



THE Savings & Loan Reporter

A Weekly Commentary on Developments Affecting the Thrift Industry

Volume 13 #14

Mailing Date: August 19, 1988

WALL STREET BROKERS CONSIDER S&Ls EXCELLENT INVESTMENTS

By Bob Duke

FSLIC's growing woes and the industry's overall losses aside, healthy savings and loan stock associations are still regarded as excellent investments by Wall Street brokers and industry attorneys.

They are seen as fine investments not only from the standpoint of their stock, which appeals to many investors because it's selling below book value and the price for comparable commercial bank stock, but as potential, low-cost acquisition targets for bank holding companies.

In fact, the investment value of healthy thrifts is expected to increase substantially in both respects when the Federal Reserve Board or Congress allows them to be acquired by bank holding companies, Salomon Brothers, Inc., says in a comprehensive research report on bank and thrift affiliations.

There is speculation that this may happen as early as 1990. It probably won't occur before then because of the congressional freeze on healthy thrift departures from FSLIC, scheduled to expire August 10, 1989, but which could be extended through that same date in 1990.

The moratorium was originally imposed August 10, 1987, to prevent well-capitalized thrifts from switching to FDIC coverage to escape FSLIC's special assessment.

After the freeze ends, S&Ls leaving FSLIC would be subject to an "exit" fee consisting of two years of regular and special insurance premiums.

While bank holding companies await permission from the Fed and Congress, they might want to stake out the healthy thrifts they're interested in acquiring, thrift industry attorneys say.

"Bank holding companies are going to be permitted to acquire healthy S&Ls and operate them as thrift subsidiaries," one attorney says. "During the interim, they should stake out the ones they like."

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Apart from other factors, he says, such acquisitions particularly would become valuable for bank holding companies if Congress or the Fed let the acquired thrifts continue to engage in their traditional activities, including real estate investment and certain insurance operations.

Meanwhile, the value and attractiveness of savings institutions could receive a big boost if Congress passed a proposed Senate bill designed to enhance the charters of thrifts in S&L holding company structures.

The legislation, sponsored by the Association of Thrift Holding Companies and Senator David K. Karnes, R, NE, cleared the Senate Banking Committee last month.

In its report, Salomon Brothers says banks are becoming increasingly interested in investing in well-capitalized S&Ls.

"Actual and potential affiliations between commercial banks and savings and loan associations have begun to capture the attention of stock investors," it says. "This interest has been prompted in part by the consolidation that has occurred among regional banks...coupled with the realization that S&L equities have traditionally been valued below those of commercial banks."

Because of these developments, Salomon Brothers says, investors feel some bank holding companies should consider acquiring thrifts as a relatively low-cost means of expanding.

"Although there are currently a number of legislative and regulatory restrictions on BHC acquisitions of healthy stock thrifts, we expect this environment to change significantly over the next few years," Saloman Brothers says.

Last year, the Fed proposed to permit bank holding companies to acquire healthy S&Ls but subsequently decided not to act on the proposal until Congress deals with FSLIC's plight and determines what changes should be made in the financial services industry structure.

Until then, bank holding companies may only acquire failing thrifts and run them as S&L subsidiaries.

THE SAVINGS & LOAN REPORTER is published by Mortgage Commentary Publications, The Newsletter Division of American Banker-Bond Buyer, P.O. Box 30240, Bethesda, MD. 20814. (301)654-5580. Available by subscription only at \$345 per year. Single copy price is \$15. Copyright, 1988. Reproduction in whole or in part without written permission is prohibited. Mortgage Commentary Publications include: Mortgage Commentary, The Mortgage Marketplace, The Savings & Loan Reporter, The Bank Board Watch, The FDIC Watch, The NCUA Watch, The Mortgage Securities Watch, The Thrift Accountant, The Bank Accountant, The Mortgage Accountant, Commercial Mortgage/Washington Watch and The Financial Services Document Watch.

