FEDERAL DEPOSIT INSURANCE CORPORATION

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IMPLICATIONS TO THE PUBLIC OF A RESTRUCTURED SAVINGS BANK INDUSTRY

Address of
Frank Wille, Chairman
Federal Deposit Insurance Corporation

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Before the

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of the

National Association of Mutual Savings Banks

Regency Hyatt House
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Two years ago when I addressed your Golden Anniversary Conference, the Presidential Commission on Financial Structure and Regulation was just being organized. We knew that it would examine questions of mortgage financing, deposit-rate ceilings and the need of thrift institutions, particularly savings and loan associations, for greater flexibility to adapt to market developments such as those that occurred in 1966 and 1969. We knew that the Commission was being asked to create a financial and regulatory structure that would encourage vigorous innovation and competition, that would serve an expanding and increasingly complex economy, and that would respond with sensitivity to changing demands in the future. What we did not know, insofar as mutual savings banks and the savings and loan industry were concerned, was whether the Commission would opt for a solution in which both types of institutions would remain relatively specialized in authorized powers in order to assist the allocation of credit to particular sectors of the economy like housing or whether instead it would urge a solution in which both would become more generalized, full-service institutions like commercial banks, each seeking to attract lendable funds in an increasingly competitive deposit market.

The Commission's report, issued last December, takes the second, more generalized, approach, leaving to individual managements any decision to specialize. A number of important differences would remain between commercial banks, mutual savings banks, and savings and loan associations but it was obviously the Commission's belief that each institutional type would have a substantially equal opportunity to compete for lendable funds in an environment without deposit-rate ceilings. In order to give deposit thrift institutions this capability, the Commission recommended a significant enlargement of their authority to diversity both the liability and the asset side of their operations. Then, to avoid the possibility that new investment opportunities would divert funds from traditional levels of investment in residential housing, the Commission further recommended basic reforms in residential mortgage lending practices, coupled with the enactment of a special tax credit, available to all institutional lenders, based on gross interest income from residential mortgages.

Some of these recommendations have very wide support, whether or not the Commission's full package of recommendations is adopted. I would include among these (i) the eventual removal of deposit rate ceilings, (ii) authorization for a wider range of time and savings deposits and certificates of deposit that would vary considerably as to interest rate, withdrawal power and maturity, and (iii) the reforms suggested in residential mortgage lending practices.

The removal of interest rate ceilings on time and savings deposits, if accomplished in such a way that the financial soundness of each institutional type is protected, would be of obvious benefit to depositors, especially those who are unsophisticated or whose savings are limited in amount. As we know, rates of interest paid on money market instruments and corporate obligations during periods of tight money can exceed by substantial proportions the deposit rate ceilings which may be imposed to protect the liquidity positions of financial intermediaries. Knowledgeable and substantial customers, however, can invest in such higher-rate instruments directly, and they appear increasingly likely to do so the longer a period of tight money continues, thus contributing to the exact liquidity strains deposit rate ceilings are in part intended to ameliorate or avoid. When the ceilings differentiate further between large savers and small savers in a manner unfavorable to the latter, basic inequity is added to long-run ineffectiveness.

The removal of rate ceilings would encourage all deposit institutions to approximate the rates available through direct investments in the market if they are to attract new deposits or avoid the loss of existing deposits. Assuming that their rate patterns would not discriminate against small savers (and the vigorous competition likely to exist for deposits makes this unlikely), both large and small savers should experience benefits of convenience and higher interest payments when rates are rising generally in the money markets. When market interest rates are declining, the same forces of competition are likely to keep deposit rates as high as possible -- possibly even higher than money market conditions would dictate because institutions which invested long at relatively high rates can afford to pay such rates and are willing to do so to maintain a steady inflow of deposit funds. The deposit experience of mutual savings banks over the past year in the face of market uncertainties and some reduction in commercial bank deposit rates makes this point quite clearly -- and it is the general public which has had the benefit of your continued high rates.

