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A LONG-RUN STRATEGY FOR MUTUAL SAVINGS BANKS

REMARKS OF

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PHILADELPHIA, PENNSYLVANIA

MAY 18, 1976

## A LONG-RUN STRATEGY FOR MUTUAL SAVINGS BANKS

NOW IS A TIME FOR MUTUAL SAVINGS BANKERS TO CONSIDER THEIR LONG-RUN STRATEGY. THE DEMISE OF THE FINANCIAL REFORM ACT HAS SPOILED SHORT-RUN CHANCES FOR A MAJOR BREAKTHROUGH FOR THE THRIFTS. WILL OPPORTUNITY KNOCK AGAIN? HOW SHOULD SAVINGS BANKERS RESPOND?

THESE, OBVIOUSLY, ARE QUESTIONS YOU WILL HAVE TO ANSWER FOR YOURSELVES, AND PERHAPS IT IS GRATUITOUS FOR ME TO OFFER COMMENTS ON A MATTER THAT IS SO CLEARLY YOUR OWN BUSINESS. BUT THE FINANCIAL COMMUNITY AND, INDEED, THE WHOLE ECONOMY HAVE A GOOD DEAL AT STAKE IN WHAT YOU MAY DO. SO IT IS FROM THIS STANDPOINT OF THE PUBLIC INTEREST THAT I'D LIKE TO OFFER A FEW THOUGHTS ABOUT YOUR LONG-RUN FUTURE. FIRST, A WORD ABOUT BROADER POWERS FOR THRIFTS; SECOND, IMPLICATIONS OF BROADER POWERS FOR GROWTH; THIRD, IMPLICATIONS FOR HOUSING; AND FOURTH, THE IMPORTANCE OF PRICING IN HANDLING CHECKING ACCOUNTS.

### POWER TO THE THRIFTS

I HAVE A STRONG BELIEF THAT YOUR CURRENT FRUSTRATION IS ONLY ONE CHAPTER IN A LONG STORY ABOUT THE HISTORY OF FINANCIAL INSTITUTIONS. THIS STORY TELLS ME THAT CERTAIN PRESSURES--IN THE LONG-RUN--WILL HAVE INEVITABLE RESULTS.

COMPETITION HAS A WAY OF DOING AWAY WITH ARTIFICIAL MAN-MADE BARRIERS. WE HAVE SEEN THIS CLEARLY IN AGRICULTURE. THE INGENUITY OF BUREAUCRATS TO PRESERVE THE SMALL FARM HAS BEEN WONDERFUL TO BEHOLD: PARITY, SUBSIDY, OUTPUT RESTRICTION--YOU NAME IT. I'M NOT

PASSING JUDGMENT ON THE SMALL FAMILY FARM AS A WAY OF AMERICAN LIFE, BUT THE FACT IS THAT SOMEHOW THE FORCES OF COMPETITION INEVITABLY HAVE OVERRIDDEN OR WORKED UNDER AND AROUND ALL THESE DEVICES.

IN THE WORLD OF FINANCE NUMEROUS KINDS OF SPECIALIZED INSTITUTIONS HAVE SPRUNG UP OVER TIME IN RESPONSE TO NEEDS EXPRESSED BY SOCIETY. MUTUAL SAVINGS BANKS WERE ONE OF THE FIRST. AS THESE NEEDS HAVE MULTIPLIED AND THE KINDS OF INSTITUTIONS HAVE PROLIFERATED, HOWEVER, YOU--AS WELL AS MANY OTHERS--HAVE ASKED QUESTIONS ABOUT THE VIABILITY OF THIS KIND OF FINANCIAL STRUCTURE. HOW TO SEAL OFF INTO SELF-CONTAINED CELLS CERTAIN KINDS OF ACTIVITIES FOR CERTAIN KINDS OF INSTITUTIONS? EXPERIENCE SHOWS THIS IS VERY HARD TO DO BECAUSE HUMAN INGENUITY IS JUST TOO GREAT. YOU CAN ALWAYS FIND NEW WAYS TO CIRCUMVENT (I HAVE DIFFICULTY FINDING A VERB WITHOUT SOME OVERTONE OF MORALITY, ALTHOUGH NONE IS INTENDED) ARTIFICIAL RESTRAINTS TO COMPETITION. NOW ACCOUNTS ARE THE BEST CURRENT EXAMPLE.

