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PROBING THE FUTURE OF THRIFT INSTITUTIONS

Address of

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PROBING THE FUTURE OF THRIFT INSTITUTIONS

This has been a summer of discontent for the thrift industry in general, and for no single group within the industry more than the savings banks of New York State. It is they which have absorbed some 60 percent of the net outflow of funds from the nation's savings banks since the first of July, and it is they which have the most at stake in the regulatory response, both legislative and administrative, to the competitive pressures in which savings banks operate today. You are entitled to know my assessment of where things stand for the savings bank industry and where they seem to be heading.

First off, let me say that I am not given to gloom and despair. Thrift institution outflows have been severe during the past four months, but they look much less severe if payments of interest and dividends are taken into account. The savings and loan industry, despite its cries of anguish over the summer, actually shows an increase in total deposits for this period. The nation's savings banks have not been so fortunate, however: total deposits have dropped by about $850 million over the same period. On the other hand, savings bank inflows were substantial for the first half of 1973; most of you are reporting modest inflows since November 1; and virtually all of you are likely to end the year with deposits up over year-end 1972 even after interest and dividends paid during the year are deducted. Put another way, 1973 is likely to show some net deposit gain for the nation's savings banks despite the trauma of disintermediation experienced this past summer and despite the dislocations caused by reductions in forward mortgage commitments, by higher than normal borrowings and by losses realized on the sale of securities.

Moreover, the present rate structure for four-year certificates offers you some protection against commercial bank competition, even if future events may show the new 7.50 percent rate to be of only limited utility against the pull of market instruments. On that score, pressure from market rates has been reduced but not yet eliminated, with Treasury bill rates fluctuating between 7 and 8.50 percent, few issues of Treasury notes in prospect and Federal agency rates apparently declining. Savings banks, accordingly, are likely to recoup some of their recent deposit outflows over the months immediately ahead with both 6.75 and 7.50 percent certificates. The longer term results will, of course, depend on intervening movements of interest rates and our success (or lack of success) as a nation in reducing inflation generally. But for the moment the worst appears to be behind you.

Unlike a number of your speakers, I do not view this past summer as an unmitigated disaster and I don't think you should either. You now have a far greater capacity to stretch out your deposit maturities than ever before, which gets at one half of the "borrow short, lend long" syndrome that has afflicted thrift institutions for years. Rates on these deposits may be higher than you would like, but thanks to the new penalty provisions and to the further restrictions which a growing number of savings banks are placing on certificate accounts, you have today a better chance than ever before of holding on to these deposits regardless of changes in these market conditions during the term of the certificate. In addition, while the process of public education is by no means complete, we are succeeding in our efforts to convince depositors of the distinction between a time deposit and a regular passbook account. And bringing the penalty provisions of all three rate-setting agencies into relative conformity, after years of difference, was a significant accomplishment even if it took two months longer than you would have liked. As to those July 5 rate changes and the so-called "wild cards" in particular, I for one remain convinced that your deposit outflows would have been far, far worse than they were in the third quarter if these changes had not been made. Finally, I think it fair to say that there are some valuable lessons in this summer's experience, both for the rate-setting agencies as well as for savings bank managements. We might look at the regulatory side of this first.

The July 5 changes in deposit rate ceilings were designed by the regulatory agencies with a number of purposes in mind, the principal ones being to give all deposit institutions some means of checking the massive outflow of funds which seemed likely to begin in early July, to maintain the approximate competitive balance between commercial banks and thrift institutions that existed before July 5, and to give the average saver some of the benefits of higher rates available to institutional investors and those individuals with $100,000 or more to invest. The creation of a four-year, ceiling-free certificate was one part -- and an experimental part at that -- of several interrelated changes in rates made at the time, but it soon became the lightning rod of public attention, largely because the rate-setting agencies miscalculated the degree of popular appeal it would have. We erroneously assumed that only a few savers would in fact be attracted to a fixed or even a variable rate instrument which required them either to leave their funds on deposit a full four years or to revert to the regular passbook rate less an additional penalty if they didn't. To that one miscalculation can be traced virtually all the twists and turns of interest rate policy this summer, including the imposition and subsequent modifications of the 5 percent limitation, the change in policy as to penalties on pre-July 5 certificates and the Congressional directive last month that a ceiling be placed on all consumer-type deposits held by the nation's commercial banks and thrift institutions. As a result of this summer's experiences, I think it likely that the Federal Reserve, the FDIC and the Federal Home Loan Bank Board will be following these general guidelines in setting deposit rates in the future:

1. Some differential between the deposit rate ceilings of commercial banks and those of thrift institutions is likely to be maintained in all time deposit categories and in the regular passbook accounts until such time as the asset powers of thrift institutions are significantly broadened.

