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MANAGING SAVINGS BANKS FOR PROFIT AND SOUNDNESS

Address by

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before the

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MANAGING SAVINGS BANKS FOR PROFIT AND SOUNDNESS

It is a great pleasure to be with you today and, of course, to be here at the Greenbrier. Although I was a commercial banker in a state in which there are no mutual savings banks, one cannot have worked at the FDIC for more than four years, and with leaders of the savings bank industry longer than that, without appreciating the savings bank perspective.

In recent years mutual savings banks have been in the vanguard in developing new financial services such as new accounts and telephone transfers. These and other developments have moved mutual savings banks a long way down the road in the evolution into "full service family banking institutions" or "people banks" as your convention theme suggests. I believe that the development of savings banks into full service family banking institutions is a highly desirable goal. We at the federal level and you in the industry should be hard at work developing and supporting proposals which will speed the evolutionary process or at least, remove the the impediments to the achievement of this goal.

Ira Scott spoke to you yesterday about managing savings banks for profit. I would like to expand on that this morning to include managing savings banks for soundness as well as for profit. Over the long run both are vitally important.

Generally speaking, the performance of savings banks has been mixed in recent years. For example, 1970, 1974, and 1975 were particularly bad years due primarily to high interest rates and disintermediation. However, recent trends are encouraging. After reaching a low point in 1974, savings banks' earnings improved steadily. The net income to total assets ratio for 1977 should be about 15 percent higher than that for 1976 according to FDIC figures and nearly

50 percent above that for the recession year of 1974. Moreover, deposit maturities have continued to lengthen. While this raises the cost of funds, over the long haul this shift in deposit structure will afford savings banks more protection from the ravages of disintermediation. On the asset side, the addition of greater amounts of short-term loans and securities has improved liquidity and also has resulted in a better matching of asset and deposit maturities.

Although recent trends have been generally favorable, it is important to recognize that certain problems do pose potential threats to the financial strength of savings banks. Specifically, these problems are reflected in the low earnings levels of savings banks and deteriorating capital (surplus plus reserves) ratios. For example, earnings as a percent of total assets over the last seven years has averaged 0.37 in New York State mutual savings banks and 0.48 in savings banks in other states. These figures represent approximately a 5.3 percent return on capital in New York State and a 6.8 percent return in the other states. Neither of these rates is as high as the maximum savings banks may pay on a long-term time certificate of deposit.

Although it is not necessarily the goal of mutual savings banks to maximize the rate of return on capital, if this rate is less than the rate of growth in total assets the capital ratio, of necessity, must decline unless additions to capital can be made from nonearnings sources. Over the same seven-year time period, assets have grown at an annual rate of about 8.6 percent in New York savings banks and about 10.2 percent in other savings banks. As a consequence, the average capital to asset ratio has fallen from 6.9 percent in New York State mutuals in 1970 to 6.4 percent in 1976. The average capital ratio for savings banks in other states is higher but it has declined even more, from 8.2 percent in 1970 to 7.0 percent in 1976. If total assets continue to grow at the same rates in the next few years and if earnings rates remain at the recent low levels, the capital ratio will continue to deteriorate. Assuming no additions to capital from nonearnings sources, this ratio would decline over the next ten years to 4.7 percent in New York State and to 5.1 percent in other states. Although there is reason to view these figures as "worst-case forecasts," they indicate that the prospect of declining capital ratios should not be treated lightly.

I would like to add at this juncture, however, that the FDIC does not judge the soundness and future prospects of a savings bank on its capital ratio alone. Other criteria such as management capabilities, profit outlook and deposit flows also are considered. We recognize that a capital ratio in one savings bank may be cause for real concern while the same ratio in another bank is not. Furthermore, if risks can be reduced, lower capital ratios may be acceptable. And, there are prospects that some risk reduction may be a possibility in the future.

