Cautious play marks S&L approach to commercial lending

Christine Pavel and Dave Phillis

The boundaries of the financial services industry are being redrawn by nonbank competitors developing new distribution networks and repackaging old products into new ones, and by large banking organizations searching for and exploiting loopholes in the regulatory framework. But where do thrifts fit in this changing financial services industry?[1]

Congress has granted the thrift industry a number of new powers over the last four years (see Table 1), including the power to make commercial loans and accept commercial demand deposits—the essence of commercial banking according to the the Supreme Court.[2] Thrifts, however, have been slow in utilizing their new powers. One way to evaluate the position of thrifts in this rapidly changing financial environment is to examine how they have used their new powers, in particular, their commercial lending powers. In doing so, we can better understand the regulatory debate over the relevance of commercial banking as a distinct line of commerce in merger analysis.[3]

Since 1974, controversy has centered on whether and to what extent thrifts provide competition to commercial banks in traditional banking services.[4] In 1974, most thrift institutions were limited to offering time and savings deposits and making residential mortgage loans. In the few states where thrifts were allowed to offer transactions accounts and consumer and commercial loans, thrifts had very small market shares. The Supreme Court determined, therefore, that they did not compete with commercial banks, though the Court did acknowledge that thrifts may become significant competitors in the future should trends apparent at that time continue.

The issue of thrifts as commercial banks' competitors resurfaced in the 1980s when Congress granted all thrifts the power to make consumer and commercial loans and to issue transactions accounts. Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMCA) to help the thrift industry retain its deposit base and improve its profitability. DIDMCA allowed thrifts to make consumer loans up to 20 percent of their assets, issue credit cards, accept Negotiable Order of Withdrawal (NOW) accounts from individuals and nonprofit organizations, and invest up to 20 percent of their assets in commercial real estate loans.

DIDMCA, however, did little to alter the thrift industry's behavior and therefore resolve the fundamental problem of the thrift industry—maturity mismatching, i.e., short-term liabilities funding long-term assets. Further deregulation occurred in 1982 with the passage of the Garn-St Germain Depository Institutions Act (Garn). As shown in Table 1, Garn increased the proportion of assets that thrifts could hold in consumer and commercial real estate loans and allowed thrifts to invest 5 percent of their assets in commercial loans (7.5 percent for savings banks) until January 1, 1984, when this percentage limitation was raised to 10 percent.

Since the passage of DIDMCA and Garn, many studies have examined how S&Ls have utilized their commercial lending powers to determine whether these new powers have enhanced thrifts' profitability and to determine the extent to which thrifts compete with commercial banks.[5] These studies look to the financial statements of thrifts for answers. In general, they have found that thrifts have been slow to use their commercial lending powers and that thrifts have not used them to the full extent of the law. These studies conclude that thrifts will continue to experience problems due to the maturity mismatch of their portfolios and that they have not yet become significant competitors of commercial banks.

Financial statements, however, provide limited information. In this article, we report the results of a survey of all S&Ls in Illinois and Wisconsin concerning their commercial lending activities and examine the financial statements of the S&Ls.[6] The survey was con-

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Christine Pavel and Dave Phillis are associate economists at the Federal Reserve Bank of Chicago. Helpful research assistance was provided by Janet Zimmerle, who was a summer intern at the Bank during the fall of 1984.

Table 1
New powers granted to federally chartered thrifts

New powers	DIDMCA	Garn-St. Germain
	(Effective March 31, 1980)	(Effective October 15, 1982)
Consumer loans	Consumer loans up to 20 percent of total assets	Consumer loans up to 30 percent of total assets
	Educational loans up to 5 percent of total assets	
	Issue credit cards	
Commercial loans	Commercial real estate up to 20 percent of total assets	Commercial real estate loans up to 40 percent of total assets
	Unsecured construction loans up to 5 percent of total assets	Other commercial loans up to 5 percent of total assets prior January 1, 1984 (7.5 percent of total assets for savings banks) and up to 10 percent of total assets thereafter
		Equipment leasing up to 10 percent of total assets
Transaction accounts	Now accounts from individuals and nonprofit organizations	Now accounts from governmental units
		Demand deposits from persons or organizations that have established "a business, corporate, commercial or agricultural loan relationship" with the institution

ducted during the fall of 1984.[7] Because of the high response rate (81 percent), the samples are representative of the thrift industry in the two states, and as shown in Figure 1, these two states are typical of the thrift industry in the nation.

