For Release on Delivery
9:00 a.m. PST (12:00 a.m. EST)
Thursday, December 12, 1985

SAVINGS BANKING IN THE NEXT DECADE

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

Eleventh Annual Conference of the
Federal Home Loan Bank of San Francisco

"Financial Stability of the Thrift Industry"

San Francisco, California
December 12, 1985

SAVINGS BANKING IN THE NEXT DECADE
Preston Martin
Vice Chairman
Board of Governors of the Federal Reserve System
Eleventh Annual Conference of the
Federal Home Loan Bank of San Francisco
"Financial Stability of the Thrift Industry"
San Francisco, California
December 12, 1985

Why is it that the dialogue regarding financial institutions always emphasizes the failures and the risks? I marvel at that, not because I fail to recognize the extensive risks in our system but because successful adjustments to the decade long financial services revolution are virtually ignored. We cannot have a reasonably clear long-term view of the financial services industry without recognizing that thrifts, banks, securities firms, and insurance companies have succeeded in evolving and in adapting each of their major activities in some way -- whether that adaptation is in assets, liabilities, cash flow, or geography. The marvel is that the forces for change have come from the market. Regulators have merely reacted to those forces. The wonder is not that there have been failures, but that there have been hundreds of successes.

I believe there are basic trends that are irreversible because they have such momentum that turning them aside will be improbable. One such trend is deregulation. A tenet in the United States is that regulations are often poorly designed and administered and that they can have negative effects on efficiency, equity, and stability. Of course, the costs and uncertainties of transition from the previous state of over-regulation are considerable. Certainly the combination of regulatory liberalization and market innovation has enabled some managers to engage in growthmanship and excessive risk-taking. Outweighing these real and pervasive costs, however, deregulation has allowed customers to enjoy the largest increases in rate of return and in new services in the history of this or any other nation. Market participants and regulators all over the world are studying our experience and are emulating us in various ways. The deregulated environment, with some reregulation for safety and soundness around the margin, is here to stay.

In part because of deregulation, the encroachment by one kind of institution into the markets of others will continue over the next decade, but management will be free to specialize in new and different combinations. Specialization will proliferate, not perish. Since there will always and everywhere be a need for housing specialization, the returns on investment in savings banking will be ensured for well-managed institutions. I am using the term "savings banking" in a broad sense to subsume all of the ways you will be serving your communities. "Thrift" just does not cover the present or the future situation. In fact, I just hope you don't oversell your credit services to households the way some marketeers are doing today. That certainly is the antithesis of thrift!

Fine, you may be thinking, but how can a financial system that is so open to competition and innovation survive the slings and arrows of the speculator/gambler type of managers? Won't their excesses and failures lower our customers' confidence? And won't these failures result in the nationalization of great segments of our industry? I'll give you an unorthodox answer: not if your industry will commit itself to self-regulation. No I don't want to replace the FHLBB and the FSLIC nor, heaven forbid, the Fed!

Self-regulation to me means that management of the strong institutions, acting for the common welfare, become the militia and the national guard of savings bank supervision -- at first by ensuring that the known, good policies regarding asset acquisition and management are spread throughout the industry. Sharing information, procedures, and analytical tools in a structured environment can help propagate good management practices and drive out the bad. That is the essence of self-regulation -- effective management acting responsibly. Once the preventive maintenance is under way, then I advocate industry surveillance of and counseling with certain of the fast operators in the business.

A Savings Bank Principles Board could be the forum for establishing standard business practices. In the future, such a Board could encompass such areas as a code of ethics, accreditation programs for savings banks (and maybe even for individual managers), forums for the discussion of problem situations, strategic planning models, and ultimately a mechanism for enforcement. The exact structure of the Board is much less important than the impact of its being created and supported by the industry. Successfully implemented, such a board could be <u>the</u> major change in how the industry regards itself, how it restores ebbing public confidence, how it adapts to change, and how it relates to the regulators. The alternative is an inevitable overkill in re-regulation some time in the next decade.

