

## Changing the Asset and Liability Structure

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The justification for specialized savings institutions which receive Government financial assistance for restricting their asset and liability structure rests largely on a balancing of public policy and economic considerations. This balancing requires first an appraisal of the importance of the public policy objectives involved—which economists have relatively little to say about; second, a cost-benefits analysis which can rarely be precise but should at least consider roughly what the direct and indirect costs are and what is being achieved; and third, an examination and assessment of the alternative approaches to attaining the same policy goals. A *Study of the Savings and Loan Industry* which was recently published considers at some length the costs and benefits of the savings and loan industry with its present asset-liability structure, the desirability of changing that structure, and the comparative advantages of these changes to alternative approaches to achieving the same objectives.<sup>1</sup> The present paper summarizes those parts of the *Study* which deal with these issues.

Savings and loan associations have the most specialized asset structure of all the major groups of savings intermediaries and the greatest imbalance between the maturity structure of assets and liabilities. They have been by far the single most important supplier of mortgage credit for residential housing, especially for owned homes. Their role in the economy has been to accumulate funds from individual savers and to make these funds available for financing housing. Like all financial intermediaries, savings and loan associations mediate between savers and investors, between the

<sup>1</sup>*Study of the Savings and Loan Industry*, Vols. I-IV, Washington, D.C., G.P.O., 1970; see especially Irwin Friend, "Summary and Recommendations," and "Changes in the Asset and Liability Structure of the Savings and Loan Industry."

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ultimate suppliers of funds in our economy and those requiring funds for a specific investment purpose. As a consequence of various types of economies of scale (at least as one goes from a small individual saver to a large financial intermediary) and the much greater potential for diversification of risk, the intermediary role played by savings and loan associations, as well as by other financial institutions, would be expected to lower the cost of and increase the effective demand for investment in housing and other forms of durable goods. The basic economic incentive to individual savers in these associations is higher return for given risk (including short-term liquidity as well as long-term insolvency risk) or lower risk for given return.

The most important reason for providing Government assistance to savings and loan associations has been to encourage adequate housing and home ownership and, to a lesser extent, thrift among the lower and middle income groups. It is generally agreed by commercial banking authorities that the fact these needs were not being met by the commercial banks was largely responsible for the creation, favorable regulatory treatment, and growth of both savings and loan associations and mutual savings banks. Savings and loan associations have received special help from the Government but they have had to pay the price of a loss in flexibility, especially in their investments but also in their liabilities.

It is not the purpose of this paper to assess either the wisdom of expending public resources to aid housing and home ownership, or the desirability of continuing this subsidy to the present array of beneficiaries, instead of limiting it to disadvantaged groups only.<sup>2</sup> The paper is concerned primarily with maximizing the usefulness of savings and loan associations and of related financial institutional arrangements for advancing the social objectives that they are designed to serve. The level of Government assistance to the associations, which is only a small part of the total subsidy to housing, is mainly taken as given, though the relative benefits of this type of assistance to housing are compared with other alternatives. While the performance of the associations in the housing markets receives particular attention, consideration is also given to the industry's performance in the savings markets.

<sup>2</sup>Most of the benefits of current forms of direct and indirect housing subsidies flow to the lower middle, middle, and upper income classes rather than to the poor. For an analysis of tax benefits, see Richard Netzer, *Housing Taxation and Housing Policy*, The Brookings Institution, 1967.

*Consequences of Monetary Stringency*

The 1966 crunch and subsequent developments highlighted the vulnerability of the savings and loan associations and of the housing markets to protracted periods of tight money. The problem is particularly acute in view of the vast, growing need for new housing. A number of different approaches to reducing this vulnerability are possible.

One obvious approach is to institute broad changes in the fiscal-monetary mix, placing more emphasis on fiscal restraint in periods of excessive overall demand. The available evidence strongly suggests that general monetary or credit policy, which has traditionally been considered to affect the economy in a reasonably evenhanded fashion, is to a substantial extent a selective means of credit control impinging in particular on housing.

