

Regulation Q: The Money Markets and Housing—II

ROBERT LINDSAY

It is hard to stand this close to Allan Meltzer and not feel singed by the lightning of the Lord. I would like to talk, however, about Regulation Q. And I find it hard to cover the Regulation Q ground and not see some flowers of evil growing there.

My chief concern about rate ceilings on consumer-type deposits starts with the consumers in question. I think we have put them at a considerable disadvantage, particularly those of moderate means. In a time of sharply and continuously rising prices, we force them, as a consequence of public policy, to make a bad choice. They must either accept interest yields well below the going rate, or else they must venture into the open market where their inexperience and small size expose them to capital risk and high transaction costs. In effect, rate ceilings raise the cost of institutional intermediation for small savers without reducing the cost of self-intermediation. Indeed, as Allan Meltzer has pointed out, ceilings may *raise* the costs of self-intermediation, as savers venture into new markets that are not yet fully developed.

Public policy, however, is often faced with the necessity of favoring some groups at the expense of others. The question before us is whether the benefits flowing to *mortgage borrowers* in some way justify the burdens placed on the small lenders.

One immediate possibility is that mortgage borrowers are not essentially different in economic status from consumer-type savings depositors. The deposits might even be the seeds of future down payments against such loans. Rate ceilings, in that context, would

still force one group to subsidize another, but at least the general economic standing of the saver would give him a possibility of getting over on the other side. In fact, this does not seem to be the case. The figures are somewhat limited, but mortgage borrowers, at the time the loan is made, seem to have higher incomes than the average depositor at the savings institution making the loan. It would also appear that the need for a downpayment requires an accumulation of funds beyond that of the average depositor at an S & L or a mutual savings bank.

Perhaps this should be expected. Another quite separate defense of the Q type ceilings assumes that institutions will charge the highest mortgage rate they can get. The low cost of input money is not designed, that is, to provide mortgage funds for low income borrowers, but rather to help keep the institutions from perishing. And, in fact, concern for the health of these institutions as mortgage lenders often generates a plea for abolishing ceilings on lending rates while reinforcing them on deposit rates.

A second possible benefit of Q type ceilings might be, however, that they keep all interest rates lower than otherwise. I have in mind here the possible contribution to the efficiency of monetary policy. This touches on an area that Frank has enjoined us to stay away from, having to do with the large corporate CD's. But the argument has pertinence for the large individually owned claims too. The structure of ceilings we currently have breaks off at deposits of \$100 thousand. Thus there might be a lot of people below that \$100 thousand level who respond in the way that the large holders of CD's, the corporate holders, respond. In any case, I think you are familiar with the argument. The idea runs something like this: the most vigorous force for credit expansion takes the form of business loan demand. With the emergence of liability management as a bank strategy in the early 60's, rate ceilings offered a direct means of containing these expansive forces. Banks were financing business loans by selling CD's. QED: hold down the ceiling and choke back excessive lending. Tighten where tightness was most needed, and thereby avoid restricting the entire economy to get at one part of it. The mortgage market would benefit accordingly.

The flaws, or what I view as flaws, in this reasoning have now been well ventilated. If CD ceilings are kept too low, the large depositors will take their funds into the open market. They will lend them directly, and only rarely will the recipients be residential mortgage borrowers. The 1969 Annual Report of the Federal Reserve Bank of New York puts it this way. Using Regulation Q "to hold down bank

credit growth . . . did not fully take into account the ability of many borrowers--particularly the larger corporations--to by-pass the banking system and obtain funds directly in the open market . . . Indeed the distortion and supervisory problems that developed during 1969 as a result of noncompetitive rate ceilings suggest that more sparing use of this type of limitation is probably desirable."

To which I would add that the ceiling structure we have now seems to acknowledge this strong market competition for the large corporate depositors. The earlier reasoning does seem to linger on, however, in the much lower ceilings for all deposits under \$100 thousand.

In passing, one might also note that the various efforts of banks to escape through the Eurodollar markets and the commercial paper markets need not be associated peculiarly with Regulation Q. They could be expected to flow from any sharp tightening that encompassed banks of national and international scope. If the System has decided to meet the expansion of these banks by raising their reserve requirements, or rationing them more sharply at the Discount Window, the same kind of search for escape routes would probably have been stimulated.

We come finally to the viability of the principal mortgage lenders--that is, to Regulation Q type ceilings as a contribution to the viability of these lenders. There are, as I understand it, two healthy correctives that rate controls are said to supply. One is to prevent excessive rate competition among the non-bank intermediaries, as well as between them and the banks. This sort of competition serves everyone poorly, it is said, because it leads to rash lending decisions. In the end it threatens a rise in bankruptcy. Individual depositors will then, at best, be inconvenienced, and they may lose something important, as will we all, if confidence in the financial sector in general is undermined.