IN SHORT, I HAVE GREAT FAITH IN COMPETITION AS A LEVELLER OF BARRIERS. PERHAPS YOU ARE NOT IN A MOOD TO BE PATIENT, BUT I BELIEVE THE LONG-RUN IS IN YOUR FAVOR. THE LONG-RUN WILL SERVE YOUR PURPOSES AND YOU SHOULD NOW BE FORMING YOUR STRATEGY WITH THAT IN VIEW. IT WILL ALSO SERVE THE PURPOSES OF SOCIETY BECAUSE MORE COMPETITION USUALLY DOES BRING THE BENEFITS OF BETTER AND CHEAPER SERVICE. I SUSPECT YOU WILL NOT BE CONTENT TO LET THE LONG-RUN COME ABOUT ON

ITS OWN; YOU WILL WANT TO HELP IT ALONG. THE ECONOMIST IN ME TELLS ME THAT YOU ARE WORKING IN THE RIGHT DIRECTION.

IMPLICATIONS OF BROADER POWERS FOR GROWTH

CONSIDER, FOR A MOMENT, THE EXPERIENCE OF COMMERCIAL BANKS DURING THE LAST DECADE. FROM MID-1960 THROUGH 1973 WAS A PERIOD OF GREAT EXPANSION OPPORTUNITY FOR BANKS. LIABILITY MANAGEMENT TECHNIQUES WERE DISCOVERED AND REFINED TO THE POINT WHERE BANKERS WERE SURE THEY COULD MEET ANY NEED FOR FUNDS BY BUYING MONEY. BANKS EXPANDED LOANS, SHAVED PROFIT MARGINS, AND INCREASED LEVERAGE. BANK HOLDING COMPANIES BRANCHED OUT INTO MORTGAGE BANKING, REITS, LEASING, CONSUMER LOAN COMPANIES AND MANY MORE BUSINESSES. IT WAS A PERIOD OF HEADY GROWTH.

BY HINDSIGHT, WE FIND THAT THESE GROWTH OPPORTUNITIES WERE NOT ALWAYS USED WISELY. THERE WAS A SIGNIFICANT INCREASE IN THE RISK EXPOSURE OF MANY COMMERCIAL BANKS. PROFIT MARGINS DECLINED, LEVERAGE GREW, AND CAPITAL POSITIONS BECAME NOTICEABLY WEAKER. THE RECESSION OF 1974-75 BURST THIS FRAGILE BUBBLE AND CREATED SOME VERY SEVERE PROBLEMS FOR BANKS THAT HAD OVEREXPANDED. THE PROBLEMS EXPERIENCED BY THOSE INSTITUTIONS INDIRECTLY WEAKENED THE ENTIRE SYSTEM. BANKERS ARE NOW NARROWING THEIR SIGHTS, RESTRICTING GROWTH OBJECTIVES, AND TRYING TO REESTABLISH PROFIT MARGINS AT LEVELS WHICH WILL ENHANCE THE FINANCIAL STRENGTH OF THEIR INDUSTRY.

WHEN YOU GET BROADER POWERS, YOU MAY CONFRONT A PERIOD OF SIMILAR GROWTH POTENTIAL. NEW SOURCES OF FUNDS AND NEW INVESTMENT

OPTIONS MAY PRESENT YOU WITH ENTICING EXPANSION OPPORTUNITIES. YOUR SUCCESS IN THE LONG-RUN MAY DEPEND ON HOW WELL YOU HAVE LEARNED FROM THE COSTLY MISTAKES OF THOSE BANKS WHICH WERE PRE-OCCUPIED WITH GROWTH. YOU HAVE DEVELOPED GREAT SKILL AND A SUBSTANTIAL COMPARATIVE ADVANTAGE IN MORTGAGE LENDING. AS YOU MOVE AWAY FROM THIS FAMILIAR GROUND, IT WILL BE IMPORTANT TO KEEP EXPOSURE MANAGEABLE UNTIL YOU ARE SURE YOU APPRECIATE ALL THE NUANCES OF THESE INVESTMENTS THAT CREATE CREDIT RISKS.

