Address by

Irvine H. Sprague, Chairman
Federal Deposit Insurance Corporation

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National Association of Mutual Savings Banks

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In recent weeks there have been four actions -- one administrative, one legislative, one judicial and one regulatory -- which vitally affect the regulatory environment of mutual savings banks and other federally regulated depository institutions. I refer, of course, to the FDIC's decision denying a branch approval under the Community Reinvestment Act, the House Banking Committee's decision to sidetrack the Federal Reserve membership bill, the D.C. Court of Appeals decision invalidating automatic transfer accounts, and the proposal out for comment by the regulatory agencies on small saver instruments. I would like to share with you this morning the FDIC's current perspective on these major developments in banking regulation.

COMMUNITY REINVESTMENT ACT

As you know, in enacting the Community Reinvestment Act of 1977 Congress concluded that:

(1) regulated financial institutions are required by law to demonstrate that their deposit facilities serve the convenience and needs of the communities in which they are chartered to do business;

(2) the convenience and needs of communities include the need for credit services as well as deposit services; and

(3) regulated financial institutions have continuing and affirmative obligations to help meet the credit needs of the local communities in which they are chartered.

Congress further declared that the purpose of the Act was to require each Federal financial supervisory agency to use its authority to encourage financial institutions to help meet the credit needs of the local communities in which they are chartered,

consistent with the safe and sound operation of such institutions, and to consider whether such needs are being met when the agency is acting on a branch or merger application by the bank.

While some may view these congressional findings as truisms and others may contest the need for this type of legislation, the Community Reinvestment Act is, nonetheless, the law of the land. Apart from the law, I believe that most banks will agree that in the long run financial institutions are only as sound as the local economic environment. It is a matter of self interest and preservation to promote economic activities and growth within one's local community.

Section 804 states that in connection with the examination of a financial institution, the appropriate Federal financial supervisory agency shall assess the institution's record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of such institution, and take such record into account in its evaluation of an application for a deposit facility.

There is an affirmative responsibility on the part of a financial institution to serve the credit needs of its local community. Since enforcing compliance with this requirement may appear to some extent inconsistent with the FDIC's traditional function of assuring the soundness of insured banks, there may be some misunderstanding as to the perception of CRA by the FDIC. I would like to clear the record on that particular issue, and it can be addressed in three specific points.

First. The prime provider of the nation's credit is its banks. In the case of mutual savings banks, the credit need to be served is mortgage credit. The Congress, in allowing mutual institutions to have some advantage in the acquisition of funds, expects these institutions to make a greater effort to meet the mortgage credit needs of their local communities. The Community Reinvestment Act reinforces this expectation and commissions the regulatory agencies to encourage banks to meet their responsibilities in this area.

Second. Congress, while recognizing the need to make credit available, very properly enjoined that such need be met in a manner "consistent with the safe and sound operation of the institution." It was not the intent of Congress to require regulatory agencies to encourage financial institutions to make loans which are unsafe and unsound. Any perception of CRA that leads to the conclusion that it forces bank regulators to require banks to make any and all loans no matter what the borrower's credit standing is clearly in error. The Community Reinvestment Act is an attempt to encourage banks to intensify their search within their own communities for good loans which were available but which in some cases were not being made for a variety of reasons, including location, occupations of the residents of the community, the perceived lack of repayment programs, or any other of myriad reasons. The posture of the regulators in carrying out the will of the Congress cannot be construed as advice to make bad loans, but it should be construed as encouragement to make good loans which have previously not been made.

Third. CRA is not an allocation of credit law. It has been suggested by some that this is a prelude to allocation of credit by government fiat. This is not so. The law, as I have previously described, allows banks to remain independent in making their credit judgments, but encourages them to do a better job of developing available, credit-worthy loans in their local communities.

The regulation implementing the law recognizes the differences in the credit needs of different communities. It urges bankers, as the best perceivers of those needs, to set their own guidelines on reinvestment within their respective communities. The bank CRA statement clearly is intended to give you the opportunity to take the initiative in defining your community's credit needs as you see them and to say what you will do to meet them.

