FDIC

FEDERAL DEPOSIT INSURANCE CORPORATION, Washington, D.C. 20429

OFFICE OF THE CHAIRMAN

Three Items of Unfinished Business

Edited from Remarks of

Frank Wille, Chairman
Federal Deposit Insurance Corporation

before the

82nd Annual Convention
Savings Banks Association of New York State

Fairmont Hotel
New Orleans, Louisiana

November 12, 1975

It is a pleasure, as always, to join your deliberations, and I welcome this opportunity to discuss a number of matters of mutual interest. I am going to talk this morning informally about three items of unfinished business, and to proceed immediately to the first, which has to do with how the FDIC will handle the establishment of off-site electronic facilities.

EFT Facilities

The FDIC intends to issue shortly to its Regional Directors instructions with respect to the procedures it will follow in the establishment of off-site remote service facilities. We will not be taking an official position as to whether or not these particular facilities -- if they take deposits or cash checks or facilitate withdrawals or transfer activities -- are or are not branches for purposes of federal law. That question is obviously a hotly debated one and it is one that is not likely to be settled short of a Supreme Court decision one way or the other. There is significant judicial precedent to support the district court decisions that have been issued so far in the various cases attacking the Comptroller's ruling. On the other hand, there is a possibility that the facilities, being different than the bricks-and-mortar branches that Congress initially had in mind, will be found by the Supreme Court not legally to be branches.

Nonetheless, without taking an official position on that particular point, FDIC will be expected by the Congress, and will want, for its own purposes, to monitor very closely the establishment and development of

electronic facilities. We have looked at the FDIC's normal branch application, as well as the information that we think should be required whenever these facilities are established and we have found that we do not need all the information required in the case of a full-service branch and what we do need is the same whether or not they technically are "branches" for purposes of federal law.

That being the case, we will seek to have this information not less than 30 days before the actual establishment of an electronic facility or group of facilities, and the information follows very closely the Banking Board's regulations in New York under Part 73.

This information includes such items as:

1. The banking functions which are to be performed;
2. The costs that are involved and estimates of the first three years' operating expenses;
3. The proposed location and the identification of nearby competitors. "Nearby," for this purpose, will be defined as within two miles in locations other than cities of 250,000 population or more, while within such cities, it will be defined as any reasonable area that can be justified by the bank filing the information;
4. The status of the facility under state law and regulation. In New York, you have a rather specific statute and regulation now with respect to these facilities, but that is not true of other states. Some states treat these facilities as branches, like New York, some states treat them quite specifically as nonbranches, and still other states are completely silent on this matter. We are hoping that this request for information will fill out some of the gaps we now have in the legal status of these facilities at the state level and keep us up-to-date as events unfold;

5. The details of any planned joint venture or sharing between the institution establishing the facility and other institutions in the same general market area. Shared facilities have a potential for considerable economies, and yet they may also be adverse to the public if anticompetitive arrangements in the pricing of services are included. The FDIC wants to take a very careful look at the way in which those sharing arrangements are developed and the specifics of them;

6. The security arrangements for these facilities and whether or not the bank establishing them will be complying with FDIC regulations, Part 326, having to do with the physical security arrangements for other types of branches and facilities. We are also seeking information about the insurance protection against misuse of the facility by outsiders and also the details of protection against internal control hazards which may be particularly pertinent if the system is on line, real time for the first time.

As to general procedures, we have determined that one form can be filed for multiple locations if they are all part of a system. If facilities are to be shared, however, separate applications and forms will be required to be filed by the different participants in that sharing program.

The FDIC intends to publicize the filing of this information so that competitors will be properly advised of the intentions of the bank establishing the facility. And we will also, in the case of those applications where the bank seeks to have the FDIC approve them as branches, treat them in every respect as a branch application, except, as I say, the information required will be less extensive than if it were a full-service branch.