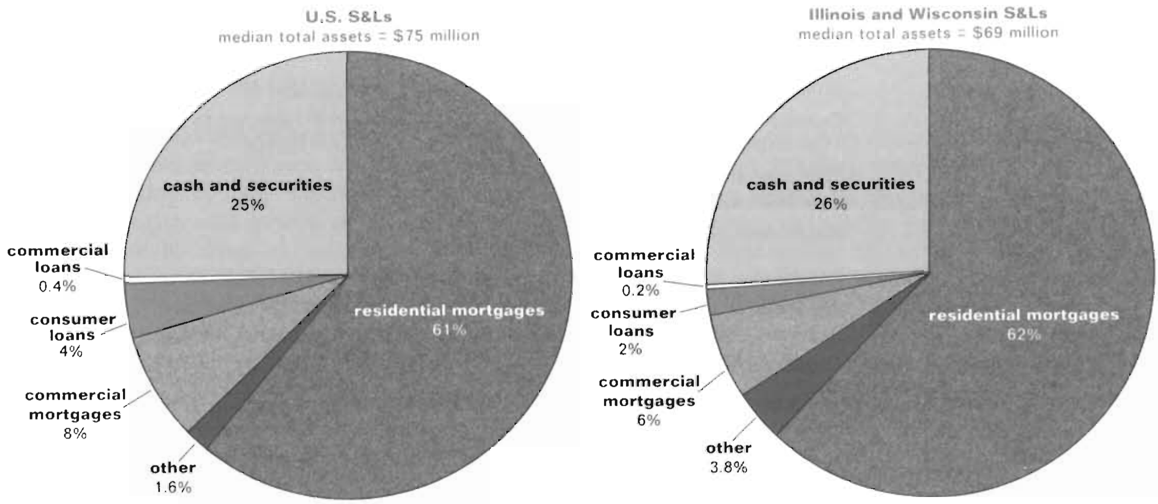
We describe how S&Ls in two states have reacted to their new commercial lending powers. In so doing, we shed some light on the proper distinction between banks and thrifts in the competitive analysis of bank mergers and acquisitions. The first section describes which S&Ls in Illinois and Wisconsin have used their commercial lending powers, and the second describes how they have used these powers—what products are offered and what markets are targeted. The third section identifies the characteristics of S&Ls that make commercial loans. The fourth section discusses how these institutions view the commercial lending environment. The last section reviews the most important findings of this study and discusses their implications for bank merger analysis.

The players and the spectators

One-quarter of the S&Ls surveyed in Illinois and Wisconsin engage in commercial lending (lenders) or, in the fall of 1984, were planning to do so (planners). Almost half of these S&Ls have chosen to operate separate commercial lending departments staffed by one or two experienced commercial loan officers. Another 25 percent indicated that they will employ at least one full-time commercial loan officer at the end of the first full year of business lending.

The remaining three-quarters of the respondents do not make commercial loans and are not planning to make such loans (nonlenders), but almost half of these S&Ls have considered engaging in commercial lending. When asked to explain in their own words what influenced their decisions not to offer commercial loans, these S&Ls executives typically cited a perceived high level of risk, high start-up costs, and lack of prior experience as the primary reasons. Other reasons given by the nonlenders

Figure 1
Asset composition of S&Ls: 1983



were the small size of the association, the high degree of competition among commercial lenders, poor regional and national economic conditions, and concomitant low demand for commercial loans.

