For release 1:00 p.m.
Central Daylight Time
May 17, 1966

Remarks of J. L. Robertson

Vice Chairman of the Board of Governors
of the
Federal Reserve System

at the

75th Diamond Jubilee Anniversary Convention
of the
Illinois Bankers Association

Peoria, Illinois

May 17, 1966

An Alternative to Fossilization

When I appeared before this group in 1963, I expressed some unpopular ideas. Your tolerance of them has led to my return. Events in the last three years have demonstrated the soundness of those ideas and emphasized the reasons why they will be accepted - eventually.

The gist of them is quickly stated: first, federal supervision of commercial banks should be consolidated in a single agency, and second, that agency should be an independent Federal Banking Commission. The bank supervisory powers now exercised by the Comptroller of the Currency and the Federal Reserve and all powers and functions now vested in the Federal Deposit Insurance Corporation would be transferred to the new Commission, the members of which would be appointed by the President on a nonpartisan basis.

Today I feel even more strongly about the need for the Federal Banking Commission than I did when I first made the proposal. And I am pleased to report that in the ensuing years it has attracted a gratifying - although as yet inadequate - degree of support. Unification of the federal supervisory functions is imperative in order that the banking industry may operate under a single set of federal "rules of the game" - ground rules that would apply uniformly and equitably to all federally-insured banks.

We are now faced with a situation in which the "rules of the game" have become so different for one group of banks than for other groups that competitive equality, which is essential for a sound banking system, is less and less of a reality. If carried much further, the debilitating consequences may be the undoing of the dual banking system, and that could lead to the unification of supervisory powers - but in a form that many would abhor.

This is not the kind of problem that is solved by sitting back and hoping it will go away. It is not a problem that arises principally from the personalities of the heads of agencies. It is ingrained in the legislative fabric. Only by remedial legislation can the present crazy-quilt pattern of federal banking laws and regulations become a congruous system of fair and readily understandable rules, which will not only benefit banks but also be in the general public interest.

My purpose today is not to expound again the merits of a Federal Banking Commission, for I am confident that the tide is running in its favor and will soon be too strong to be resisted - even by those who are inclined to espouse the maintenance of the status quo. Rather, I want now to ask you to look over the horizon again, but in a slightly different direction. I would like to invite your consideration of the wisdom of seeking and developing uniform "rules of the game" that would cover a broader range of financial institutions. I have in mind commercial banks, mutual savings banks, and savings and loan associations.

In recent years the competition among these institutions has become intense - to put it mildly. Commercial banks have moved further and further into the financial areas in which mutuals and savings and loans specialize. As a result, those specialized institutions have felt, more and more, the pinch of the limitations imposed on their operations by law and regulation. This has understandably led to efforts to relax those limitations so that such institutions may broaden the scope of their activities.

It is natural, perhaps, that commercial bankers have generally reacted adversely to these efforts of mutual thrift institutions to enlarge their powers. We must remember, however, that both mutual savings banks and savings and loan associations were originally created to meet financial needs that - in all candor - were simply not being met by commercial banks.

Not too long ago, commercial banks catered to a select clientele of businessmen, farmers of substance, and wealthy individuals. They did not encourage the patronage of men in overalls; and consumer loans were considered a bit immoral. This contributed to the origin in the northeastern states of mutual savings banks - banks devised to encourage thrift among the working classes by offering them a safe place to invest their modest weekly or monthly savings - savings often too small to be welcomed by the commercial banks.

Savings and loans originally had a similar function of serving the low-income groups. From their outset they were oriented to the great American goal of home ownership. This was indicated by their early designation as "building and loan associations". These organizations, in all sections of the country, provided, on one hand, a means through which families could accumulate funds to buy a home; on the other, they offered home financing tailored to the needs of their modest-income borrowers.

To encourage the development of these mutual thrift organizations and to facilitate their ability to fulfill their worthy objectives, they were granted certain special privileges. The most significant were favorable tax treatment (either by exemption or by lower rates than were applicable to commercial banks) and less stringent (if any) reserve and liquidity requirements.

As I hardly need remind people who are on the firing line, commercial banks, savings banks, and savings and loans now vigorously compete for deposit-type savings in the general market. Only a few years ago competition for deposit-type savings was confined largely to local market areas, and even there many commercial banks did not actively compete with the specialized institutions. Today they do - and strenuously.

For years, savings and loans offered their shareholders higher interest rates than commercial banks could pay on time accounts. But, particularly since last December, when the ceilings on time deposit interest rates were raised, this situation has drastically changed. The development of bank certificates of deposit as a means to attract individuals' funds, at interest rates in excess of the highest permissible rate on bank savings accounts, has enabled commercial banks to out-compete their thrift rivals in this market. In some places today, banks are offering gimmick instruments, such as savings certificates and savings bonds, that are attracting substantial amounts of funds away from thrift institutions, at rates the latter simply cannot afford to pay because of the composition of their earning assets - long-term real estate loans on which the interest rates were set when the pattern of rates was lower. And because of the greater sophistication of savers today, the market for these funds has become more and more nation-wide.