To repeat, the Corporation will give banks throughout the country the option of asking FDIC to approve these facilities as branches or not as branches. If they do not seek a branch approval, we will be quite satisfied with the information that banks file with us 30 days in advance, subject to a review and possible change in some of the terms of the sharing arrangements or proposed lease terms under which facilities will be operated.

Because of the status of these facilities under state law, I would expect all mutual savings banks in New York to seek FDIC's approval for these facilities as branches, and we are prepared to do that. We have in fact granted branch approvals for similar facilities in other states throughout the year.

In other states, such as the State of Washington, which consider these facilities not to be branches under state law, we have been asked specifically by applicant banks not to approve them as branches, and we have not done so.

In short, we are prepared at the Corporation to leave this question to the good judgment and sense of the banks seeking to establish these facilities. We view the receipt of a branch approval basically as a form of protection to the bank establishing them. That being the case, if a bank does not seek to have them approved as branches, it will be taking its own chances and risks as to the final adjudication of the status of these facilities under federal law by the Supreme Court initially and possibly thereafter by the Congress.

In New York State, where most of these facilities are going to be considered branches, FDIC will accept the state application form with cross-references to our prescribed FDIC form as an adequate filing, so long as the specific additional details we are seeking, like the competitive environment, the actual provisions of leases and contracts affecting the facility, and the operating costs for the first three years, are added as supplements.

I think you will find that the procedures to be followed, at least for mutual savings banks in New York State, will be simple and will not be unduly detailed. Eventually, although probably not initially, most of the branch approvals you will be seeking will be decided at the Regional Office level, with only the very unusual situations referred on to Washington for decision.

To sum up FDIC's attitude on these electronic facilities, we are generally supportive of the new electronic banking. We believe these facilities will be a considerable public convenience and that this will become more and more obvious in the future. We also think that their establishment will be generally pro-competitive, and for both reasons, that public policy should encourage their use. We are concerned about matters of competition and impact, and those are the basic purposes of the review which we seek by our requirement for advance notification.

1974-1975 Performance

The second matter that I would like to raise this morning has to do with the situation in which the mutual savings bank industry finds itself in late '75.

Over the last year or two, I have spent a great deal of time worrying about the asset condition of a limited number of commercial banks, but I am glad to say that those particular problems don't seem to have touched the mutual savings bank industry to any significant degree.

In the United States, about 1 to 2 percent of all commercial banks are problem banks. Since there are some 15,000 such banks these days, that works out to between 150 and 300 at any one time.

I am glad to report that, insofar as mutual savings banks are concerned, only two of the 330 FDIC-insured mutual savings banks are on that kind of a problem list today. Those two are very, very small, and they are not in New York State, so that at least from the Corporation's point of view, the mutual savings bank system does not present the kind of system risks or individual institution risks which the commercial banking system does.

Commercial banks continue to be the primary risk takers in the American financial structure and they will no doubt continue to be in that position as long as they have commercial lending powers.

On the other hand, the mutual savings bank system, in my view, has some structural problems from which, in the long run, it must find a

way out. I refer basically to questions of asset powers and, in particular, problems of earnings and earnings retention flowing from your present asset powers.

These are important because, as the business cycle fluctuates and deposit outflows accelerate in times of very tight money or disintermediation, it is obvious that in order to retain deposits, mutual savings banks will be compelled, if at all possible, to pay a higher rate of interest than they have been accustomed to pay -- higher, possibly, than they may be able to pay given their asset structures and earnings capabilities at the present time.

Similarly, if you look at the earnings retention of mutual savings banks over the last ten years or so, it is very apparent that earnings retention has been on a down slope, and understandably so, in view of the rising interest costs which have been impelled upon the mutual savings bank system by changes in Regulation Q and in market conditions generally and which have been necessary, in our view, to retain the bulk of deposits already in mutual savings banks and other thrift institutions.

