Meritor Savings Bank	Philadelphia, PA	12/11/92	4,126,701	0
Milford Savings Bank	Milford, MA	07/06/90	328,062	137,790
Monroe Savings Bank FSB	Rochester, NY	01/26/90	520,587	25,508
New England ALLBANK for Savings	Gardner, MA	12/12/90	173,269	70,404
New England Savings Bank	New London, CT	05/21/93	914,884	115,216
New Hampshire Savings Bank	Concord, NH	10/10/91	1,171,673	234,637
Numerica Savings Bank FSB	Manchester, NH	10/10/91	509,074	112,154
The Permanent Savings Bank	Niagara Falls, NY	07/13/90	329,994	0
Plymouth Five Cents SB	Plymouth, MA	09/18/92	220,972	7,078
Riverhead Savings Bank	Riverhead, NY	06/12/92	388,806	0
Seacoast Savings Bank	Dover, NH	08/28/92	84,808	7,537
Seamen's Bank for Savings FSB	New York, NY	04/18/90	3,391,988	188,916
Southstate Bank for Savings	Brockton, MA	04/24/92	285,923	16,692
Suffield Bank	Suffield, CT	09/06/91	294,777	86,222
Syracuse Savings Bank	Syracuse, NY	05/13/87	1,183,321	0
Union Savings Bank	Patchogue, NY	08/28/92	491,100	118,874
The U. S. Savings Bank of America	Seabrook, NH	07/27/90	12,416	1,511
Vanguard Savings Bank	Holyoke, MA	03/27/92	427,949	126,739
Winchendon Savings Bank	Winchendon, MA	08/14/92	65,213	7,745
Woburn Five Cents SB	Woburn, MA	06/07/91	247,219	44,154
Workingmens Co-op Bank	Boston, MA	05/29/92	223,665	14,583
Yankee Bank Finance & Savings, FSB	Boston, MA	10/16/87	525,481	65,689