Conference Series No. 8

POLICIES FOR A MORE COMPETITIVE FINANCIAL SYSTEM

A Review of The Report of the President's Commission on Financial Structure and Regulation

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PROCEEDINGS OF A CONFERENCE HELD IN JUNE, 1972

FEDERAL RESERVE BANK OF BOSTON

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CONFERENCE

Held at

NANTUCKET, MASSACHUSETTS

JUNE, 1972

Sponsored by

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FOREWORD

The Federal Reserve Bank of Boston is particularly pleased to publish these proceedings, the eighth in our series of conference volumes. The conference, which was held in June 1972, reviewed *The Report of the President's Commission on Financial Structure and Regulation*, more commonly known as the Report of the Hunt Commission.

The Hunt Commission Report contains a series of recommendations which would greatly change our financial structure and institutions. Because of the importance of these ideas, a distinguished group of economists, government officials and lawyers was invited to participate in the conference and to analyze the Commission's findings and recommendations. We hope that this volume will be useful to all who are interested in the issues of financial structure raised by the Commission.

Frank E. Morris
President

Boston, Massachusetts
June, 1972

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A Review of The Report of the President's Commission on Financial Structure and Regulation

Overview of the Commission's Philosophy and Recommendations

DONALD P. JACOBS and ALMARIN PHILLIPS*

Introduction

The regulatory environment in which deposit intermediaries operate was to a large extent fashioned in the 1930s. Although a number of changes in the regulation of financial institutions have been made in the last four decades, the majority of academics, legislators, managers of financial institutions and regulators would agree that the pace of regulatory change has been slower than desirable. In large measure this is attributable to the complex relationships among the institutions and the legislative and regulatory processes which consider change on a piecemeal basis. Alterations in the regulations governing one set of institutions invariably affect the other types. The introduction of proposed legislative or regulatory change invariably calls forth efforts by those adversely affected to modify or defeat its adoption, and these efforts are often successful.

The President's Commission on Financial Structure and Regulation was given the task of recommending changes which would improve the performance of the financial system and, at the same time, have a high probability of being implemented by the federal regulatory agencies, the Congress and, where appropriate, by state legislatures and regulators. The major advantage of a commission is that it, in contrast to regulators and legislatures, can take a system view of the operation of the deposit intermediaries. This allowed the Commission on Financial Structure and Regulation to develop a package of interrelated recommendations. Each recommendation moved in the direction of improved performance. In light of political reality, the package was designed with the hope that interested parties would coalesce to support the entire set, even while the same recommendations, taken individually, would have small likelihood of acceptance.

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The Report of the President's Commission on Financial Structure and Regulation contains 89 recommendations. Since the contents of the report are by now well known, we will not detail all the recommendations. Very briefly, the Commission recommended, among other things, that:

1. In the immediate period interest rate ceilings on time and savings deposits be used only in the event of the threat of serious disintermediation; that, if ceilings must be used, the inter-institutional differentials on the ceilings currently existing be removed within five years; and that the ceilings be entirely eliminated within 10 years.
2. All deposit institutions be permitted to offer third-party payment services, with identical reserve requirements and equal tax and regulatory burdens.
3. Savings and loan associations and mutual savings banks have a far wider range of loan and investment powers.
4. Charter conversions from one institutional type to another and from mutual stock forms be made easy to implement.
5. Regulatory provisions be made to authorize all types of financial institutions to offer the sorts of finance and finance-related services allowed bank holding companies, subject to the same public interest and the same competitive safeguards as apply to bank holding companies.
6. Social priority investments be implemented by direct subsidies to consumers and/or tax credits on interest income to all holders of debt instruments directly related to such investments.
7. Federal regulatory agencies by reorganized in the interest of efficiency and more effective monetary policy.

There clearly is some sentiment in academic circles – and scattered feelings outside of academe – that the recommendations should have gone further. Immediate – or, at least, faster – abolition of Regulation Q has a good deal of support. Many would urge that elimination of the prohibition of interest payments on demand deposits should have been recommended. Similarly, rather than imploring states to be progressive in their policies toward branching, as recommended by the Commission, there is considerable sympathy to the view that the McFadden Act should be repealed to permit true interstate branching and the end of locational protection through state banking laws. Variable-rate deposit-insurance premiums, based on differential risk factors, also have support.

We have no intellectual quarrel with our colleagues who would have gone further. Rather, our concern is with the possibility that the *Report*, consisting in our view of the minimal necessary changes to permit financial institutions to serve the public efficiently and effectively in coming years, may not gain the support necessary for legislation and administrative action. We suggest here that further piecemeal adjustments of the regulatory structure are a far worse course for public policy than the Commission's recommendations. We suggest, too that the critics of the *Report* – not the academic critics who would have gone further, but the supporters of the *status quo* – have failed in their criticisms to make clear just what these alternatives are.

In the period since it was made public the *Report* has been the focus of broad study and discussion. For the most part statements by trade association leaders and government officials have been favorable but they usually conclude with a cautious "wait-and-see" attitude. None of the responses to the *Report* since its release is a great surprise, despite the conscious design to fashion *The Report* with a view to achievability. The world has changed in ways that make the subjects of *The Report* seem less important. We think they are quite as important as they were in 1970; failure to consider them could lead to results far inferior to those recommended by the Commission.

The Commission was established during a period of considerable domestic monetary unrest. Funds flows were at the time being diverted from the traditional deposit intermediaries. The commercial paper market had grown enormously – and had demonstrated its proclivities toward crises. Eurodollar borrowings were rising. Direct placements of small-denominated debt obligations by substantial borrowers were in the offing. Residential construction received very limited funds from traditional sources, and new borrowing techniques were being developed by larger borrowers and lenders. States and municipalities faced financial crises and small businesses were badly squeezed for both long- and short-term capital requirements. On top of this, and to some extent for related reasons, one-bank holding companies were rapidly expanding in number and in proposed activities. Something, it seemed, had to be done.

Something was done. There was patchwork revision of Regulation Q – largely in the form of its abolition on large denomination certificates of deposit, where it failed to work at all. New programs were initiated by federal housing agencies and by the Federal Home Loan Bank Board. But, most important of all, monetary restraints were

eased so that the depositary intermediaries and their customers faced financial markets which were much more "normal". In other words, without apparent crises the pressure for change subsided. Yet *The Report* looks forward to the possibility of future crises and seeks to avoid them. None of the changes to date in any way mitigates the dangers the Commission foresaw.

Foundations of the Commission's Recommendations

Almost immediately after its formation, the Commission made a number of fundamental decisions. It would not act as a "fire brigade", making emergency recommendations on immediate and conceivably interrelated problems on an *ad hoc* basis, *in seriatum*, as the gravity of such problems might dictate. Nor would it, with the power of hindsight, report on problems of the past and policy failures related thereto. Instead, it chose to consider the complex interrelationships among financial markets and, with the uncertainty which always accompanies forecasting, to ascertain how these markets were likely to operate over the years ahead, given what seemed to the majority of the Commission to be the most probable course of events.

The Commission settled – rightly, we think – on two important projections concerning the coming decade or two. First, while the situation was regarded as far from ideal, the Commission felt that periodic or possibly chronic pressures toward inflation were probable. There was little debate as to whether these pressures were fiscal, monetary or "cost-push" in origin. There was little explicit debate about "Philips curve" trade-offs between inflation rates and unemployment. Regardless of basic causes and regardless of such trade-offs, the Commission concluded that monetary policy was likely to be used from time-to-time in the future as an anti-inflation measure. Restrictive monetary policy seems to have become an institutionalized response to inflation. Thus, periods of fluctuating and periodically high rates of interest, with their concommitant differential effects on various segments of financial markets, were accepted as "good" forecasts for the future.

The second projection is less obvious from the text of the *Report*, but no less important in the Commission's recommendations. Financial markets had undergone pervasive changes based on new technologies in the years immediately prior to the Commission's being established. The materials and views the Commissioners discussed and considered gave little evidence that the opportunities

for change afforded by technology would appear at diminishing rates in the future. Moreover, these opportunities seemed to include alternatives to branching for extending the geographic area served by particular institutions and to reduce the importance of entry barriers arising from state branching laws. Here the evidence is largely from the revealed interests and behavior of borrowers and lenders, but it seemed to the Commission – again, correctly in our view – as extraordinarily persuasive.

These technological changes which influence financial institutions have originated, for the most part, outside the institutions. That is, the basic technical advances have occurred in scientific activities and in research and development programs carried on for reasons quite apart from changes in production methods and product offerings of financial institutions. In fact, one might argue that the institutions themselves have been slow in their rate of adopting new methods and products which technology makes possible.