While the available data are not adequate for assessing the costs of the disruption in the housing and mortgage markets induced by reliance on monetary stringency to curb general inflationary pressures, it is clear that these costs to home purchasers and sellers, to the building industry, and to mortgage lending institutions, are not negligible. The costs to young families and to disadvantaged groups looking for homes may be particularly large. In addition to very real inconveniences to prospective purchasers and sellers, the shift of idle resources obviously is not complete or instantaneous, and the operational efficiency of the construction industry may be reduced significantly as a result of major unplanned fluctuations in output. Moreover, the profit requirements of the savings and loan associations as well as of the construction industries may be inflated by these fluctuations in the volume of their business. For the savings and loan industry, a prolonged period of inflationary pressure contained mainly by monetary policy and rising interest rates could be disastrous.

Thus, in spite of the unsatisfactory nature of the available data for appraising these costs of monetary policy, it seems reasonable to assume that greater reliance should be placed on fiscal policy for counteracting cyclical excesses than has been the case in recent years. This should make possible a more efficient allocation of resources and a more equitable distribution of the effects of restraint among different groups in the population, as well as provide what could be (apart from policy decision lags) a more certain and speedier overall impact. Income taxation can be evenhanded in a way that monetary policy cannot.

Restrictive monetary policy, as presently conducted, is not really a general, across-the-board deterrent to investment and consumption demand. Moreover, it is selective in an arbitrary fashion since it is not designed to dampen a type of demand which for some reason is considered excessive or unhealthy. In fact, activity in the housing industry may very well be curtailed by monetary stringency at a time when that industry, unlike the economy as a whole, has substantial excess capacity as well as large unfilled demands. The greater impact of monetary stringency on housing than on the rest of the economy apparently is due mainly to a capital rationing effect, resulting from deficiencies in current institutional arrangements for providing mortgage credit; and probably also to an interest rate effect, reflecting a greater interest elasticity of housing demand than of demand generally.

The most effective use of fiscal policy to avoid cyclical excesses would require that the executive branch of the Government be provided with the power to modify tax rates within limits and under circumstances previously prescribed by Congress, so that differences in opinion on the nature of changes in tax rates and the conditions under which they are to be made effective can be resolved when the passage of time is not critical. Even if this power is given--and there is no reason to expect it will be in the near future--it might still be necessary and would in any case be desirable to correct the deficiencies in the current institutional arrangements for providing mortgage credit. Similarly, if the interest rate spiral is arrested for any other reasons, and interest rates stabilize or decline, causing the position of the savings and loan industry and of the housing markets to improve even without changes in institutional arrangements, such changes would further improve industry performance and overall economic efficiency.

*Correction of Institutional Deficiencies*

The different possible approaches for correcting these institutional deficiencies include (1) the introduction of greater flexibility into association asset-liability structures (and those of other specialized savings intermediaries), and the provision of more adequate credit facilities, so that the specialized intermediaries can compete effectively for funds with the commercial banks; (2) improvement in the structure of mortgage markets to make home mortgages more adequate capital market instruments, permitting them to compete more effectively with open market securities, without either the



payment of excessive interest differentials or the curtailment of residential construction; and (3) modification of the current interest rate ceilings on savings accounts and mortgages. The desirability of these changes is discussed in detail in various parts of the *Study of the Savings and Loan Industry* and, to the extent they are relevant to this paper, are summarized below.

An analysis of economic efficiency and public policy considerations points to the need for introducing greater flexibility into the asset-liability structure of savings and loan associations (and other specialized savings intermediaries) to the extent that this can be done without undermining housing policy objectives. However, a complete integration of specialized and diversified deposit intermediaries, which would maximize flexibility of what are now the specialized savings institutions, is probably not desirable at this time. This conclusion is based on the advantages of having a specialized group of lenders to implement housing policy, the economies of scale in mortgage lending, the diffusion of economic power, the costs of rapid change, and the absence of significant evidence that overall efficiency in the financial system has been impaired by the dual system. A more promising approach seems to be a judicious modification of the present asset-liability structure of specialized intermediaries to alleviate the problems associated with specialization; but this does not preclude further measures towards integration of specialized and diversified deposit intermediaries at some later time.

