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Statement by

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before the

Subcommittee on Financial Institutions

of the

Committee on Banking, Housing and Urban Affairs

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Mr. Chairman and Members of the Subcommittee on Financial Institutions:

The Federal Deposit Insurance Corporation welcomes this opportunity to discuss possible reforms in the nation's financial structure. Your hearings are timely, in view of the Administration's recent submission of proposed legislation (S. 2591) to implement the policy positions it took in reviewing the Hunt Commission's recommendations to the President in December 1971. Generally speaking, the FDIC supports the basic purpose of the financial reforms proposed by the Administration. While many of these proposals are controversial, we believe they are basically sound. We hope that Congress will ultimately share this view.

#### Interest Rate Ceilings and Expanded Liability Powers

For several years it has been fashionable for Government officials and executives of financial institutions to state that they favored elimination of deposit interest ceilings in principle. But times never seem quite appropriate to effect that change, and we need review only the events of this past summer to recognize how predictable were the reactions even to a limited waiver of Regulation Q ceilings. By opting for a future date for the elimination of interest rate ceilings, the

Administration's proposals on financial institutions assume a compromise position enabling banks and thrift institutions to make appropriate adjustments in anticipation of such a change. Some will protest the length of the adjustment period (5 1/2 years), but what is even more important is the Administration's commitment to the elimination of the ceilings as of a specific future date. Concomitant with the elimination of the ceilings, it might be helpful if a temporary, stand-by authority to set deposit ceilings were vested in one of the bank regulatory agencies for a short period following the adjustment period to enable the agencies and Congress to assess the reactions of the different institutions to their new powers and the new competitive environment.

At least prior to the rate changes inaugurated last July, interest ceilings caused depositors, particularly small depositors, to be short changed. Deposit rate ceilings have distorted the allocation of our financial resources and, on balance, they have probably adversely affected the flow of money into those sectors of the economy the Congress may have wanted to favor.

Interest ceilings tend to limit rate competition. The result has been that the small saver generally has been able to earn interest at a rate that, at times, was four or five percentage points

below prevailing long-term market interest rates, and even, at times, was below short-term rates. Additionally, discrimination against the small, less sophisticated saver has been consciously implemented by raising the minimum denomination for Government security purchases, by differentiating rate ceilings according to deposit size and by distinguishing the various categories of certificate from an ordinary passbook account. The effect has not only been unfair to the average depositor; it has also limited his inducement to save during periods of buoyant demand, rising prices and high interest rates.

Direct restrictions as to rate competition have led to indirect rate competition through such mediums as premiums, marginal services, more liberal terms in matters other than rate and perhaps overly elaborate offices. The public and the economy as a whole might well have been better served by direct rate competition.

Some industry groups and observers believe that interest ceilings and differentials have protected institutions from deposit outflows to more aggressive institutions of the same type and, under some circumstances, reduced outflows from thrift institutions to commercial banks. While there appears to be some substance to this position,

under certain conditions, it is more important to note that, on balance, interest ceilings probably have contributed to, rather than discouraged, disintermediation from both commercial banks and thrift institutions during periods of rising interest rates. Rate limitations imposed upon banks and thrift institutions under such conditions have resulted in a wide spread between the rates they can pay and those available in the money market. This wide rate spread has, of course, caused a large volume of fund outflow from banks and thrift institutions. As a result of significant fund outflow from financial intermediaries, those borrowers not having access to money and bond markets -- principally mortgage borrowers and small businesses -- have been even more severely affected by tight money than might have been the case if no ceilings had existed and at least some money had been available even at a higher price.

I am not suggesting that elimination of interest ceilings will totally eliminate disintermediation. Indeed, as long as substantial reliance for economic stabilization is placed upon monetary policy and as long as interest rates periodically attain or approach new highs, some degree of disintermediation will always be a potential problem.

But it should be less of a problem in an environment where financial institutions are free to pay competitive rates.