There was a strong view within the Commission that the failure of financial institutions to take full advantage of technically feasible and economically rewarding alternatives was in some measure the result of regulatory inhibitions. An equally strong view arose that if the existing institutions were denied the opportunity to adapt to new technological opportunities, new institutions – unregulated at the outset, at least – would arise specifically because of those opportunities. The development of the Eurodollar market, the rise of the commercial paper market, the popularity of one-bank holding companies, the possible growth of direct placements of small-denomination debt instruments by major borrowers, the emergence of real estate investment trusts, the growth of the "third market" in corporate securities, innovations in third-party payment services by thrift institutions and credit unions, the spread of bank credit card systems, the growth of loan-production offices of commercial banks, the new functions and services performed by mortgage bankers, the adoption of electronic clearing systems for check payments, the ease with which large businesses could keep working balances in interest-bearing securities, and the imaginative, if not always permissible, schemes developed by commercial banks to accommodate the demands of savers for higher interest and the needs of borrowers for adequate funds – all of these gave credence to the view that technological opportunities had far outrun those relevant when the existing regulatory structure was fashioned.

It would be a mistake to suggest that the Commission uniformly foresaw the "checkless society" as a reality in the near future. But it

is no stretch of the truth to say the Commission foresaw that some rather indefinite changes would continue to be afforded by technology which, in the absence of fundamental regulatory reform, would result in possible "second-best" adaptations to the new technologies by new institutions and a gradual decrease in the role of traditional institutions in the intermediation process. Precision in the definition of future developments was impossible to attain; strength in the view that it would occur was nonetheless clear.

An Evaluation of the Policy Alternatives

Commissions obviously have no claim to infallibility; this one may prove to have been wrong in its assessment of the future. In either case, right or wrong, the consequences of the principal recommendations being adopted and their not being adopted can be considered. That is, what are likely to be the main differences in social costs and benefits if: (a) the Commission was correct and its recommendations are accepted; (b) the Commission was correct and its recommendations are rejected; (c) the Commission erred and its recommendations are accepted; and (d) the Commission erred and its recommendations are rejected?

Alternative (a): This alternative is the one which the *Report* itself assumes and only a few additional points need to be made. While acceptance of the recommendations would permit institutions to adapt to changing monetary and technological conditions, the Commission recognized that some firms – those which are inherently inefficient and those whose managements fail to make appropriate adjustments – would fail. On balance, the Commission felt that these failures would yield net social benefits and not reach such proportions as to cause system-wide complications. The alternative to the recommendations would be anticompetitive protection regulations and, during some monetary conditions, industry-subsidization programs which would produce both inefficiency and a slowing of technical progress with attendant high social costs.

The most vocal objection to the *Report* under this alternative has been that the flow of funds to housing would be adversely affected and, consequently, that national housing goals would not be met. Some have said that both the cyclical variation in mortgage funds flows would continue and that the long-term flows would be inadequate.

We feel there is little question but the cyclical problem of housing finance would be alleviated under the Commission's recommen-

dations. Private institutions supplying mortgage funds would be better able to attract funds during periods of rising interest rates and the differential impact arising from the supply side would disappear. It may, of course, be true that the demand for housing finance is more interest-elastic than that of other borrowers and cyclical sensitivity from this side would continue. If the relatively elastic private demand fails to capture the full social benefits of high levels and reasonably constant rates of housing construction, supplementary public programs would be required. The Commission supported such programs.

Beyond this, we feel that national housing goals are more complex than is expressed by a global figure of, say, 2.5 million starts per year. In fact, the latter objective seems more appropriate for a program to support the building industry than one to meet public housing needs. National housing shortfalls vary across income groups, across urban, suburban and rural classifications, and, after correction for income, perhaps across racial groups. The direct subsidy approach adopted by the Commission is certainly a finer tool to correct specific kinds of housing shortfalls than are existing financial regulations on thrift-institution asset portfolios and subsidies and quasi-subsidies which are determined by institutional types.

We should not conclude this section without admitting that additional social benefits on allocative-efficiency criteria could be expected if the Commission's recommendations had included some additional changes. Of these, the most significant, quantitatively, would be the removal of the restriction on the payment of interest on demand deposits.

The social costs imposed by not adopting most of the others often suggested are either expected to be short-lived because of the Commission's phase-out period or relatively small because new technology will reduce their impact. The Commission recognized the social costs imposed by this restriction but decided on a judgmental basis that the broad set of changes recommended would severely stretch managerial ability to make adjustments and that the desirability of removing the interest-rate prohibition should be evaluated after experience with the new regulatory environment is available.

Alternative (b): If the Commission was correct about future monetary and technological conditions and its recommendations are not adopted, a number of economically disturbing and socially costly developments will emerge. Because of the monetary conditions, financial institutions with slow-turning asset portfolios will have both earnings and liquidity adversely affected when rates rise. If, as we

believe, the deposit customers of these institutions will be quicker to disintermediate in the future than in the past, and if new types of intermediary markets will be formed more quickly in the future than in the past, the situation could become acute without extreme monetary tightness and extraordinary higher interest rates. That is, more system-wide complications including the possibility of high failure rates, could develop under this alternative than under alternative (a).

Emergency enactment of the Commission's recommendations in such circumstances would be to no avail. A period of adjustment is necessary for them to work. Regulation Q, as it existed, would be even less effective than in the past in protecting the institutions and maintaining the desired flows of funds. Conceivably, interest-rate maxima could be extended to all sorts of financial instruments – but then the cost effect of monetary policy on restraining aggregate demand would be lost. Further, except as the rate maxima were manipulated to achieve the purpose, interest rates would not operate to allocate resources among alternative ends.

We doubt the efficacy as well as the efficiency aspects of global interest-rate controls. Gaps between the funds demanded and those supplied at the controlled rates would exist generally, yielding at least temporarily the desired effects on aggregate demand due to availability effects. The gaps would almost certainly result in uncontrollable "black markets", however, and disintermediation from the "legitimate institutions" to the "black markets" would occur rapidly. In short, we do not think universal interest-rate controls are a preferable alternative to the Commission's approach.

If interest-rate controls would not work well, the remaining policy alternative would be to subsidize the failing instituitons in some way. Operations by federal agencies in secondary markets, special reserve allowances, special discount privileges and tax relief would be among the possible ways to achieve the results. All of these would operate in a direction contrary to that dictated by monetary policy, yet they could be defended by reference to sacrosanct housing needs – and sundry other social goals as well as the need to preserve large numbers of deposit institutions from defaulting. In our view, it would be rare that social goals could in fact be efficiently achieved by subsidies to the institutions. Again, the Commission approach seems preferable.

Technological change, unlike changing monetary conditions, is unlikely to lead to acute effects of crisis proportions. Instead, failure

to adopt the Commission's recommendations would provide preferences to some organizational types over others and some institutions which might efficiently innovate would be denied the opportunity to do so. Inefficiency – in the sense that possibly non-optimal organizations would be supported – would result, with the possibility of a gradual withering-away of some of the traditional institutional forms. The thrift institutions are prime candidates for playing a relatively less important intermediating function if they are denied third-party payment services and other "full service" financial lines of commerce. Similarly, since existing law favors the holding company organizational form as a means of utilizing technological opportunities, this organizational form would probably grow relative to divisional and subsidiary organizational arrangements.

Projections over the decades ahead indicate the possibility of very substantial changes. Technology is quite likely to bring pressures on state legislatures to permit state chartered institutions – mutual savings banks and credit unions, in particular – to engage in activities denied to their federally-chartered counterparts. Similarly, business firms which now utilize the traditional intermediaries will discover preferred means for funds transfers, some of which will utilize new market organizations, and some of which will be handled through intergration and non-market mechanisms. In short, whether the Commission's recommendations are accepted or not, new technologies which provide new services, better-quality services, or cost reductions will ultimately be used by someone, somehow. To deny existing institutions the opportunities to innovate makes little sense to us.

Alternative (c): If the Commission erred in its views of future monetary and technological conditions and yet made its case so persuasively that the recommendations were favorably acted upon, still different consequences would occur. Chief among these is that financial markets would be more competitive. And the prime reason for the increase in competition would be the reductions in entry barriers which would occur. Whether or not actual entry took place on a large scale, existing institutions would be permitted to extend product lines in competition with other types of institutions and to expand the geographic dimensions of their markets. Easier entry into finance-related markets would exist and, via holding company and subsidiary affiliations, even the barriers formed by state lines would be reduced.

Understandably, these results would be unwelcome to both financial and non-financial businesses which are protected by the

present regulatory framework. They would be adversely affected. But if competitive theory has any applicability to policy problems, it is hard to conclude that the results would not be socially beneficial. The Commission, it should be recalled, recommended nothing to weaken the force of antitrust laws in inhibiting changes with anti-competitive consequences. Only competitively neutral and pro-competitive changes would be encouraged.

This alternative has consequences for housing finance, also. Since, by assumption, periods of tight money and high rates of interest do not occur, the cyclical character of housing which relates to squeeze from the supply of funds side are immediately ruled out. To the extent that institutions currently specializing in housing finance diversified, however, with no reverse diversification from others not currently in that market, a smaller flow of private funds would be available.

