Regulation Q: The Money Markets and Housing—III

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As I understand it, my assignment today is to present the case for continuation--over the near term only--of the existing authority to set maximum rates payable on small-denomination savings and time deposits of commercial banks, mutual savings banks, and savings and loan associations. Even with the time horizon limited to the short run, I must confess to mixed emotions about undertaking this task. I share the general aversion to these controls, fully subscribing to the usual arguments that, when effective, interest-rate ceilings, among other things, discriminate against small savers, distort the allocation of financial and real resources, and serve to perpetuate the underlying inadequacies in the financial structure. I am, moreover, fully aware that arguments for inaction over the short run can be mounted over the long run.

Yet I do feel that there is, in fact, a compelling case to be made for deferring to a later date the suspension or abolition of our authority to set the maximum deposit rates in question. The particular changes which I happen to view as appropriate cures for the competitive ailments of the thrift institutions and the mortgage markets would involve considerable time to bring to fruition, and during the transition period the power to set maximum deposit rates would continue to be needed for whatever protection such competitive regulation can afford against renewed disruption in the markets for thrift deposits and mortgage money. Indeed, a premature abolition of the deposit ceilings would run the risk of causing the creation of other devices to protect the thrift institutions and the

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mortgage market that might be even more detrimental to the free functioning of the financial markets. In this connection, a good case can be made for the view that had we not had the deposit rate setting authority as a means of protecting the thrift industry and mortgage market in recent years, other means of direct control for achieving that end would have been invented. Thus, one certainly cannot overlook the possibility that the Regulation Q ceilings now and for some time to come may be the best insurance we have against worse alternatives being devised for directing the allocation of credit.

Some Observation on the Thrift Institutions' "Problems"

The source of the cyclical difficulties of the savings and loan associations, and to a lesser extent the mutual savings banks, is well recognized and hardly needs repeating in detail here. Among the major financial institutions, the thrift institutions by all odds have the greatest disparity between the average maturity of their liabilities, largely deposits, and the average maturity of the investments, primarily mortgages. Thus, the responsiveness to interest rate movements of their cost of funds is much faster than is their rate of return on investments. Consequently, when interest rates move sharply higher, as they did almost continuously over the last half of the 1960's, the thrift institutions are hard pressed to pay competitive rates on deposits out of earnings on investments that reflect past average mortgage rates rather than the current rate.

The "problems" of the thrift institutions are currently almost always described, as I have done, in the context of increasing interest rates--perhaps because the current period of inflation and high rates has been so long that it exceeds the recall of most observers, and particularly those who write for the financial press. I feel, therefore, compelled to point out that there is an opposite side of the cycle in which interest rates do in fact fall, resulting in "problems" for the thrift institutions and the mortgage market of an entirely different nature than those of the past five years.

The first half of the past decade provides a good case in point. During those years of comparatively low interest rates, thrift institutions enjoyed a clear competitive advantage over those institutions with shorter average portfolio maturity. The problem with the thrift institutions and mortgage market then was certainly not lack of ability to compete for funds. They were, in fact, on average paying deposit rates equal to or greater than those available in the market on high grade corporate bonds. And, you may recall

that in those days writers for the financial press, not to mention more than a few economists, were competing for attention with cries of alarm about the deteriorating quality of mortgage credit, the great overbuilding in the housing industry, and the growing availability and use of mortgage credit for nonhousing purposes. It is certainly true that at the time, the deposit rates thrift institutions were able to pay--and were paying--far exceeded that which they needed to pay in order to mobilize the financial resources needed for adequate home building.

The past decade, therefore, divides about equally between periods of good and bad years for the thrift institutions as far as relative earnings power is concerned. Now, the point I would like to make is that because of this the boom and subsequent bust that occurred in the mortgage market need not have been anything like as severe as it was. The heart of the problem was (and still is) not the cyclical nature of the thrift institutions per se, but rather the failure of these intermediaries and the relevant regulatory bodies to manage themselves and the industry in an appropriately counter-cyclical fashion. All that would have been necessary to achieve reasonable stability in the thrift industry and the mortgage market over the past decade was a policy of dividend stabilization somewhat along the lines of that practiced by cyclical industrial corporations. Very simply, had the thrift institutions paid out less than their earnings in the 1960-65 period, and thereby accumulated substantial earned reserves, they would have been able to consistently and quite legally pay dividends well in excess of their portfolio earnings during the intermittent tight money episodes of the succeeding half decade. Such a procedure would have not only improved the thrift institutions' relative financial position in those more recent years, but also would have avoided the earlier excesses that contributed as much as anything else to the mortgage market crunch and home building collapse of 1966.