The arguments advanced in defense of interest ceilings seem less convincing and less relevant today than at various times in the past. Interest ceilings, along with the prohibition of interest payments on demand deposits, were put into effect in the early 1930's largely because it was felt that deposit rate competition, through its impact on earnings and asset quality, contributed to bank failures in the 20's and early 30's. More recent studies have seriously questioned the importance of this relationship to the incidence of bank failures. Moreover, while greater deposit rate competition could have a significant impact on the earnings of banks or thrift institutions, I do not feel that the public is well served by the present policy which insulates banks and thrift institutions from competition to the degree that high earnings are assured even for institutions with questionable management quality. And I strongly believe that the basic managerial competence of banks and thrift institutions is such that few would encounter any difficulty in an environment without rate ceilings -- so long as they had adequate time to adjust their asset and liability structures before such intensified competition was implemented.

The fact that assets of thrift institutions tend to be long-term in nature and that interest rates have generally risen during the past several decades bolster the argument favoring insulation of thrift institutions from bank rate competition. But average yields on thrift institution portfolios have risen substantially during the past seven years and, despite the rapid recent increase in interest rates, thrift institutions are currently in a stronger earnings position than in any other recent high interest rate period. The additional portfolio flexibility proposed by the Administration for federally chartered thrift institutions -- and I will discuss this particular issue shortly in greater detail -- will better enable thrift institution earnings to keep pace with market rates. And, in the long run, an emphasis on longer deposit maturities should help to stabilize the earnings, and hence the competitive position, of thrift institutions.

The arguments I have advanced on behalf of the eventual elimination of interest ceilings have to do with matters of equity to the depositor, resource allocation and a more efficient financial system. These may not be the kinds of arguments that will draw a large, vocal constituency. Nevertheless, I believe the public interest

would be well served if these arguments receive the full attention of this Committee as it considers legislation such as S. 2591.

The Administration's proposals would give federally chartered thrift institutions the right to offer demand deposits. Such authority presently exists for mutual savings banks in Delaware, Maryland and New Jersey and the service is being offered to a limited degree in all three jurisdictions. Connecticut mutuals will be able to offer checking accounts no later than December 31, 1975. Federal savings and loan associations also have limited third party payment authority if it takes the form of a nonnegotiable order drawn for certain specified housing purposes.

Enactment of this proposal should broaden the liability base of thrift institutions, lessen their vulnerability to deposit outflows and contribute to their ability to be reasonably full-service family-oriented institutions. While the Administration has suggested that thrift institutions should be allowed to compete for corporate demand deposits, I believe this proposed authority should not be granted unless authority is also conferred on thrift institutions for more general business lending operations than S. 2591 proposes.

The Administration's proposals would not permit interest payment on demand deposits, although they would move in this direction by allowing banks and thrift institutions in all states to offer NOW-type accounts. I suspect the Congress may wish to examine the results of the current experiment with NOW accounts in Massachusetts and New Hampshire before permitting the nationwide extension of this new practice.

#### Changes of Powers on Asset Side

Broadening the scope of loans and investments that financial institutions can legally make will tend to benefit the public in at least two ways. First of all, it will result in increased competition in loan markets leading to a greater number of alternative sources of funds for potential borrowers and, in some instances, more favorable lending terms. Additionally, we believe that a broadened scope of operations will result in thrift institutions that are more diversified and better able to cope with interest rate fluctuations than at present.

The Administration's proposals advocate increasing the asset options available to federally chartered thrift institutions. The impact of these proposals will be felt most by savings and loan associations.

Commercial banks, of course, already have even broader options at their disposal, as do mutual savings banks in at least some of the 17 States and Puerto Rico in which they operate.

The Chairman of the Federal Home Loan Bank Board will undoubtedly address in some detail the question of expanded asset powers insofar as it applies to savings and loan associations. I will therefore restrict myself to a few general observations within this context before moving to a more specific discussion of the asset recommendations which affect the 484 mutual savings banks in this country.