Whether or not this change would be socially beneficial depends on externality conditions and on the choice of policy tools to deal with externalities. If private demand and private costs accurately reflect social valuations — a condition which we personally reject because we believe that housing has clearly manifest externalities — the reduced flow of funds to housing would be the correct change in resource allocation. On the other hand, if private demand undervalues the social benefits of housing, or particular types of residential construction, the effects of increased competition, by themselves, are not allocatively efficient.

It is our view that externalities do exist in the housing area and, indeed in many other areas. Protecting financial institutions and the presently constituted building industry are not the social goal we have in mind, however. The goal is to build the type of residences, in the locations, and for the people to which the externalities pertain. We remain of the view that direct subsidies (including forms of tax credits for the consumer involved) are better policy tools for dealing with externalities than are subsidies and tax relief for broad classes of financial institutions. Suburban housing for middle and upper income groups is not, we think, the place where the externality problem is the most grave.

Alternative (d): If the Commission erred in its views of the future and if its recommendations are rejected, the consequences are obvious. We stay in today's world, with no great problems to concern us. True, financial markets would contain what to the academic scribbler are not inconsiderable amounts of monopoly power. True, there would be existing technological opportunities which could not

be realized in an optimal fashion. True, the policy tools for compensating for externalities are not ideal. Yet no grave problems appear.

In truth, the difficulty with this alternative is that the probability of its reflecting the realistic situation is essentially zero. Technology will change; tastes will change; externality conditions will change. The Commission's recommendations allow for this. In fact, as a matter of slight historical interest, at least, the Commission was so impressed with the changeable nature of the world – and the inadequacy of man to foresee the future – that there was discussion of explicitly recommending the periodic reinstitution of new Commissions on Financial Structure and Regulation.

Conclusions

Sketched broadly, these are the policy alternatives with respect to the Commission's *Report*. We believe the payoff from implementing the Commission's recommendations would be greatest if the future economic and technological conditions expected by the Commission actually occur. But, it is our opinion that given any reasonable forecast about inflation, interest rates, and technology available to financial institutions, the expected social benefits outweigh any possible costs which might occur as a result of the recommended restructuring of the deposit institutions.

To repeat, our contentions are not with fellow academicians and the few members of the financial community who would have proposed more radical reform. Our contentions are with those who, on the one hand, regard the *Report* as a revolutionary document which, if followed, would do great harm. On the other hand, our contentions are with others who regard the *Report* as a great giveaway to financial institutions. It is neither. Those who fear the consequences of the *Report* on grounds of its doing social harm are, we suggest, putting their own interests in the preservation of the *status quo* above the social interest in change. This position is understandable, yet not one to which a commission might dedicate itself.

Less sympathetically, we suggest that those who see the *Report* as favoring existing financial interests have somehow failed to grasp how markets operate and the meaning of economic efficiency. This judgment is both harsh and potentially erroneous, we admit. Still, as we see it, it remains true that in the existing system very large numbers of financial institutions are of sizes far below those indicated by our knowledge of scale economies. It remains true that

financial institutions are denied access to markets they seek to serve and in which, if permitted, they would very probably raise the degree of competition. It remains true that, due to market imperfections and antiquated regulations, discrimination in the availability and price of finance and finance-related services abound. And it remains true that the world will change and that institutional responses are required.

It is our hope that somehow rational choices based on informed judgments can take place. We are far from sanguine that our hopes will be realized. But changes in public policy with respect to financial markets which occur in a crisis atmosphere seem to us to be far from ideal. Of the possible alternatives, those proposed by the Commission have much merit.

Chartering, Branching, and the Concentration Problem

DONALD I. BAKER*

Nobody who has worked on and witnessed multi-member task forces in operation can be too optimistic about their results.[1] Yet, having started with such a gloomy premise, I was pleased by what the Hunt Commission turned out on competitive policy. From the outset, the Commission's report stresses competition as a major, affirmative policy:

> The American financial system is unique in the modern world. Made up of tens of thousands of highly diversified individual units, ranging from general purpose to specialized institutions, its structure mirrors the decentralized free enterprise economy which it serves.
>
> The system did not evolve through happenstance. For well over a century the American public has insisted that its financial institutions be both competitive and sound. The two objectives are not easily reconciled, and yet both must be achieved if we are to avoid, on the one hand, a highly concentrated financial structure and, on the other, a system unable to withstand the vicissitudes of economic change. The public is entitled to the benefits of a dynamic and innovative system responsive to shifting needs. Yet the public also should be able to rely on the strength and soundness of the system.[2]

This clear and affirmative theme – the need to assure both efficiency and safety – recurs throughout the report.

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The views expressed are those of the author and do not necessarily represent the Department of Justice. The Department normally would not have any occasion to take a position as such on the Hunt Commission Report. It will of course have to consider any legislative proposals, affecting competitive policy, in the future when these are formulated.

[1] See, e.g., the Antitrust Division's comments on the Ash Council Report on administrative agencies. 57 VA.L.REV. 925 (1971).

[2] *The Report of the President's Commission on Financial Structure and Regulation,* 1971, p. 1.

At the same time, the Hunt Commission is fairly conservative – or should one say "realistic" – in facing the broad issues of the day. It offers us an improved model of the status quo, rather than a grand plan for the next generation. Its "bottom line" judgments on competitive questions are generally sound, even though it fails to spell out its detailed underlying rationale in many cases. This conservatism can be illustrated by looking at the Commission's discussion of payment of interest on demand deposits (see pp. 27-29): it articulates most of the reasons why interest should be permitted on such deposits, and then comes out the other way in a rather delphic four-line paragraph beginning "Even so. . . ." This decision seems to rest on the concern that "immediate abolition" would adversely affect thrift institutions, and have other "potential deleterious effects."[3]

In approaching the broad issue of market structure, the Commission does not seem to come to grips openly with the underlying questions in any detail. I believe that these questions are at least two in number: first, *why* do we directly regulate market structure in banking? And, secondly, *how* should we regulate bank structure – which is a matter of both agency structure and substantive legal standards?

There seems to me to be a great tendency, not only in banking but in other regulated industries, to muddle through on fundamental questions like these. To do so is to make regulation seem obscure and highly technical – much loved by the inside experts, but rather poorly understood by the public at large. So, therefore, let's ask the questions.

Why do we regulate bank structure? One can imagine a variety of arguments, of varying degrees of persuasiveness and plausibility, as to why bank structure is regulated. These include the following:

(1) To protect banks, depositors, and communities from bank failures;
(2) To protect banks from possible "destructive competition;"

[3]Of course, there would be transitional difficulties of elimination of this prohibition of payment of interest against demand deposits. There are similar interim problems in elimination of rate ceilings against time deposits, which the Hunt Commission endorses, on a gradual basis. (see pages 23-26). Yet Professor Samuelson has stressed, ". . .The main thrust of economic analysis [is] that we *evolve* away from dependence upon these inefficient and inequitable devices." See Samuelson, "An Analytic Evaluation of Interest Rate Ceilings For Savings and Loan Associations and Competitive Institutions," *Study of the Savings and Loan Industry*, Part IV (Washington, D.C., July 1969), 1563, at 1589.

(3) To protect small banks from the competition of large banks;
(4) To assure bank shareholders of an adequate rate of return on their capital;
(5) To protect bank managements from their own follies; and
(6) To deal with the actual or imagined evils of "concentration."

To state goals in this way makes the whole process sound a little silly. We know that regulation of bank structure "just growed" – and it did so in response to economic conditions that are entirely different from those we face today. It began before the Civil War. Later, amid the gloomy shadows of the Great Depression, banking regulation, especially on new entry, burst forth as a means of saving the country from even more bank failures. It was designed to both curb the expansive bank and protect the weaker one. Today, conditions are entirely different, and these factual premises need to be reexamined in the light of today's needs. For example, assuming bank failure is the risk which we seek to avoid, can we find anything in the experience of the last decade or so which shows a close relationship between bank structure regulation and bank failure? I think not – as most recent bank failures and near failures have been brought on by the doubtful activities of various entrepreneurs running banks, by a mixture of gross incompetence and/or outright fraud.

On the other hand, if the purpose of bank structure regulation is to protect the weaker competitor, then really should such protection go on forever? In the 1970s such a solution might be regarded the way we do a fuse box – as a temporary protection for an existing wiring system, but not as a permanent excuse for failure to rewire the house to meet current needs.

How should we regulate structure? At issue here is the broad question – addressed at least in part by the Commission – of dual regulation as between state and federal agencies and the question of the legal standards to govern the regulator's conduct.

