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A STUDY OF THE IMPACT OF THE FLOW OF DEPOSITS ON THE BALANCE SHEETS OF THE MUTUAL SAVINGS BANKS AND THE SAVINGS AND LOAN ASSOCIATIONS OF NEW YORK STATE: A SECTIONAL COMPARISON 1966-1980

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A STUDY OF THE IMPACT OF THE FLOW OF DEPOSITS ON THE BALANCE SHEETS OF THE MUTUAL SAVINGS BANKS AND THE SAVINGS AND LOAN ASSOCIATIONS OF NEW YORK STATE: A SECTIONAL COMPARISON

1966-1980

A DISSERTATION SUBMITTED TO THE FACULTY

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ABSTRACT OF A DPS DISSERTATION
JOSEPH P. FREY

The purpose of this study is to determine and compare the impact of the flow of deposits on the balance sheets of the mutual savings banks (MSBs) and the savings and loan associations (SLAs) of New York State (NYSTATE). They were compared to each other for the years 1966 to 1980 with a 1981 update. The State was divided into two sections, NYCITY, basically the New York City SMSA plus Nassau and Suffolk Counties and NYOTHER, the balance of the State. These were also compared to each other.

A substantial review of the literature investigated 5 major commissions and studies. Major industry problems were also examined. Finally the Depository Institutions Deregulation and Monetary Control Act of 1980 was examined and summarized.

It was hypothesized that the two subareas of each institution would have different reactions to the same influences, and also that the two thrifts would have different reactions. The statistical tool was a correlation coefficient analysis with 60 data points.

Chapter 3 analyzed the liability accounts. Chapter 4 analyzed asset account management, including a discussion of liquidity. Chapter 5 analyzed net worth as a proxy for profit. The balance sheet accounts were compared for relationships to the flow of deposits, the market place yields, and to each other.

The major findings for these chapters can be summarized as follows:

1) the MSBs and SLAs are not different in their reactions except in their asset management.

2) that the inflows have not "suffered" from high interest rates.

3) that mortgage loans were not terribly affected until 1980, only the rate of increase was affected.

4) there has been an increasing sensitivity of deposit flows to interest rates.

5) the liquidity ratios have improved, but the improvement is deceptive.

6) that regular passbook savings held up in NYOTHER until 1979.

The evidence presented supports the hypothesis that NYCITY will have different reactions than will NYOTHER to the same type of influences with each type of thrift institution.

The evidence presented supports the hypothesis that the two types of institution of NYSTATE will have different reactions to the same type of influences.

There is a major public policy issue pinpointed by this study. The thrifts have been historically viewed as separate and distinct institutions which react differently and which are viewed as different by the public. The evidence does not confirm this. The liability accounts did not support the hypotheses. Should the regulators, the legislatures, and the various banking authorities continue to view them as separate. This study suggests that they do not do so and regulate for them as if they are identical and equal.

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This study was structured in 1975 after two serious bouts of disintermediation and several quarterly ripples of negative deposit flows. It was originally constructed with Doctor Philip Lohman. I am most thankful for his help and encouragement which gave structure to this project. After Doctor Lohman retired, Doctor Clarke Johnson agreed to "pilot" the project through to completion. For his help and advice, and that of Doctor Franklin Sharp of Pace University, the writer is most grateful.

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CHAPTER 1

THE PROBLEM

Statement of the Problem

The problem is to determine and compare the impact of financial intermediation on the balance sheets of mutual savings banks (MSBs) and the savings and loan associations (SLAs) of New York State, New York City and outside of New York City.

Specific Problems

The first problem is to determine and compare the impact of money market yields on the deposit flows of the MSBs and the SLAs of New York State.

The second problem is to determine and compare the impact of money market yields and the deposit flows upon the liability structure of the mutual savings banks and the savings and loan associations of New York State.

The third problem is to determine and compare the impact of the liability structure on the asset structure of the mutual savings banks and savings and loan associations of New York State.

The fourth problem is to determine and compare the impact of the liability and asset structures on the net worth of the mutual savings banks and the savings and loan associations of New York State.

DEFINITION OF TERMS

The following definitions will be used for the purposes of this study.

Financial Intermediation

Financial intermediation is defined as the flow of funds in an economy from savers with a surplus of funds to borrowers with a need for funds through financial intermediaries. For this study, the financial intermediaries to be studied are the mutual savings banks and the savings and loan associations.

Financial disintermediation, hereafter referred to as disintermediation, is defined as a withdrawal of funds previously located in a deposit account, and the direct placement of these funds into other money market instruments or deposit account in a financial intermediary other than the mutual savings bank or the savings and loan association from which the withdrawal occurred. It does not include deposits withdrawn and deposited into another deposit account in the same institution. It is also a reversal of net savings flows.

Many writers use different definitions for disintermediation. Jane F. Nelson considers it to be the bypassing of thrift institutions and the direct placement of the funds into the securities market.[1] John J. Arena, using a much stricter definition, defined disintermediation to include funds withdrawn from one type of institution and redeposited into another.[2] Donald J. Mullineaux, assuming that the reader knows the term describes the cause of disintermediation as induced when "market securities offer a sufficiently higher interest rate compared with deposits to offset the costs associated with trading in securities

[1] Jane F. Nelson, "Disintermediation," Federal Reserve Bank of Richmond, Monthly Review, April, 1968, p. 8.