Likewise, in the lending markets competition among the several types of financial institutions has intensified. Commercial banks have substantially increased their mortgage portfolios in the last few years. To combat this, the lending powers of some savings and loan associations have been extended beyond residential mortgage credit. Savings banks have tried to meet the problem of investment limitation by gaining authority to acquire a larger proportion of their investment holdings from beyond their home state borders.

Such relaxations of the rules governing mutual institutions have provided only moderate relief. And even that relief has been largely offset by the increasing difficulty for some mutuals to exist (let alone grow) in the present economic environment - with its high cost of funds. As this difficulty becomes greater, as it well may, pressure will build up at both federal and state legislative levels to broaden further the permissible activities of the thrift institutions. The more intense the competition from banks, the more intense will be the pressure for alleviating the restrictive rules governing those institutions.

The direction of these pressures may be illustrated by the banking legislation passed by the New York legislature the week before last. Included with provisions that are designed to equalize the competitive strength of state-chartered and national banks in New York are provisions that authorize mutual savings banks and savings and loan associations to invest up to a fifth of their assets in mortgages on real estate located in states other than New York, and to expand their branching privileges. Other pending legislative proposals would permit New York savings banks to convert into commercial banks and authorize savings and loans to receive demand deposits.

The prospect for prompt enactment of proposals like these, in state and federal legislatures, may be dim. They cannot, however, be ignored. Nor can we disregard the recommendations of two recent studies of our financial institutions. In 1961, the report of the nongovernmental Commission on Money and Credit of the C. E. D. recommended "that the regulatory authorities be authorized to permit greater flexibility to savings banks and savings and loan associations to acquire a wider range of suitable long-term debt instruments." In 1963, the President's Committee on Financial Institutions favored broader powers for institutions specialized in their lending activities.

There is no question that, from the economic standpoint, a good case can be made for the adoption of these proposals and recommendations. They would foster an atmosphere of more vigorous competition among our nation's financial institutions. Such competition would tend to facilitate the transfer of financial resources from savers to borrowers. The proposals would encourage initiative and competition, which in turn would increase the contribution of private financial institutions to economic growth.

As a practical matter, offering our specialized institutions the opportunities to adjust to changing conditions and their willing acceptance of such opportunities is - in my judgment - necessary for their survival. I remember when I was a small boy in Broken Bow, Nebraska, a farmer plowed up a huge brontosaurus bone, which he brought into town to show to his friends. I thought at the time how strange it was that those giant dinosaurs had been unable to survive. Later I learned that they became extinct because they were unable to adapt to their changing environment. Something like this faces our specialized financial institutions. As the need for their limited services decreases - perhaps because of the expansion of commercial bank activity in their field, or as commercial bank activities cause the cost of their funds to reach or exceed earnings on loans in the specialized field - they must either adapt to the change or risk becoming as extinct as the brontosaurus.

It is insufficient merely to grant to mutual thrift institutions broader lending powers. Desirable as this may be, it would seem to leave us about where we are now - with a number of different types of depositories known as commercial banks, savings banks, savings and loan associations, et cetera, operating under an almost bewildering maze of federal and state laws and regulations, competing under ground rules that differ, if not conflict, for each type of institution - rules that differ even among members of the same type of institution, depending on the source of their charters.

This, of course, describes our commercial banking system today. And its correction in so far as federal bank supervision is concerned is the principal reason behind my proposal for consolidating federal supervisory powers in a Federal Banking Commission.

To meet the problem of the mutual thrift institutions, I suggest that we need a major change in our philosophy about them. We must not regard them as permanently tied to a specialized function, but as potential candidates for full service financial status.

Accordingly, I propose that all depository institutions be permitted to become comprehensive lenders and borrowers, subject to uniform bank-style limitations on the exercise of their powers.

Adoption of such a proposal would allow these depository institutions (<u>at their option</u>) to exercise enlarged powers, including the acceptance of demand deposits and the acquisition of the full bank range of assets. While a broad spectrum of lending and investment possibilities would be opened up, local institutions could (if they desired) concentrate on different sectors of the spectrum. Their areas of concentration would depend upon community needs and their own capabilities.

Failure to enlarge the lending powers of our thrift institutions will impel them, I fear, to reach out for riskier and riskier loans in their limited field. As the credit demands in the specialized area decline or as commercial banks absorb a greater and greater proportion of these demands, the mutuals may be forced into higher-risk assets. Otherwise, they will not produce earnings sufficient to pay interest at competitive rates on funds placed with them.