### IMPLICATIONS FOR HOUSING

MUTUAL SAVINGS BANKS WERE FOUNDED TO ENCOURAGE SAVINGS AND TO FINANCE HOUSING. WHETHER OR NOT SUBSIDIZING HOUSING THROUGH THE THRIFT INSTITUTIONS IS A SENSIBLE AND EFFICIENT WAY TO ENCOURAGE HOME CONSTRUCTION IS SOMETHING ELSE AGAIN, BUT THAT SUBSIDY OBJECTIVE IS CLEARLY IN THE MINDS OF LEGISLATORS WHEN THEY LOOK AT MUTUALS. IT HELPS TO EXPLAIN REGULATION Q CEILINGS, TAX DEDUCTIONS TO BUILD LARGE LOAN RESERVES, AND LIMITS ON ASSET DIVERSIFICATION. WHEN CONGRESS FINALLY DOES BROADEN YOUR POWERS, I HOPE IT WILL FOLLOW THE PRINCIPLE THAT EQUAL POWERS CARRY WITH THEM EQUAL RESPONSIBILITIES. IF IT <sup>CONTAINS</sup> CONTAINS SOME PREFERENTIAL TREATMENT IN TERMS OF INTEREST RATES PAID BY SAVINGS BANKS, IT WILL BE DOING SO WITH AN EYE TO PROMOTING HOUSING.

AND IF THIS IS THE WAY EVENTS, IN FACT, TURN OUT, YOU CAN USE THE RIGHT TO INVEST IN A BROADER RANGE OF ASSETS IN EITHER OF TWO WAYS. ONE IS BY REDUCING MONEY FROM FINANCING MORTGAGES AND PUTTING

IT INTO OTHER KINDS OF ASSETS. ANOTHER IS BY ALLOCATING SOME OF YOUR NEW MONEY TO A PROGRAM OF BROADENING THE ASSET PORTFOLIO. THE DISTINCTION IS IMPORTANT BECAUSE DIVERSIFICATION AT THE EXPENSE OF HOUSING MAY BE TREATED AS A BREACH OF FAITH BY THE COMMUNITY AND BY LAWMAKERS. IF YOU REALLOCATE A SUBSTANTIAL PROPORTION OF FUNDS FROM HOUSING TO OTHER ASSETS, YOU COULD FIND YOURSELF WITH MORE RESTRICTIONS ON INVESTMENTS LATER.

THIS IS SIMPLY A SUGGESTION THAT IN YOUR LONG-RUN STRATEGY YOU MAKE AMPLE ALLOWANCE FOR WHAT MANY CONSIDER TO BE YOUR SOCIAL RESPONSIBILITY TO HOUSING. ANY LONG-TERM PROFIT ANALYSIS MUST INCLUDE THE COSTS OF UNDERMINING THE PRIMARY RATIONALE FOR GRANTING THRIFTS SOME COMPETITIVE PREFERENCES AS AN OFFSET TO THE POTENTIAL SHORT-RUN BENEFITS OF IMPROVING YIELDS AND SPREADING RISKS.