None of us can go back to the bad old days when thrifts were inhibited by state usury statutes, depository rate ceilings, and tax advantages that led to over concentration of fixed-rate residential mortgages in portfolios. Nor can we, as have past generations of Americans, consider the fixed-rate residential mortgage as a God given or Constitutionally given right -- another "entitlement." It seems so long ago that these conditions prevailed, but it was less than 10 years past.

In today's deregulated world, the survival of many institutions is under question. Wall Street has both a cult of "performance" and a huge appetite for securities backed by pools of residential mortgages. Inflation is in remission, and some mortgage defaults are occurring even at the first payment date, in part because prices of homes in a low inflation environment no longer rise inevitably. Core deposits are hard to find or even define. Funding is at market rates, and those rates fluctuate as much within a week as they once did within a Presidential term. Housing is low on the public policy agenda, and even our family structure is significantly different. Despite all of these changes, the specialized housing institution remains, but its assets and liabilities reflect management's decisions over 20 years or so within a rigid governmental framework. The burden of old, fixed rate below-current-market mortgages contrasts sharply with liabilities whose costs are very much at current market rates, which vary hourly.

Inexorable market forces have compelled financial institution managers to attempt to change and adapt. For some, a major objective is to become a "financial supermarket." This attitude is an understandable response to loss of market share. But deregulation of deposit rates has enabled commercial banks and savings banks to recapture some of the market share lost to the money market funds -- albeit at rising costs. The blurring of the lines between and among different kinds of financial institutions leads management to strategies of providing wide ranges of financial services to its increasingly sophisticated customers. But deregulation has enticed a new breed of high risk-taking owners and managers into the industry.

This is not to deny that one-stop shopping for financial services has advantages as well as disadvantages. Indeed, it is clear that large and small institutions -- through franchising, leasing lobby floor space, and other joint participation techniques -- can compete by providing a multiplicity of financial services. Furthermore, financial service supermarkets offer different products of varying convenience and quality, in part because management is typically not equally competent in several fields. As the financial revolution compels adaptation, the odds are that each savings bank or commercial bank management will offer some services in a really competitive way but stay away from other services that can better be obtained elsewhere. My conclusion is that the financial services supermarkets of the future will not eliminate the more specialized financial institution from all or even most submarkets.

But what will the economic environment of the next ten years be like? Will the soaring inflation of the 1970s return and lead to deposit interest rates that will reverse today's favorable interest spreads? And can we expect economic growth over the decade to continue at the sluggish rate of the past year or so? Since the answers to these questions will importantly affect the outlook for your industry, let me give you the macroeconomic assumptions underlying my outlook.

I expect the economy to grow at a moderate and relatively stable rate for the next decade. Potential output may grow at nearly a 94 percent rate, with higher trend productivity increases partially offset by a slower rise in the labor force. The economy may also stay much closer to its trend growth path than has been the case over the past several years. Although there will be unavoidable fluctuations in economic growth, I do not expect a repeat of the extreme boom-bust cycles associated with the supply shocks and accelerating inflation of the 1970s.

The Federal Reserve's policy of careful monetary accommodation -- together with deregulation and intense foreign competition -- will in my view contribute to U.S. progress toward price stability over the next decade. For the next few years at least, inflation will be held down by ample productive resources both here and abroad. World manufacturing and agricultural capacity is underused; unemployment is rife in Europe and the LDCs; and we, too, have our jobless. An optimistic inflation outlook depends, of course, on resisting moves toward re-regulation and protectionism that stifle competition. It is also a function of continued trimming and skimming of costs by U.S. businesses. Disinflation also depends on the Federal Reserve's commitment to pursue sustainable economic growth, but to resist truly inflationary increases of money and credit, a commitment I can assure you is intact. Overall, I expect inflation to average less than 4 percent over the next decade, with further gradual declines in the core inflation rate and only limited cyclical variability around that rate.