The potential danger of this - not only to them but to the whole financial system and the nation's economic structure - is fairly obvious.

However, as you will already have inferred, enlarging the powers of mutual institutions is not the whole proposal, nor would it be an appropriate solution. It may be the desired solution of certain of those institutions, at least temporarily. But the problem is to accommodate these depository institutions to the future needs of our economy. This means a substantial revision of the structure of the depository system itself. The governing rules must be revised - over time - to provide more uniform lending authority, investment powers, reserve requirements, tax treatment, branching privileges, and supervisory powers as to commercial banks, mutual savings banks, and savings and loan associations alike.

This, of course, means that there is a corollary to changing our philosophy toward mutual thrift institutions. They must also change their philosophy toward themselves. As we should assist their efforts to expand their operations, when they wish to do so, they should not resist assuming the responsibilities of commercial banks.

As they enlarge their powers and become full-service financial institutions, they must relinquish the special privileges that were designed to assist them in developing as specialized thrift institutions. The inequities of tax treatment must be eliminated. They should be required to maintain reserves against deposits on a basis comparable to that of banks that are members of the Federal Reserve System. They should be required to maintain appropriate liquidity. In other words, with the powers of a commercial bank must go the burdens.

A basic structural change such as I have suggested cannot and need not be accomplished overnight. The problem is one for long-run solution. That may take decades rather than years. But we need to select the star to which we should hitch our wagon. Once we have done that, we can begin to determine how to reach our goal. In some respects, legislation will be essential; in others, legislation may simply be desirable as a means of helping mutual savings banks and savings and loan associations to become full-service commercial banks.

The proposal to permit mutual thrift institutions to convert to commercial bank status is not visionary. Such conversions have already occurred.

A recent instance was the conversion of the Society for Savings in the City of Cleveland to the Society National Bank. The basic approach used in that case and others was to convert a mutual organization into a stock company. The depositor-owners of the savings bank became equity owners of a holding company that owned the national bank.

Variations of this approach would include a distribution of the accumulated surplus of the mutual to its depositor-owners, in the form of either cash or stock in the successor institution. Legislation such as that now pending in New York State contemplates conversion into stock companies along these lines.

Perhaps less cumbersome and more satisfactory arrangements can be devised. Presently I see no theoretical or supervisory reason why commercial bank operations could not be handled entirely on a mutual basis. Mutual organizations could be authorized by law to accept demand deposits. Their entire operation could be safeguarded by suitable reserve requirements, commercial bank lending restrictions, and specified liquidity ratios. Such reserve requirements and liquidity ratios would need to be somewhat higher than for stock companies in order to take the place of the cushion of protection furnished by capital stock.

But whatever the approach, I am confident that, with imagination and ingenuity, we can develop appropriate legal and procedural means for achieving the goal. The task of making it easy for mutual savings banks and savings and loan associations to convert into full-service commercial banks is not beyond the intellect and determination of man.

To recapitulate, the problems of competition among commercial banks, mutual savings banks, and savings and loans call for unbiased, thoughtful consideration. Our need is for flexible uniformity rather than rigid specialization. Our responsibility is to accommodate our depository institutions to the expanding needs of our communities and our nation. This demands more than a broadening of present institutional lending powers. It requires a significant revision in our philosophy of the organization and operation of the depository system.

This new philosophy calls for full competitive equality, if and when desired, for all depository financial institutions. Failure to provide adequately for institutional change and to envision our depositories as integral parts of a general financial system raises more than the risk of fossilization. Such failure would lay the groundwork for demands for further fragmentation by the creation of new types of institutions with additional special powers to meet newly-emerging needs.

This problem, like that in the field of federal bank supervision, demands a solution. Maintenance of the status quo is impossible. None of us can afford to sit on our hands and do nothing. For the moment it may be the other fellow whose ox is being gored, but that may not always be the case.

If a rational and workable solution is not developed and adopted, we may wake up one day to find that we have several nation-wide financial depository systems, each with assets and liabilities in the hundreds of billions of dollars. They will have overlapping lending and investing powers - unless I grossly misjudge the political climate and strength of the pressures for legislative relief. But it is more than likely that there will be unequal competitive abilities because of inequalities in taxation, reserve and liquidity requirements, branching privileges, and governmental supervision. In that case, it might even be the commercial banking system that becomes the extinct brontosaurus of the financial world.

Neither the extinction of the mutual thrift institutions nor the extinction of the commercial banking system is in the public interest. What is in the public interest -

which should ever be uppermost in our minds - is that our nation's financial institutions should be given the opportunity to adapt to changes in their environment. Only by encouraging initiative and competition, in a climate of equal opportunities and obligations, can we assure the maximum contribution of our private financial system to the nation's economic growth and well being.