Planners and lenders were asked to explain why they decided to engage in commercial lending. Both groups cited the potential for profits and improved asset and liability management. Planners and lenders also cited the need to diversify their lending activity, to accommodate existing customers, to attract businesses' savings and demand deposits, and to become a "full service" association. In addition, several lenders said they wanted to attract new customers. One S&L executive commented, "We had to [make commercial loans] to be able to attract business from the banking industry."

The game plan

Overall, S&Ls have been slow to make commercial loans. As shown in Figure 2, at the end of 1983, only 31 associations (9 percent of all S&Ls in Illinois and Wisconsin) were making commercial loans. By the end of 1984, however, 59 associations (about 16 percent) were making such loans, and we estimate from the survey responses that by the end of 1985, over 20 percent of the S&Ls in Illinois and Wisconsin will be making commercial loans. Nevertheless, commercial loans still account for a very small portion of thrifts' total assets. At year-end 1983, commercial loans accounted for only 0.6 percent of assets for those associations in Illinois and Wisconsin that engage in commercial lending.

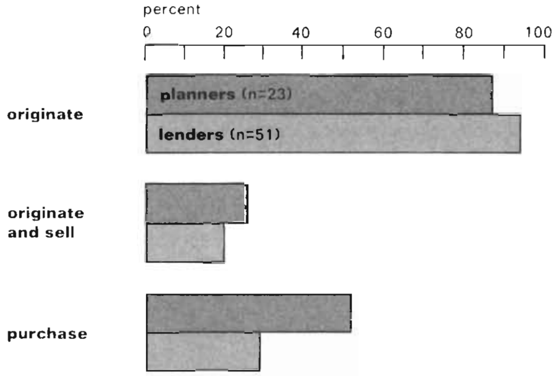
However, the S&L executives responded that commercial loans would represent about 1.6 percent of their associations' total assets at the end of their first full year of business lending, and nearly twice that after the second full year. If these S&Ls allocate their assets as indicated, they should increase their commercial loans outstanding more than fourfold within two years even if their total assets remain the same.

Many S&Ls seem to be testing the waters and trying to gain experience in this lending area before building volume. One S&L executive said that his association plans "to offer commercial loans to a few firms which have requested them and with which we are familiar. After some experience we will decide whether we want to expand further into this area." Some S&Ls, however, indicated that they are merely offering commercial loans to meet existing customers' needs and to retain these customers.

One (of the many) reasons for the slow growth of commercial lending at S&Ls so far is that they are not simply buying commercial loans to hold in their portfolios. Rather, they are actively writing commercial loans (Figure 3). Almost all (92 percent) of the planners and lenders in Illinois and Wisconsin expect to originate commercial loans, but less than one-fourth of these anticipate selling loan participations. Furthermore, many of those institutions that do sell loan participations are acting as syndicators of very large loans. The average commercial loan originated by S&Ls and outstanding at the end of the first full year of business lending was about $150,000. In comparison, the typical size of a loan participation sold by an S&L to other institutions was $450,000.

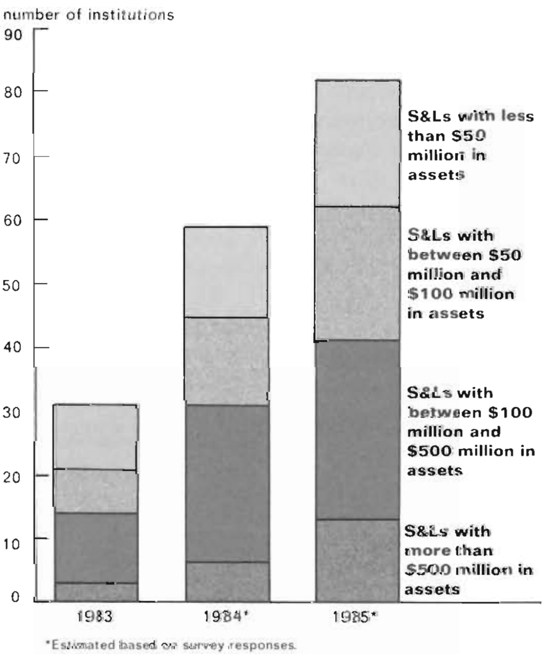
Some of the planners and lenders have chosen to supplement their commercial lending activity by purchasing commercial loans from other financial institutions. One-third of the planners and lenders purchase, or plan to purchase, commercial loans. Only 4 of the 74 planners and lenders have chosen to rely solely on the purchases of commercial loans. In general. S&Ls seem to prefer to buy loans from banks, but they are indifferent as to whom they sell participations.

