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FEDERAL DEPOSIT INSURANCE CORPORATION

SAVINGS BANKS: PROBLEMS AND PROSPECTS

An address by

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In the past I have appeared before you to address the impact that changes in the economic environment are having on your industry. I have discussed the problems these changes are causing and how they are likely to change the shape of the thrift industry and the way you do business. I have encouraged you to focus on the adjustments that will be required during the next decade to ensure for you and your industry the brightest possible future.

It was and is my sincere belief that in the long run you will be able to make the necessary adjustments. I recognize, however, that many of you are finding it extremely difficult to revitalize your institutions under current economic conditions.

I want to emphasize at the outset that we at the FDIC understand the nature of your problems and share your concerns. As many of you know, we created late last year a high-level task force which has devoted a great deal of time and energy to this subject. We have met frequently with a wide variety of people -- including representatives of other financial institution agencies, congressional staff, administration officials, managements of savings banks, officers of your Association, and others -- seeking the broadest possible input in our deliberations.

Today I would like to share some personal views on the problems facing your industry, the reasons those problems have arisen, and ways to address them. I will conclude with a brief discussion of the protection afforded by our deposit insurance system.

I. THE PROBLEM

The rise in interest rates that began last fall has eroded hopes for improvement in mutual savings bank earnings this year. During 1980, insured mutuals suffered aggregate losses of $248 million, or a negative return on average assets of 0.16 percent. Losses in New York City savings banks alone amounted to $379 million, or 0.61 percent of average assets, indicating the industry outside New York City was profitable in the aggregate.

Based on first quarter performance and April deposit flows, losses during 1981 will in all likelihood surpass those suffered during 1980. Interest rates are running higher, deposit mix is becoming less favorable, and earnings are no longer being supplemented by early withdrawal penalties to the extent they were last year. Without a significant drop in interest rates and improved deposit flows, some institutions will have substantially depleted their surplus accounts within the foreseeable future, and their continued viability will be seriously jeopardized.

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II. WHY THE PROBLEM EXISTS

Until recently the general strategy of thrift institutions to fund long-term, fixed-rate assets -- principally housing credit -- with stable, low-cost deposits went unchallenged. In a virtually inflation-free environment, flows of funds were predictable, and few questioned the soundness of investing deposit dollars in 25- and 30-year residential mortgage loans. The notion that an asset/liability mismatch might cripple an entire industry did not occur to many thrift executives even though warning signals appeared in 1966, 1969, and 1973.

With the advent of interest rates that made Regulation Q ceilings unrealistically low, and the specter of continuing disintermediation, savings institutions began to experience an earnings squeeze brought about by having to pay more and more to fund assets locked into low yields and long maturities. As the high rates persisted over the last couple of years, the pressure on margins increased and was exacerbated by unprecedented rate volatility, which made funding and investment decisions even more hazardous.

Government policies encouraging or even requiring asset specialization have added to the problems, as have restrictive usury laws. In some states, recent earnings losses suffered by thrifts have been compounded by tax laws that impose inequitable and unrealistic burdens. In New York, for example, state and city franchise taxes are imposed irrespective of earnings or losses, which adds significantly to the problem of severe earnings losses. As a large proportion of the assets of mutual savings banks is located in New York, these taxes are a source of great concern to us.

Although the current harsh economic environment and government policies are to blame for many of the problems of the mutual savings bank industry, management cannot be absolved of responsibility. Even in the face of current adversity, a number of savings banks are profitable. These tend to be banks that have maintained a fair degree of liquidity, strong surplus ratios, comparatively short-term investment portfolios, and relatively tight controls on overhead.

III. SOLUTIONS TO THE PROBLEM

There is no question that many thrifts are facing the most difficult period in their history. We can take a number of steps, which I will consider presently, to help ease the burden. Indeed, a number of actions have already been initiated, including usury relief, greater asset powers,

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variable rate mortgages, and the phaseout of interest rate ceilings on deposits. It must be emphasized, though, that most of these measures treat only the symptoms of the disease. They are aspirins and Band-Aids, not panaceas.