The Administration's proposals would enable savings and loan associations to make consumer loans for the first time. They would be allowed to make such loans up to 10 percent of assets plus the unused portion of a 10 percent limit on corporate bonds and commercial paper and plus the unused portion of a 3 percent limit on leeway investments. This would enable most savings and loan associations to make consumer loans up to an amount that approximates the share of commercial bank assets (about 12%) currently held in the form of consumer loans. Some savings and loans may eventually prove to be vigorous competitors in the area of consumer lending. But we should

not expect too much too soon in this area: substantial and profitable penetration of the consumer loan market will not come easily or quickly to any institution which now enters the field for the first time.

A more varied asset portfolio that includes consumer loans, corporate bonds, commercial paper and construction loans will provide savings and loan associations with more flexibility, a shorter average asset maturity and somewhat more liquidity. As a result, the vulnerability of savings and loan associations to outflows of funds in periods of rising interest rates should be somewhat reduced. If such outflows during these periods are stemmed, we might expect a moderation of the wide cyclical swings in the availability of funds to the mortgage market that we have been experiencing during the past fifteen years. First, the ability of savings and loans to compete for funds in periods of rising interest rates would be enhanced. Additionally, we might expect savings and loans to shift away from the mortgage market in periods of monetary ease, when mortgage funds typically are abundantly available, and to place greater emphasis on mortgages in periods of monetary restriction when longer term loan commitments are apt to be most attractive. (This would assume a willingness to reduce other forms of lending or to sell other assets at such times.)

Because the asset powers of savings banks are determined by the laws and regulations of the 17 States and Puerto Rico where savings banks exist and because many of these have authorized the powers sought by S. 2591, the Administration's proposals on asset diversification are likely to have considerably less impact on savings banks than on savings and loan associations.

Upon conversion to a federal charter, a savings bank would be entitled to acquire quality commercial paper and private investment grade securities up to a limit of 10 percent of assets. But no state law presently forbids corporate debt investments by mutuals and only Oregon and Connecticut impose an investment limit below the 10 percent proposed by the Administration. Moreover, FDIC data indicate that as of June 30, 1973, corporate obligations aggregated 12.1 percent of total assets of all mutual savings banks and 12.4 percent of federally insured mutual savings banks. Pennsylvania savings banks had the highest such ratio (20.8 percent) and Alaska savings banks the lowest (less than one percent).

A federal savings bank would have no authority under the Administration's recommendations to invest in equity securities. State-chartered mutual savings banks that convert to a federal charter

would, under S. 2591, be able to "grandfather" their current holdings of equity investments. But what is important to note is that with the exception of Indiana, Ohio, Oregon and Wisconsin, all states with mutual savings banks permit equity investments and June 1973 statistics show that all mutual savings banks as a group held equities equal to approximately 3.7 percent of their total assets.

The Administration's recommendation that thrift institutions be permitted to make interim construction loans would, once again, affect savings and loan associations more than mutual savings banks. All savings bank jurisdictions presently permit such institutions to engage in some form of construction lending. As of June 30, 1973, FDIC figures indicate that construction loans aggregated 1.2 percent of the assets of all savings banks. Indeed, several large mutual savings banks are already operating well developed construction loan departments which specialize in financing large commercial projects.

Consumer loan authority also should not be a totally new experience to a mutual savings bank since their state laws enable them in all 17 savings bank States and Puerto Rico to make consumer loans of one sort or another. But in many states the authority is limited. Thus, the state laws of Alaska, Delaware, Minnesota, New

Jersey, Pennsylvania and Puerto Rico limit consumer loans to the home improvement and higher education categories. In New York, mutual savings banks may also make loans for the purchase of mobile homes and cooperative apartments.