Competitive regulation – and that's what it is – is a phenomenon largely unique to banking. It is a useful tool (although some would say a cosmetic) if our overriding goal is to keep down the level of effective public regulation. This is important because there is a natural tendency for regulators to favor enterprises subject to their

regulation, over the needs of third parties or the public generally.[4] Dual regulation of bank entry works against this protectionist tendency since one or the other chartering authority may let a new entrant in.[5] The Hunt Commission recognizes this practical truth in supporting dual regulation. A single agency, it says, "may become over-zealous in protecting existing firms, with the result that entry by new firms is effectively foreclosed" (p. 60).

On the other hand, in the bank merger area, competitive regulation has often served us poorly. Chairman Frank Wille at the F.D.I.C. made this point clearly in an excellent speech in early 1971.[6] There is a continuing threat of competition in regulatory permissiveness on mergers. The Comptroller of the Currency has approved virtually every merger application filed with him for a long period of time, while the other two agencies have applied stricter standards. This might have led to an extensive switch to national charter, but for strong antitrust enforcement by the Department of Justice. The latter has in fact tended to equalize the "regulatory advantage" enjoyed by national banks in the merger area – and thereby avoid something which could be likened to a Gresham's Law of bad regulation driving out good. At the same time, the subject deserves further study not given it by the Hunt Commission; and, in particular, Chairman Wille's proposal for centralized regulatory authority in the merger area deserves study.[7]

[4]See LeDuc, "The FCC v. CATC, et al., A Theory of Regulators' Reflex Action," 23 FCC B.J. 93 (1969); Scherer, *Industrial Market Structure and Economic Performance*, (1970) 538-540; *Hush-A-Phone Corporation* v. *United States*, 238 F. 2d 266 (D.C. Cir. 1956). In the area of banking, Dr. Paul Horvitz has discussed these regulatory issues in a provocative article. Horvitz, "Stimulating Bank Competition Through Regulatory Action", *The Journal of Finance*, (March 1965), 9-10. See also Almarin Phillips, "Competition, Confusion, and Commercial Banking", *Journal of Finance*, 19 (March 1964), 39-41; Ross M. Robertson, "The Rationale of Banking Regulation", *Proceedings of a Conference of Bank Structure and Competition*, (Federal Reserve Bank of Chicago, 1970), 118-120.

[5]We had a rather interesting illustration of this point in connection with the pending Supreme Court case, *United States* v. *First National Bancorporation*. This is a potential competition case. In the trial court, the defendants offered evidence as to the prospects for new entry. The Comptroller's regional representative testified that he would not recommend and could not foresee a new national bank charter in Greeley. The state superintendent of banking was unwilling to take a position at trial, and within a matter of months authorized the formation of a new state bank by another Colorado holding company. See *American Banker*, June 2, 1972, p. 1.

[6]"The Bank Merger Act Revisited", Washington, D.C. March 26, 1971.

[7]"The Bank Merger Act Revisited", *supra*.

The Hunt Commission really did not face these underlying questions of policy in a detailed, analytic way. Nevertheless, they should be kept in mind as we discuss the specific questions of entry, mergers and concentration in banking.

The Entry Question – Chartering and Branching

It is trite but true that the conditions of entry are a key factor in industry performance.[8] It is equally true that entry into banking and into local banking markets has generally been held at a level below that which marketplace forces would have dictated.

The Hunt Commission would ease up on the restrictions to entry in two ways: first, the Commission would relax the degree of product specialization among banks and other depositary institutions; and, secondly, it would eliminate some of the existing geographic barriers. I am basically only considering the latter here.

The existing geographic barriers are extensive. Federal law prevents a bank or a bank holding company from operating bank offices in more than one state (12 U.S.C. 36; 12 U.S.C. 1842(d));[9] it gives the states a veto over bank holding company activities (12 U.S.C. 1846); and in the McFadden Act, it binds national banks to the same branching standard as the state banks in a particular state (12 U.S.C. 36).[10] Taken as a whole, this package represents a substantial deference to the states on the whole issue of entry. It is important because state law is very restrictive in many states. Fifteen prohibit branch banking altogether, while 16 others limit branch

[8]See Scherer, *supra*, 10, 216-218, 376-377; Phillips, *op. cit.*, 41; Bernard Shull and Paul M. Horvitz, "Branch Banking and the Structure of Competition," *Studies in Banking Competition and the Banking Structure* (The Administrator of National Banks: January 1966), 108-110.

[9]Of course, a very limited number of banks operated banking offices in more than one state at the time these restrictions came into force, and these operations were "grandfathered." In addition, a number of bank holding companies have "grandfathered" subsidiaries in more than one state; while additional acquisitions by the holding company are prohibited, the existing subsidiaries may branch or merge with other banks to the extent permitted by state law.

[10]The concomitant federal restrictions on savings and loan associations result from a combination of statute law and regulatory policy. Savings and loan holding companies are prohibited by statute from acquiring associations in more than one state (12 U.S.C. 1730a(c) (3)). Specific restrictions on branching are enunciated in regulations issued by the Federal Home Loan Bank Board.

banking to local markets. Still others provide "home office" protection to existing banks, and a few even protect branch offices in the same way. Finally, 11 states prohibit multiple bank holding companies by statute, and 5 others restrict them in lesser ways. As a result of these various limitations, only 12 states remain with both statewide *de novo* branching and freedom of holding company entry.

The Hunt Commission favors statewide banking. It recommends that "by state laws, the power of commercial banks to branch, both *de novo* and by merger, be extended to a statewide basis, and that all statutory restrictions on branch or home office location based on geographic or population factors or on proximity to other banks or branches thereof be eliminated." (Recommendation 6, pp. 61-62)

Needless to say, I embrace this recommendation with some enthusiasm. It is quite similar to what the Department of Justice recommended last year to the Council of State Governments — namely, that the states be urged to revise and liberalize existing restrictions on branching and holding company activity.[11]

The Commission does not discuss the underlying basis for its recommendation in great detail — but a strong case exists for it. The legislative limitations which the Commission and the Department were criticizing stem largely from a widespread fear of overbanking prevalent following the bank holiday of 1933. As I have indicated, those conditions are entirely different from those which pertain today. The case for reform is clearly stated by former Superintendent William Dentzer of New York. Talking about the situation in New York, he notes that "the most telling argument in favor of some modifications of existing law is that it offers the hope of increasing competition and the range of consumer choice for banking services in a number of communities throughout the State."[12] Moreover, "without major changes, new competition cannot readily be introduced into many markets. Such competition would provide bank managements with more challenges than they now face, the likely result being that the public would be better served." In criticizing his state's home office protection law, he notes the "anomalous situation" that, while designed primarily to protect

[11]Research Paper and Policy Statement of the United States Department of Justice Regarding State Legislation Affecting the Structure of Banking Markets (submitted under the Suggested State Legislation Program to the Council of State Governments, 1971).

[12]"Banking Structure in New York State: A Thinking Man's Guide to the Issues," Rochester, New York, October 15, 1970.

small banks in local communities, it serves also to protect some of the largest up-state banks with deposits in the billion dollar range.

I think Mr. Dentzer hits just the right tone. The concern of public policy should be to stimulate banking performance in the local markets, to provide the spur of competition. I fear that too often deliberations on law and structure have focused more on the interests of small banks than on the needs of small bank customers. Moreover, Mr. Dentzer's department has sponsored some interesting studies on the effect of large bank entry into markets they were formerly barred from. "These studies indicated that the profitability of small independent banks is not adversely affected either when large institutions entered the small bank's community by merging with one of the other small banks there or when new branches or larger institutions open near the home office community of these small banks. In both situations, to be sure, the rate of deposit growth of the small banks slowed down, although rarely was there any absolute decline in deposits."[13]

Leaving Branching Policy to the States

One feature of the Hunt Commission proposal that has attracted criticism is that the Commission would continue to leave branching policy, and holding company entry, in the hands of the states. Some would-be practitioners of practical politics say that there is very little opportunity for getting the necessary changes enacted at the state level, and that therefore the Commission should have opted for some form of federal pre-emption in this area. From a legal standpoint, this could be done – since Congress, by repealing the McFadden Act limitations on national banks, could easily have forced the states to follow suit. From a practical standpoint, however, I think such a course would be unwise. In some states, and I suspect Illinois is an example, there seems to be a strong and rather broadly held belief that big banks represent an evil that should be curbed. The spirit of William Jennings Bryan lives on. These are feelings that transcend notions of efficiency, and transcend the normal desire of banks to be protected from increased competition. The people in such a state should, in my view, be allowed to make the choice whether to have unit banking or not, even if the decision itself may seem to have a

[13] *Ibid.* He is referring to studies entitled: Ernest Kohn, *The Future of Small Banks,* The New York State Banking Department, December 1966, 12-19; Kohn and Carlo, *The Competitive Impact of New Branches,* The New York State Banking Department, December 1969, 8-9.