I believe, therefore, that it is quite fair to argue that the problems of the thrift institutions ultimately derive more from management and regulatory shortcomings than from basic flaws in their concept. And, while changing the concept to fit the way thrift institutions are managed and regulated is one way to solve their difficulties, it does seem to me that it ought to be more widely recognized that this is precisely what most proposals in this area largely involve. At the least, the fact that we do have the alternative of trying to do a better job with the thrift institutions as they are presently constituted justifies careful scrutiny of the structural reforms that are being

proposed. Those reforms are by no means as essential as seems to be commonly accepted.

Giving Thrift Institutions Greater Balance Sheet Flexibility

As stressed at the outset, my case for keeping the authority to set interest rate ceilings on thrift deposits rests on the belief that the institutional framework that has created the need for the ceilings is likely to remain little changed over the foreseeable future. This is especially true in the case of the various proposals to increase the balance sheet flexibility of the thrift institutions--proposals which I largely support provided they are applied cautiously and with a view to their effects in the mortgage market and elsewhere.

The speed of transition to a more diversified and hence financially flexible thrift industry would, of course, be limited by the managerial resources in that industry. I have no idea how long it would take those institutions to develop the necessary expertise and competitive strength to carve out a significant share of, say, the consumer credit market, but certainly the time frame would be measured in terms of years--not months--even in the best of circumstances. Moreover, in the financial environment that now seems to be emerging, the incentives to diversify are limited and the speed of response to new borrowing and investment opportunities is therefore likely to be lessened. Indeed, the structure of interest rates in recent months has become increasingly favorable to the process of borrowing very short and lending very long--a fact that would tend to encourage thrift institutions to maintain the status quo rather than taking advantage of new powers to diversify. It is not altogether unlikely that we may now be moving into a period much like 1960-65 in which mortgage rates, because of their inherent stickiness, offer a superior rate of return over almost all alternatives of comparable risk. Moreover, because of the steeply increasing term structure that appears to be emerging, the movement of thrift institutions into longer-term sources of funds would increase their average cost. Thus, at the moment at least, diversification on either the asset or the liability side of the thrift institutions' balance sheets would involve heavy costs in the form of reduced average rates of return on the one hand, and higher total interest payment obligations on the other. The incentive for balance sheet diversification is strongest when interest rates are under upward pressure and the term

structure of interest rates is relatively flat, yet we seem to be moving rapidly away from that situation.

Moreover, any move to achieve a more flexible balance sheet position would need to be paralleled by other changes in the financial system to avoid any severe dislocation in the flows of funds, especially in the flow of home mortgage credit. Certainly, permitting and encouraging the savings banks and savings and loan associations to diversify out of mortgages should be tied in with steps to improve the flow of mortgage credit from other sources. That would, however, involve making the mortgage a "better capital market instrument," and it is difficult to envision that being achieved on any large scale in the foreseeable future. The problems involved with gaining simplified and uniform state laws in this area are sufficient alone to guarantee that progress on this front will be agonizingly slow. Too, I suspect that public acceptance of a less direct relationship between mortgage borrower and lender--an almost inevitable outcome of creating an impersonal national mortgage market--will be difficult to achieve.

Finally, while I believe that changing the institutional framework of the thrift industry and the mortgage market will in any event be a slow process--requiring continued Regulation Q authority to protect that segment of the financial markets if necessary against further stress--it is also legitimate to raise the question at this time as to whether this is the appropriate moment to begin the change. The nation's housing problem has now reached near-crisis proportions, and we might well be abandoning our existing private mortgage finance system at the very time when financial conditions are emerging that make that system capable of producing a massive shift of funds into the mortgage market. Certainly, the magnitude of the housing problem makes it imperative that it be given temporary priority over the considerably less pressing consideration of the "efficiency of the capital markets."

The Variable Rate Mortgage

Since my defense of continued Regulation Q authority in the area of small time and savings deposits rests on the argument that there is no quick way out of the tight money problems of the thrift institutions, I am compelled to address some comments to the variable rate mortgage scheme. This means of injecting greater cyclical flexibility into the portfolio earnings and, hence, the deposit-paying capabilities of the thrift institutions has captured considerable interest. Undeniably, its widespread application would quickly give the nonbank savings institutions the effective equivalent of a very short average portfolio maturity, thereby eliminating the lag between investment earnings and deposit costs.