Widespread failure of financial institutions would certainly create genuine dangers. What is less clear is whether rate ceilings will prevent these failures and, if so, whether they are the most desirable means to that end. I have been unable to judge from the two papers in the Irwin Friend study whether higher deposit rates played a major role in the Illinois and Chicago S & L's which closed in such large numbers. Obviously, it is not enough to establish that fail institutions were paying high dividends. It must be shown that their

rates were higher than those offered by continuing institutions and that high rates contributed significantly to their failures.

The other strand of the viability issue stems not from mismanagement, but from what is judged to be a fundamental weakness of non-bank intermediaries. Their ability to compete for savings, particularly the S & L's, is almost entirely derived from the mortgage market. Much of the *bank* demand for these savings deposits, on the other hand, is derived from the market for business loans and consumer credit. If these demands are much less interest-elastic than the mortgage demand, or if the net yield on them tends generally to be higher than mortgages, then banks can outbid the non-banks in the savings market. In addition, if the savers get some psychic return from doing business with banks, the non-banks must bid still higher.

Thus, on this logic, a set of ceilings is needed that neutralizes the inherent advantage of banks over non-banks. And this, I would take it, is the underlying aim of the ceiling structure we have now. Ceilings on bank rates should keep the banks from climbing over into the savings markets on which the non-banks depend. Ceilings on the non-banks protect them from each other, and perhaps from their own foolishness, but also make the banks more willing to accept their own ceilings. The mortgage lenders are thus free to keep mortgage money flowing to borrowers.

Quite obviously, the effort at neutralization has not maintained the flow of mortgages from these private intermediaries. With wires and pulleys strung all around the banks and non-banks, the call of the open market has grown stronger and stronger. To be sure, funds have continued to flow, at varying speeds, into time and savings deposits and not on balance out of them. But obviously many savers have ventured into the open market, braving the capital risk and the search costs that may eat up their gain in gross yield, particularly for the smaller savers. The consequence, as we all know, has been a very thin flow of mortgage money from private savings going through private mortgage lending institutions.

The flow would be even nearer to disaster, were it not for the Federal intermediation that we will hear about tomorrow morning. But that solution also *discriminates against the small savers*. For the market instruments by which Federal intermediation is financed, as I understand it, are deliberately placed beyond the reach of the small depositor by making the minimum unit quite large.

Thus an important source of funds for housing in the last couple of years has come from *outside* the neutralized sector of finance. Still another accommodation was made by shifting the *use* of funds as well as the sources. I have in mind here the mobile home phenomenon. These homes accounted in 1969 for a third of all one-to-four-family housing starts. They are financed chiefly, however, by consumer credit from commercial banks. Thus neutralization through rate ceilings on time and savings accounts did not keep the banks out of this market. Indeed, the particular channels of savings seem to have little at all to do with the matter. One can guess that the success of mobile homes represents, among other things, the coincidence of cheap housing and expensive credit. The borrower-buyer can pay the high cost for credit because it goes with a low cost house. The lender is pleased to supply the high cost credit on what is a repossessable and marketable consumer durable. The point is that on this, a second count, the neutralizing effect of deposit rate ceilings has done little to help the flow of housing finance. Of the flow that did occur, an important fraction came from Federal agency mortgage money, and another important fraction came from commercial bank installment credit.

A different set of deposit rate ceilings might have been more successful. It seems to me very unlikely, however, that we can ever find a structure that will just fit. We are looking, remember, for appropriate relationships between non-bank deposit rates and mortgage rates, between non-bank deposit rates and open-market security rates, between non-bank deposit rates and bank time and savings deposit rates, between demand deposit rates set at zero and bank savings deposit rates and non-bank rates. Then there is the subdivision in each case by maturity, by size of deposit, by negotiability of the claim, by timing of interest payment, and by timing of notification of withdrawal. The path we are headed down is the one Allan mentioned, it seems to me.

Add to this the division of authority among the Federal Reserve, the FDIC, and the Federal Home Loan Bank Board, and the flexibility of the arrangement is still further reduced. The weaker rival for savings deposits will always be fearful of raising the ceiling. It may be losing deposits to the open market, but higher ceilings will seem to threaten new losses to the rival institutions as well. It seems to me that no amount of wisdom and goodwill is likely to allay this anxiety. And while the negotiations go on, the rise of market rates toward and through the ceilings will create market confusion and market disturbances.

So my view is that ceiling rates on consumer-type deposits have not served us well. They have denied many small savers the chance to share the high returns on their capital during a capital shortage. At the same time they have not headed off the strong rival demand from business borrowers. Where the private flow of mortgage money has shown a fresh vigor, i.e., in mobile homes, only in a perverse way has the ceiling been the cause. In addition, the flow itself has been expensive as credit and doubtful as a feature of national housing policy. Mostly, of course, the flow has been public money--again, not a success for the rate ceiling policy.