"horse and buggy" quality in the age of high speed computers and communications. Retail banking is most affected by these historic limitations, and at the same time retail banking is a largely local business; if local citizens want to make a local choice to stay with the past, and to possibly pay more for it, this is the choice they should be allowed to make. To summarize, I strongly endorse the Hunt Commission's proposals for liberalized bank entry into new geographic markets within a state, and I endorse the thought that it would be better done at the state level. In any event, repeal of the McFadden Act seems even less likely than reform at state level in many states — a point which is underscored by recent liberalizations of state law in New York and New Jersey.

Interstate Banking

The Hunt Commission never really faced up to the interstate banking issue. The report simply says in passing that: "Although the Commission rejected proposals to permit interstate branching or metropolitan area banking by federal legislation, it urges states to be progressive in changing their laws." (p. 62) I think this is a significant subject worthy of a great deal more consideration. On the broad question of interstate banking, I really have not seen enough evidence one way or another to convince me whether the existing prohibitions are wise or not. In the end, economics will probably not provide us with any final answers. Certainly the proven economies of scale in banking[14] are not such as to lead one to believe that wide open or even limited interstate banking is likely to substantially change cost performance in the industry. In the end, the case against wide open interstate banking may well turn out to be more political than economic — resting on the desire to avoid concentrations of political power and generally the type of banking structure found in England or Canada, where a handful of institutions dominate commercial banking in the country.[15] (I say this is a political issue

[14] *Cf.* F.W. Bell and N.B. Murphy, *Costs in Commercial Banking: A Quantitative Analysis of Bank Behavior and its Relation to Bank Regulation* (Boston: Federal Reserve Bank of Boston, 1968).

[15] That large banks already have substantial political power is an obvious reality — rather strikingly illustrated by the success of Manufacturers Hanover in obtaining special legislation (P.L. 89-356) to exempt it from the adverse antitrust decision in *United States* v. *Manufacturers Hanover Trust Co.*, 240 F. Supp. 867 (S.D.N.Y. 1965).

more than an economic one because I think that, even with interstate banking, the antitrust laws would be more than adequate to prevent the type of narrow concentration found in some of these foreign countries.)

Metropolitan Area Banking

I also believe that the idea of "metropolitan area banking" deserves more careful attention than the Commission apparently gave it. Geographic barriers can be highly arbitrary, especially when erected by circumstances centuries ago. Take, for example, the Washington Metropolitan Area, which includes the District of Columbia and parts of Maryland and Virginia. Banks and holding companies are basically confined to one of the three sectors. The boundaries that divide them date back to some 17th Century grants by English kings, to the creation of the original District of Columbia at the end of the 18th Century, and to the return of half the District of Columbia to Virginia in the mid-19th Century. Yet it is a common area, from the standpoint of business, media, traffic flow and so forth. In such circumstances, one can ask whether banking organizations should not be permitted – perhaps by the holding company route – to operate and compete throughout the whole metropolitan area. The question deserves serious study. I suspect that such a metropolitan approach would make for better banking competition in downtown Washington, as well as in the Virginia and Maryland suburbs. Somewhat similar situations exist in New York and Philadelphia, as well as in a few other metropolitan areas, mostly in the East and Middle West. I wish the Hunt Commission had given more study to this problem.

Standards for Authorizing New Branches and Charters

The Hunt Commission really did not detail the exact substantive standards which regulators should apply in authorizing new branches and charters. This is too bad, as the area deserves a great deal more careful thought. The F.D.I.C. has recently indicated that competitive policy is an important consideration in branching cases[16] – a position I agree with – but the statutes are less than specific on the point. Even amended Section 4(c) (8) of the Bank Holding Company Act, providing standards for the Federal Reserve Board to authorize

[16]F.D.I.C. Order Denying Application of Citizens and Southern Emory Bank to Establish a Branch, dated October 15, 1971.

banking entry into financially-related activities, is much more specific in telling the regulator what to consider. Specifically, the statute requires the Federal Reserve Board to consider whether performance of a particular activity by bank holding companies". . . can reasonably be expected to produce benefits to the public, such as greater convenience, increased competition, or gains in efficiency, that outweigh possible adverse effects, such as undue concentration of resources, decreased or unfair competition, conflicts of interest, or unsound banking practices."[17] You will note that the stress here is on benefits to the public, not on protecting competitors. This is important, and it is the kind of thinking that the Hunt Commission should have given its consideration to.

My own view is that the legal standards governing the granting of bank branches and bank charters should be more specific than most of these presently are; and, as with the amended Bank Holding Company Act, the focus should be on benefits to the public in the form of new services and so forth. I would favor more liberalized entry – at least in circumstances where no bank failures were threatening. Outside of the potential failure situation, I would do far more to leave it to the management as to whether the community is "overbanked" or not.

I would also consider writing into bank entry statutes a provision requiring the regulator to give preference to banks not already in a market in handing out branches and charters. This is contrary to the law or policy in some states (where the preference runs the other way),[18] but it seems to me to make considerable sense. Local banking markets are in most cases quite oligopolistic. Such oligopoly positions can to some extent be eroded if the leading firms in the local market are encouraged by law to go elsewhere for expansion and other banks are encouraged to expand within the market. The community with four banking offices, which is capable of supporting a fifth, is likely to be more competitive if the fifth office is awarded to a strong competitor not already in the market.

Pre-Emptive Branching

This last point is related to the problem of preemptive branching. An existing bank branch or charter really has two elements: first, it is a franchise doing business in the particular local market, and,

[17]P.L. 91-607, amending 12 U.S.C. 1843(c).

[18]See Purdon's *Penn. Statutes Annotated,* Title 7, Section 905 (b).

secondly, it is a means of excluding others from the market. Thus, a leading organization already in a banking market can on occasion foreclose new entry by applying first for all the new banking opportunities – even if this involves running uneconomic offices for a period. This difficult problem has been raised by the Federal Reserve Board in several cases involving the creation of new *de novo* subsidiaries by leading holding companies already in a local market. Thus, in 1968 the Board stated:

> "Inasmuch as entry into a commercial banking market is restricted, opportunities for deconcentration are limited.... If every newly developing need for banking facilities which arises in a concentrated market were to be filled by the market's dominant organization, any meaningful deconcentration of the market's banking resources would be made impossible, and further concentration might be encouraged."[19]

Similarly, in 1970, three dissenting Governors stressed that the establishment of a new bank by a dominant organization:

> "will perpetuate that dominance and foreclose an opportunity for the establishment of competitive facilities at Bank's location.... [A]nd much more significant benefits to the community would result from provision of such services by alternative sources.... Applicant controls 32 per cent of the deposits in Dane County....[S]uch an organization, because of its ability to shift deposits from one office to another, may be capable of grasping an opportunity to establish a new office at a developing location long before it is economically feasible for others to take advantage of such an opportunity."[20]

The problem of pre-emption is even worse where the bank involved has secured some sort of exclusive right – typically in a shopping center or industrial park.[21]

[19] First Wisconsin Bankshares, 54 FED. RES. BULL., 645 at 647 (1968).

[20] First Wisconsin Bankshares, 56 FED. RES. BULL., 586, at 589 (1970), opinion of Governors Robertson, Brimmer, and Maisel.

[21] See complaint in *United States* v. *Wachovia Bank and Trust Co.*, Civ. C-135-WS-71, filed June 22, 1971 (involving an exclusive right to a night depository in a shopping center mall); and First National Bancorporation, Inc., 57 FED. RES. BULL. 47 (1971) (involving an apparently exclusive right in an industrial park).

The Hunt Commission does not really deal with this pre-emptive branching problem. Nor is there any clean straightforward solution. Regulators simply should be required to apply sound antitrust principles in passing on branch and charter applications – and antitrust law would prevent the truly dominant firm from acquiring new business opportunities before they become viable in order to foreclose them from others.[22] In addition, direct antitrust enforcement is a possibility, at least where the pre-empting enterprises enjoy some contractual type of exclusive right which restrains competition.

To summarize, the Hunt Commission's recommendations relating to bank entry are generally sound. I certainly endorse the Commission's proposals for eliminating geographic barriers and home office protection within the state. I also concur in the Commission's observation that dual control over entry is less likely to lead to protectionism of existing enterprises (see p. 60). At the same time, considerably more thought is needed on the whole issue of substantive standards which regulators should be required to apply in authorizing entry. The existing statutes are often too vague, and frequently fail to make clear that the overriding concern in this field is the needs and convenience *of the public* for banking services, rather than the convenience of the banks themselves. Competition is an important consideration, and this should be spelled out.

The Concentration Question – And Merger Policy Generally

The Hunt Commission did not seem to put great weight on "concentration" in its deliberations. This is perhaps just as well, since the concept of "concentration" is often subject to a great deal of loose usage – especially among us non-economists – in discussing bank structure questions. The concept is used at at least three levels – local market concentration, statewide concentration, and national concentration. At the price of parading my ignorance, let me give you my views on each of these concepts.

"Local" concentration in banking seems to me to be the most important. It is the economist's classic sort of market concentration: it is a means of measuring market position of competitors in the local service market in which they all operate. In banking, local concentration is generally quite high.