Nevertheless, the capital ratio cannot continue to deteriorate without eventually seriously weakening the financial condition of mutual savings banks and, hence, their ability to absorb unexpected setbacks and their ability to be strong and aggressive competitors. However, I believe that there are solutions to the problems of weak earnings and declining capital ratios. And, I am confident that such solutions will be found. In the remainder of my remarks, I would like to analyze the options for dealing with these problems. Some of these options look promising, others do not.

There are three general types of solutions. First, if the asset growth rate could be slowed down to 5 or 6 percent, capital ratios would stabilize and might even increase. Second, an earnings increase of approximately 50 percent over current levels would have the same effect. Finally, ways could be found to supplement capital from sources other than earnings. This has already occurred to some extent through the issuance of subordinated debentures.

Fundamentally, there are two ways to slow asset-growth rates. A decline in the inflation rate and the rate at which the money supply increases would probably accomplish this. However, a slowing of inflation, at least in the near future, cannot be counted on. Certainly, there are many who feel that inflation at rates of 5 to 6 percent or even higher will be a fact of life for the foreseeable future. Also, it is a fact of life that the money supply growth rate and, hence, the growth rate of financial assets usually equals or exceeds the inflation rate. This means that asset growth rates in all likelihood will continue to range from 8 to 10 percent.

Alternatively, mutual savings banks could voluntarily reduce their rate of asset growth by restricting deposit growth. In my judgement this would be highly undesirable for two reasons. First, deposit growth probably could be slowed only by reducing deposit interest rates below other competitive market rates and this would be unfair to savings bank customers. Second, such a step would concede the initiative to other types of institutions and in all likelihood would set in motion a process of rigor mortis which might eventually result in the elimination of an important and vital competitor.

Turning to the second category of solutions, I think we would all agree that from the point of view of the industry and customers alike strategies for improving earnings are much more desirable than those for reducing the asset growth rate. Some ways of improving earnings include increasing earnings rates on various assets, stabilizing earnings over the business cycle and reducing noninterest operating expenses.

I don't need to remind you that the earnings problem in mutual savings banks stems from a mismatching of asset and deposit maturities. Rates savings banks must pay on deposits tend to adjust to market rates very rapidly, but rates that they earn on their assets adjust much more slowly. So long as inflation remains at a constant rate over an extended period of time, the difference in asset and liability maturities is unimportant so far as earnings are concerned.

This problem is, of course, most acute during periods of rapidly increasing market interest rates. But there is some reason for optimism on this score because over the last three years long term new mortgage rates on a nationwide basis have been fairly stable at around 9 percent. If rates remain stable at current levels for several more years, old low interest rate mortgages eventually will be eliminated from the portfolios of most savings banks. Thus, mortgage turnover alone should provide a substantial boost to earnings since the current average rate of slightly over 9 percent on new mortgages is more than 150 basis points above the average rate earned on the typical mortgage portfolio.

Another way of improving earnings even more quickly would be to sell older, low-rate mortgages. This, of course, has an immediate adverse impact on capital. But eventually capital would be replenished through higher earnings generated by investing the freed-up funds at current interest rates. Of course there is always the risk that higher earnings will not materialize and for that reason many, including the FDIC, have been reluctant to endorse a strategy of selling deeply-discounted mortgages. Nevertheless, it is an option that I believe should receive serious consideration.

If interest rates do not remain stable but accelerate as they have so frequently in the past, savings banks again will be confronted with a severe earnings problem.

At least a partial solution to this potential problem and an option that deserves consideration is the development of various kinds of alternative mortgage instruments which would provide some measure of rate flexibility.

Another depressant of earnings in New York State, as well as in several other states, is usury laws. The New York law limits rates on conventional residential real estate loans to 8-1/2 percent. Usury ceilings in addition to harming savings banks' earnings rates, harm potential borrowers. When interest rates rise above usury ceilings, a financial institution may continue to make loans to its best customers, sometimes even at a loss, but will cease making loans to riskier potential borrowers who would be creditworthy at a higher rate of interest. Thus, in such cases, those whom usury ceilings are designed to protect are, in effect, shut out of the market for credit. When people are shut out of the legitimate market they become the potential prey of unscrupulous loan sharks who not only charge exorbitant and usurious interest rates but may otherwise place onerous terms and conditions on the extension of credit.