However, the development of this new type of mortgage instrument has been slow, and I think for very good reasons indeed. Certainly, public acceptance has hardly been enthusiastic--though there does not appear to have been any repetition recently of the near-riots that greeted the earliest attempts to apply this technique--and I suspect that the mortgage borrowing public will continue to resist attempts by financial institutions to place the risk of interest-rate changes on their shoulders. I must also confess to considerable sympathy with that resistance, since it seems to me that the risk-absorbing function should continue to rest with the financial intermediary as a matter of economic principle.

Of course, many proponents of the variable rate mortgage argue that the risk burden on borrowers could be eased by varying the maturity of the mortgage to hold monthly payments constant. However, that would leave the cash flows to thrift institutions unchanged, and in a world of symmetrical interest-rate fluctuations such a procedure would, from the standpoint of the mortgage lender, average out to nothing more than a device for cyclically varying the accounting allocation of cash flows between interest income and repayment of principal. While I am somewhat sympathetic with such a device for escaping the tyranny of accounting procedures, I would prefer that it not involve such heavy potential costs to individual mortgage borrowers. And, of course, my enthusiasm for this arrangement is further limited by the fact that the earlier comments on the cyclical problems of the thrift institutions could be crudely summarized with the statement: thrift institutions don't need variable rate mortgages; they only need to determine earnings available to pay deposit interest as though they had them.

Moreover, I suspect that the thrift institutions themselves are about to discover that the variable-rate mortgage is no panacea for their cyclical earnings problem. Their ability to sell such debt instruments is likely to be limited primarily to periods of tight credit (and high interest rates) when mortgage borrowers are in a weak bargaining position. At times of ample mortgage credit availability and strong borrower bargaining powers, they may find it virtually impossible to lend on variable-rate contracts if the typical home buyer is as rational as I suspect he is. Therefore, the thrift institutions that have been most aggressive in this type of lending are apt to

find that they have indeed increased the cyclical flexibility of their earnings, but mostly on the downside.

Finally, I might note that management of the variable-rate mortgage scheme involves some problems. The variable rate would have to be adjusted in accordance with changes in short-term interest rates, since as far as we know those are the most important rates against which the thrift institutions must compete in order to attract funds. Two proposals that I am aware of would in one case gear the mortgage rate to the Treasury bill rate and in the other to a measure of the cost of funds in the deposit markets.[1] Such procedures, while satisfactory on other grounds, would of course anchor the financial fortunes of a good segment of the public to changes in money market conditions arising in part out of Federal Reserve and Treasury debt management policies, with a fair potential for mischief as a result.

Finally, given the politics of home ownership in this country, I would like to express my severe doubts that a system of variable-rate mortgages, if it ever affected a significant proportion of mortgage borrowers, could survive a period of extraordinarily high interest rates in unregulated form. For instance, had the variable-rate mortgage come into widespread use during the 1960-65 period, massive political pressures would no doubt have been generated in later years to impose limits on the extent to which mortgage rates could be raised. Indeed, I have the suspicion that any variable-rate mortgage scheme, once given widespread application, would ultimately become surrounded by controls of a more severe nature than Regulation Q. In that connection, I understand that a few states have already imposed, or are considering imposing, severe constraints on the use of variable-rate mortgages.

Concluding Comments

In arguing for continuing authority to set maximum rates on the small time and savings deposits of commercial banks, savings associations, and mutual savings banks, I have stressed that we should

[1]Messrs. Anderson and Eisenmenger, in another paper presented at this conference, argue for the use of current market yields on fixed-interest mortgages as the proper guide for setting variable mortgage rates. However, that approach seems clearly inappropriate since the term structure of interest rates does vary, and quite sharply. There is no fixed relationship between the going mortgage rate and the deposit rate needed to attract short-term funds.

approach financial change with great caution. I think this conservative approach is fully warranted. The past years are full of instances where seemingly minor tinkering with the financial system gave rise to totally unforeseen developments of great magnitude. One need only reflect on the events set in motion by the 1962 increase in commercial bank time deposit rate ceilings or the later imposition of the interest equalization tax--actions taken largely out of narrow balance-of-payments considerations--to refresh his memory on that score. Another point that should be kept in mind is that the severe problems of the thrift institutions in recent years reflected the extreme financial situation that developed during the period. Perhaps our time and energy would be better spent in improving our economic policies to avoid such financial storms than in trying to make the thrift institutions more able to weather them.