"Statewide" concentration will in most instances represent an aggregation of local competitive retail market positions. The results

[22]See *United States* v. *Aluminum Company of America,* 148 F.2d 416 (2nd Cir., 1945).

of such statewide aggregation vary greatly: in a few states, such as Oregon and Rhode Island, we can see that two banks dominate the state entirely, while in some other states a reasonable degree of diversity and choice exists even among the larger banking organizations.[23] In addition, statewide concentration may be an appropriate *market* measure of certain wholesale-type services offered on a statewide basis (such as correspondent banking or perhaps factoring).

"National concentration" is almost pure aggregation of local market positions. Of course, on a national scale, banking is a quite "unconcentrated" industry, with over 13,000 banks. Taking total bank deposits as a universe, one finds that the largest institutions in the country – although very large indeed – do not dominate the country. Thus, by my calculations based on December 1971 figures on domestic deposits, the nation's top five banks (with deposits of $67 billion) account for about 12 percent of national deposits; the top 10 (with deposits of $99 billion) account for 18 percent; and the top 25 (with deposits of $146 billion) account for 27 percent; and the top 100 (with deposits of $228 billion) account for 42 percent. Thus, the top 183 banks account for exactly half of all domestic deposits. In addition, there are a few national wholesale markets for large commercial borrowers and customers in which national concentration figures would be appropriate.[24]

The concentration question is important at at least two levels. One concerns the broad policy questions of structure – including statewide banking and indeed even interstate banking. The other concerns merger policy, and particularly antitrust enforcement in the merger area.

I have already generally discussed the legislative issue. I would note, however, that most of the use of concentration in this area is concerned with statewide or even national concentration. When the opponents of branch banking or holding companies scream out about "concentration", they are not talking about local markets – but rather are expressing concern about domination of a state or indeed the nation by the large money center banks.

On the other hand, merger policy in general, and antitrust merger policy in particular, have been primarily concerned with competition and concentration at the local level. Banking is always a local

[23]See "Recent Changes in the Structure of Commercial Banking," 56 FED. RES. BULL. 195-210 (1970).

[24]See *United States* v. *Manufacturers Hanover Trust Company*, 240 F. Supp. 867, 901-922, (S.D.N.Y. 1965).

business, and for larger banks it may often be a regional or national business. The antitrust laws and enforcement have stressed local markets because convenience is a vital factor for retail customers and local business; and effective choices are the most limited at the local level. Economic performance in local markets has often been quite poor, with the "quiet life" the order of the day. Thus, the District Judge in the *Phillipsburg* case summarized the situation in a passage noted by the Supreme Court:

> . . .most of the small banks in the area have not been interested in building up banking services except to the extent that aggressive competitiors led the way. An ultraconservative policy of banking seems to have been prevailing with reluctant change occurring only when profits and future growth were threatened by virulent competitors. There is an attitude of complacency on the part of many banks. They are content to continue outmoded banking practices service and extend services over a greater area to a larger segment of the population. 306 F. Supp 645, 661 (D.N.J. 1969).

Antitrust Enforcement

The Justice Department's often-controversial enforcement efforts are directed to this challenge. We have been actively concerned about anticompetitive local bank mergers, and have brought 26 cases against such transactions since 1966. (We have also been concerned over the years with anticompetitive arrangements between local bank competitors: these include price-fixing, cross-ownership arrangements, director interlocks, and "understandings" among the local bankers against poaching on each others' customers.) Our enforcement with respect to such local mergers has two elements: first, to prevent elimination of viable competitive alternatives, and secondly, to preserve the opportunities for new entry. The two policies are necessarily related in a state such as New Jersey where a "home office protection" statute prevents *de novo* entry, and hence new entry by a "virulent competitor" can only come by acquisition.[25]

Ever since the *Philadelphia National Bank* decision in 1963,[26] antitrust enforcement in banking has stressed concentration in local

[25]In states where holding companies are permitted, it may be possible to enter "closed" markets through *de novo* bank charters.

[26]374 U.S. 321 (1963).

markets. Section 7 of the Clayton Act represents a strong Congressional mandate that increases in market concentration which are created by merger are generally not to be tolerated. The Department of Justice and the Supreme Court have vigorously applied this policy of preventing local concentration. This policy applies in smaller markets which are usually more concentrated than large metropolitan ones. The Supreme Court was very clear on the point in its 1970 *Phillipsburg* decision: "Mergers of directly competing small commercial banks in small communities, are subject to scrutiny under these [antitrust] standards. Indeed, competitive commercial banks, with their cluster of products and services, play a particularly significant role in a small community unable to support a large variety of financial institutions."[27] The alternative, said the Court, "would be likely to deny customers of small banks – and thus residents of many small towns – the antitrust protection to which they are no less entitled than customers of large city banks. Indeed, the need for that protection may be greater in a small town. . ." where the alternative institutions are more limited.[28]

So much for local concentration. The antitrust rules add up to a strict test. As Chairman Wille of the F.D.I.C. said in a speech last year, "It is unlikely that many mergers of viable banks already competing in the same market can be justified" under the *Phillipsburg* standard.[29]

The Hunt Commission did not really deal with this problem of local concentration in any detail. Nor, as I see it, are there any real reasons for them to have done so, for so far as mergers are concerned, the situation is under reasonable control. What is required – and what we may continue to expect – is continuing vigorous enforcement by the Department of Justice in this area.

Concentration – or more accurately dominance – at the statewide level is something that has been a matter of growing concern to the Department of Justice. Here, however, we are not talking about concentration in a real market sense so much as the elimination of potential competition into local banking markets within a state. The state boundaries are of course significant to competitive analysis in banking, because they delineate the widest area from which potential

[27] *United States* v. *Phillipsburg National Bank*, 399 U.S. at 358 (1970).

[28] 399 U.S. at 361-2 (1970).

[29] "The Bank Merger Act Revisited," *supra* n. 6.

competitors can be drawn. I am therefore concerned when I see a trend in a state in which the leading banking organizations move on to a position of statewide dominance by acquiring the leaders in local banking markets throughout the state. In most of the states where the Department has brought suit, there were only a handful of banks or holding companies which could enter a market *de novo* or by a small "toe hold" acquisition, and from the outset be a competitive force to be reckoned with in that market. Any time one of these few significant potential entrants enters a concentrated local market through acquisition with the local market leader, then that loss of potential competition is likely to occur. Therefore, the Government argues that a Section 7 violation can be found in a bank merger case if the Government proves that (1) the acquiring defendant is one of but a fairly small number of capable potential entrants legally eligible to enter a market; (2) the acquired bank is a leader in a concentrated local market; and (3) the acquiring defendant has an alternative means of entry (e.g., either the market is growing fast enough to support additional banking facilities *de novo* now or in the future or a small competitor is present in the market as an entry vehicle).

I think that this approach is particularly appropriate in commercial banking. There are several considerations here. First, the availability of potential entrants is limited by law: no bank or holding company can enter a state from the outside. This necessarily limits the number of significant potential entrants and makes potential competition even more important. Secondly, all potential entrants are not equal in banking: the large, strong bank has a higher legal lending limit than the smaller bank, and therefore can compete for a broader range of customers; it may offer a wider range of services and may have other advantages as well. This gives it a better chance than a smaller potential entrant to challenge, as a *de novo* or foothold entrant, the leaders in the local banking market. Thirdly, the barriers to entry and full competition imposed by law and regulation make it more important – not less important – to preserve the opportunities for future competition. If a few large, strong banks come to entirely dominate banking throughout a state – as in Oregon – no relief from the outside is available except in the very, very long term, and perhaps not even then. One does not suddenly establish a new billion dollar bank as if it were a hot-strip mill or a Caribbean resort complex. In these circumstances, the strongest banks in a state (if relatively few in number) should be preserved as challengers to local market leaders – rather than being permitted to accumulate a position of overall dominance through piecemeal acquisition of local leaders.

This approach to the statewide "concentration" problem is very much at issue in the *First National Bancorporation* case, which the Supreme Court will decide next Term.[30] That involves the acquisition by the largest bank in Denver of a leading bank in one of the larger local markets of the state. At the time the case was filed, the same defendant had a number of other pending proposals in most of the other leading Colorado markets. The importance of this case is underscored by the fact that both the Federal Deposit Insurance Corporation and the New York Superintendent of Banks have filed *amicus* briefs supporting the use of the potential competition standard in commercial banking.

In at least one recent antitrust case, statewide markets have been directly alleged particularly for certain wholesale services. The complaint in the pending *Wells Fargo* case includes allegations of increasing statewide concentration in banking, correspondent banking and loans to medium-size businesses.[31] Generally, however, as I have indicated, statewide markets in a strictly economic sense have not been a great factor in antitrust cases.