Moreover, even individuals who are not shut out of the legitimate loan market may be compelled to accept more onerous terms including higher downpayments, larger front-end fees and shorter loan maturities. An additional effect of usury ceilings is that lenders look for investments that do not have rate restrictions. In the case of New York State mutual savings banks, over the last ten years there has been a substantial movement toward investment in securities and out of mortgages. For example, mortgage loans as a percent of assets has fallen from 82 percent in 1966 to 60 percent in 1976.

Most bankers would welcome elimination of usury ceilings on interest rates. In my opinion, the prospects for dealing with usury ceilings would be greatly enhanced if bankers worked to eliminate deposit interest rate ceilings commonly referred to as Regulation Q. It has been shown clearly that deposit interest rate controls are an inefficient means of assisting housing and assuring stability of mutual savings banks. Regulation Q simply does not work well as a device for allocating funds to housing. Although it may protect thrift institutions from commercial bank competition to a certain extent, it does not protect them from competition from the unregulated money market. In times of high interest rates such as was the case in 1966, 1969-70 and 1973-74, many depositors forsook depository institutions and invested their funds directly in market instruments. As a result of such disintermediation, the mortgage market dries up and savings banks suffer earnings and liquidity pressures.

Moreover, even if the ceilings were effective in assuring a stable flow of funds to the housing market, they would still be highly objectionable because they constitute a regressive and inequitable tax on small savers. These are the people who are the very backbone of the thrift industry. In my judgment, the proper focus of our attention should be upon how and when and not whether to phase out interest rate ceilings. For this reason I favor designation of a specific date for their demise. I believe that only in the context of such certainty will bankers, regulators and the Congress begin to plan seriously for a world without deposit interest rate controls.

Time for doing this is already running short because non-regulated institutions, such as Sears and Merrill Lynch increasingly are competing vigorously for the depositor's dollar. Furthermore, improvements in electronic payments systems will enhance the competitive capabilities of non-regulated institutions. The answer is not to bring these institutions under rate control because that would only place additional unnecessary restraints on the economy and almost certainly ways would be found to circumvent controls. Therefore, I believe that you, as savings bankers, must face the reality of competing for deposits on an equal basis in the future. This means that management for profit and soundness will become an absolute necessity.

Another way to improve earnings would be to match deposit and asset maturities better. This would lessen the sensitivity of savings banks' earnings rates to changes in market rates of interest over the course of the business cycle. The rapid growth of time deposits over the last several years has contributed significantly to a lengthening of deposit maturities. The advent of mortgage-backed bonds in the last year or so also points out a new way of lengthening liability maturities. Washington Mutual Savings Bank of Seattle, Washington, recently successfully placed privately a large issue of mortgage-backed bonds. It should be recognized that the process of underwriting and privately placing debt issues is not easy. Nevertheless, it is an option that should be given serious attention.

In some states, asset flexibility has been increased by permitting thrift institutions to put part of their assets in installment loans and other kinds of short maturity loans. Furthermore, the development of the full panoply of financial services for consumers should help to stabilize deposits. For example, New York State savings banks now have checking powers and New England savings banks have NOW account powers. Traditionally, transaction-type deposits have not been nearly as sensitive to interest rate changes as savings deposits.

In addition to improving earnings flexibility, broadening the asset investment powers and the deposit taking powers of savings banks will not only make them more competitive with other institutions but also will give them the added flexibility needed to reduce their dependence on excessive liquidity. Furthermore, I believe that savings banks should be allowed to offer a wider range of services to the public so as to strengthen customer relationships and insure a more stable source of lendable funds. Expanded investment powers should provide a continuity of cashflow and an improved ability to adjust earnings more readily in response to changing interest rates.

