FDIC NEWS RELEASE

FEDERAL DEPOSIT INSURANCE CORPORATION

FOR IMMEDIATE RELEASE PR-43-72 (6-28-72)

"EXPANDED POWERS FOR DEPOSITORY FINANCIAL INSTITUTIONS"

Comments on Certain Recommendations
of
President's Commission on Financial Structure and Regulation

by
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before the
Conference on "Policies for a More Competitive Financial System"

held by the
Federal Reserve Bank of Boston

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on
Nantucket

June 20-23, 1972

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One service the Hunt Commission has performed for us all has been to remind us how interrelated many aspects of the nation's financial system are. I do not mean by that to suggest that each of its numerous recommendations must be adopted if any one of them is, because this is manifestly not the case. I am suggesting that once the Commission made the basic policy decision that it would seek to promote competition in the same market on substantially equal terms for all depositary institutions, the thrust of its basic recommendations, particularly those dealing with interest rate ceilings on deposits, operating powers, reserve requirements and taxation, could have been predicted. What must now be decided is whether the financial system proposed by the Commission -- compromises and all -- will serve the country significantly better than the system we now have -- a system one banker has tagged as "balanced inequality". If we have doubts on that score, can the framework for reform suggested by the Commission be improved?

The Commission was formed, as we know, after two relatively lengthy periods of tight money in which deposit institutions had lost a significant volume of funds because the ceiling rates allowed to be paid on deposits were well below market rates on long-term investments. This deposit outflow adversely affected the funds available for residential housing and smaller businesses throughout the country. It was not surprising, therefore, that the Commission was given a broad general mandate to recommend improvements in the nation's financial system with more specific mandates in three areas: (i) mortgage financing, (ii) the role of interest rate ceilings, and (iii) the need for flexibility on the part of deposit institutions to permit a sensitive response to changing demands. While the Commission's report includes a number of relatively minor reforms in mortgage lending practices that should be implemented regardless of what happens to the rest of its recommendations,[1/] the fundamental changes it proposes are the eventual removal of deposit rate ceilings, a wider authority for all institutions to bid for lendable funds, and much broader asset powers for the so-called specialized deposit institutions, namely mutual savings banks and savings and loan associations.

1/ E.g., authorization for variable rate mortgages, the removal of administered ceilings on FHA and VA mortgages, the repeal of state usury ceilings and other unreasonable restrictions on residential mortgages, simplification of the legal work in mortgage originations and foreclosures, permitting loans to be made on properties anywhere in the United States, further encouragement for secondary market operations for mortgages and the abolition of "doing business" barriers which some states place on out-of-state institutions lending money on or holding real property within their borders.

The most basic of these recommendations is the eventual removal of Regulation Q-type ceilings for all deposit institutions. If implemented, the change would remove the discrimination that presently exists between depositors with more than $100,000 and those with less than $100,000. It would also abolish the distinctions that presently exist between the rates which can be paid by deposit thrift institutions and those which can be paid by commercial banks -- a distinction that inhibits the growth of commercial banks without ready access to nondeposit sources of funds. More to the point, this change would give all deposit institutions an opportunity to compete effectively with market instruments in future periods of monetary restraint thereby blunting the forces of disintermediation, attendant liquidity strains and sudden reductions in the availability of lendable funds. These benefits could not be realized, however, unless deposit institutions were in a position to respond promptly to increases in market rates particularly on instruments attractive to depositors. Their ability to do so will obviously depend on the yields in their asset mix, their cash flows, the speed with which they can change to higher yield investments if this should be necessary, and the level of retained earnings available for temporary use if current earnings cannot meet a significant increase in the interest expense on deposits.

In order to bid competitively for deposits in a world without ceilings, deposit institutions would all have compelling incentives to maximize earnings. A high level of earnings on a current basis relative to other competitors would allow an institution to move upwards in rate as quickly as possible when the market required, and if market rates allowed some stability in interest expense, maximum earnings would permit an institution to add to its retained earnings for possible use at some future date when income on a current basis might be insufficient to meet a rapid upswing in interest expense. The necessity to maximize earnings so as to be ready for upward movements in market rates -- whether precipitated by monetary conditions or the actions of a competitor -- makes me question the distinctions that would remain, even under the Commission's recommendations, in the asset powers of different types of institutions.

I would have thought the logic of the Commission's recommendation on deposit rate ceilings would have led to a recommendation that all institutions have exactly the same asset powers. Such a recommendation would also have been more consistent than the Commission's actual recommendations with its guiding principle of equality for all competitors in the same market. As it is, some important differences remain -- dictated presumably by considerations of historical emphasis or political acceptability. Thus, commercial banks would continue to be the exclusive suppliers of short-term credit to American businesses and only they could offer checking account services to business firms. As a result, the average commercial bank might continue to have a loan portfolio of relatively shorter term than the average thrift institution, with consequent advantages when interest rates are rising and corresponding disadvantages when interest rates are falling. Mutual savings banks and savings and loan associations, on the other hand, would have under the Commission's proposals an authority denied to commercial banks to invest for their own account in equity securities listed on a national exchange, as well as fewer restrictions than commercial banks on the use of the proposed "leeway investment" authority. Unlike commercial banks, however, thrift institutions would be subject to a 10 percent of assets limitation on consumer loans. It seems hardly likely, under these circumstances, that all deposit institutions would have the same ability to respond in the face of rapid increases in the rate demands of their depositors. Those that could not meet the highest rates offered by competitors in the same market might well experience precisely the disintermediation, liquidity strains and loss of lendable funds that the removal of deposit rate ceilings was intended to avoid.