There is one, and only one, cure for the plight of our nation's thrifts: inflation must be eradicated. So long as inflationary expectations continue at or near current levels, savings flows will be weak and interest rates will remain at unacceptably high levels. If this pattern continues much longer, the essential character of your industry will, of necessity, be fundamentally altered. For some of you, it will be a question of survival.

Recognition of this simple fact of life has led your Association in the past to be supportive of government efforts to bring inflation under control. I urge you -- for the good of our nation and for the sake of your own institutions -- to redouble your efforts.

If I were in your position, I would make this the number one priority of my Association. I would spare no effort in making known in all quarters of government your insistence that inflation be brought under control. I would hope that no one in this audience requires further convincing as to the urgency of this task -- of the advanced stage of the malady.

As for other measures to help you cope with the current and possible future economic and competitive climates, I believe it is convenient to group them under two general headings: actions government might take and steps you should be considering as individual institutions.

A. Possible Actions by Government. There are a number of possibilities for government action which require consideration. Some steps could be taken promptly; others would require more lead time.

1. Interest Rate Decontrol. Plans are already being implemented to decontrol interest rates on both sides of the balance sheet. These measures must be implemented as soon as possible consistent with principles of safety and soundness. An overall plan and tentative timetable for decontrol ought to be adopted to enable depository institutions as much lead time as possible to prepare their strategies. In the meantime, efforts are continuing to develop new deposit instruments, which might provide some short-term assistance. The challenge is to design instruments which are competitive in the marketplace but do not exacerbate the earnings pressures. We are also mindful of the problems associated with locking up for long periods a large volume of very high-cost funds at fixed rates.

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Money market funds, which now have assets in the range of $120 billion, are a continuing source of concern to us. It is unrealistic to believe that we can move quickly to make thrifts and many banks -- with their long-term, fixed-rate asset portfolios -- fully competitive on the liability side with money market funds. Thus, we must consider whether it would be feasible and appropriate to limit, in some fashion, the transaction account activities of money market funds. To do so would require legislation, which would clearly be difficult to obtain in view of the widespread public acceptance of money market funds.

2. Asset Flexibility. The Depository Institutions Deregulation and Monetary Control Act of 1980 has expanded the asset powers of federally-chartered thrifts, and some states have also responded. These are steps in the right direction, but more can and likely will be done.

3. Tax Issues. Although you have been given additional powers to diversify your assets, federal income tax laws still contain a strong incentive for you to invest heavily in mortgages. The propriety of this must be reviewed. Consideration might also be given to permitting greater flexibility in the use of current tax losses to offset past and future tax liabilities. States that impose taxes on institutions regardless of their income or losses ought to reconsider these laws. Finally, tax incentives to encourage savings flows need to be explored. Two principal questions in this regard relate to the degree to which they can and should be targeted -- for example, on specific accounts or types of intermediaries -- and ways of counterbalancing the potential budget impact.

4. Methods of Attracting Capital. One of the most damaging consequences of the current period of high inflation and volatile interest rates has been the erosion of surplus ratios. Because of their mutual form of organization, the only way mutual savings banks currently have to rebuild their equity accounts is by increasing earnings, a feat nearly impossible to achieve under current economic conditions. The ability to convert from mutual to stock ownership might provide a means to raise capital other than through earnings retention. This and any other alternatives for augmenting capital must be explored.

5. Accounting Treatment of Losses. Thrift industry representatives have urged that institutions be permitted to sell low-yielding assets and defer recognition of losses for financial reporting purposes (the losses would be amortized over a period of years). The entire loss, however, would be taken immediately for tax purposes. The potential benefits of amortizing a loss in this way would be

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federal income tax relief -- which would be of limited utility to savings banks -- increased liquidity, and a modest enhancement of earnings. While we have serious reservations about this proposal, we have not yet rejected it. Generally, we perceive the benefits to be marginal and the accounting issues to be substantial.