[2] John J. Arena, "The Outlook for Financial Disintermediation," Federal Reserve Bank of Boston, New England Business Review, Dec., 1967, p. 2.

markets."[3] Ritter and Silber state that savers, instead of shifting funds to, shift them out of financial intermediaries and put them into corporate, municipal, and government securities.[4] The McGraw-Hill dictionary of modern economics defines disintermediation as "the removal of funds from interest-bearing time accounts in savings institutions and commercial banks for the purpose of reinvesting the funds at higher rates in market instruments."[5]

All of these definitions are adequate and correct, but are not suitable for the purposes of this investigation. Our definition is strict and narrow. This study is an investigation of the flow of deposits and the impact of those flows. The interest that is credited to the account of the surplus savers are excluded from the definition. Interest is not a flow of funds into a financial intermediary, rather it is earned by the intermediary and is beyond the control of the surplus savers until it is transferred to the savers' deposit account.

Mutual Savings Bank

A mutual savings bank is defined as "a financial institution without stockholders, whose depositors contribute the capital and share in the profits, operated in the depositor interest by elected and self-perpetuating trustees, geared to the concept of thrift and serving

[3]Donald J. Mullineaux, "Interest-rate ceilings and the Treasury Bond Market,""Disintermediation and the Small Saver," Federal Reserve Bank of Boston, New England Business Review, July/August, 1973, p. 19.

[4]L.S. Ritter and W.L. Silber, Principles of Money, Banking and Financial Markets, Basic Books, Inc. (New York, 1974), p. 332.

[5]The McGraw-Hill Dictionary of Modern Economics: A Handbook of Terms and Organizations, 2nd ed. (New York: McGraw-Hill Book Co., 1973), p. 171.

individual savers who have quick recall for their deposits, and chartered and regulated by the state for the purposes of providing for the safety of funds."[6] The proxy term MSB may be used in this study.

Savings and Loan Association

A savings and loan association[7] is defined as a financial intermediary that holds a charter, federal or state, which designates it as a savings and loan association. The proxy term SLA may be used in this study.

The definitions referring to the balance sheet categories are included in this study as Appendix A.

Basic Assumptions

It is assumed that the impact of financial intermediation and disintermediation on the thrift institutions is identifiable and capable of measurement and analysis.

Basic Hypothesis

It is hypothesized that the two types of thrift institutions will have very different reactions to environmental influences. The two institutional types have very different capital structures and the regulation of each type is through different governmental agencies. The mutual savings banks of New York State are regulated and overseen

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[6]Walter R. Miller, Jr., "The Marketing Concept and Mutual Savings Banks: An Appraisal of the Marketing and Competitive Situations of Mutual Savings Banks in New York" (Unpublished Ph.D dissertation, New York University, 1966), p. 62.

[7]McGraw-Hill, op. cit., p. 521.

primarily by the New York State Banking Department and the deposits are insured by the Federal Deposit Insurance Corporation (FDIC). The Federal Savings and Loan Associations are regulated by the Federal Home Loan Bank, the State Federal Savings and Loan Associations by the NYSTATE Banking Department and both types are insured by the Federal Savings and Loan Insurance Corp. (FSLIC). In addition, the mutual savings banks have had a historic orientation to provide for the safety and growth of savings for their depositors. The savings and loan associations historically have had a philosophical orientation to provide mortgage money, safety of the savings of depositors and, if it is a publically owned association, profits for the common stockholders. Therefore it is reasonable for two different types of institutions with different basic investment philosophies and different governmental regulations to react differently.

In addition, in the fourth quarter of 1966 (1966:4) the New York State SLAs were 18.7% of the combined MSB and SLA total assets in New York State. The MSBs have much more exposure and it is reasoned that they will react differently because of that exposure.

The second broad hypothesis is that the New York City area (NYCITY) will have different reactions to the same types of influences than will the area outside of New York City (NYOTHER). The MSBs in New York City at 1966:4 had 78.5% of the total New York State (NYSTATE) MSB assets. The SLAs in the NYCITY area had 77.1% of the total NYSTATE assets. The NYCITY thrifts have much more exposure. It is reasonable that they will react differently than will the area called NYOTHER.

Within these broad hypotheses the analysis chapter will have sub-hypothesis as follows:

For Chapter 3:

1. It is hypothesized that the liability structure of the two institutions will have different reactions to the same type of influences.

2. It is hypothesized that the NYCITY area will have different reaction for both institutions than will the NYOTHER area in the liability reactions to the same type of influences.

For Chapter 4:

1. It is hypothesized that the asset structure of the two institutions will have different reactions to the same types of influences.

2. It is hypothesized that the NYCITY area will have different reactions for both institutions than will the NYOTHER area in the asset reactions to the same type of influences.

3. It is hypothesized that the liquidity changes will be different for both types of institutions and in both sub-areas, NYCITY and NYOTHER for both institutions.