Figure 3
Source of commercial loans for planners and lenders



Lenders that originate commercial loans and planners that expect to originate them were asked about the customers they target (Tables 2a and 2b) and the products they offer (Figure 4). Very few associations target large businesses (with sales of over $25 million). Most S&Ls (79 percent) target small companies (with annual sales from $50,000 to $1 million).[8] Over half of the lenders are making commercial loans to construction companies, retailers, and professionals. Most of the planners intend to make loans to these customer groups as well, but they also intend to make loans to manufacturers. The specific types of commercial products and services that S&Ls have chosen to offer to small businesses include equipment lease financing, construction loans, inventory financing, commercial mortgage loans, and commercial checking accounts.

Figure 2
Commercial lending participation of S&Ls in Illinois and Wisconsin



*Estimated based on survey responses.

Identifying the players

The S&Ls that make commercial loans and those that are planning to, have several characteristics in common.[9] These characteristics include familiarity with commercial mortgage lending, the acceptance of commercial demand deposits, and large size. Also, thrifts in metropolitan areas that are characterized by a large proportion of small businesses and dominated by a few commercial banks are likely to engage in commercial lending.

Table 2
Business targeted by planners and lenders

(a)

Planners (n = 21)

	Sales under $50,000	Sales $50,000-$1(mil.)	Sales $1(mil.)-$25(mil.)	Sales over $25(mil.)	Total
Construction	10%	29%	19%	0%	57
Manufacturers	5	29	24	10	62
Wholesalers	10	19	24	5	52
Retailers	24	29	14	5	67
Auto dealers	10	5	5	0	19
Farmers	33	10	5	0	38
Professionals	19	62	24	0	90
	48	76	43	10	

(b)

Lenders (n = 47)

	Sales under $50,000	Sales $50,000-$1(mil.)	Sales $1(mil.)-$25(mil.)	Sales over $25(mil.)	Total
Construction	11	43	13	0	62
Manufacturers	4	26	17	2	43
Wholesalers	0	23	11	2	32
Retailers	21	57	11	0	79
Auto dealers	2	26	23	2	51
Farmers	6	26	0	0	32
Professionals	17	62	2	0	77
	30	79	38	2	

Table 3
Total assets and capital-to-assets ratios of respondents

(a)

Total assets (1983)	Nonlenders	Planners	Lenders	Row total
less than $50 million	77	6	11	94
$50-100 million	53	7	12	72
100-500 million	79	3	22	104
more than $500 million	217	23	6	21
Total	217	23	51	291

(b)

Capital-to-assets (1983)	Nonlenders	Planners	Lenders	Row total
less than 1%	19	4	2	25
1% to 3%	52	0	15	67
3% to 5%	58	8	22	88
more than 5%	88	11	12	111
Total	217	23	51	291