In this regard, I believe that providing mutual savings banks a federal chartering option would be very helpful. Dual chartering of commercial banks and savings and loan associations has resulted in the adoption of innovations which genuinely satisfy customer needs. At times the stimulus has come from the federal side and, at other times, the stimulus has come from the state side. In my judgment, mutual savings banks and their customers should not be denied the considerable benefit of this unique and positive feature of American financial regulation. For this reason, I strongly favor immediate adoption of legislation which would provide the federal chartering option for mutual savings banks.

Several bills currently pending before the Congress would authorize the Federal Home Loan Bank Board to issue charters for federal mutual savings banks. In addition, most of them would limit the federal chartering option to the 17 states where mutual savings banks currently exist. I do not favor restricting the federal chartering option geographically, nor do I favor limiting this option to existing institutions. It seems to me that mutual savings banks have been effective, viable competitors in the 17 states where they exist and there is no reason to limit their benefits to these states.

Furthermore, I think it is appropriate to point out that the FDIC has had more than 40 years of experience in examining and supervising the mutual savings bank industry -- experience which would be most useful to a chartering authority. One of the unique advantages the FDIC possesses that the other financial regulatory agencies do not possess is that we must be concerned with both commercial banks and thrift institutions. This, I believe, has given us a balanced regulatory perspective. I know, for example, that this is most useful in our deliverations with respect to interest rate ceilings.

Finally, one way to improve earnings, frequently overlooked because of its difficulty, is to reduce noninterest operating expenses. Since 1970 noninterest operating expenses as a percentage of total assets has increased by more than 40 percent. This means that those expenses have increased at a much faster rate than deposits or assets. At best, only a part of this can be blamed on inflation. The most significant increase in noninterest operating expenses has occurred in the "other" operating expense category. Much of the increase may well stem from introduction of automated data processing equipment, development of capital intensive telephone transfer and other types of EFT Systems. Whatever the cause, the continued rise in operating expenses in the long run could have chilling effects on earnings. It is probably none too soon to focus attention on getting operating expenses under control. In the future competition for deposits and for assets will limit a savings bank's ability to control earnings. The only real source of increasing earnings that will be directly under savings banks' control will be noninterest operating expenses.

Finally, a third genreal way of assuring the continued financial strength of mutual savings banks in the future would be to develop alternative sources of capital funds. Two alternatives have been suggested. These are preferred stock and subordinated capital notes and debentures. According to recent figures available to the FDIC, New York State Mutual Savings Banks already have about $58 million in subordinated notes and debentures. This equals just over 1 percent of total capital. Although subordinated notes and debentures are far from a perfect substitute for capital, they could reasonably make up a larger proportion of capital than 1 percent. There are, however, some drawbacks. Most importantly, subordinated notes and debentures carry fixed interest payments and failure to meet these payments could force the failure of the savings bank. Because of this and other risks it is likely that the FDIC will continue to limit the amount of such debt instruments. Nevertheless, we are willing to explore what that limit should be.

Former Superintendent of Banks of New York State and current Comptroller of the Currency, John Heimann, suggested the possibility of issuing preferred stock as a way of buttressing capital. Presumably, such a security would be like an income bond in the sense that the holders would not have the status of owners as they would in stock-based corporations and the passing of an interest payment would not jeopardize the solvency of the mutual savings bank as would the failure to meet the interest payment on a subordinated debenture. To the best of my knowledge, present New York tate banking law does not permit mutual savings banks to issue such a security. These and other possibilities of supplementing capital need to be studied carefully.

We at the FDIC are interested in investigating the possibilities for maintaining sound capital ratios and improving earnings and would welcome the opportunity to work with savings banks in this regard. I do not purport to have all of the answers nor do I think that they are to be found in Washington alone. As a first step, I would welcome and encourage savings bankers to come forward with concrete and constructive proposals. I hope that we can work together and engage in meaningful dialogue in the coming months to devise reasonable solutions to the problems facing mutual savings banks.

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