The savings and loan associations, at least until the mid-1960's, were quite competitive in providing savings deposits as well as mortgage credit for small- and medium-income groups and added significantly to the mobility of savings and mortgage funds among different regional markets. The encouragement of housing via incentives to the savings and loan industry does not seem to have resulted in generally excessive investment in housing even from an economic (totally apart from a public policy) viewpoint. A comparison of both gross and net mortgage and other interest yields over the postwar period as a whole does not indicate that the channelling of funds into housing by specialized savings intermediaries had lowered mortgage rates below rates on most other loans of comparable risk (even after allowance for differences in transactions costs). Apparently the special assistance given housing simply helped to offset the imperfections of the mortgage markets as compared with the markets for securities or for business loans.

*Changes to Improve the Economic Performance  
of Savings and Loan Associations*

From the viewpoint of significantly improving the industry's overall economic performance without risking a serious impact on the housing market, the modification of the asset-liability structure of savings and loan associations which seems most promising includes additional flexibility in the areas of consumer credit, mortgages on multifamily residences (including limited use of equity participations), longer term savings accounts, capital notes or debentures, and a limited form of checking accounts.<sup>3</sup> If the level of consumer (or other non-real estate) loans is limited to the 10 percent of assets now permitted under Federal tax laws, but not by most of the supervisory authorities, no further tax concessions would be involved. (This 10 percent limitation applies to corporate but not to U.S. Government and agency or municipal issues.)

The gains to the savings and loan industry in profitability, in liquidity, and in the ability to service and attract customers are believed to compensate for the possibility of some diversion of resources from residential mortgages over the cycle-- even apart from competitive improvements in consumer credit markets. Additional flexibility in mortgages on multifamily residences is justified on the grounds that, apart from allowances for differences in risk, it is difficult to rationalize any discrimination in favor of single-family houses at the expense of the typically lower income inhabitants of multifamily residences.<sup>4</sup> Still other types of flexibility that may be desirable include the minimization of geographic restrictions on mortgage lending. A more drastic change in the asset structure--more extensive use of variable rate mortgages-- might be required if inflationary conditions worsen, but the serious problems associated with this change suggest that it be reserved for use mainly as a last resort against irresponsible fiscal and monetary policies.

On the liabilities side, more flexible powers to issue longer term savings accounts and capital notes or debentures also seem to have some potential for improving the industry's profitability and liquidity, without any diversion of resources from residential

<sup>3</sup>Steps to implement some of these proposals have already been taken.

<sup>4</sup>Though the average income of inhabitants of multifamily residences is clearly lower than for single-family homes, a significant portion of new multifamily housing has been directed at the middle and upper income brackets.

mortgages, but this potential seems more limited than earlier studies have suggested. More important, the grant to the associations (and other specialized savings intermediaries) of limited powers to issue demand deposits or checking accounts should, without perceptible social cost, greatly reduce a substantial comparative disadvantage from which these institutions now suffer. Such powers would significantly increase competition for deposits, to the benefit of the specialized savings intermediaries, the housing markets, and depositors generally. The issuance of demand deposits by savings and loan associations would, of course, be limited by their asset composition and would require a new set of reserve requirements.

Two related objections that might be raised to some of these proposed changes in the associations' asset-liability structure are, first, that they would raise total costs to the Government (in view of the favorable tax treatment of income received by specialized savings intermediaries) which have been estimated to be already somewhat over \$100 million a year;<sup>5</sup> and, second, from the viewpoint of equity among competing institutions, these changes would alter the relative benefits provided by the Government to the associations and commercial banks. However, no additional tax or other subsidies are implied by the proposed changes in the associations' asset-liability structure, though higher profitability of the industry would involve larger tax benefits as well as higher taxes.