### PRICING

BROADENED POWER POSES ANOTHER PROBLEM FOR YOUR LONG-RUN STRATEGY: THE PRICING OF YOUR SERVICES. COMPETITION AMONG THRIFTS AND COMMERCIAL BANKS COULD BE VERY STRONG. IT COULD EVEN FORCE INEFFICIENTLY MANAGED INSTITUTIONS--BOTH MUTUALS AND COMMERCIAL BANKS--OUT OF BUSINESS OR INTO MERGERS WITH STRONGER ORGANIZATIONS. WHAT'S MORE, CUTTHROAT COMPETITION BETWEEN COMMERCIAL BANKS AND THRIFTS COULD WEAKEN THE ENTIRE FINANCIAL SYSTEM. SOME COMMERCIAL BANKS WILL NOT BE WELL EQUIPPED TO ENGAGE IN PRICE COMPETITION WITH THRIFTS FOR CHECKING ACCOUNT CUSTOMERS. YET, IT IS HARD TO IMAGINE COMMERCIAL BANKS BEING PASSIVE ABOUT PRICE OR ADVERTISING COMPETITION

WHICH THREATENS A LOSS OF CHECKING ACCOUNTS TO THRIFTS. THAT BUSINESS IS TOO BASIC TO THEIR INDUSTRY FOR THEM TO GIVE IT UP WITHOUT A FIGHT.

THE PIVOTAL DECISION IN THIS COMPETITIVE STRUGGLE WILL PROBABLY BE THE PRICING OF CHECKING ACCOUNT SERVICES. THIS DECISION WILL DETERMINE HOW FAST YOUR DEPOSITS GROW, WHAT KIND OF MINIMUM RETURN YOU WILL NEED ON YOUR ASSETS, AND HOW PROFITABLE AND SOUND YOUR BANK WILL BE. ONCE AGAIN THERE ARE TWO OPTIONS FOR SETTING THIS PRICE. ONE IS "LOSS-LEADER PRICING." UNDER THIS STRATEGY THE PRICE WOULD BE SET BELOW THE COST OF PROVIDING THE SERVICE. SINCE THIS CREATES OPERATING LOSSES, SUCH AGGRESSIVE PRICING COULD NOT BE SUSTAINED FOR AN EXTENDED PERIOD, BUT IT WOULD ATTRACT A LARGE VOLUME OF BUSINESS RAPIDLY.

A SECOND STRATEGY IS ONE OF "FULL-COST PRICING." IN THIS INSTANCE THE PRICE SET WOULD BE ONE WHICH COVERS ALL OF THE COSTS OF PROVIDING CUSTOMERS WITH THE SERVICE AND INCLUDES A PROFIT MARGIN SUFFICIENT TO BUILD SURPLUS ACCOUNTS AT THE RATE YOUR INSTITUTION'S DEPOSIT BASE IS GROWING. THIS PRICE IS ONE THAT CAN BE SUSTAINED OVER A LONG PERIOD BECAUSE IT DOES NOT PRODUCE LOSSES WHICH UNDERMINE YOUR FINANCIAL STRENGTH. DEPOSIT GROWTH IS LIKELY TO BE MUCH SLOWER UNDER THIS STRATEGY, AND COMPETITION WITH COMMERCIAL BANKS IS LIKELY TO BE LESS INTENSE.

I PREFER THE LATTER STRATEGY BECAUSE ITS LONG-RUN BENEFITS TO THE INDUSTRY EXCEED THE SHORT-RUN BONANZA IT PRODUCES FOR

CONSUMERS. IT WOULD CREATE A MORE STABLE BANKING ENVIRONMENT, PRESERVING THE FINANCIAL SOUNDNESS OF INSTITUTIONS WHICH ARE EFFICIENT ENOUGH TO COMPETE AND AVOIDING THE PROBLEMS OF INTRODUCING CONSUMERS TO A PRICING STRUCTURE WHICH CANNOT BE MAINTAINED. A RECENT STUDY BY DAVID CATES AND SAM CHASE FOR THE SOUTH CAROLINA BANKERS ASSOCIATION INDICATES THAT FREE CHECKING HAS THE POTENTIAL FOR BEING VERY UNPROFITABLE, ESPECIALLY FOR BANKS WITH LARGE NUMBERS OF SMALL ACCOUNTS. THESE RESULTS EMPHASIZE THE IMPORTANCE FOR MANAGERS OF HAVING RELIABLE ESTIMATES OF ALL THE COSTS ASSOCIATED WITH PROVIDING THIS SERVICE BEFORE THEY SET A PRICING POLICY THAT COMPETITIVE PRESSURES MAY FORCE THEM TO USE FOR AN EXTENDED PERIOD. THE DIFFICULTY OF THIS PROBLEM AND THE CHANCES FOR SERIOUS ERROR ARE EVEN HIGHER IF PAYMENT OF INTEREST ON THIRD-PARTY PAYMENT ACCOUNTS BECOMES LEGAL EVERYWHERE.

