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**- THE 1980s: A WATERSHED DECADE FOR THE
MUTUAL SAVINGS BANKS**

Address by

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to the

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THE 1980s: A WATERSHED DECADE FOR THE MUTUAL SAVINGS BANKS

by William M. Isaac*

Double-digit inflation, double-digit interest rates, and the prospect of a recession have captured everyone's attention. People are asking, how high will interest rates rise? Have they peaked? How severe will disintermediation become? How deep and how long will the recession be? Has it begun? These kinds of questions deserve and are being given serious consideration in financial circles and in government meeting rooms.

While our attention is naturally commanded by the crush of current events, we should not permit short-range planning to consume all our energies. We must make time for the longer-term, more fundamental issues confronting the mutual savings bank industry. I know that while I am trying to persuade you to shift your attention from the current environment and focus briefly on the long-range prospects for your industry, many of you are wryly recalling Lord Keynes' famous dictum: In the long run, we're all dead.

Coping with the current environment is certainly of the highest priority. Nonetheless, I believe it is critically important to focus now on the adjustments that will be required during the next decade to ensure for you and your industry the brightest possible future.

Three Important Questions

The time is ripe for the industry and for the management of each mutual savings bank to address, frankly and systematically, Peter Drucker's classic trilogy: "What is your business? What will your business be? What should your business be?" The search for answers will not be a simple one; the answers are not obvious. Drucker points out that:

An essential step in deciding what our business is, what it will be, and what it should be, is... systematic analysis of all existing products, services, processes, markets, and users....Are they still viable? Are they likely to remain viable? Do they still give value to the customer? Are they likely to do so tomorrow? Do they still fit the realities of population and markets, of technology and economy? If not, how can we best abandon them...?

*The views expressed are personal and do not necessarily reflect F.D.I.C. policy.

Addressing these questions is clearly one of the most important responsibilities you have as managers of your banks and as leaders of your industry. As you find the answers, it is imperative that they be acted upon without delay -- for it is my firm conviction that developments in our economic environment, in the competitive climate for depository institutions, in technology, in demographic trends, in the political climate, and in regional growth patterns will culminate to mark the 1980s as a watershed decade for the mutual savings bank industry.

The Changing Role of Mutual Savings Banks

Mutual savings banks have not always specialized in mortgage finance. Indeed, in the industry's infancy, savings banks did not make loans but invested only in federal and state obligations. They were strictly in the savings business and offered workers in the expanding industrial cities in the Northeast a safe place to accumulate funds to help tide them over periods of seasonal unemployment. It was a well-defined market niche.

Interest was paid on savings to encourage thrift, the primary purpose of the philanthropist organizers of the first savings banks. Savings bank depositors were creditors, not owners, of the organization but, as indicated by the term "mutual", they shared in the earnings of the institution. The philanthropic founders appointed managers and a board of trustees to run the bank.

Savings banks enjoyed good growth through the 19th century, largely due to their location in the growing industrial cities, the earlier inability and later unwillingness of commercial banks to accept consumer savings deposits and the lack of a truly competitive savings alternative. But by the early part of this century, the savings bank share of time and savings deposits had fallen dramatically from 61% of the total in 1880 to only 30% of the total in 1915. Only a small number of mutual savings banks have been founded since the early 1900s, and today the industry's share of total time and savings deposits has declined to 12%.

The loss of market share by savings banks resulted partly from the geographic expansion of commercial banks, which followed the nation's agricultural and industrial development. When commercial banks ceased to be indifferent to small savers and began their evolution into full-service institutions, they had an already established presence in virtually every deposit market. In contrast, savings bank expansion was more limited, and today mutuals operate in only 17 states. Market share was further eroded by the

emergence of credit unions as personal lending specialists, beginning in 1909, and by the strong growth of savings and loan associations whose principal purpose was to finance home ownership.

