Click here for Full Issue of EIR Volume 14, Number 17, April 24, 1987

What interest rate blows out thrifts?

Government estimates say another 1.5% will put the entire U.S. thrift system "under water."

A mere 150 basis points' rise in short-term interest rates will make one-third of the nation's 3,500 thrift institutions unsalvageable, against today's "dead list" of slightly over 400, government analysts estimate. Short-term interest rates rose more than 50 basis points in the week to April 15 alone.

The collapsing dollar implies much higher interest rates—City of London estimates go up to 20-25%—to draw in hesitant foreign money to finance the United States' current-account deficit of $150 billion a year.

The thrift institutions, as a whole, were running a loss as of the third quarter of 1986, and many supposedly profitable institutions made money exclusively by borrowing short-term, and lending long-term.

Government data show that the net loss is spread asymmetrically between the 20% of the thrifts now running huge losses, and 80% either breaking even or showing a profit.

However, that profit would turn into a drastic loss, with a rise in short-term rates to about the 8% level.

Last week in this space, a Chicago Federal Reserve study was reviewed, showing the dependency of the weakest sectors of the commercial banking system on securities-trading profits.

The two-and-a-half-year drop in interest rates, supported by Japanese and other capital inflows, raised the general level of bond prices, and allowed commercial and savings banks alike to show paper profits on securities trading, particularly in mortgage-backed securities, of which the thrifts hold over $400 billion in portfolio.

These mortgage-backed securities have already collapsed in value by more than 10% since April 1. That will not affect thrifts' profitability until they must sell them off at lower prices; the bonds may remain on the books at cost-of-purchase, until they are sold, and the loss is realized.

If the cost of short-term money rises to match or exceed the interest-rate which the thrifts receive on their huge portfolio of mortgage-backed securities—roughly 8%—then the entire thrift system "will be under water," one government analyst said.

A "duration gap" arises between thrifts' short-term liabilities, and medium- to long-term assets, in accounting parlance.

Although government data are not published, sources estimate the "duration gap" at about 20% for the thrift industry as a whole.

That means, simply, that the maturity of their assets is, on average, 20% longer than that of their liabilities.

It also implies that for every 1% rise in interest rates, the thrifts lose profits (or add losses) equivalent to 0.2% of their assets.

A 1% rise in rates will add losses of over $2 billion, i.e., more than the insurance premiums which the thrifts currently pay to the FSLIC.

However, that $2 billion is the resultant sum of profits and losses at all institutions; some thrifts will actually make money on financial speculation as rates rise.

The median duration gap among U.S. thrifts is closer to 50%, analysts say, which means that the typical thrift will show a loss equivalent to 0.5% of its total assets for every 1% rise in interest rates.

On that basis, analysts calculate that about one-third of the nation's thrifts will become insolvent on the basis of a mere 1.5% rise in rates.

However, it is not merely the squeeze between their cost of funds, and their income on long-term assets, which run up losses for the thrifts.

At the point at which they must pay more for deposits than they receive on the bonds purchased with those deposits, the thrifts will have to start selling off the bonds, at a loss. The trading losses will multiply the operating losses.

Several large thrifts, e.g., the $30 billion Financial Corporation of America, have aggressively borrowed short-term funds, and bought mortgage-backed bonds, in order to show some profitability, despite their massive losses on real estate and similar ventures. They will be the first to go under if interest rates continue to rise.

The implications for the government's unimpressive plan to rescue the S&L's insurer, the Federal Savings and Loan Insurance Corporation, are staggering, according to Washington analysts. Federal Home Loan Bank Board Chairman Edwin Grey's estimate of $25 billion in cash to bail out FSLIC, and wind up the affairs of over 400 unsalvageable S&Ls, only reflects immediate requirements, with no reserve left over, they say.

Another $25 billion will be needed as matters stand; if interest rates rise another 1.5%, that $50 billion could rise to $100 billion or more.

© 1987 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.