Deposit inflows during the first six months of 1975 were obviously very good, but they have been relatively unimpressive since June, with some outflows in the summer which have now diminished to a point of equilibrium. The aggregate net inflow, so far, in 1975 seems to be about $4 billion for all mutual savings banks that are FDIC-insured.

However, the earnings side of mutual savings banks is not quite so encouraging. Last year, during the final quarter of '74, there was a significant upswing in operating expense for mutual savings banks caused

primarily by the need to borrow money for liquidity purposes. Although there was, of course, a steady increase in the interest paid on deposits during 1974, as well as a steady increase in the revenues being generated by your assets, the two were in pretty good relationship. The one principal reason why net operating income after dividends and interest last year dropped so dramatically was because of the high interest expense paid on borrowed funds for liquidity purposes.

With the deposit inflows of the first six months of 1975, mutual savings banks have recaptured about one-half of that net income drop experienced in the last quarter of 1974, and it looks as though, with the possibility of increased deposit inflows over the next few months, net income will continue to rise.

Nevertheless, if you look at the figures as a percentage of total assets, those retentions in the last quarter of 1974 -- net income after interest expense and all operating expenses, but before securities gains and before taxes -- came to only .50 for the mutual savings bank system as a whole, whereas the high point in recent years was .85 for all of 1973.

For all of '74, the same figure was .66, so that there was a significant drop from much higher averages in the first three quarters down to .50 in the last quarter -- October, November and December -- of '74. Right now, the comparable figure stands at approximately .59, so that more than half of the actual drop from 1974 as a whole has been recovered.

What has happened so far in 1975 is that mutual savings banks have been paying off those high-cost borrowings of the last quarter of 1974, although recently, with the threat of further disintermediation this past summer, overall borrowings started to pick up again. Now they are sliding back to the pattern of the first six months because of the general easing in monetary conditions.

The situation seems to be in relative control, as far as net operating income less expenses other than borrowed money is concerned. So to the extent mutual savings banks have been paying off high-cost borrowings and putting some of their net deposit inflows into shorter term liquidity instruments, I think that has been all to the good, and in a way, prepares you for what may be a significantly different problem in '76. I would even suggest that as you approach '76, more of the same is in order and that now is the time to be preparing for liquidity problems during the second half perhaps of 1976. I will get back to that in just a minute, because I think it is related to Regulation Q and a number of other things which will be of interest to you as you look forward to 1976.

This leads me to questions of how best the mutual savings bank system can increase its ability to earn money, the key to your ability to pay higher deposit rates for your customers in future periods of tight money as they find other types of instruments -- money market funds, treasury bills, or what have you -- more attractive, and how indeed you can improve your earnings retention for the long run.

I do not need to dwell on the fact that the FDIC supports -- just as your industry supports -- the Administration's proposed Financial Institutions Act, and that there seems to be some considerable movement toward passage of that legislation in the present Congress.

This turns out to be my twelfth consecutive Savings Banks Association meeting -- six as Superintendent and six as Chairman of the FDIC -- and over that period of time, looking back, there has been an extraordinary increase for you in the number of savings bank branches and in the geographic reach you have been able to achieve. There has also been a significant improvement in your legal capacity to offer various types of deposit services, particularly in the time deposit area. On the asset side, you have nationwide mortgage lending now, which you did not have before, and some leeway provisions which I think have been uniformly helpful over the past six or seven years they have been in existence.

Nonetheless, there seems to be growing awareness and more general agreement that among the powers you really must have in the very near future are wider personal lending powers and checking account services.

I mention checking account services, and obviously access to clearing facilities as well, not because I think that this will be a convenience for customers of savings banks, or because it will be generally pro-competitive to have more competition for demand deposits within the financial system, both of which are the case, but because I think it will

be necessary for you to have that power in order to protect your passbook savings accounts and your shorter term certificates.