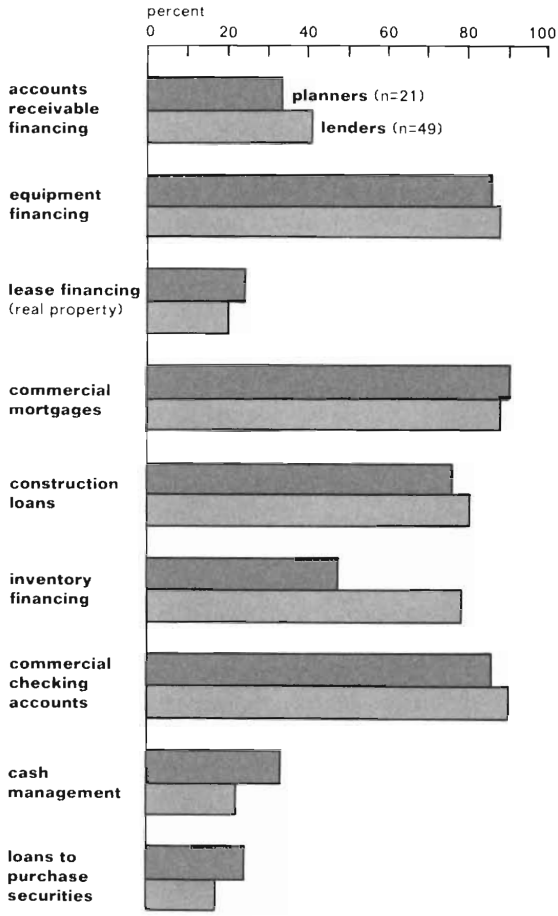
Many planners (87 percent) and lenders (94 percent) offer commercial real estate loans. Experience gained in making commercial mortgages may provide an S&L with the expertise and customer contacts to make nonreal estate commercial loans, and therefore move the S&L along the experience curve, reducing its costs of providing such loans. One S&L executive commented, "We had a business relationship with real estate companies and commercial loans to them were a natural starting point." Commercial real estate lending may also help an association establish its commitment to building a long-term relationship with business customers.

The ability to offer commercial demand deposits also seems to influence an S&L's decision to engage in commercial lending. Garn permits an association to offer commercial demand deposits only to customers that have a lending relationship with the association. As mentioned above, many S&Ls said that they decided to make commercial loans in order to attract the deposits of businesses. Commercial demand deposits also help reduce the cost of commercial lending by providing in-house information on business customers through the deposit relationship.

As shown in Table 3a, large S&Ls tend to be planners and lenders. Of the 21 institutions in Illinois and Wisconsin with assets in excess of $500 million, nearly two-thirds are planners or lenders, whereas only 17 of the 94 institutions with less than $50 million in assets (18 percent) are planners or lenders. This is to be expected since large institutions are better able to absorb the start-up costs of offering a new product. Nevertheless, only 4 percent of those S&Ls that are either planners or lenders are large institutions because S&Ls with over $500 million in assets account for only a small percentage of all S&Ls in Illinois and Wisconsin. Thus, while large institutions seem more likely to engage in commercial lending, most of the institutions that are making commercial loans, or are planning to do so, are medium-sized institutions.

Small and medium-sized institutions, on average, are better capitalized than large institutions. Since most of the S&Ls that are lenders or planners are medium size, most S&Ls that engage in commercial lending are adequately capitalized according to regulatory standards. As shown in Table 4b, 72 percent

Figure 4
Commercial products and services offered by planners and lenders



of the planners and lenders had capital-to-assets ratios of at least 3 percent, and 31 percent had capital exceeding 5 percent of assets at year-end 1983. However, 17 percent of the planners had capital-to-assets ratios below 1 percent. All but one of these institutions were large associations, with total assets in excess of $500 million.

Almost two-thirds of all S&Ls in Illinois and Wisconsin were able to report profits, no matter how small, in 1983. Similarly, about two-thirds of the nonlenders, planners, and lenders earned profits in 1983. Profits, therefore, do not distinguish an S&L that makes commercial loans from one that does not.

Table 4
Risk and cost perceptions of respondents

(a)

	Nonlenders	Planners	Lenders
Risk			
Low	1%	0%	8%
Moderate/average	29%	50%	61%
High	70%	50%	31%

(b)

	Nonlenders	Planners	Lenders
Cost			
Low	5%	17%	15%
Moderate/average	46%	65%	67%
High	49%	17%	19%

Most S&Ls in Illinois and Wisconsin (68 percent) are located in metropolitan areas. As shown in Figure 5, a large proportion of planners and lenders (73 percent) are located in metropolitan statistical areas (MSAs).[10] This is not surprising since metropolitan areas are home to a large number of businesses.