The Commission's recommendation that thrift institutions be allowed to offer a wider mix of maturities, interest rates and withdrawal restrictions should benefit both the thrift institutions and their savers. This has been the experience in many savings bank States where longer-term certificate accounts have been authorized, with the highest rates of interest reserved for those of longest maturity and the most restrictive withdrawal provisions. An institution whose earnings or surplus position might not be conducive to paying a competitive rate on all its accounts uniformly would than have the option of paying such a rate at least to those depositors willing to share with it the longer term risks of reinvestment upon maturity. The evidence we have on disintermediation indicates that the major problem faced by financial intermediaries during periods of rising market rates is the loss of existing deposits. To prevent withdrawals by rate-conscious depositors, such institutions should in my judgment be allowed to diversify their liability structure by (i) segmenting the market for deposits, (ii) creating a deposit structure built on marginal rate differentials, and (iii) lengthening the average maturity of deposits to encourage stability over the business cycle. Such authority in a world without ceilings, would, for example, permit institutions to develop in addition to the usual certificate accounts, "bonus-at-maturity" accounts under which a depositor would commit his funds for a given period of time at a fixed rate of return plus a bonus of some specified amount, payable only at maturity and forfeited in the case of early withdrawal. The owners of such special deposit accounts would benefit by receiving the competitive rate, or a bonus rate, without the inconvenience of withdrawing their funds and making a new investment in the market, while the institution would succeed to some extent in stabilizing its deposit structure within its own revenue limitations.

Each of these basic liability reforms should smooth out the flow of savings to deposit and share accounts in thrift institutions and many small commercial banks. If sizeable percentages of their combined assets continue to be invested in residential housing loans, the flow of funds into housing should be significantly more even than in the past, thereby avoiding the peaks and valleys that have traditionally accompanied swings in the business cycle.

The Commission's recommendations for reforms in mortgage lending practices are also designed to smooth the flow of funds into the housing market. These include such items as authorizing variable rate mortgages, allowing interest rates on FHA, VA and conventional mortgages to be determined by market forces rather than by statutory or administered ceilings, removing unreasonable restrictions on loan-to-value ratios, permitting loans to be made on properties anywhere within the United States or its territories, simplifying the legal work in mortgage origination and foreclosure work including the development of a standardized conventional mortgage form, and abolishing the "doing business" barriers which some States place on out-of-State institutions lending mortgage money on or holding real property within their borders. All of these are sound recommendations that should make mortgage loans throughout the United States more attractive to institutional lenders that have other equally attractive or more attractive investment alternatives available to them. To the extent more funds are made available to the housing market nationwide through these reforms than would be the case today, the builder and the homeowner benefit from the assurance that a plentiful supply of funds for their purposes will be available -- although the price of such funds, rather than their availability, may actually be more important to them, a subject to which I shall return in a moment.

Research conducted by the FDIC indicates that much of the variation in the flow of mortgage credit from deposit institutions can be explained by variations in the flow of funds to these institutions. It appears, for example, that the speed with which these institutions commit funds to conventional mortgages depends primarily on three factors: (i) the variations in the flow of savings over the preceding three or four quarters, (ii) the stability associated by the institution's management with the various components of its deposit structure, and (iii) the interest rates available on mortgages relative to those available on competing market instruments. While current deposit flows are significant in explaining an institution's mortgage commitment and acquisition policy, a greater correlation is found with the long-run stability or lack of it in the deposit structure. If inflows appear relatively stable, the exact pattern is then determined, in great measure, by the alternative investments available to each type of institution -- those with numerous short-term investment alternatives being slower to make commitments and to fund mortgage loans than the institutions with fewer alternatives. The most important factor, however, at all institutions in explaining net acquisitions of mortgages appears to be the variability, long term, of deposit inflows. The Commission's recommendations to remove deposit-rate ceilings, diversify the savings deposit structure of thrift institutions and make mortgage loans more attractive investment alternatives should all result, therefore, in a greater and more even flow of funds into residential housing in future periods of tight money periods than occurred in 1966 or 1969.

There appears to be far less correlation between the flow of funds into residential housing and an institution's increased authority to diversify its investments and its services. The average commercial bank, with a broad capacity to diversify its loans and investments, devotes a far smaller percentage of its total assets to residential mortgage loans than the average savings bank, and the latter, which has significant but limited opportunities to diversify its loans and investments, devotes a significantly smaller percentage of its total assets to such loans than the average savings and loan association - - the institutional type with the least opportunity to diversify at the present time. Of the three, the savings and loan industry, at least in recent years, has been the principal supplier of funds to the residential housing market, both in dollar volume and as a percentage of total assets. Public officials and legislators are quite justified on this basis in asking what effect the proposals for asset diversification recommended for thrift institutions by the Hunt Commission will have on the future supply of funds for residential housing.