Yet I do not think that the basic problem has gone away or will go away. Continuing prosperity does seem to militate against the residential mortgage market. Moreover, in this particular time, population growth and relocation suggest an enormous need for new housing. We, of course, need appropriate monetary and fiscal policies and subsidy programs--whatever "appropriate" means here. Within this context, however, my own conviction, that is to make more effective use of the private finance sector, our public policy must continue to encourage specialization in mortgage lending. Separate investigations by George Benston, and by Brigham and Pettit--both done for the big savings and loan study--have found considerable economies of scale in residential mortgage financing. As a result, and as Irwin notes in his summary of the study:

Mortgage lending can ordinarily be handled more efficiently by a specialized rather than by a diversified intermediary in view of the relatively small size of the great majority of savings and loan associations and commercial banks in this country.

He adds that, at present, the median asset size of S & L's is larger than that of commercial banks, and this is even more true of the comparative size of their mortgage portfolios. I think one can say the same for mutual savings banks. As for life insurance companies, they might be able to realize their own economies, but they have been moving out of the one-to-four family market, which makes it all the more important to deepen the specialization of non-bank intermediaries of the deposit type.

The problem is *how* to promote this specialization and how, at the same time, to protect the flanks of these specialized institutions that are left exposed by the specialization itself. Ceilings on deposit rates are an effort to protect by neutralization, by freezing the rate structure. But this takes the competitive decision out of the hands of

individual thrift institutions, and rigidifies it into a detailed code for the entire nation. Individual associations that might meet the open-market competition by different combinations of rates, maturities, notice periods, and other terms of the trade, find the way made hard. They have to wait for the lowest common denominator to be found by the regulatory authorities.

This seems the wrong direction to me. But what might be the better way of protecting mortgage specialization? The hopper is full of ideas, and we are going to be talking about them for quite a while. There are two possible reforms, however, on which I would like to comment briefly.

One of them, in my view, would also take us in a wrong direction. This is the proposal to allow checking accounts at savings and loan associations and mutual savings banks. This, it seems to me, would protect the specialized institution but would do so by undermining the specialization. It is hard to see how checking accounts would be much help to the S & L, unless depositors make sizable use of the service. But if they do, the S & L is taking on an expensive specialization of another sort. It is no accident that commercial banks, with their checking accounts, have a very different structure of assets than S & L's do. And it is no accident that checking account proponents within the S & L industry link this proposal to a petition for consumer credit authority as well. S & L's would have to grow very much larger to realize both the economies of scale in the mortgage market and the quite distinct economies of scale in demand deposit management. In the meantime, they will be much tempted to make consumer loans *instead of* mortgage loans. And we will not have aided our cause.

I would like to urge that we continue to nurture the non-bank lenders but that we do so by taking the opposite tack. Instead of throwing up walls to keep bankers out of the savings market, we should move to draw bankers' energies more deeply into their own specialization.

It is not clear that we know just how to do this, but one possibility might be to reward the banks more handsomely for what is now their special expertise—the management of the payments mechanism. For example, suppose we were to reduce reserve requirements behind demand deposits down to the same level as those behind time deposits. This would take away an important incentive that banks now have for encouraging customers to shift from demand deposits to time deposits. Indeed, under the current arrangement, we keep the rate ceiling on time and savings deposits

below market to discourage the expansion of these deposits, but we offer a reserve ratio differential that encourages this expansion.

If we abolished this differential by reducing the reserve ratio for demand deposits, we would increase the relative value of demand deposits to banks. If we also reduced total reserves accordingly, we would give this new relative appeal to demand deposits without creating excess reserves in the system. If we then continue to have the zero rate ceiling on demand deposits, which is a very different kind of institutional animal anyway, banks would have an incentive to offer non-price inducements to depositors. Among other things, banks would have a new incentive to develop services associated with the payments mechanism.

One can look at this from several sides. Some people feel that there is a great deal of urgent work to be done if the payments mechanism is not to slip away from the banks in any case. Thus, one could think of a reduction in the reserve requirement differential as simultaneously a means of (a) encouraging this urgent development, (b) financing the development, and (c) getting the banks out of the savings deposit business or making them less fierce competitors in that business.

The notion is still a bit raw. One obvious risk is that a bigger shelf of services attached to demand deposits would make banks even tougher competition for the non-banks. It might greatly expand the appeal of one-stop banking. To head off this danger, maybe it would be necessary to *raise* the time deposit reserve ratio, persuading the banks to accept this in exchange for sharp and permanent reduction in demand deposit requirements. There is also a question whether this introduction of non-price competition would lead to any higher yield for small savers on their non-bank claims. This would be a particularly important question if the new bank services take forms that small savers cannot use. Even then, however, we would free the savings rate to greater flexibility in market response than we have now.

Whatever the mechanism, it seems to me that we must search for some positive way to retain the specialization of our chief mortgage lenders and, if we possibly can, do a better job by our small savers. If we can do this by enriching the payments mechanism specialization of our banks, so much the better. It does seem to me that ceilings on deposit rates are not taking us down any roads we want to travel.