To explain that, I have to point out that in the variations and changes which have been made in some of the underlying ground rules of Regulation Q over the last six or seven months, the Federal agencies have acted in such a way as to increase the power of commercial banks, in particular, to service customer demands which involve the use of deposit accounts. In adopting these changes, which include preauthorized and telephone transfers of savings deposits to third parties, the line between savings accounts and demand deposits has been further blurred, and I think this evolution will continue.

About the only thing that has not been adopted at this point is some automatic transfer right between a savings account and a checking account, where that transfer may be necessary in order to prevent an overdraft.

Now, obviously a commercial bank which can offer an automatic transfer service in the event of an overdraft -- and I view that as a logical extension of some of the changes we have already made in Q -- will be able to offer an attractive savings account-demand deposit package which at least, under present law, cannot be matched by the mutual savings bank system, at least in states like New York which have not affirmatively authorized demand deposit powers and a general consumer lending authority.

Now, while savings banks have the protection of a one-quarter point differential on the passbook savings rate, and also on the shorter term certificates, I suspect the commercial banking system will be able to make a considerable degree of impact by marketing the convenience of the transfer privileges they presently have or may get in the near future, a service with which mutual savings banks cannot compete unless they have not only checking account powers (and clearing facilities), but also the power to make general personal loans in such a way that overdrafts can exist in the mutual savings bank system.

There are other reasons for the personal lending power, but that is one use of them. And whereas your arguments in the past have been addressed to the desirability of such a power because of convenience and competition, I think in the near future you may be able to point forcefully to the competitive necessity for such a power. Needless to say, I hope that you are successful in your efforts to convince the New York State legislature that these are powers that you need and which will serve the New York public well in the years ahead.

Regulation Q Possibilities If Disintermediation Returns

Finally, I want to make a few remarks about Regulation Q this morning, and they are a continuation of my remarks with respect to the earnings posture of the mutual savings bank industry. I do not expect any return to tight money in the very near future, although it is quite possible

that late in the second quarter and thereafter in '76, tight money and some degree of disintermediation will again be with us as the Federal Reserve tries to fight the forces of inflation which have been so prevalent and persistent in the United States' economy.

If it comes to that, and we are faced in '76 with a new round of disintermediation, I think the ability of the Federal rate agencies -- the Federal Home Loan Bank Board, the FDIC and the Federal Reserve Board -- to respond by raising interest rates will be significantly limited because of the earning situation of thrift institutions generally, including savings and loans whose recent earnings performance has been comparable to that of mutual savings banks.

Under those circumstances it is obvious that our ability to raise Q ceilings generally in an effort to fight disintermediation will not be there to the extent it was perhaps in '73 and at times during the 1960's. That being the case, we will be looking particularly hard not at the rates on passbook savings or the shorter term certificates, but at the rates on longer term certificates, i.e., those between two and six years.

We are undoubtedly going to be selective in our review of such rates, and if there are to be increases in '76 with a new round of disintermediation, I would expect those increases only on some or all of the two, four and six-year certificates.

Now, at least as far as maturity is concerned, there is probably a limit of public acceptability beyond which we cannot go, and the six-year

certificate may already have reached that limit. These six-year certificates, as you know, were introduced sometime ago, but at only one quarter of a point over the four-year certificate. It is very clear that, so far, for mutual savings banks, the six-year certificate has been a bust. It has not attracted significant deposit inflows and it has not been aggressively marketed. The six-year cost to the bank of that kind of certificate may be a factor, but surely the public reluctance to commit for another two years in return for merely one-quarter of one percent more than a four-year certificate is a major part of the market reaction.

Moreover, if inflation continues, I suspect that very few members of the public will be willing to put aside their funds for six years at almost any rate likely to be authorized under Q. It is just too long a period to accept a fixed rate at those levels, not knowing what all the circumstances in the economy will be as those six years run out.

The agencies might well move to increase the rate differential between the six-year and the four-year certificate, but I doubt there will be any significant impetus toward an even longer term certificate.

