

Statement of
Chairman K. A. Randall
Federal Deposit Insurance Corporation
before the
Committee on Ways and Means
House of Representatives
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I appreciate this opportunity to appear today before the Committee on Ways and Means of the House of Representatives to discuss with the Committee some aspects of mutual savings banking that are relevant to the Committee's consideration of the tax reform studies and proposals prepared by the U.S. Treasury Department staff, pursuant to the Revenue and Expenditure Control Act of 1968.

The Corporation's immediate interest in discussing taxation of mutual savings banks with the Committee stems from our impression that implementation of proposals similar to those advanced in the Treasury staff study could eliminate the necessary degree of flexibility now incorporated in mutual savings bank portfolio powers. Such a result would be wholly contrary to the portfolio diversification increasingly permitted mutual savings banks over the years and would increase the problems of both the institutions and their supervisors in dealing with ever-changing economic and financial conditions.

As the Corporation understands the Treasury staff proposal, tax policy will in effect be used to penalize mutual savings banks for failure to maintain a certain proportion of their assets in residential

mortgages. So, to the extent that mutual savings banks are forced by tax considerations to make heavier commitments in real estate mortgages than they might have without the tax penalty, they would become much like savings and loan associations. Savers would then be disadvantaged because they would lose the services of mutual savings banks that are primarily thrift-oriented institutions. Such a tax policy, moreover, would produce the highly undesirable effect of reducing the present flexibility of savings bank portfolio policies and would further constitute a major contradiction of the basic principles of mutual savings banking.

At this time, since there is no specific legislative proposal before Congress for changes in the taxation of mutual savings banks, the Corporation wishes only to bring to the attention of Congress some fundamental considerations that should be taken into account when specific legislation is being drafted. The Corporation will be glad to furnish its comments to the Committee on specific legislation when it is introduced and to appraise its consequences for the banking system. Accordingly, my statement today will seek only to give the Committee an abbreviated description of the origins and evolution of mutual savings banking in this country and point up the implications that this background and recent experience hold for mutual savings banking in the present environment.

In addition to purely fiscal considerations, tax policy and practices can constitute a powerful instrument whereby the direction and purpose of the economy can be influenced. A thorough understanding of the many factors that can be affected by particular tax policies within even a small sector of the economy is essential in order to formulate a rational tax program for a rapidly changing economy.

As the only supervisor at the Federal level for mutual savings banks, the Corporation is in a position to view broadly the industry and its role in the financial mechanism. The Corporation also is concerned with the overall development of the nation's banking system and its ability to meet the financial requirements of the economy in the most efficient and effective manner. Tax policies that would help to achieve these goals are thus obviously of interest to us. It is in this context that the following comments are offered.

The first mutual savings bank was started in the United States just about 150 years ago -- a counterpart of the mutual savings bank concept developed earlier in Scotland and England. These banks were formed by public-spirited members of a community to encourage thrift and to provide a depository for the savings of the small wage earner in the newly emerging industrial society. The other financial institutions of that period did not serve the needs of this wage earner group.

The objectives of the founders of these early mutual savings banks were to provide safety, liquidity, and an attractive, though often small, rate of return for funds left with the bank. These funds in turn were

placed at first mainly in legally permissible Federal or State obligations and then in an ever-widening range of investments as the legal lending powers of the savings institutions were broadened.

As time passed, mutual savings banks were empowered by state legislation to undertake the financing of residential and nonresidential mortgages. But, unlike savings and loan associations, mutual savings banks were not established for the primary purpose of home mortgage financing. The increase in the proportion of mortgages in mutual savings bank portfolios came about in part because yields on mortgages became relatively more attractive than the returns from alternative investment opportunities. A strong demand for housing pushed up the interest rate on mortgages and made them desirable investments for mutual savings banks.

The higher yields available on mortgages -- as compared to other types of investments -- have thus enabled mutual savings banks to satisfy two major objectives simultaneously -- to assist in financing needed housing and other construction in an expanding economy and to encourage thrift by providing attractive yields as well as safety for the funds of the individual saver. Nevertheless, the attractiveness of yield does not override investment fundamentals -- such as diversification of risk and maintenance of balance -- in the management of mutual savings bank portfolios.

Mutual savings banks are among the strongest thrift institutions in the financial community today. Their strength has been attained

importantly through their ability to invest in a diversified range of assets and to vary the composition of these assets in accordance with changing economic and financial conditions. This flexibility is essential if mutual savings banks are to achieve their major purpose, which is to safeguard the funds of the smaller saver and encourage thrift. A sacrifice of this flexibility in order to facilitate some particular type of financing would amount to a significant departure from the basic purpose of mutual savings banking.

The need for mutual savings banks to remain flexible and adaptable when rapid and sharp changes occur in the environment in which they operate was clearly demonstrated during the "credit crunch" of 1966. Owing to the flexibility inherent in their investment portfolios, mutual savings banks as a group were prepared to withstand the pressure of that period and were therefore able to tolerate sharp declines in deposit inflows. In this respect they differed substantially from other specialized thrift institutions that because of their very nature cannot have the advantage of this flexibility.

Nonetheless, the resultant depressing impact of this period on housing and on the mortgage markets is one that we do not want to see repeated. Perhaps the best way to prevent the recurrence of such a situation is to encourage saving and thus assure a steadily growing movement of funds into mortgage financing. The benefits to the nation would accrue from a larger volume of savings generated by the economy rather than from an arbitrary channeling of a given volume of savings

into particular outlets through punitive taxation designed to reshape the portfolio policies of particular financial institutions or particular groups of savers, irrespective of the possible side-effects.

The nature of mortgage financing -- its relatively long maturities and large average size -- makes it especially advisable that mutual savings banks, for example, protect themselves against excessive commitments in mortgages in a volume that would interfere with their ability to adjust to external financial pressures. It would be particularly unfortunate if such a result were brought about inadvertently through inappropriate tax treatment; this would negate the major purpose of the savings bank -- to provide for the welfare of the saver.

Viewing the 1960's in retrospect, events of the past two years probably give us a better preview of the future than the early years of the decade. As a consequence, we must take into account the increased interest sensitivity and consciousness of savers to changes in rates of return or in rate differentials between alternative investment opportunities. Policies which affect rates payable by mutual savings banks and other thrift institutions or yields on competitive market instruments can have a much more immediate and concentrated impact than similar policies might have had several years ago. And depositors in mutual savings banks appear to be somewhat more sensitive than savers in other thrift institutions to interest rate differentials. These are some of the realities that must be taken into consideration today.

To sum up, the Corporation believes that the strength and resiliency of the mutual savings banks have been due not only to the high quality of their management but to the industry's ability to maintain diversification in its portfolio policies. These advantages should not be diminished or dissipated by inappropriate tax policies that may not even achieve the objectives for which they are supposedly designed. Tax policy should ideally be neutral in its institutional impact -- unless the deliberate decision is made that the tax policy should be used to bring about institutional changes. In that event, it is essential that such an intent be fully recognized and the consequences weighed. And it goes without saying that the change should be in "the right direction" and should be permitted to proceed in an evolutionary manner.

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