Moreover, it is likely that commercial banks have been a greater beneficiary of Government policy than savings and loan associations as a result of their ability to provide checking accounts for their customers, the proscription of interest payments on such accounts, the significantly lower cost of time and savings deposits to them than to the associations (perhaps on the order of one-half of one percent) as a result of the convenience of one-stop banking, and the limitations placed on the entry of competitors. Commercial banks also receive other benefits from the Government, including a more favorable tax treatment than is accorded to nonfinancial corporations, though not so favorable as the tax treatment extended

<sup>5</sup>The U.S. Treasury Department arrives at a substantially larger estimate of revenue loss on the assumption that only actual rather than potential estimated bad debts should be allowed as deductions from income. (U.S. Treasury Department, *Tax Reform Studies and Proposals*, Part 3, pp. 458ff., 91st Congress, 1st Session, U.S. Government Printing Office, Washington, D.C., 1969.) The tax advantage to the savings and loan industry has been sharply reduced in the past year, but other forms of Government assistance have been increased.

to the associations. Finally, if the proposed asset-liability changes are put into effect and substantially increase the profitability and hence the tax benefits to the savings and loan industry, their tax treatment might well be reconsidered if at any time the costs to the Government of the tax incentives given these institutions seems excessive from the viewpoint of benefits received.

*Most Efficient Method of Stimulating Housing: Availability of Credit*

A more fundamental objection that might be raised to these changes in the asset-liability structure of savings and loan associations is that perhaps their most basic objective—the stimulation of housing—might be achieved more efficiently by other means. This is more an objection to any support of savings and loan financing of housing than to the specific changes proposed. The essential question here is what is gained by continuing to give incentives to specialized institutions which must devote the bulk of their resources to providing home financing credit as against other policy alternatives.

In view of the high sensitivity of housing to the terms and, especially, to the availability of external credit, providing borrowers with mortgage money on favorable (or restrictive) terms is likely to be a particularly efficient way of stimulating (or depressing) residential construction. Both the 1966 experience and econometric analysis for the postwar period point to the importance of the availability of credit as distinguished from the terms of credit, on the effective demand for housing, with a major impact on housing of any substantial shift of savings from the specialized savings intermediaries to the commercial banks. However, it is at least theoretically possible that greater availability of housing credit might be provided more expeditiously either by extending favorable tax treatment or other direct Government assistance to any holder of a mortgage and not only to a specialized intermediary, or by changing the mortgage instrument itself so that it is a more effective substitute for securities traded in the capital markets.<sup>6</sup>

The main justification for directing any subsidy to a specific intermediary rather than to all mortgage lenders is the belief that this provides greater control over the successful implementation of housing policy than leaving the investment decision in the hands of a diversified lender (though, even with specialized intermediaries, the

<sup>6</sup>As noted earlier, a more rational monetary-fiscal mix would also help, but this mix will be determined in large part by considerations outside the field of housing.



past effectiveness of housing policy leaves much to be desired). Another argument that might be adduced in favor of concentrating on a particular intermediary would be the economic advantages of specialization and economies of scale. A final argument against extending tax or other direct subsidies to all mortgage lenders is that we are not starting from scratch, and with the uncertain benefits of this change it is probably undesirable to extend further the area of housing subsidies, except for specialized programs confined to low income families.

#### *Changes in the Mortgage Market*

Changes in the mortgage instrument and related changes in the mortgage market appear to offer more promise as a mechanism for improving the availability of housing credit. To the extent that transactions costs on mortgages, including the costs of risk appraisal, can be reduced and marketability increased, pension funds, insurance companies and commercial banks would be more willing to deal in residential mortgages without requiring excessive interest rate differentials, and the need for special treatment of savings and loan associations (or other specialized savings intermediaries) would be lessened. However, while methods for improving the mortgage market are examined in the *Study of the Savings and Loan Industry* and several promising proposals are discussed there, it appears that, at least for the foreseeable future, the specialized savings intermediaries will continue to perform a useful function in implementing housing policy.