National market figures have not really played any significant role in antitrust enforcement. Defendants in antitrust cases – including the *Philadelphia* and *Houston* cases – have frequently asserted that they needed to engage in horizontal local mergers in order to effectively compete on a "national" or "international" basis. The courts and the Department have generally rejected this plea on two grounds. The "national" wholesale market is generally better served and has more competitors than local retail markets, and therefore this does not provide a basis for upholding anticompetitive local mergers. Moreover, in the *Philadelphia* case, the Supreme Court stressed that alleged procompetitive effects in one market were not a justification for allowing anticompetitive effects in another.[32] Quite apart from

[30] *United States* v. *First National Bancorporation,* No. 71-703, decided by the District Court in favor of the defendants, 329 F. Supp. 1003 (D. Colo. 1971).

[31] *United States* v. *Wells Fargo Bank, et. al.,* (D.C.N.D. Cal. CA No. C-72-98 RHS filed Jan. 17, 1972). It should be noted that this case involves two banks which compete directly in many parts of the state. In the *First National Bancorporation* case, *supra,* there is an allegation of vertical foreclosure in correspondent banking in a market which included all of Colorado. In the *Marine Bancorporation* case in Washington State, there is an allegation of elimination of actual and potential competition in correspondent banking in an eastern Washington market. *United States* v. *Marine Bancorporation et al.,* (D.C.W.D. Wash. CA No. 237-71 C2, filed October 22, 1971.

[32] *United States* v. *Philadelphia National Bank,* 374 U.S. 321, 371 (1963).

the question of law, this seems sound as a matter of policy so long as an adequate level of competition exists in the first market, for surely it is the need of the banking public for service and not the desire of particular banks to participate in the market which should be the controlling issue of policy.

There has also been a certain tendency among defendants and commentators to mix up concentration at national and local levels in order to justify mergers. This is a real case of apples and oranges. The argument runs that we have "too many" banks in this country, and therefore we ought to be hospitable to some consolidation by merger. This argument is fine so far as it goes, but it ignores the fact that, even if we have "too many" banks on a national basis, we have too few banks in most local markets. What I am suggesting is this: there is no reason not to have some rationalization of banking structure so long as one does not eliminate significant local alternatives – in other words, so long as the mergers involve parties in different markets, while avoiding any threat of statewide (or national) dominance.

To summarize, I think that concentration in banking is a matter of serious concern at the local level because it is here that market choices are limited. On the statewide level, there should be concern, because statewide "concentration" can lead to important reductions in potential competition. On the other hand, "concentration" on a national basis is really not at this time a pressing policy problem.

Conclusion: Antitrust and Reform

The Hunt Commission would increase competition among banks and other depositary institutions in a number of ways. This is highly desirable, as a means of improving efficiency.

The Commission's proposals, if adopted, would be significant for antitrust enforcement. As you know, antitrust enforcement has clearly been active in banking. The Department has brought over 50 bank merger and holding company cases since 1966. There are several reasons for vigorous enforcement in this area. First, the depositary and credit functions are vital to our economy. Second, the Department and the courts recognize the basic truth stated by the Supreme Court a decade ago: "The fact that banking is a highly regulated industry critical to the Nation's welfare makes the play of competition not less important but more so."[33] Third, local banking

[33] *Philadelphia National Bank*, 374 U.S. at 372.

markets are often already protected by existing legal barriers from full competition – competition from commercial banks in other geographic areas and from other types of institutions.

Enactment of the Hunt Commission proposals would open up some of these classic preserves and thereby reduce, to some degree, the need for such extensive enforcement in this field. For example, if the nation should adopt the Commission's proposals to eliminate the existing barriers between commercial banks and thrift institutions, the antitrust analysis of bank mergers would have to change to accommodate this reality – specifically by including at least the growing demand deposits of thrift institutions in any market analysis.

Similarly, the elimination of home office protection and other geographic barriers to entry into local markets might lead to somewhat greater flexibility in approaching certain horizontal mergers in those areas. Under present law, a horizontal merger between direct competitors may permanently reduce the number of effective (or potentially effective) banking alternatives available in a community. *Phillipsburg* offers a good illustration. New Jersey law has a home office protection feature, which means that no other bank could branch into Phillipsburg *de novo*. Thus, after the merger between its two largest banks, there would be two banks in Phillipsburg and the only hope for new entry appeared to be a new charter. The opportunities for the market-place correcting anticompetitive power are particularly limited under any "home office" protection type of statute, and, therefore, a merger between two local banks is a much more serious proposition than a merger between two local supermarkets[34] – for the merged supermarket would still always have the threat of unregulated new entry if it abused its market position.

I mention this all by way of an added incentive – if any is necessary – for all of us to look with care at these proposals for reducing some of the historic barriers to competition in banking.

[34] But cf. *United States* v. *Von's Grocery*, 384 U.S. 270 (1966).

DISCUSSION

ROSS M. ROBERTSON*

I speak this morning as an alumnus of both the Federal Reserve System and the Office of the Comptroller of the Currency. As I sat here and heard the Comptroller's Office subtly maligned, you can imagine how I reacted to this particular commentary. I must say that I had a feeling as I read Donald Baker's paper that I was being dealt with by Peter Falk's TV character Detective Columbo – that is, there is a certain self-effacement about his knowledge of economics and history and business that is, to say the least, deluding. But don't kid yourselves. Don Baker is knowledgeable, like his colleagues in the Antitrust Division of the Justice Department generally. He is four-square for maintaining competition in the economy, whatever that may be, and the paper, as I read it, is superficially very persuasive indeed. In other words, it is written by a man who is knowledgeable, not just about the law but about economics, and he knows his history. Straight off I will just say that my objection to his paper is that, like those who take a vigorous antitrust position generally, he picks and chooses. He seems to applaud the Hunt Commission Report insofar as it is on the side of competitive processes; yet he refuses to face up to the logical outcome of competition, which is, in finance in any case, large units and often very large units indeed, perhaps ultimately a dozen great banking systems in this country.

Banking Concentration

As I see it, Mr. Baker takes this latter view of the regulatory problem, particulary with respect to concentration and especially

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concentration through merger. He sees no problem in the national market, and I applaud this view. He did not cite his statistics, but they are very clear. If you take the top 50 or the top 100 or the top 200 banks in the country, you will find that since the middle-1950s the percentage of the total banking assets controlled by that specific number has been gradually decreasing – to take the example of the top 100 banks in the country, from about 55 percent of total assets in the mid-fifties down to about 43 percent in 1971.

Liberal Bank Entry

Second, Mr. Baker endorses liberalized bank entry into new geographic markets within a state, which certainly goes along with the Hunt Commission recommendations. But it is interesting that he becomes extremely ambivalent toward any kind of extension of a single bank's operation across state lines. At first he says he thinks they ought to be confined to the states – and here I want to read from the paper, for this is the kind of prose that really moves a man. He says that "in some states," – and I suspect Illinois is the example – "there seems to be a strong and rather broadly held belief that big banks represent an evil that should be curbed. The spirit of William Jennings Bryan lives on. These are feelings that transcend notions of efficiency and transcend the normal desire of banks to be protected from increased competition. The people in such a state should, in my view, be allowed to make the choice of whether to have unit banking or not. Even if the decision itself may seem to have a horse-and-buggy quality in the age of high speed computers and communications." He goes on to say "retail banking is most affected by these historic limitations. If local citizens want to make a local choice to stay with the past and to possibly pay more for it, this is the choice they should be allowed to make." For this kind of talk we have a two-syllable expletive out in the Midwest that I am not going to use here because of our mixed group, but I should like very much to use it. The reason no branching is allowed in the state of Illinois has not a damned thing to do with what people out there want. It is the consequence of political shenanigans on the part of little banks in southern Illinois that, as a consequence, have made the Continental-Illinois National Bank and Trust Company the largest bank under one roof, or adjacent roofs, in the whole country. It is patent nonsense to say that the people of Illinois want this kind of banking structure.

Branching in Trade Areas

But I wish to get on to the point that I really am concerned about, one that the Hunt Commission did not consider. Don Baker raised the question, which must occur to anyone who thinks about U.S. banking structure – should commercial banks be allowed to branch in trade areas? Now this idea, I assure you, is not a radical notion. Comptroller Pole, who was the Comptroller of the Currency under that flaming liberal, President Herbert Hoover, made this suggestion some forty-odd years ago. Comptroller Pole said that we should have branching over trade areas within a radius of 50 miles, and I think this was then and is now a good idea. Now trade-area branching is no small matter of course. Once you open this door, not just in Washington, D.C., where it has recently been set ajar, but in New York City, Chicago, and so on and on, you have the problem of branching across state lines. I personally think that it is just a matter of time until permissive legislation along these lines is forthcoming. In any case, it is one of the matters that Congress must one day consider should the Hunt Commission Report and its general recommendations be put in the form of a bill.