2. This differential may be either ¼ or ½ of one percent depending on our experience with the present mix of differentials. Put another way, you should not count on always having a 50 basis point differential. Such a differential did <u>not</u> exist across the board prior to July 5, does not exist now and can seriously restrict your future flexibility in responding to market conditions in a manner consistent with your earnings capabilities.

3. Future rate changes when competing interest rates are rising are likely to emphasize the rates payable on time deposits rather than the regular passbook rates, just as the July 5 changes did. Changes in the regular passbook rates are likely only if residual earnings, after the demands imposed by time deposit contracts and net worth considerations, permit such an increase.

4. On the other hand, the agencies are unlikely to maintain a status quo on deposit rate ceilings when thrift institution earnings, after all expenses are met and after crediting dividends and interest, reach the levels they did prior to July 5. One of the more disappointing arguments heard from thrift institutions during the summer was that everything would have been just fine if only the rate agencies hadn't stirred up depositors by announcing the rate changes when they did. "Disappointing" because these arguments came in the face of widespread publicity as to competing market rates and in the face of thrift institution earnings at their highest levels in more than seven years; "disappointing" because these arguments seemed to run counter to the concept that thrift institutions, and particularly savings banks, are managed with the interests of their depositors uppermost in mind. While the agencies will continue to be "depositor-oriented" to the extent I have indicated, I can assure you we will also be taking into account the likely impact of higher deposit costs on your ability to retain earnings and on the general level of home mortgage rates throughout the country.

5. On one important procedural issue, we recognize now that rate changes on consumer deposits need not be announced with immediate effective dates merely to stop newsleaks and the possible misuse of information others don't have simultaneously. The same results can be achieved by immediate announcement of the rate decisions reached but with a future effective date. The contrast between the orderly way the November 1 rate changes took effect and the scramble which occurred after the July 5 rate changes needs no further elaboration from me.

Savings bank managements can also profit from a re-examination of this summer's experience. The following items seem relevant:

1. The time deposit is <u>not</u> a regular passbook account and it should not be treated like one. The headlong rush by a few savings banks to raise interest rates on preexisting certificates struck me as particularly unfortunate, since it defeated the very flexibility in meeting higher interest costs that time deposits were designed to achieve -- namely that an increase in regular passbook accounts would <u>not</u> require an across-the-board increase over the entire deposit structure. When your time deposit authority was enacted by the New York State Legislature, it was the clear assumption of the Mills Committee, the New York State Legislature and the State Banking Department that the only <u>quid pro quo</u> a time depositor would get for his commitment to keep funds on deposit for a specified term was the higher rate of interest to which he agreed when he took out his certificate accounts. Across-the-board increases on preexisting certificates destroyed that assumption, blurred the distinction between regular and time accounts and used up scarce earnings that the rate-setting agencies fully expected to be used for new or maturing time deposits.

Fortunately, the new penalty provisions make a repetition of this reaction unlikely in the future but it does indicate that savings bankers themselves need to keep the distinctions in the two basic types of accounts ever before them in their policy decisions.

2. The relatively high cost of the four-year certificates requires careful planning as to the total principal amount of such certificates which a savings bank management is willing to have in its overall deposit structure. Many savings banks first offered their "ceiling free" certificates without such a self-imposed limitation, but it now seems to be the rule rather than the exception as an increasing number of newspaper ads attest. I would suggest that if mortgage rates drop in the future to the levels that prevailed only one year ago, you might wish to go through the same analysis with respect to the shorter term, lower-yielding certificates you also offer.

3. The range of time deposits now allowed by regulation, with varying rates for varying terms, provides you with some new flexibility in your marketing strategies, which you can tailor to your specific earnings capabilities. No longer should every savings bank feel it must run continuous advertisements offering every type of account permitted. Necessity is the mother of invention, and the 5 percent limitation led to some increasingly sophisticated advertising as the summer wore on which should not now be forgotten. Shorter term certificates and even regular passbook and day of deposit-day of withdrawal accounts were once again touted as able to fill the needs of particular types of depositors. In smaller communities as well as major cities, individual banks have proven that they can survive quite well competitively by stressing one type of account even when the competition is stressing another type. I would expect more of this discrimination and fine tuning as savings banks face up to their individual earnings limitations.