It is interesting to note, as the Table below for June 30, 1973, indicates, that even in states such as Connecticut, Maine, Maryland, Massachusetts and Washington, where relatively broad consumer loan authority exists, the ratio of consumer loans to total assets remains, with the exception of the four mutuals in Maryland, relatively low (even the Maryland figure is below the nationwide percentage for insured commercial banks):

Table I

	<u>Mutual Savings Banks</u>	<u>Consumer Loans</u> (000)	<u>Total Assets</u> (000)	<u>Ratio</u>
Connecticut	68	271,921	8,073,789	3.37%
Maine	32	52,832	1,413,856	3.74%
Maryland	4	130,253	1,248,035	10.44%
Massachusetts	167	392,211	16,606,211	2.36%
Washington	9	49,054	2,052,211	2.39%

As noted earlier, federally chartered savings banks would require time and a significant management commitment to develop the expertise necessary for effective competition in the broad consumer loan field envisaged by S. 2591.

The FDIC favors a dual chartering system for mutual savings banks in the 17 States and Puerto Rico where they now operate. Such an option would enable each bank to weigh the relative merits of remaining state-chartered or opting instead for the powers envisaged by S. 2591. In many states, there would be substantial reasons to remain state-chartered, while in others the federal charter alternative might well be preferable. In none of the states, I might add, would the advantages of the federal charter option be so overwhelming as to destroy the value of a state charter.

I suspect the preferred course will depend on an individual bank's assessment of its own future operations and of the future legislative climate for mutual savings banks both in the Congress and in their respective state legislatures. I might further observe that Congressional action in many instances has traditionally led to consideration by state legislatures of consistent action. If several state legislatures were to enact laws expanding the deposit, consumer loan

and branching powers of savings banks, there might well be few, if any, conversions by mutual savings banks to a federal charter. Even if this were to be the final outcome of S. 2591, the benefits aimed at by the Administration's proposals might then be realized on a decentralized basis.

We have every reason to believe that the use of third party payment authority combined with the use of broad consumer loan authority will ultimately lead to an increase in 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. The use of checking account and NOW 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 the deposit structures should be smoother than might otherwise be the case.

In any event, if for whatever reason, various state-chartered mutual savings banks chose to become federally chartered, they would have available relatively broad, but by no means unfettered, authority

on both the asset and liability side of their ledgers to conduct a viable and competitive family-oriented financial institution. And in periods of disintermediation, they should have a solid ability to compete more effectively for loanable funds.

#### Residential Housing Credit

The Administration'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 portfolio yields, while the Administration'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.

Any doubts I might have that this will be the case stem from the fact that there appears to be 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 and loan association -- the institutional type with the least opportunity to diversify at the present time.

As of June 30, 1973:

- commercial banks were investing only about 9.0 percent of their total assets in residential mortgages;
- mutual savings banks had about 55 percent of their assets invested in such instruments; and
- savings and loan associations were allotting about 77 percent of their total assets to such mortgages.

Since many savings banks already have broad asset powers, we tend to assume that the added powers proposed by the Administration will not have any substantial effect on the flow of their funds to

residential housing. Yet the same proposals also apply to the nation's savings and loan associations that presently invest a large portion 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 55 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 adverse despite improved flows of funds.

This potential decrease in mortgage credit availability has been addressed by other proposals and is likely to be offset to some extent by increased lending in this market by commercial banks.

First, and most importantly, the proposed tax credit on residential mortgage income would be available to commercial banks and would increase the relative yield on these instruments above what it has been under current conditions. This new yield differential, increasing steadily as the basic commitment to residential housing rises above 10 percent of total assets, should induce many commercial banks to increase their holdings of such instruments. Second, consumers would have the option of obtaining most financial services they need,

including checking accounts and consumer loans, as well as home mortgages, from thrift institutions. Consequently, commercial banks would no longer enjoy the benefit of being the sole full-service institutions in most markets. In order to compete effectively in this new environment and retain consumer deposit balances, commercial banks might also feel the need to increase their mortgage lending services to these same customers. Third, the proposed changes include provision for liberalized lending powers for national banks with respect to real estate loans.

Again, thank you for the opportunity of appearing before you on S. 2591. I hope my presentation will be helpful to the Committee in its deliberations. Should there be additional data which the Committee wishes the Corporation to provide, we will, of course, be glad to do so.

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