Lower inflation will allow further declines in interest rates. Rates have come down a long way since mid-1984, but there is still considerable room for further declines. However, long-term interest rates, including mortgage rates, can only settle so far unless federal government spending and budget deficits can be brought under control. As you know, Congress and the

Administration have been negotiating ways to bring budget deficits down over a multi-year horizon. If they are successful -- as I pray they will be -- we could see single-digit fixed-rate mortgages within the next few years: rates on conventional mortgages are already at the lowest level in six years. In addition, the more stable economic growth and low inflation I project will tend to limit the fluctuations in interest rates.

Can you remember how to manage a savings bank in an economy with low and stable interest rates? Let me ask a more pragmatic short-run question: are you selecting the best index for your adjustable rate mortgage portfolio if rates come down and the classic upwardly sloping yield curve prevails in the future? Do you really want to continue to tie rates on ARMs to short-term Treasury rates? The answers to these questions require that you plan today for the more stable environment I think you will face tomorrow.

Tomorrow's savings banker must be a strategic planner, not because his MBAs want him to be but because the strong institutions will have so many ways to specialize, some of which are incompatible. Of course, you could indulge in all of the opportunities afforded by deregulation, securitization, computerization, and internationalization. But I don't think you will decide to do so. The strong management will choose an interrelated set of activities and a few geographical areas on a profit center basis. Among these inevitably will be portfolio lending and origination-for-sale. Securitization of both your mortgage and consumer paper will be matter of fact. You will likely practice relationship banking: from the student loan to the reverse annuity, your customer will be served, paid returns, insured, advised, and informed by telecommunications devices as yet unknown but soon to be commonplace. Direct investment will be taken for granted, as will your customers' participation therein through both simple and complex syndications.

My notion of your strategic planning isn't the once a year variety put together at a resort with your directors and then tossed on the shelf. With a cornucopia of alternatives from which to choose, you will engage in virtually continuous fine tuning of your organization regarding both the allocation of management and financial resources and the method of correcting inevitable mistakes. Strong management will play an important role in a dynamic, changing U.S. economy that will demand the continuing revolution in financial institutions and practices. Why do you think the British and the Japanese are so interested in the sweeping changes in our financial system?

Thus, you can see that I believe the strongly managed firms are in for a challenging and profitable decade. There is no such rosy future, though, for the several hundred weakest operators, whose numbers have been frequently exaggerated but whose asset-importance for your industry has not. The decade to come will be marked by failure and absorption of these firms and of any others that are practicing growthmanship in defiance of new regulatory limits. There will at some stage be a further reaction -- call it re-regulation if you will -- to limit the growth of institutions with such characteristics as inadequate tangible net worth. This need not and should not mean reversing broader powers for strong institutions. But it may well mean much more severe penalties for fraudulent behavior. Also, accounting conventions cannot forever condone bleeding away capital through unwarranted dividend payments while preserving the fiction of a remaining net worth. Indeed, I ask you to join me in demanding that the CPAs serve you more adequately in testing the quality of assets.

Meanwhile, difficult political decisions must be made. Do you envy our politicians facing such issues as possibly merging the FDIC and the FSLIC, special premium assessments, and structuring of equitable risk-based insurance premiums and/or capital requirements? What will the next Bush Commission recommend with regard to who should insure and who should regulate? How will some future Congress reconcile the new product, local orientational advantages of the dual chartering system with the disadvantage of the super risktakers it attracts?

Well, don't despair of the political process in these matters. We will reach solutions that will ultimately buttress this the most adaptable financial system on the planet. As I suggested in my opening thesis, we have together survived a financial services revolution against a background of social change unequalled since the 1930s. As the hundreds of new examiners learn how to do their jobs in the changing environment, we can hope that the prevailing political climate will produce better supervision without unnecessary re-regulation.