STILL ANOTHER REASON FOR ADOPTING A CONSERVATIVE POSTURE IS THAT YOU WILL HAVE TO REINVEST THE FUNDS PROFITABLY. ANY OF YOU SHOULD BE ABLE TO FIND GOOD USES FOR A FEW MORE DOLLARS AT ALMOST ANY TIME. BUT WHAT WOULD YOU DO WITH THE MONEY IF YOUR DEPOSIT BASE WERE TO INCREASE BY 10 OR 15 PERCENT IN A FEW MONTHS? COULD ALL THOSE FUNDS BE PUT TO WORK AT ATTRACTIVE YIELDS OR WOULD THERE HAVE TO BE COMPROMISES ON EITHER YIELDS OR QUALITY IN THE PORTFOLIO? SUCH COMPROMISES MIGHT JUST BE ENOUGH TO MAKE WHAT SEEM TO BE ATTRACTIVE FUNDS SUDDENLY UNPROFITABLE.

### CONCLUSIONS

SOME OF WHAT I'VE JUST SAID MAY SEEM INCONSISTENT WITH THE



STRONG POSITION IN FAVOR OF COMPETITION WHICH I EXPRESSED AT THE OUTSET. LET ME REAFFIRM THAT OVER THE LONG HAUL, VIGOROUS COMPETITION AMONG BUSINESSMEN WHO ARE TRYING TO MAXIMIZE THEIR FIRMS' LONG-TERM EARNINGS WILL CREATE THE INCENTIVES FOR EFFICIENCY AND INNOVATION THAT SERVE SOCIETY'S BEST INTERESTS. THE KEY TO ACHIEVING THIS COMPETITIVE IDEAL IS FOR YOU TO KEEP THE LONG-TERM IMPLICATIONS OF YOUR DECISIONS FIRMLY IN MIND. IF, IN AN EFFORT TO GAIN SHORT-RUN ADVANTAGE, YOU SACRIFICE YOUR LONG-TERM GOALS, SOCIETY'S INTERESTS WILL BE COMPROMISED AND THE STAGE WILL BE SET FOR ADDITIONAL REGULATION OR LEGISLATION.

IN SUMMARY, I LEAVE YOU WITH THESE THOUGHTS. LONG-RUN FORCES ARE WORKING IN THE DIRECTION OF EXPANDED POWERS FOR THRIFTS. WHEN YOU GET THESE POWERS, KEEP IN MIND THE PROBLEMS OF THOSE COMMERCIAL BANKS WHICH OPTED FOR RAPID EXPANSION STRATEGIES RATHER THAN PROFITS WHICH COULD BE SUSTAINED OVER THE LONG-RUN. REMEMBER ALSO THAT THE RATE PREFERENCES YOU ENJOY ARE PREDICATED ON SERVING THE COUNTRY'S NEEDS FOR MORTGAGE FUNDS. FINALLY, DO YOUR COST ACCOUNTING HOMEWORK CAREFULLY. YOUR PRICING DECISIONS WILL HAVE AN ENORMOUS IMPACT ON YOUR OWN PROFITABILITY AND THE SOUNDNESS OF BOTH THE THRIFT AND COMMERCIAL BANKING INDUSTRIES. THIS KIND OF LONG-RUN STRATEGY WILL SIMULTANEOUSLY SERVE YOUR CUSTOMERS, YOUR INDUSTRY, AND SOCIETY.