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Even if there were no freeze on healthy thrift departures from FSLIC, current Fed policy requires that a healthy S&L become FDIC-insured before it can be acquired as a separate subsidiary of a bank holding company.

Specifically, federal law bars a federally chartered, FSLIC-insured association from directly merging with or converting directly into a bank. Simultaneously, the Fed prohibits such an institution from being acquired by a bank holding company as a separate subsidiary.

Under the Fed proposal, several conditions would be attached to any bank holding company acquisition of a healthy thrift:

- The acquired S&L would continue to operate as a thrift.
- The thrift subsidiary's activities would be limited to those permissible to bank holding companies.
- Branching would be restricted.

If bank holding companies are allowed to acquire healthy S&Ls, Salomon Brothers indicates, it would be beneficial to keep them FSLIC insured so they could continue to take advantage of generous tax breaks.

"Thrifts that have invested a substantial portion of their footings in housing-related assets have historically been given favorable tax treatment, as an inducement to channel funds into housing," the investment firm says. "This was accomplished via an outsized bad debt reserve for tax purposes."

As a result, Salomon Brothers says, a considerable portion of thrift accumulated earnings haven't been affected by taxes.

"Upon conversion to a bank, the company (S&L) may have to 'tax effect' its bad debt reserve, adversely affecting its capital position," it says.

As they wait for the freeze to end, healthy S&Ls desiring to affiliate with bank holding companies should consider applying for FDIC insurance immediately--as authorized by the 1987 Competitive Equality Banking Act--and asking Congress for "grandfather rights" in case it decides to extend the moratorium through August 1990, Salomon Brothers says.

In addition, it says, bank holding companies should consider buying large amounts of stock in potential thrift targets.

Since 1985, despite barriers, 14 healthy stock thrifts have been acquired by bank holding companies, Salomon Brothers says.

In those instances, it says, the bank holding companies paid between \$40 million and \$440 million for the S&Ls. Moreover, on average, they paid a 43.3 per cent premium "to the market valuation of the acquired thrift stock" (defined as the market value one month prior to the announcement), it says.

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Meantime, as mentioned earlier, the Senate Banking Committee has reported out a bill (S.2073) that would enhance the thrift charter, thus making them even more valuable as acquisition targets.

Pat Forte, president of the Association of Thrift Holding Companies, says the legislation would eliminate some of the "most burdensome restrictions that have limited the ability of thrift holding companies to operate profitably and to access the credit markets in a timely manner."

The measure, supported by the Bank Board and all thrift trade associations, would:

- Remove a National Housing Act restriction that bars nondiversified thrift holding companies from incurring debt in excess of 15 per cent of consolidated net worth without prior FSLIC approval. (The restriction made it difficult for holding companies to raise funds at a favorable rate in a volatile market).

- Permit thrifts held by holding companies to engage in larger transactions with their affiliated companies by eliminating the current \$100,000 limit on such transactions and allowing transactions in excess of the greater of \$100,000 or 0.1 per cent of the institution's assets, up to \$2 million.

There is a catch to these additional powers.

To be exempt from the debt-control restriction and to be eligible for the new \$2 million affiliate transaction allowance limit, a holding company's insured thrift must comply with the highest capital level required by the Bank Board.

In other words, the thrift must be a "capital-qualified institution."

Originally, the bill required the insured S&L either to have five per cent GAAP capital or meet a GAAP capital standard authorized by the Competitive Equality Banking Act.

If the original language had prevailed, Forte says, it could have been confusing, since the Bank Board is currently contemplating changes in its net worth regulation, including moving toward capital requirements similar to those of commercial banks.

Under the Senate measure, a "capital-qualified institution" also is one that isn't affiliated with any institution that is failing to meet its minimum capital requirement.

Exempted from the above part of the definition is an S&L acquired under the emergency acquisition provisions of the National Housing Act.

Forte notes that this is the first time since 1967 that a congressional committee has cleared an ad hoc bill specifically aimed at helping thrift holding companies and their S&Ls.

(The information contained herein, while obtained from reliable sources, cannot be guaranteed).