Besides freeing up rate competition for deposits, the Commission has proposed greater latitude for all deposit institutions as to the ways in which they can acquire lendable funds. Deposit thrift institutions would be allowed to offer a wider variety of deposit accounts varying with respect to maturity and withdrawal power as well as rate -- a power commercial banks already have subject to rate ceilings. Presumably, the highest rates of interest would be reserved for deposit accounts of the longest maturity and the most restrictive withdrawal provisions. Thus, an institution whose earnings or surplus position might not be conducive to paying a competitive rate on all its accounts uniformly would then have the option of paying such a rate to depositors willing to take some risks as to market levels during the term of the account and upon maturity. This effort to segment the deposit base and lengthen average maturities has been helpful, in states where it is now allowed, in matching increases in interest expense with increases in current earnings and has served to hold existing deposits that might otherwise be attracted to other investments. The experience to date, of course, is not a clear indication of things to come, because deposit rate ceilings were applicable. But even if a larger percentage of total deposits moves more quickly into such accounts in the future, the rise in interest expense should be more gradual than it would be if all accounts had to receive the market rate, and liquidity strains should be diminished by longer average maturities. This process should smooth considerably the flow of funds into all deposit institutions. [2/]

2/ Commercial banks would have some additional capabilities for acquiring lendable funds during the initial five-year period when differentials in deposit rate ceilings could still exist between different types of institutions depending on whether or not third party payments were being made. Thus, they could incur non-deposit liabilities through the temporary or contingent sale of assets and not have them classified as deposits subject to the rate ceilings. Similarly they could create bankers' acceptances without being subject to a statutory limit based on capital (although possibly still subject to administrative limits). Both proposals reflect the view, as does the basic proposal to abolish deposit rate ceilings, that policies of monetary restraint can be more effectively implemented by means other than deposit rate ceilings broadly applied -- a view most economists seem to share. Commercial banks and thrift institutions would also be free to issue short-term subordinated debt instruments as well as the seven-year instruments currently authorized, so long as they were bona fide additions to capital. As a practical matter, only the largest institutions might be able to market these noninsured capital instruments if regular deposit accounts were also competitively available at market rates. The Commission is unclear as to whether such short-term instruments could be offered before, or only after, deposit rate ceilings are removed. If before, their offering to depositors could easily subvert the ceilings still in force.

Most of the Commission's asset diversification proposals can be supported on grounds either of increased competition or of increased public convenience, whatever problems they may otherwise present. Consumer credit markets, for example, are demonstratively imperfect resulting in higher than necessary rates for many borrowers. Permitting mutual savings banks and savings and loan associations to make consumer loans 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. Permitting such institutions to make construction loans in the same manner as commercial banks or to make loans on mobile homes should have the same result as well as benefitting the housing markets they presently serve. A limited "leeway investment" power could benefit some borrowers 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. The management and sale of mutual funds, including commingled agency accounts, would broaden the financial services offered to bank customers and permit investment talent within offering banks to be more completely utilized -- although even the largest banks may shy away from the risks of customer dissatisfaction in the event of unfavorable performance.

Checking account services at thrift institutions would constitute another form of deposit competition and might serve as a convenience for some thrift institution customers who do not utilize commercial banks. To the extent these services attract or retain deposit customers, the stability of deposit structures should be smoother than might otherwise be the case.

I would be remiss, however, if I failed to indicate my reservations with regard to some of the Commission's asset recommendations that would introduce a far greater degree of risk into the financial structure than we have today. Those that could have serious repercussions on safety and soundness, at least in the form proposed by the Commission, include the following:

1. The power to make direct investments in real estate.

   The Commission states this recommendation in terms of a limitation equal, in most cases, to 30 percent of an institution's net worth, but a close examination of other recommendations would indicate that the limitation is illusory. For example, additional investments up to another 30 percent of net worth would appear to be authorized under the "leeway" investment provisions.

And it would appear that no limitations would be imposed upon the investments a thrift institution or a commercial bank could make in a subsidiary which engaged in real estate development or ownership. Because real estate can fluctuate significantly in value and is one of the most difficult assets to sell if liquidity is needed, the potential for loss has historically been considered greater than for many other investments. An effective limitation substantially less than 100 percent of net worth should apply to all direct investments in real estate, including bank premises, regardless of the form of the investment.