B. Steps Your Banks Can Take. Although your future will be greatly influenced by the actions taken by federal and state governments, circumstances do not permit you to sit by awaiting decisions from Washington, Albany, or other centers of government. Many of the forces contributing to your problems are now beyond your control -- high and volatile interest rates, depressed local real estate markets, sluggish regional economies, unfavorable state laws, heightened competition from money market funds, and, most of all, persistent inflation. It is essential, however, that you move as quickly as possible to take whatever steps are in your power to improve your own situation. Your goal should be to enhance earnings, improve liquidity, and alleviate the severe mismatch in your asset/liability structure as rapidly as possible. I know that most of you are already moving in these directions, but let me mention briefly some short- and long-term actions we believe your institutions should consider.

1. Immediate Steps.

a. Improve Earnings. Opportunities to increase profitability or reduce losses must be sought on both the income and expense sides of the ledger, although we recognize the paucity of revenue-generating measures in the current environment. No reasonable avenue for augmenting income or reducing expenditures should be left unexplored. Possibilities for income from such activities as packaging, selling, and servicing mortgage loans and providing various consumer, trust, and small business services should be considered. We will be emphasizing in our supervisory efforts the control of operating costs through careful budgeting and elimination of duplicative or wasteful operations and expenditures. Curtailment of expenses might be achieved by personnel reductions and branch sales or closings.

b. Asset/Liability Mismatch. It is obviously essential that you bring your asset/liability structure into greater equilibrium in order to diminish your exposure to interest rate fluctuations. While the current environment does not afford much opportunity to make significant adjustments on the asset side, you might consider greater use of secondary markets. On the liability side,

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it is clearly difficult in the current interest rate environment to lengthen the average term of your liabilities. However, this must be done when and to the degree feasible. In the right climate, the prudent use of mortgage-backed bonds may provide a means of lengthening the average maturity of your liabilities, while stabilizing the cost of those funds.

Your investment portfolio may present an opportunity to improve your overall condition. Repayments flows (or amortization) -- to the extent not needed to fund deposit outflows -- should be used to improve your liquidity and repay borrowings. Many of you need to shorten the average maturity of your investments. If efforts to increase income take hold, you may be able to sell your long-term investments and take whatever losses can be reasonably absorbed.

c. Membership in Federal Home Loan Bank System. Many of you have chosen to become members of the Federal Home Loan Bank System. We recommend that the rest of you explore this option. It represents an additonal expense -- particularly in view of the limited opportunities in the present climate to expand assets -- but it may also represent a dependable and much-needed source of liquidity.

2. Long-range Planning. Recognizing that the future direction of your industry depends to a large degree on the course of the economy and actions taken by Congress and state legislatures, I believe you must nevertheless begin to develop long-range plans for your institutions. Most fundamental, perhaps, is for each of you to determine whether your bank has the ability to survive and compete effectively in an environment vastly different from the less competitive, relatively inflation-free one in which your industry operated for decades. Beyond that, there are a number of considerations you ought to take into account in preparing to operate in a changed environment.

a. Management. Good management will be even more important for the success of your bank in the future. You must consider whether you have the kinds of managers, technicians, and specialists essential to enable you to compete in an increasingly competitive and complex financial services industry.

b. Board of Trustees. One of your bank's most valuable assets should be its board of trustees. If your bank does not have a strong and interested board that is involved in formulating policies and goals and in making strategic decisions, you ought to take immediate steps to correct the deficiency.

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c. Other Initiatives. In developing a longer-term strategy for your bank, some introspection is essential. You need to examine the ways in which your bank does business to determine whether those strategies will be suitable in a drastically changed banking environment. Has your bank stayed abreast of technological developments? Does it have the capability, for example, to compete in the arena of electronic funds transfer? What about branching structure -- are your branches profitable, up-to-date, and well-located -- do you have too many or too few? Does your bank have the sophisticated accounting and financial disclosure systems and reports necessary to participate in national financial markets? What about other modern internal controls, such as management information systems, credit analysis and review procedures, and audit systems? Defining your identity is perhaps the most fundamental task. You must decide -- particularly as legislative changes alter your basic statutory authority -- what your mission will be, who your customers will be, and how you will go about fulfilling your mission and serving your customers.