It appears that specialization in mortgage finance, which characterizes savings banks today, happened by way of a series of historical accidents. The first savings banks followed a conservative investment program in spite of the absence of asset restrictions in their charters. By the end of the Civil War, mutual savings banks were still investing principally in government obligations; mortgages represented only a small percentage of their assets. However, with the scarcity of government debt in the late 1800s, and with the widespread failure of national savings and loan associations in the Panic of 1893, mortgages rose to 29% of total savings bank assets in 1885 and to 41% in 1893. Although savings banks were permitted by state authorities to invest in railroad bonds, mortgage yields became more attractive and by the end of the 1920s, savings banks held over half their assets in mortgages.

To the industry's credit, only a handful of savings banks failed during the Depression, even though half of the industry's mortgage loans were in default during the early 1930s. Since then, industry assets have been dominated by either government securities or mortgages, depending on financial circumstances in this country. By 1940, in response to the Depression, mortgages had declined to 40% of total assets. In 1945, government securities represented 63% of total assets, reflecting the demands of heavy war financing. By 1964, mortgages had climbed to 75% of savings bank assets, and then declined again to the current level of about 60%.

Today, mutual savings banks are perceived by consumers, regulators, and the Congress as mortgage lenders. The well-defined market niche as a savings institution has all but disappeared. Mutuals, which began with the most noble of purposes -- to serve working men and women by giving them a place to earn a decent return on their savings -- have frequently been painted as villains for not making enough mortgage loans in their communities. They have been buffeted by severe disintermediation and have experienced significant earnings problems due to accelerating inflationary pressures, volatile market interest rates, limited asset flexibility, and outdated state usury laws. More recently, savings banks have even incurred the wrath of groups such as the "Gray Panthers". Circumstances have forced the industry into the incongruous position of opposing legislative and regulatory initiatives designed to provide a better return to smaller savers.

Many of the difficulties that savings banks have encountered in recent years stem from their identification as mortgage lending specialists. What I urge you to do, instead of merely resolving the problems specific to mortgage lenders, is first to re-examine your mission -- your goals. What is your business? What will your business be? What should it be?

Trends through the 1980s and Beyond

Today I want to relate to you some major trends that many believe could have a profound effect on the environment you will confront in the 1980s and beyond. These perceived trends may have an important bearing on your response to the Drucker trilogy, and in that sense may shape the future of your industry.

First, changes in the age distribution of our population have been forecast. During the next decade the number of persons entering the 25-35 age group -- the group identified as first-time home buyers -- should peak and then begin to decline. This would mean our population would tend to be of older average age, and we could anticipate a levelling off in additions to housing demand. We could also begin to see a change in the types of dwelling units demanded as greater numbers of our population enter retirement age each year.

Second, there are projections that our population will continue to shift away from the older cities in the northern tier of states to the Sunbelt. The shift may be accelerated by the growing proportion of our population in retirement, as many retirees seem to prefer the Sunbelt. This movement would draw people away from the population centers where most mutual savings banks are located.

Third, continuing shortages of key materials and resources are anticipated. The scarcity of nonrenewable energy sources would likely impact the Northeastern states with greater severity than other regions of the country. It could accelerate the relocation of people and industry to regions where energy supplies are more plentiful relative to demand. To the extent that the older housing stock in the Northeast is also less energy-efficient, higher energy prices, coupled with the potential for reduction in housing demand due to demographic changes, could result in downward pressure on housing values over time.

Fourth, some believe that we will experience continuing inflationary pressures. Seemingly relentless increases in the prices of food and natural resources, huge Federal deficits, and our woeful productivity performance contribute to inflationary expectations. If we should experience

continuing bouts with inflation, savers would require greater returns to compensate them sufficiently for the loss of purchasing power. Deposits would become even more interest-sensitive, and disintermediation, when market rates rose, would be much swifter and more pervasive -- unless deposit rate ceilings were removed or indexed. There would be no alternative but to phase out Regulation Q in this type of environment.