2. <u>The power in deposit thrift institutions to invest up to 100 percent of net worth in equity securities listed on a national exchange.</u> While mutual savings banks in some states today have a similar power, and state-chartered commercial banks not members of the Federal Reserve System in some states may also own equity securities for their own account, the pressures to maximize profits will, as we have seen, be greater in a world without deposit rate ceilings than they are today. In addition to normal risks of loss in stock market investments, these pressures may encourage undue speculation in order to

gain an edge over competitors or to overcome the edge of other institutions. The exposure of an institution's capital funds should be significantly less than 100 percent in my judgment, even if the basic recommendation is retained.

3. The power to engage directly in nonbank activities presently being authorized for bank holding companies by the Federal Reserve Board. The objections to a general grant of authority along these lines, on the grounds of safety and soundness, are well stated by Dr. Chase in his paper, although undoubtedly there are some activities being authorized by the Board of Governors for bank holding companies which could be carried out by deposit institutions directly without significant increase in the risk to which they are presently subject. To those who say that the Commission's recommendation contemplates a review by the Administrator of National Banks for national banks, the Administrator of State Banks for state banks, and the Federal Home Loan Bank Board for savings and loan associations before such authority is granted, I think the clear expectation of the Commission had to be

that all the activities being authorized for bank holding companies by the Board of Governors for bank holding would be authorized for direct operation by deposit institutions. There are clear exhortations for a liberal interpretation of the Bank Holding Company Act Amendments of 1970 and the divided review contemplated by the Commission almost guarantees this. 3/

3/ To the extent the three agencies differ in their authorizations under this recommendation in any competitively meaningful way, there would be every incentive to convert to the jurisdiction of the most lenient supervisor. There are at least two different ways of administering the provision which would avoid that result:

(i) the Federal Reserve Board itself could be assigned the job of determining which of the related activities being authorized for bank holding companies might properly be conducted directly by deposit institutions or their subsidiaries, and under what conditions; or

(ii) Congress could enact a "positive" laundry list of related activities authorized to be performed directly by supervised institutions, prescribing any necessary conditions by statute, and supplementing the provisions periodically.

Obviously the first alternative has advantages in terms of flexibility and is the only one which assures that the same criteria being applied by the Federal Reserve Board in determining the approved activities of bank holding companies will also be applied in determining the activities to be authorized for direct operation by banks and their subsidiaries.

With these exceptions, the Commission's recommendations for expanded asset powers are likely to increase competition and public convenience without substantial increase in risk to the financial structure as a whole. They should also assist deposit institutions in maximizing earnings, while the Commission's liability proposals should smooth out the peaks and valleys in the flow of funds to such institutions. But I think it overstates the effect of these recommendations to claim for them as well an inevitable, beneficial effect on credit flows to residential housing in future periods of tight money. At best such an effect 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 flows. Even under such circumstances, a net plus for housing would be felt only if institutional managements were determined to commit new funds to residential housing in such proportions that the total would approximately equal the percentage of total assets presently invested by all deposit institutions.

My doubts that this will be the case stem from the fact that there appears to be only an inverse correlation today between the degree of diversification permitted to an institution and its commitment to the residential housing sector. The average commercial bank, with the broadest capacity to diversify 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 $200 billion savings and loan industry, at least in recent years, has been the principal supplier of funds to the residential housing sector, both in dollar volume and as a percentage of total assets.

Those of us from New England and New York, where the $90 billion in the mutual savings bank system is concentrated, tend to overlook the relatively greater contribution and commitment made by savings and loan associations to the residential housing market. Since many savings banks in these states already have the power to make nonresidential mortgage loans on commercial property, consumer loans up to some limited percentage of assets, investments without limit in corporate or municipal debt obligations, and limited investments in common stocks or leeway investments, and since they still invest on the average 59 percent of their total assets in residential mortgage loans, we tend to assume that the added powers proposed by the Commission will not have any perceptible effect on the flow of funds to residential housing. Yet the same proposals also apply to the nation's savings and loan associations that presently invest about 85 percent of their assets in residential housing. If that much larger industry, in utilizing the same powers under the same competitive conditions, were to reduce the percentage of its total assets committed to residential housing to the same 59 percent of assets presently invested by the savings bank industry -- even if this occurred gradually over time -- the effect on the residential housing sector could be noticeably adverse despite improved flows of funds.

To its credit, the Commission appears to have recognized this problem by suggesting in its new scheme of things a direct government incentive, either by way of tax credit or direct subsidy, which would maintain present high levels of investment in residential housing; but the details of any such incentive have not yet been spelled out and it would appear impossible for observers at this stage of the game to speak with authority on the impact which implementation of the Commission's recommendations would have on the funds available for residential housing. The most that can be said is that if present levels of investment are maintained by deposit institutions throughout the nation, residential housing should not suffer and might indeed benefit from the more even flow of funds which the Commission's recommendations on the liability side are designed to encourage. But this would seem to me to be a big "if" until the magnitude and relative attractiveness of the incentives to be proposed become known.