4. The new competitive environment, no less than the rate increases the industry successfully weathered in 1965-66 and again in 1969-70 requires of every savings bank management increased attention to the details of your revenue structure as well as to the details of your operating expenses, so that your net income available for dividends, interest and net worth additions can by maximized. A policy commitment to 8.50 percent home mortgages on properties located in New York State may require correspondingly greater effort to raise the yields on nonmortgage income or to lower your expenses than other types of lending policies, but it can and is being done even within the framework of the new deposit rate ceilings.

5. On a point of detail in the new time deposit competition, the attentive savings bank knows that the new penalty provisions in our Regulations specify a <u>minimum</u> penalty only and do not preclude other restrictions that may be agreed to between the bank and its deposit customers. You are, accordingly, free to offer time deposits with no redemption option at all, or none for the first 90 days or none for some other specified part of the time deposit term. So long as you collect the minimum penalty, you may continue to require the showing of some "emergency" even though this is no longer mandated by regulation. More and more savings banks are using this discretionary authority to

further stabilize their deposit structures. If you follow their example, I would caution you that we will expect a specific and complete disclosure of these additional restrictions to your prospective depositors when they open a time deposit account, and appropriate references to the substance of such restrictions in your newspaper advertising.

Continued pressure on your earnings to meet interest and dividend requirements and to make continuing additions to net worth places a premium on further progress in your efforts to obtain increased asset authority and operating powers, including access to and authority to participate in electronic funds transfer systems -- the credit system of the very near future.

No one in Washington expects final action this year or next on the President's legislative recommendations for reforms in the nation's financial structure. But the groundwork is being laid for serious deliberations on the whole gamut of Hunt Commission recommendations and their implications for action in the Congressional Session which starts in January 1975. In the background hearings which Senator McIntyre started last week, I reaffirmed the FDIC's support for the basic reforms proposed by the Administration. The various proposals are obviously controversial, but we believe they are basically sound, and we hope that Congress will ultimately come to share this view.

We continue to believe that the eventual removal of interest rate ceilings on deposits is very much in the public's interest -- so long as banks and thrift institutions both have adequate time to adjust their asset and liability structures before we enter a world without Q. The Administration proposes that we approach that point in time over a five and one-half year period. We at FDIC believe that it might be helpful if, immediately following the five and one-half year phase-out of Regulation Q, a <u>temporary</u> standby authority to set deposit ceilings were vested in the rate-setting agencies for a short period so that they and the Congress can assess the results of the transition period and the competitive reactions of different institutions to their new powers and to the new environment. If the changes proposed are made carefully and deliberately, I fail to see the need for a permanent standby authority such as your national representatives have proposed. If such a crutch remains permanently available, it is likely to be used without regard to necessity. Yet if the necessity exists, I for one believe the Congress can be relied upon to respond quickly.

The Administration's recommendations, as well as those of the Hunt Commission, include much broader operating powers for all Federally chartered thrift institutions, a mortgage tax credit which would replace your special tax reserves as a means of stimulating continued investment in residential housing and a Federal charter option for the nation's mutual savings banks. The recommendations as to operating powers will mean much more to the savings and loan industry than they will to mutual savings banks because limited consumer loan powers and most of the other operating powers proposed to be authorized are already in effect in a number of the States where savings banks operate. A general purpose consumer lending power, however, is particularly important to both types of institutions, since it will increase short term cash flows, improve the yield on a limited portion of the total portfolio, and help to attract younger customers who may be tomorrow's depositors.

New York savings banks lack this broad consumer loan power as well as the demand deposit, NOW account and branching powers envisaged by the Administration's bill, but the branching part of this equation will be largely resolved by the advent of statewide branching in 1976. Even if no progress is made in Albany on a general purpose consumer loan bill, you would have to weigh carefully the surrender of your very broad authority under New York law to invest in corporate debt obligations and a number of other differences, before opting to select the Federal charter alternative currently proposed. I suspect that for many of you a Federal charter will remain largely a stick in the closet to influence the State Legislature in Albany.

Even if your primary legislative efforts are directed at the Legislature in Albany over the next few years, as I believe they should be, you would be well advised to continue your efforts simultaneously on behalf of the Administration's Hunt Commission proposals in Washington. At either level, judging from what I've heard here this weekend, several years of patient, persistent and unwavering lobbying will be required to attain your goals. But on that lobbying, in my judgment, your future will depend.

There is a clear danger that the course of events, stimulated by bank technology, the aggressive behavior and packaging of services by your commercial bank friends, and their long headstart in electronic funds transfer systems, will overtake the thrift industry competitively. But I am optimistic about the vigor of your response, the determination you have to build upon a long history of service to New York residents and families, and the underlying strength I know to exist among the savings banks of New York State.

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