The existence of such intermediaries may provide better control over the implementation of housing policy than leaving the investment decision in the hands of diversified lenders even with improved mortgage markets. Moreover, it would probably require a 100 percent guarantee by the Government of mortgage payments as they become due to eliminate a large part of the advantage specialized savings intermediaries now have in their ability to appraise mortgage risk economically; and it is doubtful that such a guarantee would or should be extended to all groups in the population regardless of risk and cost.<sup>7</sup> Finally, the viability of the

<sup>7</sup>However, the plan for a 100 percent guarantee of mortgage payments developed by Jack M. Guttentag in one of the papers in the *Study of the Savings and Loan Industry* seems like a relatively attractive form of Government subsidy to housing, especially for disadvantaged groups in the population.

specialized savings intermediaries is important not only in view of their potential for facilitating housing policy but also to make optimum use of available facilities for providing desired services to depositors. Thus, it appears that the proposed additional flexibility in the asset-liability mix of savings and loan associations is desirable totally apart from any other likely changes in mortgage markets.

#### *Some Further Observations*

It may be helpful to make three further comments on the subjects covered by this paper. First, many economists would consider that the simplest solution to the financing problems of the savings and loan and housing industries--and of specialized intermediaries generally--would be to eliminate interest rate ceilings both on savings accounts and on mortgages and to make mortgages more marketable. Eliminating the ceilings on savings accounts would allow the associations to compete for funds at all times at the market rates, while eliminating ceilings on mortgage rates would permit the associations to obtain sufficient income from mortgages to use profitably the funds they raise. Making mortgages more marketable would protect the associations against liquidity crises.

While these arguments have merit, it is easy to overstate the extent to which this prescription of eliminating ceilings and improving mortgage markets would help the savings and loan and housing industries. Thus, higher interest rates on savings accounts have to be paid on many of the old accounts as well as on the new accounts so that under the present structure of assets and liabilities it may be unprofitable for the associations to raise interest rates significantly in periods of great money tightness. Moreover, making mortgages substantially more marketable seems to be extremely difficult without the use of (and problems associated with) Government guarantees. Changes in interest rate restrictions and in mortgage market arrangements are desirable and are recommended in the *Study of the Savings and Loan Industry*, but they do not seem to affect seriously the desirability of changes in the asset-liability mix.

Second, it might be noted that mutual savings banks have much more in common with savings and loan associations than either have with commercial banks. Therefore the arguments against the integration of all deposit intermediaries into a single system do not necessarily apply to the integration of savings and loan associations and mutual savings banks. The bill to establish a new system of Federal mutual savings associations, proposed by the last

Administration, is a step toward such integration, at least in the long run. But the bill also represents an attempt to enhance competition among savings intermediaries by extending the present network of mutual savings banks countrywide, and to enhance the flexibility of savings intermediaries by expanding their lending powers.

Ultimately, it may be desirable to have an integrated system of deposit intermediaries under a single regulatory authority, with the asset-liability structure of the member associations determined within broad regulatory limits by the individual association but with the details of regulation and any Government assistance dependent on the asset-liability structure adopted. However, that time seems far off.

Finally, it should be stressed that while the *Study of the Savings and Loan Industry* does consider the cost-benefit issues which are basic to any evaluation of the desirability of different changes in our financial structure, the analysis is limited by the state of arts. Neither the analysis carried out by the Study nor other available work provides definitive answers to a number of important questions relating to the effects of various institutional and market arrangements on economic efficiency or of different Government subsidies on housing and other demands. Much more work is required and should be carried out in these areas.

## *Structural Reform with the Variable Rate Mortgage*

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The disadvantages of interest rate ceilings on savings and small time deposits have already been outlined at this conference. In this paper we discuss a long-run plan and several shorter-run plans for eliminating these ceilings.

We conclude that the shorter-run plans are either unworkable or politically impossible. Even our longer-run plan, introducing variability in mortgage rates, entails many practical problems. These are so difficult that it is unlikely that rate variability will be widely adopted unless it is supported and actively promoted by financial institutions, their trade associations, and the Federal Government. We favor such support. Variable-rate mortgages would help low-income savers, bolster thrift institutions, and permit the elimination of Regulation Q as it applies to savings and small time deposits.

### *The Present Situation*

The current problem of thrift institutions is often blamed on "borrowing short and lending long." However, if these institutions were using predominantly variable-rate mortgages, they would not need to match the maturity of their assets with the maturity of their liabilities.<sup>1</sup> The principal current problem of thrift institutions is their low yield on assets and consequently their inability to compete with commercial banks in free and open competition. In our

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