The FDIC will continue to consider CRA cases on their individual merit, as we do in all cases involving applications. If the record is unsatisfactory we will deny. If the record is satisfactory we will approve. The bottom line will be the institution's record of performance with regard to its continuing and affirmative obligation to help meet the credit needs of its local community, including low and moderate income neighborhoods, consistent with safety and soundness.

FEDERAL RESERVE MEMBERSHIP LEGISLATION

While the Federal Reserve membership bill appears to be at least temporarily bogged down in the House and Senate banking

committees, there is always the possibility of a compromise that will see this proposal reemerge as a viable legislative initiative. It may well surface again this week in House hearings on transaction accounts.

We feel that the Federal Reserve should have the tools it needs for the successful conduct of the nation's monetary policy. That prime function of the nation's central bank is critical to the nation's economy, to the well being of our people here at home, and to the maintenance of the value of the dollar in international exchange. To the extent that the Federal Reserve is handicapped in its exercise of monetary management, the nation runs a greater risk of runaway inflation or devastating depression.

Traditionally, the Federal Reserve has employed open market operations and the adjustment of reserve requirements as its two major levers in administering monetary policy. Now the Federal Reserve is concerned that the erosion in its membership is seriously undermining one of its two principal controls of monetary policy.

The Federal Reserve further contends that reserve levels serve as a benchmark against which open market operations can be gauged and that the effectiveness of such operations is impaired as reserve coverage shrinks.

There is no question that the drop in membership has been substantial. The Federal Reserve has estimated that the proportion of commercial bank demand deposits subject to reserve requirements has declined from 86 percent in 1960 to 72 percent

in mid-1978. If there is no legislative solution soon, the departures from the Federal Reserve could reach deluge proportions.

Thus, unless the banking industry reaches a compromise with the Federal Reserve on this issue, declining membership in the Federal Reserve seems destined to be resolved by "crisis legislation." While bankers can certainly block legislation in this area this year, and probably longer, I believe that when a large number of banks drop out of the Federal Reserve System and the media draw attention to the problem, a public backlash will develop. From my experience, I have found that the only way to mold good legislation is to be careful on an issue over the long term, to obtain all viewpoints, and to obtain necessary checks, balances and compromises and not wait for a crisis to develop.

ATS DECISION

Restrictions on the interest rates that can be paid on time deposits, and the prohibition against payment of interest on demand deposits, have been part of the American banking system since the major banking reform legislation of 1933 and 1935. The origin of these restrictions is somewhat more complex than generally believed.

The conventional wisdom is simply that interest rate restrictions were adopted in response to our bank failure experience of the 1920s and early 1930s. In that view, banks were competing excessively on a rate basis, bidding deposit interest rates up to levels that forced banks to acquire riskier assets in order to meet their interest obligations. Further, it was

argued, high rates on demand deposits, particularly on correspondent balances, were a means by which funds were attracted to the financial center banks from the rural and agricultural areas of the country. According to this rationale, these funds were then lent out with stocks as collateral and fed the flames of stock market speculation during the late 1920s. The problem with this interpretation of history is that over the last 10 to 20 years there have been a number of scholarly studies which do not support the view that banks engaged in widespread excessive competition to attract deposits in the 1920s and early 1930s. The evidence, in fact, suggests that deposit interest rates tended to decline during the 1920s.

Whatever may have been the reasons initially for enacting the prohibition of payment of interest on demand deposits, the imposition of artificial controls on this market mechanism gave rise to the development of ways to circumvent those controls.

Banks have avoided the prohibition against paying interest on demand deposits by providing services equal or even higher in value than interest payments would be if such direct payments and charges for services were permitted. For demand deposits, the indirect ways for paying interest may become more costly than the direct.