For Chapter 5:

1. It is hypothesized that the net worth of the two institutions will have different reactions to the same types of influences.

2. It is hypothesized that the NYCITY area will have different reaction for both institutions than will the NYOTHER area in the net worth account to the same type of influences.

The Need for the Study

In late February, 1982 Representative Fernand J. St. Germain, Chairman of the Committee on Banking, Finance and Urban Affairs of the U.S. House of Representatives introduced a bill under which the Federal Government would set up a $7.5 billion fund from which the SLAs could borrow. The loans would require a SLA to have a net worth of less than 2% its assets, and at least 50% of the borrowed funds would go for mortgages to borrowers who are first time home owners.[8]

[8] New York Times, February 28, 1982, Business Section, p. F 6-7.

This situation in 1982 is only the culmination of a tremendous change that has taken in the economic environment of the United States since 1965.

Prior to the late 1950's, positive savings flows, or savings intermediation was more or less taken for granted. The only serious prior disruption was during the great depression of the 1930's. That period was not considered disintermediation because the funds were taken out for reasons that had little to do with investments of any kind.[9] This situation was to change when the yield differentials between government securities (and other investment alternatives) and the statutory interest rates paid by the thrift institutions caused the thrifts to lose funds to alternative financial investments.

This loss of funds, the effects of disintermediation on the deposit flows have been different for both institutions in each subarea of NYSTATE. The NYSTATE MSBs have had three prolonged periods of disintermediation. The prolonged periods have been from the second quarter of 1969 (1969:2) through the third quarter of 1970 (1970:3), from 1973:3 through 1974:4 and from 1978:2 through 1980:4 and beyond. The major portion of these disintermediation periods has been in the NYCITY area where 28 of the 60 quarters (46.6%) of our analysis period have had negative net deposit flows. The NYOTHER MSB area has experienced only 17 of 60 quarters (28.3%) has had negative net deposit flows. The experience of the SLAs has been different. While the NYSTATE SLAs suffered 19 of 60

[9] National Fact Book, National Association of Mutual Savings Banks, New York, 1965 edition, table 52, p. 35 shows the flows for all institutions.

quarters (31.7%) there have been only 1 period where the net deposit losses exceeded 3 successive quarters, from 1979:2 to 1980:4 and beyond. The experience in the two subareas has been about the same. NYCITY SLAs have had 16 of 60 quarters (26.7%) of negative net flows: NYOTHER has had 17 of 60 quarters (28.3%) of negative net flows. It should be noted that as disintermediation alerted the first writers, the problem was 1 quarter in length in the NYSTATE MSBs, 1966:2, and 3 quarters in length in the NYSTATE SLAs, 1966:1 through 1966:3. Arena's[10] charts show a statistical correlation of 0.70 and confirms that the greater the yield of financial market instruments relative to that of financial institutions, the greater is the degree of financial disintermediation. Nelson flatly states "that reduced flows at thrift institutions were reflected in the drying up of mortgage funds."[11]

In the time since both Nelson and Arena there has been considerable interest in the performance of the thrift institutions. Chapter two of this study outlines and discusses the major works, studies, commissions, papers, and laws relating to this subject. The interest in the subject stems from the occurrence of very large declines in some liabilities of the thrifts and large increases in other liabilities since many of their observations were made.

Irwin Friend assesses the underlying source of this disintermediation and its impact as follows, "an asset-liability structure of relatively nonmarketable, long-term investments combined with highly liquid short-term liabilities gives rise to a high proportion of

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[11]Nelson, op. cit., p. 9.

difficulties confronting the savings and loan business, which in turn has adverse consequences for the housing markets."[12] Whether the combination does have adverse effects on mortgage lending, and therefore on housing markets is one of the specifics of this study.

Dr. Franklin H. Orstein feels that the saver, especially the small saver, goes through a learning process and that as the savers learn the process, it amplifies the direction of financial intermediation.[13]

That interest rates affect the flow of funds into and out of financial intermediaries is a commonly held view. The action noted by Arena has been documented in many studies. One such study by Watson[14] establishes that each consumer is a "maximizer" when he investigated and confirmed the specific question of the substitution between demand deposits and some short term financial instruments based upon price.

Paul M. Horvitz states quite categorically that "I believe that the "cause" of disintermediation is relatively clear: it results when market instruments pay higher rates of return than financial institutions pay on their deposits."[15] Mr. Robert Laurent, an economist

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[12]Irwin Friend, "The Desirability of Changes in the Asset and Liability Structure of the Savings and Loan Business," Savings and Residential Financing 1969 Conference Proceedings, p. 145.

[13]Opinion expressed by Dr. Franklin H. Ornstein, Ph.D., Chairman of the Board of Central Federal Savings and Loan Association, personal interview, March 29, 1976.

[14]William Watson, "The Interaction Among Financial Intermediaries in the Money and Capital Markets: A Theoretical and Empirical Study" (Unpublished doctoral dissertation, University of Southern California, 1968).

[15]Based on personal correspondence between Paul M. Horvitz, Director of Research of the Federal Deposit Insurance Corporation, and the writer.