Comment on Andrew S. Carron and R. Dan Brumbaugh, Jr.'s "The Viability of the Thrift Industry"

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The paper by Andrew Carron and Dan Brumbaugh is about the two central issues facing the thrift industry today: (1) *can* thrifts survive (or how *many* can survive) as specialized mortgage lenders, and (2) should they be *required* to be specialized lenders? The authors' answers are, basically, "probably not" and "no."

I agree with Carron and Brumbaugh's conclusions, for most of the reasons developed in the paper, and I would make a point that is in the paper but merits more emphasis: substantively, the existence of thrifts as specialized lenders will end, with or without the qualified thrift lender (QTL) test. The reason is that the freedom to switch charters is ultimately more important than are portfolio restrictions. In the past, owners of thrifts chose to put up with portfolio restrictions because the thrift charter was valuable (due to tax and regulatory advantages). Past advantages have been largely eliminated, however, and the value of a thrift franchise is not what it used to be. In the future, deposit institutions will choose their charters to match their strategy; those that choose to specialize in mortgages may well take out thrift charters. The causation has been reversed; charters will become as fungible as money.

This picture for the future reinforces the authors' proposed elimination of the QTL test. The QTL test is, at best, an inefficient diversion. The purpose of creating the thrift industry, to allow housing to compete on a "level playing field," has been attained through efficient deposit markets (for both banks and thrifts) and secondary markets.

Measuring ex ante profitability

A major issue in the paper is the estimate of returns and costs for mortgage lending and the implied skepticism about whether mortgage lending can generate normal profits. The skepticism is warranted. I have an adjustment to the paper's measurements that

explicitly includes the role of deposit insurance and risk taking along lines consistent with both of the authors' research. The addition is the inclusion of the imputed return from the put option nature of deposit insurance.

Returns to thrift owners are probabilistic. When they are high, the owners keep the excess return; when they are low, the owners lose up to their own equity, but beyond that the depositors and deposit insurers lose. Hence, thrift owners do not experience the whole possible distribution of outcomes.

Consequently, their expected return is *greater* than the expected return on assets minus the expected cost of funds. The difference is, roughly, the value of the put option that thrift owners have: they can put the company back to the depositor (and the insurer).

This situation is true of all companies with limited liability. However, uninsured lenders require a higher promised return to cover the put, which limits risk taking. Banks and thrifts have fixed-price insurance, the benefit from which increases with risk taking. Risk taking is limited by charter and regulatory restrictions, but not (very much) by deposit rates, which, because of deposit insurance, do not adjust in proportion to risk.

Competition among thrifts will tend to eliminate the subsidy content of underpriced insurance in the form of either lower lending rates or higher deposit rates. Hence, there will be a tendency for expected asset returns to be low relative to expected deposit costs. This tendency does not mean that the expected return to stockholders is negative or below normal, because it does not include the value of the put. Hence, calculations like those in the paper (and similar ones in a paper by Patric Hendershott, referred to by the authors) underestimate returns to thrift owners and need further interpretation.

My interpretation is that until recently ex ante returns for thrifts, including the put, were at least normal, but they depended heavily on the put value, which required a lot of risk taking. Conservative thrifts had to have lower than average costs to compete. Ex post, the results were bad, but that is what happens even in equilibrium, when the equilibrium is based on a lot of risk taking.

Since the passage of the Financial Institutions Reform, Recovery, and Enforcement Act, the risk-taking ability of thrifts has been limited, and the option-adjusted spread (OAS) between mortgage

rates and deposit costs cannot sustain the current number of thrifts. Mortgage returns are unlikely to rise by much, because the agencies are now, at least on the fixed-rate side, the marginal source of funds. They will continue to limit mortgage rate increases by means of mortgage-backed securities, not because they take more risk (which they certainly do not), but because their costs of doing business are low. Absent more risk taking, this leaves the adjustment to either lower operating costs for thrifts or lower deposit rates. Both imply fewer thrifts.

How small the thrift industry will become depends on the details. The authors find about a 30-basis-point deficiency in spread. However, there is still some juice left in risk taking on mortgages, through lack of diversification, risky (e.g., multifamily and high loan-to-value) mortgage products, and interest rate risk. There may well be a new equilibrium with nearly 30 basis points in put value and some further risk taking.

A minor point

The “inconsistency” between capital ratios for thrifts and for the agencies is not an inconsistency. Both agencies are nationally diversified in their mortgage holdings, whereas thrifts primarily hold mortgages from one local area, or at most one regional area. Diversification is a big factor in credit risk; hence, less capital is needed for more diversified institutions. When local thrifts sell mortgages to the agencies and buy their securities, the risk in the system is decreased because the agencies’ diversification reduces the risk of insolvency from a downturn in one region. As a result, less capital is required.

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