My caveat is that better supervision will not be enough, given the number of institutions under water and the super risktakers who are right now soaring off the high board, heading for the wading pool. Government supervision is for the most part after the fact, and it is implemented with limited resources. To ensure adequate oversight, strong managers in the savings bank/savings and loan industry must increase their efforts in self-regulation. Already consignment management is working to stop the accumulation of more bad assets by replaced management. I personally hope the "406 Corporation" or something like it comes on the stage and is followed by other privately run entities. In short, I am advocating a series of privately supported, privately managed organizations.

Self-regulation will not replace the Federal Home Loan Bank Board, the Federal Savings and Loan Insurance Corporation, and particularly not, from my current perspective, the Federal Reserve System. Self-regulation is certainly not a full substitute for supervision and regulation by governmental authorities -- that would be an abrogation of our responsibilities for a safe and sound financial system. But self-regulation could eventually reduce the scope of government regulation. Also self-regulation in the United States does not mean restriction of entry. It does not mean price or rate fixing -- fortunately, we do not suffer from that European disease. Yet market forces alone do not provide adequate safeguards, as experience with the crises of the last five years demonstrate. Because there have been very, very few failures that have escaped the foreknowledge of competitors, we know that the detailed knowledge is out there. It must be brought to bear in a timely fashion. If it is not, you will continue to see the tendency for bad practices and runs to threaten whole regional segments of the industry and for your credibility in the opinion polls to plummet.

Self-regulation isn't a part of the culture of finance, I concede. It seems like an unorthodox idea for savings banks and commercial banks, but it is not at all unusual in other industries, where success stories offer a trodden path for others to follow. Examples of what I advocate can be found in the New York Stock Exchange, NASD, municipal bond markets, and the accounting profession. Self-regulation in the Exchange begins with its members, which impose rules of conduct on member firms. A special surveillance committee of the Board of Directors keeps watch on troublesome situations and devises remedies. In the public accounting profession, peer review includes establishing professional standards for quality control and monitoring compliance with those standards. In this way, the industry has been fairly successful in policing itself. After all, for every audit failure, there are a thousand audit successes.

Lessons from these success stories can be applied to the savings banking industry. What is the opportunity for self-regulatory bodies in your industry, which could among other things act as a liaison with regulators -- possibly through the Federal Financial Institutions Examination Council? I think many functions could be carried out by such groups, including establishment of:

- standards for good business practices, especially in unfamiliar areas such as "securitized investments";
- a code of ethics that discourages risky or otherwise improper behavior;
- accreditation standards for institutions and perhaps even young managers;
- model strategic plans, which could be especially beneficial to small institutions; and
- surveillance procedures, either through an independent entity or as part of an existing organization.

I am asking your serious consideration of what can be done from the inside in such a way that the industry comes out stronger and more vigorous and with a heightened public image. The potential for strong management to reinvigorate the whole savings banking industry in the decade to come is considerable. But that potential could be squandered if the spillover effects from weak and failing institutions lead to re-regulation. I believe that the industry has the knowledge and ability to contribute substantially to solving its own problems, but there is not a moment -- or at least not a month -- to lose. Thus, I propose that you immediately form and fund an industry commission instructed to come up with ways to commence the self-regulatory process.

A growing U.S. economy with reasonable disinflation will continue to provide a plethora of opportunities to those managers who can determine the large or the small community's needs for longer-term financing and who can develop the skills of risk evaluation, based in part upon intimate knowledge of the communities in which they have studied and served for many years. No branch manager of a distant conglomerate can bring quite that qualitative kind of skill to the lending decision. Don't let the considerable opportunity be lost because the excesses of a few go unchecked. Set up your own Commission for the future. If you seize the opportunity and welcome the challenge, I have no doubt that your industry will prosper over the next decade.

Charles Darwin said the fittest survive because they adapt. Darwin should see you now!