IV. FDIC PROTECTION

This brings me to my final topic today: the protection afforded by the federal deposit insurance fund. No one can predict with certainty the course of the economy and interest rates over the months and years ahead. Our responsibility is to prepare for the worst and hope for the best.

Toward that end, we have projected -- with aid of data supplied by many of you, which we appreciate -- what is likely to transpire within the savings bank industry under a variety of economic scenarios. I can assure you that even assuming very pessimistic interest rate environments, the FDIC's resources -- employed wisely -- are more than adequate to deal with every contingency.

Our fund is strong, growing, and highly liquid. It exceeds $11.3 billion in size, and we project net income this year in the range of $1.3 billion. The fund holds approximately $200 million in overnight obligations and has an overall average maturity somewhat in excess of three years.

The three basic tools at our disposal for dealing with a failing institution are a payoff of insured deposits under Section 11 of our Act, a purchase and assumption transaction under Section 13(e), and direct financial assistance to an open bank under Section 13(c) provided we determine the bank is essential to its community. We must analyze each situation based on the particular set of circumstances before us and select the most appropriate of these tools. We ordinarily seek to minimize the impact on our fund.

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In the typical situation, with an isolated institution suffering from asset problems and with a number of bidders willing to pay a substantial premium for the franchise, we have found the purchase and assumption transaction to be the least costly and least disruptive solution. However, in view of the circumstances confronting a number of mutual savings banks, we may find it advantageous to utilize Section 13(c) to a greater extent, probably through the acquisition of subordinated notes.

We are always extremely reluctant to use our Section 13(c) authority; it has been employed on only five occasions. We are philosophically opposed to interfering with the normal operation of the marketplace. We abhor the thought of "bailing out" shareholders. Finally, we believe that in the typical failing institution, involving asset quality problems created by inept or dishonest management, Section 13(c) assistance is unlikely to resolve the difficulties and may simply increase our exposure.

These considerations are likely to be less of a factor in a troubled savings bank. A mutual has no shareholders. For the most part, its problems will probably be related to the interest rate climate, not asset quality. Also, our analysis indicates that Section 13(c) assistance may be substantially less expensive to the insurance fund than other means of resolving the problem.

If Section 13(c) assistance is provided, the amount of the assistance must be limited to conserve the resources of the deposit insurance fund and to avoid giving the assisted institution an advantage over competing, unassisted institutions. Moreover, terms and conditions must be imposed which will protect the interests of the insurance fund.

The FDIC has considered and rejected some rather elaborate proposals for subsidizing large numbers of mutuals. First, our statutory authority is limited. Second, our resources are finite. Third, there are a host of other factors, such as the impact on fiscal policy and on competing firms, which must be taken into account.

We will likely be seeking in the near future legislation to provide us with additional flexibility in dealing with troubled institutions. If we do propose legislation, I hope we can count on your support to ensure its swift passage.

V. CONCLUSION

These are difficult times for thrifts. Eradicating inflation is the only way I know of to cure the malady. In my judgment, this ought to be your Association's top priority.

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There are a number of actions that we in government have already taken, and can still take, to relieve some of the pressures on you. A number of such measures are under serious consideration.

In the meantime, there are several steps you can take to enhance the prospects for your institution. It would be a serious mistake to conclude that your fate is totally beyond your control. You must -- if you have not already done so -- begin to put your house in order.

If all else fails, the FDIC will be there. We have the people, the financial resources, and the resolve to carry out the task we were created to perform.

Again, I thank you for this opportunity to address your annual convention. I look forward to working closely with you in the years ahead as we endeavor to ensure for your institutions a bright and prosperous future.

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