As I understand it, mutual savings banks in the various States have one or more of the investment powers recommended by the Commission for deposit thrift institutions, but no savings bank has all of them. Savings and loan associations, on the other hand, are much more generally restricted today, and the new powers if utilized would have much greater impact on their operations individually and collectively than they would on savings banks. I am prepared to accept the argument, based on the savings bank experience in a number of the States, that the powers to make consumer loans up to 10 percent of total assets, to invest without limitation in municipal obligations and corporate debt instruments, to invest up to 10 percent of total assets in equity securities listed on a rational exchange, and to invest up to 3 percent of assets in "leeway" investments are unlikely to vary with any perceptible effect on the housing market and 63 percent of your total assets presently devoted to residential mortgage loans. But if the nation's much larger savings and loan industry, in utilizing these same powers, were to reduce the percentage of <u>their</u> total assets committed to residential housing to the same 63 percent of total assets, the effect on residential housing could over time be noticeably adverse despite the improved deposit flows likely to accrue to both types of institutions from other Commission recommendations.

There are some excellent reasons, not directly related to residential housing flows, why the various proposals for asset diversification proposed by the Commission would benefit the public as well as deposit thrift institutions. Consumer credit markets, for example, are demonstratively imperfect, resulting in higher than necessary rates for many borrowers. Additional competitors, conveniently available in the form of mutual savings banks and savings and loan associations, would markedly increase the number of credit sources available to borrowers, and the increased competition sure to result would encourage the lowest possible interest costs consistent with efficient operation. Consumer credit services, as well as checking account services, may be a special convenience for people who don't use commercial banks at all, and leeway investments subject to the asset limitation proposed can benefit the public by permitting loans to perfectly credit-worthy applicants whose collateral is unusual or not technically in compliance with the requirements of statutory or administrative policy. For the institution, each of these powers can contribute to the higher earnings or surplus necessary in periods of rising interest rates to pay market rates for deposits rather than some lower deposit rate ceiling. Greater short-term cash flows could be generated by consumer loans that mature on average in one year rather than the eight or ten years which mark the life of the average residential mortgage, thereby improving liquidity and making some additional funds available to meet prior loan commitments when money tightens. Finally, to the extent the new services attract customers who will be savings depositors at some future date, the stability of the institution's deposit structure would be enhanced, and this as I have noted earlier appears to be the necessary prerequisite for net increases in the mortgage account at all institutions.

These new services and investment powers then, are likely to bring benefits of competition and convenience to the public, but it overstates the matter to assume some beneficial effect on residential housing flows as a direct result. At best such an effort can only be indirect, through increased earnings, through the ability thereby to pay competitive market rates on deposits, and through increasingly stable and predictable deposit inflows. A beneficial effect on housing further assumes a management determination to commit new funds to residential housing in a proportion at least equal to the percentage of its total assets presently invested in such loans -- an assumption which is particularly dubious in the case of the savings and loan industry.

They, like you, will be under significant pressure when deposit rate ceilings are removed to maximize earnings. Such earnings will be necessary either to pay market rates for deposits on a current basis or to accumulate reserves for future use so that market rates can be followed upwards whenever tight money and very high interest rates prevail. If a swing away from residential mortgage financing is to be avoided as deposit thrift institutions struggle to maximize earnings, the interest cost on a home mortgage may well go up until it becomes just as attractive earnings-wise to an institutional lender as other available investments like corporate bonds or consumer loans.

The special tax credit recommended by the Commission on interest income from residential mortgages becomes a key recommendation at this point for two reasons. First, such a credit may be essential if the mortgage interest rates charged to homeowners in the future are to be held even to today's historically high levels. Secondly, such a credit may be essential if generalized lenders, including thrift institutions with the investment options proposed by the Commission, are to continue the high levels of investment in residential mortgage loans likely to be needed in this growing country in the future.

It is for these reasons that I believe the political acceptability of the Hunt Commission recommendations as to the asset powers of your industry and the asset powers of the savings and loan industry is so intimately connected with the tax credit only briefly mentioned by the Commission. How the details of that tax credit are worked out, how much impact it will have on the cost of mortgage credit to homeowners and what sort of an incentive it will actually provide for lending institutions to stay in the residential housing field may well determine the fate of the Commission's entire report.

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