The three largest metropolitan areas in the two states are Chicago, Milwaukee, and the portions of suburban St. Louis located in Illinois. In the Milwaukee and St. Louis metropolitan areas, 35 percent and 39 percent of the S&Ls are planners or lenders, a higher proportion than the 25 percent for the whole sample. In Chicago, however, only 20 percent of the S&Ls are planners or lenders. In fact, Chicago looks very similar to the nonmetropolitan areas in this regard.

One possible explanation is that S&Ls find it more difficult to identify niches that they can profitably fill in these areas, for quite different reasons. Commercial lending is highly competitive in Chicago, with some 350 banks competing in the Chicago areas. In addition, dozens of out-of-state banks compete for commercial loan customers in Chicago through loan production offices and nonbank subsidiaries of their bank holding companies. On the other hand, nonmetropolitan areas simply do not have many businesses and therefore lack the demand for commercial loans. It may be very difficult to find an unfilled niche in the Chicago market, and it may be very difficult to find any niche in nonmetropolitan areas.

S&Ls that make commercial loans also tend to be found in areas with a high concentration of small businesses.[11] Planners and lenders account for 33 percent of the S&Ls in the five metropolitan areas in Illinois and Wisconsin with the highest proportion of small businesses (business with less than 50 employees). Of the S&Ls in the five MSAs with the lowest proportion of small businesses, only 16 percent are planners or lenders.

The playing field

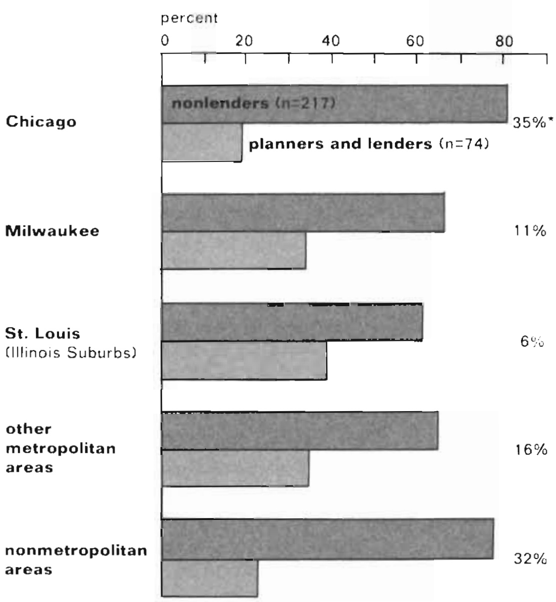
The S&Ls surveyed were asked to assess the environment for commercial lending in the markets they serve based on the following factors: competitiveness, costs, risks, demand, prior experience, and profitability. Nonlenders, planners, and lenders alike generally agreed that commercial lending is moderately profitable and moderately to highly competitive. These factors are consistent with unconcentrated markets.

Thrifts that are located in highly concentrated areas are more likely to engage in commercial lending because they can easily gain customers by undercutting the banks' high prices and still cover costs.[12] Of the S&Ls in the five most concentrated MSAs in Illinois and Wisconsin that responded to the survey, two-thirds are planners or lenders.[13] In contrast, only one-quarter of the S&Ls in the five least concentrated MSAs are planners or lenders. However, four times as many S&Ls that are planners or lenders are located in the five least concentrated MSAs than are located in the five most concentrated MSAs. This is because, in general, more S&Ls are located in relatively unconcentrated markets. Thus, while S&Ls in concentrated markets are more likely to engage in commercial lending, most of the S&Ls that do make commercial loans are located in unconcentrated markets.

Of course, commercial lending is not limited to an S&L's local market. Many S&Ls in Illinois and Wisconsin have branches statewide. But when asked what percentage of their commercial loan customers would be in a 25-mile radius of the home office, most S&Ls indicated that they were staying close to home. The average response was 81 percent for planners and 87 percent for lenders. Also, many S&Ls executives explained that they would be making loans to meet existing customers' needs and the needs of the local community.