In any event, we all know that in recent years the prohibition against payment of interest on demand deposits has been progressively less meaningful with the advent of EFTS, NOW

accounts in some states, telephone transfer accounts, overdraft checking and similar new devices. Primarily to accommodate these and other innovations in fund transfers, the Federal Reserve and the FDIC authorized, as of November 1, 1978, the automatic transfer of funds from a depositor's savings account to cover checks drawn on his checking account. In practical effect, this seemed like a relatively small step from the already permissible use of overdraft checking in combination with telephone transfers from savings to checking accounts.

Nevertheless, as we all know, the D.C. Court of Appeals, just three weeks ago ruled that the automatic transfer of funds from an interest-bearing savings account to a noninterest-bearing checking account violated the statutory prohibition against payment of interest on demand deposits. In related cases the Court also invalidated the withdrawal of funds from a savings and loan account via a remote service unit and the offering of share draft accounts by credit unions. In its opinion the Court stated --

> that the methods of transfer authorized by the agency regulations have outpaced the methods and technology of fund transfer authorized by the existing statutes. We are neither empowered to rewrite the language of statutes which may be antiquated in dealing with the most recent technological advances, nor are we empowered to make a policy judgment as to whether the utilization of these new methods of fund transfer is in the overall public interest. Therefore, we have no option but to set aside the regulations authorizing such fund transfers as being in violation of statute. We do so with the firm expectation that the Congress will speedily review the overall situation and make such policy judgment as in its wisdom it deems necessary by authorizing in whole or in part the methods of fund transfer involved in this case or any other methods it sees fit to legitimize, or conversely, by declining to alter the language of existing statutes, thus sustaining the meaning and policy expressed in those statutes as now construed by this court.

> We recognize that enormous investments have been made by various financial institutions in the installation of new technology, that methods of financial operation in the nation have rapidly grown to rely on much of this, and that a disruption of the offered services would necessarily have a deleterious impact on the financial community as a whole, in the absence of the certainty that new procedures are authorized for the foreseeable future, which certainty only a Congressional enactment can give.
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> . . . It is the responsibility of the Congress and not the courts to determine such policy.

In order to give the Congress time to act, the Court stayed the effective date of its ruling until January 1, 1980.

The agencies are working on a court review of the Court of Appeals decision; we may decide to go to the Supreme Court. At the same time, we are working with the Congress to achieve a legislative resolution of this issue. Chairman St Germain of the House Financial Institutions Subcommittee has scheduled hearings and I will be testifying tomorrow on a bill he has introduced to repeal the statutory prohibition against payment of interest on demand deposits.

In order to arrive at a legislative solution, of course, it will be necessary to traverse a sea of collateral issues which could prove to be very sticky. Such issues might include the Federal Reserve membership problem, Regulation Q and the differential, nationwide NOW accounts, expanded assets powers for thrifts, tax equality between thrifts and commercial banks, maintenance of a continuing flow of funds to housing, the status of EFT facilities as branches, interstate branching, and reorganization of the Federal regulatory structure -- to mention only a few.

While it is much too early to chart a course through such a treacherous sea as this, one possible compromise solution would be enactment of a bill limited to authorization of the three

devices struck down by the Court of Appeals; viz., automatic transfer and share draft accounts and remote service unit withdrawals from savings and loans. Another intermediate course that might be worth considering would be the extension of NOW account authority to all 50 States.

Whatever the final outcome it would seem to be a gross understatement to suggest that financial institutions and their regulators are in for an interesting legislative free-for-all in the coming months.

SMALL SAVER PROBLEM

On April 3, the Federal regulatory agencies issued for comment four proposals for actions intended to help the small saver while at the same time preserving the safety and soundness of the institutions.

To my knowledge, no one takes the position that the small savers are not discriminated against. The question is how to reduce the imbalance.

We have received 1,014 comments, by far the largest response in FDIC history to a regulatory proposal. We now are reviewing the comments and at the same time seeking to make judgments on the effect of the various proposals in terms of benefits to the saver, the effect on viability of financial institutions, the impact on housing, and other factors. We will do something to alleviate present conditions, probably in the very near future.