Fifth, we should expect competition among financial intermediaries to intensify. Greater rivalry will likely be spurred by continuing improvements in communications, transportation, and computer technology which will further blur traditional geographic and product market boundaries. Institutions that are unwilling or unable to adjust will find it increasingly difficult to stay in the race. Management skill will be at a premium. The abilities to identify and penetrate key markets, and to identify and control costs and properly price services will be essential.

Expansion of Choices

These five major trends could, in some sense, be the parameters of the future environment for your industry. But rather than constraints, I prefer to view them as expanding the choices you have -- as financial institutions and as an industry -- beyond the strict confines of mortgage lending. They are factors to consider as you decide the answers to: "What is your business?" "What will your business be?" And, especially, "What should your business be?"

The range of choice should be limitless. Should you remain specialized in mortgage lending -- not just to maintain the status quo, but by choice? Should you diversify? If so, in which directions? Should you diversify the services you offer but retain your current customer base? Should you operate like savings and loans? Or mortgage bankers? Or like "retail" banks? Or "full-service" banks? Or should you become more like mutual funds and try to recapture your role as savings institutions for small savers? You must answer these kinds of questions -- as an industry and as individual intermediaries.

When you have decided your goals and are satisfied that you know what your business is, will be, and should be, you will be positioned to address the statutory and regulatory changes needed in order for the industry to continue to make useful contributions to our society. These issues include the phase out of Regulation Q; implementation of alternatives to fixed-rate, long-term mortgages; broadened asset powers; elimination or modification of usury laws; improved access to capital markets, perhaps by conversion from mutual to

stock form or by addition of authority to issue preferred stock or some other type of security; and finally, authorization to convert into some other form of financial institution.

Organizing Your Bank for Tomorrow

While there are a number of critically important external issues that must be addressed, it is also essential that each bank carefully evaluate its own operations and management to determine whether the institution has the capacity to compete in the world of tomorrow. Does your bank have the cadre of professional managers and technical experts necessary to meet the long-range goals you have established? If not, what steps do you need to take to attract them? Does your bank have a plan for management succession and a strong program for management training? Efficiency is becoming increasingly important. Has your bank controlled personnel and other operating expenses or has it avoided facing up to difficult decisions?

One of your bank's most valuable assets should be its board of trustees. A good board has a large proportion of entrepreneurs -- people who have experience in managing successful businesses, preferably public companies. An effective board is independent and challenges management's assumptions and conclusions. The best friend -- and the best protection -- that management can have is a strong and interested board that helps formulate policies and goals and participates in strategic decisions. Such a board helps management avoid serious mistakes and is more likely to share responsibility for the mistakes that will inevitably be made. If your bank does not have this kind of board -- if the board is dominated by management's friends and social acquaintances -- you ought to take immediate steps to correct the deficiency.

You must also examine the ways in which your bank conducts its business to determine whether they will be appropriate in tomorrow's world. Has your bank stayed abreast of technological developments? Does your bank have too many or too few branches, are they suitable, and are they well located? Are your bank's accounting and financial disclosure systems and reports of sufficient quality to permit the bank to participate in national financial markets? Does your bank have a modern system for monitoring and controlling interest rate sensitivity?

Some Closing Thoughts

It is difficult, and perhaps a bit unfair, to talk about the issues and challenges facing "the industry", for there is tremendous diversity in the financial health and

prospects of the nearly 465 mutual savings banks in the nation. There is also wide variation in state laws governing mutual savings bank activities. Yet, for all the differences, you have one thing in common: the responsibility to address constructively the question of your role in our changing economic and financial environment.

I have come to you today with many questions, but few answers. That is as it should be, for it is your business and your future -- the answers must also be yours. Irv Sprague told your New York Association a few weeks ago that the FDIC stands ready to assist you in charting your future course. I reiterate that pledge. I am encouraged by the work to date of the task force that you have organized under Charley Pearce, but I ask you to go further and consider a wider range of issues and options. Your problems are not insurmountable; the answers are within your reach. I urge you to seize the opportunity now to focus on the path to your future, for your destiny will be decided by your actions -- or by your failure to act -- during the 1980s. It would be unfortunate to let this opportunity slip by.

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