Perceived costs and risks were the only discernible differences among nonlenders, planners, and lenders when asked about the environment for commercial lending (Tables 4a and 4b). Nonlenders generally perceive commercial lending to be very costly, whereas planners and lenders generally characterize the costs associated with commercial lending as moderate. Nonlenders also perceive the riskiness of commercial lending as high, while planners and lenders find it to be moderate.

Figure 5
Location of nonlenders, planners and lenders



*Percent of total.
SOURCE: County Business Patterns and Survey Data.

The differences between mortgage loans, which account for well over half of a typical S&L's assets, and commercial loans may account for the different risk perceptions between lenders and nonlenders.[14] Mortgage loans are long-term loans secured by real property, whereas commercial loans are generally short-term and unsecured. A commercial loan, therefore, requires knowledge of the borrower's business and financial condition, while a mortgage loan requires skills in appraising real estate. Nonlenders have no experience in making commercial loans, but lenders have *some* experience in this lending area. Nonlenders, therefore, would be expected to perceive commercial lending as riskier than do lenders.

To gain further insight into the competitiveness of commercial lending, the S&Ls were asked what reactions existing commercial lenders had or would have to a new entrant. Most S&Ls did not think that their commercial lending activities would alter their competitors' strategies. When asked specifically, however, about competitors' reactions in terms of pricing, service, and marketing, most S&Ls acknowledged that they did not know what their competitors would do. This uncertainty may help explain why some S&Ls have been slow to use their new powers; many may have adopted a wait-and-see attitude.

The S&Ls were also asked if commercial lending would affect their retail customers. All respondents generally agreed that it would not. Of the dozen or so S&Ls that said commercial lending would affect their retail customers, all agreed that the effect would be positive. Many of these S&Ls indicated that they have retail customers who own small businesses. By making commercial loans, these associations can provide more services to their small business customers, retain their business and cross-sell retail and commercial products and services.

At the end of the first inning

S&Ls have been slow to adopt their commercial lending powers. They are gaining experience in making commercial loans by carefully and selectively marketing this new product.

Commercial loans are very different than residential mortgage loans, which account for over half of a typical thrift's assets. Before extending credit to a business, a thrift must analyze the business's financial statements and evaluate its cash flow projections. A thrift must also be willing to stand in line with other unsecured creditors in the event of the business's bankruptcy. These are gigantic steps for an industry that has been accustomed to making secured loans for less than the full value of the collateral, which has been likely to appreciate in value over time.

S&Ls seem to be following one of two strategies. Some associations are marketing commercial loans primarily to existing customers. Others are writing commercial loans only at the request of existing customers and have expressed no plans or desires to expand their commercial lending activities further. If the S&Ls that are following the first strategy, and even those following the second, find commercial lending to be profitable, then S&Ls will increasingly pose a competitive threat to banks and other business lenders, especially in lending to small and medium-sized businesses.

Furthermore, if S&Ls find commercial lending profitable, more associations can be expected to offer commercial loans. The S&Ls that responded to our survey indicated that it took only four months from the time they started planning to make commercial loans to the time such a loan was actually made.

The S&Ls that are making commercial loans seem to be carving out a niche for themselves. They are primarily targeting small businesses and, in doing so, they are capitalizing on their existing customer base. S&Ls, in general, are not yet significant competitors of commercial banks in commercial lending and deposit taking, although in some markets a few individual S&Ls may be. S&Ls should not *yet* be included wholesale in the analysis of bank mergers and acquisitions. Rather, they should be considered on a case-by-case basis if a proposed merger raises serious concerns on a bank-only basis.

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[1] The thrift industry includes savings and loan associations (S&Ls) and savings banks; however, this article is only concerned with savings and loans.