If that is the case, and our ability to move because of your earnings situation is as limited as I think it will be in 1976, I hope the agencies and the industry will return to the concept of a variable-rate time deposit tied to an identifiable market rate. This was a suggestion, as you know, which I made at the meeting of the National Association in Portland in May 1974, and just for this discussion, I would repeat some of the basic terms I listed for that kind of a deposit.

My original suggestion was that it be a time deposit in the four-year range with monthly ceilings changed to reflect the previous month's treasury bill averages, that this rate be allowed to fluctuate but not below a prescribed floor -- which the offering bank could set at not more than 4.5 percent, that the account have a differential in favor of thrift institutions as compared with commercial banks, and that its minimum denomination be $1,000.

The response to my proposal was considerable, although I must say generally lukewarm. We had a considerable diversity of views expressed to the FDIC, but also a considerable degree of agreement on some of the basic terms.

I think what most savings bankers were concerned about in May 1974 was the question of timing. They had had very little time to absorb a full year's impact of the substantial and significant changes made in the Summer of '73 with regard to Q rates generally, and they were very much concerned that treasury bill rates might be considerably higher between '74 and '78 than they had been by historical patterns in the past.

Much of that concern over timing should be behind us now. The '73 changes in Q have been largely absorbed and I might add that you have accommodated yourselves to those increases in rates very, very well. In addition, treasury bill rates have now subsided to more normal historical levels.

The comments that we received on that May 1974 proposal included general agreement that tying the index to the treasury bill average was a good one. The average was one that was understandable to the American public and easily identifiable in weekly reports published in the Wall Street Journal and other major financial newspapers. There was almost universal agreement on the $1,000 minimum denomination requirement and also a feeling that there had to be a maximum floor, not merely to protect the customer interested in this kind of deposit on the downside, but also to discourage an undue shift away from passbook savings accounts.

There was disagreement about the term of the deposit and about setting rates on a monthly basis. We at the FDIC have thought about both of those points some more and believe now that a shorter term would be more suitable and that a quarterly change of rate would be less confusing to the public and to the industry.

Our present thinking, therefore, is that the basic outlines of this proposal are still valid and for many of the same reasons that we advanced in May of '74. We would now amend the proposal, however, so that rate changes would occur on a quarterly basis and that a much shorter term, possibly in the range of two to three years, would be permissible.

Obviously, the shorter the maturity range of this kind of a variable time deposit, the greater the ability mutual savings banks and other depositary institutions will have to compete against money market funds

and various "pass-through" arrangements which will again become prevalent when tight money returns and disintermediation threatens.

The only problem with shortening the term is that the average cost of such a variable-rate instrument over its life might be more nearly equal to or even higher than the cost of the 7 1/2 percent fixed rate, four-year certificate, since there would be less opportunity than under my original proposal for the "historical" treasury bill averages to be realized.

On the other hand, we are not able to predict exactly any future cycle. If we take the treasury bill averages for the last three years, for example, including the very high interest rates in parts of '73 and '74, the cost of a three-year variable-rate time deposit would have been only 6.65 percent rather than the 7.50 percent which your four-year certificates at the Q ceiling require.

I raise these matters now so that you will be thinking about it in greater detail over the next few months. I would repeat that we do not expect any imminent changes in the actual ceilings under Q on a nationwide basis, although we may indeed be revising the transfer powers between accounts, as I mentioned, and also possibly the penalties which are now imposed when a depositor seeks to turn in a certificate prior to maturity for early redemption.

These penalties become more onerous the longer a particular certificate is held, and that is particularly the case when it is held well into a four-year or a six-year term. The present penalty provisions need

to be revised to have a progressively smaller penalty the longer the deposit is actually held.

In any event, if we need in '76 a more effective way to blunt disintermediation, I suspect that the agencies will return to something like a variable-rate deposit, as well as possible increases in rate on the fixed, longer term certificates between two and six years.

I appreciate having had this opportunity to express our present thoughts with regard to these three different matters.