Briefly, the April 3 proposals are:

1. a 5-year certificate of deposit with interest tied to but below comparable U.S. Treasury securities,

2. a bonus savings account paying a 1/2 percent lump-sum bonus a year,

3. a rising-rate certificate with a moderate early withdrawal penalty and an interest rate that increases the longer the money is on deposit, and

4. a reduction to $500 in the minimum for certificate accounts, except for the $10,000 6-month money market certificate, and elimination of all minimum deposit requirements on certificates of less than 4 years (now required only at savings and loans).

We are dealing with a volatile situation, keeping in mind the experience with the $10,000 6-month money market certificate. The regulators authorized it beginning June 1, 1978, and in 11 months it has attracted almost $147 billion in deposits throughout the nation, including $23 billion in mutual savings banks. No one can predict with absolute certainty the effect of the proposals we now have before us so we must move with caution.

When we put our series of interim proposals out for public comment, we emphasized that none of them are untouchable, that we welcome suggestions on ways to improve the terms and conditions of the proposals while maintaining the balance with institutional soundness. We have made it plain, for example, that such specifics as maturity, rate, penalty or other terms are open to change on the basis of public comment. The package we approve, I predict, will differ from the proposals put out for comment.

None of our proposals is in any way intended to be a permanent or comprehensive solution. What needs to be done in

terms of an overall solution, in our judgment, is to phase out Regulation Q and other interest rate controls, an action that would have to be taken by the Congress. We need to set a date now for some time in the future, say, 5 or more years, and to work toward it. The ceiling would have to be eliminated gradually, either by eliminating its applicability to certain instruments or by providing for market based ceilings at different deposit maturities so that the ultimate elimination of the ceiling would be a minor event.

Thrift institutions would have to be given more investment powers to provide additional financial services to different kinds of customers, say, consumer borrowers. In the process, we should also phase down the differential between banks and thrifts and eventually eliminate it. We need to do everything possible to prepare the institutions for the transition to a market-rate interest environment and to encourage them to take steps toward that goal. The Regulation Q Task Force, set up last year by the Administration with representation from the bank supervisory agencies, has been looking at these issues. The recommendations are expected to go to the President this week.

In our effort to help the small saver, we cannot act recklessly without regard for the danger of disintermediation or the financial health of the depository institutions to which we look for a stable flow of funds to housing. In addition to our housing responsibilities, we have the duty of cooperating with

the conduct of monetary policy. Obviously, it is not unusual when these various, major, differing objectives conflict. Before the recent acceleration of inflation and the rapid increase of interest rates of the past 12 months, returns on thrift assets were approaching the point where thrifts might have been able to pay market rates on deposits. However, market interest rates moved to new, high ground and left the interest ceilings on deposits far behind. Under such circumstances, the elimination of interest ceilings could pose a serious threat to thrift solvency. Thus, the present dilemma can be explained to a large extent by the inflation rate and the recent run-up in interest rates.

Before we acted March 8 to trim the compounding and differential costs on money market CDs, our projections showed that under certain sets of assumptions about interest rates and deposit flows mutual savings banks would end 1979 in worse financial shape than at any time in this decade -- and that includes the 1974-75 recession, which many feel was the worst since the Great Depression.

We believe our recent action helped stabilize the condition of mutual savings banks, but it is obvious to us that we must do more to help thrifts improve revenues or reduce costs if we are to look to them for substantially higher payments to small savers. The financial situation today adds a new edge to the question of expanding the asset powers of thrifts.

The economic circumstances which prompted us to issue the proposals for comment a month ago still prevail. These

conditions remain today a clear mandate for the regulators to act to provide some relief to small savers caught in an inflationary pinch that has driven up everything except the government-controlled rates of interest they may receive on their savings.

This is not to say that we are unmindful of the cost and administrative burden on financial institutions. We are very much aware that whatever final regulation we impose must be thoroughly justifiable and bearable for the institutions.

We will consider all sides of the issue during our deliberations on the small saver proposals. We trust you will share our opinion that delay is not an answer.