[2] *United States v. Philadelphia National Bank & Trust Co.*, 374 U.S. 321 (1963). In this case, the Supreme Court determined that the services offered by commercial banks were unique and that thrifts were not competitors because they did not provide a complete line of bank-like services.

[3] For a more detailed discussion of commercial banking as a distinct line of commerce see Rosenblum, Di Clemente, and O'Brien, "The product market in commercial banking: Cluster's last stand," *Economic Perspectives*, January/February 1985.

[4] *United States v. Connecticut National Bank*, 418 U.S. 656 (1974). This case involved the inclusion of savings banks in the line of commerce definition. The District Court included savings banks in the definition and thereby upheld the proposed merger, but the Supreme Court overturned the decision, arguing that savings banks did not yet provide significant competition to banks.

[5] See Constance Dunham, "Mutual Savings Banks: Are They Now or Will They Ever Be Commercial Banks?" *New England Economic Review*, Federal Reserve Bank of Boston, (May/June 1982), pp. 51-72; Constance Dunham and Margaret Guerin-Calvert, "How Quickly Can Thrifts Move into Commercial Lending?" *New England Economic Review*, Federal Reserve Bank of Boston, (November/December 1983), pp. 42-54; Robert A. Eisenbeis, "New Investment Powers for S&Ls: Diversification or Specialization?" *Economic Review*, Federal Reserve Bank of Atlanta (July 1983), pp. 53-62; Robert E. Goudreau, "S&Ls Use of New Powers: A Comparative Study of State- and Federal-Chartered Associations," *Economic Review*, Federal Reserve Bank of Atlanta (October 1984), pp. 18-33; and Janice M. Moulton, "Antitrust Implications of Thrifts' Expanded Commercial Loan Powers," *Business Review*, Federal Reserve Bank of Philadelphia, (September/October 1984), pp.11-21.

[6] Unless otherwise stated, "commercial lending" is defined as nonreal estate business lending and "commercial loan" is defined as nonreal estate business loan.

[7] The Federal Reserve Bank of Chicago conducted a survey of all savings and loan associations in Illinois and Wisconsin during the fall of 1984. A questionnaire was mailed to each association's president. Of the 276 S&Ls in Illinois, 79 percent responded, and of the 84 S&Ls in Wisconsin, 87 percent responded.

[8] The Federal Savings and Loan Insurance Corporation (FSLIC) has limited the amount of credit that an insured savings and loan association can extend to a single business customer to prevent concentration of credit, which could rapidly erode an association's capital in the event of default by the borrower. The FSLIC uses the same standards that apply to national banks, which limit such loans to 15 percent of a bank's unimpaired capital and

surplus and an additional 10 percent if fully secured by readily marketable collateral.

This regulation has not forced lenders to limit their activity to small businesses. After removing "regulatory equity" from reported equity, the typical S&L in Illinois and Wisconsin can lend slightly over $500,000 to a single customer. The typical bank in these two states is limited to $375,000 in loans to one customer.

[9] Dunham and Guerin-Calvert, "How Quickly Can Thrifts Move Into Commercial Lending?" pp. 42-54. In examining the commercial lending activities of mutual savings banks in New England, Dunham and Guerin-Calvert found these same characteristics, or factors that would influence a thrift's commercial lending decision. In general, the responses to our survey support their findings.

[10] An MSA consists of one or more counties, which have a significant degree of social and economic integration; a large population nucleus; and at least one central city.

[11] Dunham and Guerin-Calvert, "How Quickly Can Thrifts Move Into Commercial Lending?" pp. 42-54.

[12] Ibid.

[13] MSAs are used as proxies for banking markets. Concentration is measured using a Herfindahl-Hirschman Index.

[14] Joseph Gagnon, "What is a commercial loan?" *New England Economic Review.* Federal Reserve Bank of Boston (July/August 1983), pp. 36-40.

NOTE: For more detailed information on the results of the survey of S&Ls in Illinois and Wisconsin, please write to:

Public Information Center
Federal Reserve Bank of Chicago
P.O. Box 834
Chicago, Illinois 60690