Freer Competition

I could carry on with this theme for hours, but I know that you as conferees want to get in the act, so I must close quickly. I think that the Hunt Commission Report is in the shape of the future in that it frees up the competitive process tremendously by bringing the nonbank intermediaries into closer competition with commercial banks. I should also like to say that, no matter what we decide in this present generation, the ultimate outcome of competition is large units. We have historical and theoretical reasons for making such a prediction, and I think we should get ourselves into the shape of the future sooner rather than later.

Let me make a few specific points. The dual banking system is a sheer historical accident. Congress clearly outlawed it in 1865. If the legislation of 1865 had come a decade earlier, there would be no such things as state banks. That is to say, the 10 percent tax placed on state bank notes in 1865, as most of you know, was intended to force state banks to convert to federal charters, and it got all but about 300 of them to do so when, lo and behold, those few held on because by that time note issue was no longer important, at least for larger banks in sophisticated money centers. I would next point out

that the proscriptions against branching in this country are the consequences of the sheerest historical mischance. There is no evidence that the framers of the 1863 and 1864 legislation meant to preclude branching of national banks. Freeman Clarke, immediate successor to Hugh McCulloch as Comptroller of the Currency, ruled that the 1864 statute requiring persons forming an association to specify *the* place where business would be carried on meant just that – singular. On the basis of this wording, which had nothing at all to do with the branching question, he ruled that national banks could not have branches, and so for a long time the question of branching remained controversial.[1] We almost had branching freed up by the federal government in 1932 as the most commonly advocated proposal for strengthening the foundering American banking system; but once again the small banks in the country bought off legislation that would have made branching completely free, not only intrastate but across state lines, by suggesting a plan of deposit insurance as an alternative way of shoring up the unit banking system.

The Theory of Oligopoly Structure

I could carry on for hours in demonstration of the historical proposition that there has never been widespread political or economic opposition to increased concentration in banking, but I want to say a word about the theory. The theory of oligopoly structure is well known to everybody in this room; there is no need for me to go into it. Our speaker, Mr. Baker, cites local banking markets – which are the markets that concern him – as being typical oligopoly markets. Well, oligopoly theory tells us that if you have a few sellers in a market, say three or four, the price and output results of adding one more are approximately the same as they would have been if you had not added the one in the first place. That is to say, we should expect oligopoly-structured markets to exhibit some elements of monopoly control so that, even without explicit collusion, prices of particular services will be somewhat higher than under conditions of perfect competition. By the same token, if public policy allows the economies of scale that large units provide, even with some monopoly elements of pricing, you are likely to have lower prices and better service to consumers than you are in an

[1] For the historical details see Ross M. Robertson, *The Comptroller and Bank Supervision* (Washington, D.C., Office of the Comptroller of the Currency, 1968), esp. pp. 81-85.

atomized industry. Here again is a major question with which all of us must be concerned.

Let me just make one more point. Historically the outcome of competition is clear. As of the end of 1971 multi-bank holding companies controlled more than a thousand commercial banks representing roughly 20 percent of banking resources in this country. Believe it or not, as of 1962 nearly 2,300 commercial banks or about 17.5 percent of the total number holding 19 percent of total deposits had a chain affiliation. (Chain banking bears examination in this decade, because the last time anybody looked was in 1962, and our data are old.) Two-thirds of the banking offices and more than 70 percent of banking assets are already under the control of branch systems. The United States is no longer a country typified by unit banking, except, as our chairman euphemistically put it, in the Heartland, where benighted legislators refuse to get into the twentieth century.

Regulation by Antitrust?

I must say a word or two in conclusion about the very last part of Don Baker's paper. This is where the punch comes. You can skip over all that smooth talk you get in the first 20 pages, and when you come up right to the end it is clear that Mr. Baker feels that the saving grace in this whole question of regulation is the Antitrust Division of the Justice Department. Now, I am going to say something that is going to start a row, but I am comforted by the reflection that the function of speakers at a conference is to start the talk going. The Justice Department really has no business interfering in the regulation of banking in this country. Here I wish that I were an attorney and could comprehend a little better the obscure wording of decisions in such cases as *Philadelphia National Bank* and *Houston*. I could then understand a little better how it is that, in its efforts to prevent mergers, the Justice Department can proceed under Section 7 of the Clayton Act and just forget all about the intent of Congress as expressed in the Bank Merger Acts of 1960 and 1966. I insist that if Congress had wanted to bring banks under Section 7 of the Clayton Act, it would have done so in the Celler-Kefauver Amendments to the Clayton Act, which carefully omitted banks from their application. It is my belief that Congress intended, particularly in the Bank Merger Act of 1966, to allow the Justice Department to intrude only in flagrant cases of merger approvals by federal banking agencies. Of course, Don can respond that all of the

Comptroller's approvals have been flagrant – but it seems to me that twenty-odd objections is a little much. So I close in concurrence with at least one point that Don made and that is that we should have deregulation, a lot of deregulation, and the first step should be to get the Antitrust Division of the Justice Department out of it.

DISCUSSION

LEONARD LAPIDUS*

It is true, as Don Baker remarks, that we haven't had terribly good luck with our monetary commissions in recent years. The Commission on Money and Credit and the Heller Committee were notably unsuccessful in effecting significant changes in our financial institutional arrangements. By contrast, the only other monetary commissions to be formed in the United States were responsible for the establishment of the Comptroller's Office and national banking system, and the Federal Reserve System. While neither of these social institutions is without its detractors, their existence alone is witness to the virility of the commissions that fathered them.

Indeed, the success of a commission in having its recommendations implemented is one measure of its value. Clearly, the other measure is whether its recommendations are "good" – in the present case, whether the Commission's recommendations provide significant public benefits. Let me discuss both points briefly.

The Role of a Commission

We misconceive the role of a commission. We seem to treat its report as the product of a group of philosophers. Oliver Wendell Holmes said that it would take no more than two hours for two philosophers to tell one another all they know. The hours of deliberation of the Hunt Commission suggest that its members were not telling one another what they knew but rather what they wanted. Commissions of this sort, in fact, are established to resolve pressing problems in a way that is acceptable to relevant interest

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groups. A commission's recommendations should represent a zone of agreement – in effect, a handshake convenant arising out of tough, self-interested bargaining.

That a commission's proposals in fact are implemented is an indication first, that the commission was probably properly constituted – that its members represented the proper cross section of significant interest groups. And second, that the members reached a realistic *modus vivendi* to such an extent that legislators were able to frame laws, or administrators to promulgate regulations, without arousing significant opposition from any of the constituencies represented on the commission.

In other words, if you want wisdom, ask a wise man. If you want a "do-able" program, at least one way is to establish a commission.

The Public Interest

What about the public interest? The public interest should also be at the bargaining table – generally in the persons of public members who are not necessarily wiser than others but simply without a clear stake in the outcome. The public is a party at interest (though oft times not an interested party), and it should get its fair share of the bargain. But, clearly, as only one of the parties, the public interest is not likely to be served as well as it might be. Thus, commission reports generally fall short of providing maximum public benefit, but we often accept their recommendations if the public interest is served "well enough." Perhaps "well enough" is the only public benefit standard that can realistically be used in appraising the reports of monetary commissions.

We might first ask, does the Hunt Commission report represent the kind of compromise agreement that Congress can count on to have the support of the relevant interest groups? I think the answer is no.

Inadequate Representation for Small Banks

As I read the report, the views of small commercial bankers – though represented at the table – are not represented in the final recommendations in proportion to their political influence. Mandatory membership in the Fed affects small banks the most. On the other hand, the primary gains of commercial banks are in the new flexibility in the composition and management of loan and investment portfolios and in the acquisition of funds from non-deposit sources. These benefit large banks, not small ones. Also, the

benefits of statewide branching, such as the Commission favors, will be gained in part at the expense of small banks. Indeed, perhaps the only comfort small banks may take is that "it could have been worse." At least the Commission did not recommend the repeal of the McFadden Act and the termination of the prohibition of interest payments on demand deposits. Donald Carlson, the Investment Bankers Association of America's outgoing president said, in truth, ". . . there is nothing in this report for us, but something for everyone else." The failure of the report to serve the small banks an acceptable share of benefits is bound to weaken the chances that the report will be implemented in anything like its present form.[1]

More generally, the report can be best understood, it seems to me, if one thinks of it as a compromise agreement between the large commercial banks and the thrift industry. The proposals that are at the heart of the compromise are happy ones. These are essentially the broader asset and liability powers for all institutions and the elimination of Regulation Q – all likely to sharpen up competitive tempers and improve the quality of service in household markets. But note again that the major negative impact of enhanced thrift powers falls on small commercial banks whose retail business represents a much more important part of their business than it does of the business of large banks.

Once past these proposals, one sees evidence of the massing of the regulated in common cause to support proposals of mutual benefit and to support one another when such support is not self-defeating. Consider, for example, the proposals on regulatory structure.

Proposals on Regulatory Structure

Multiple jurisdiction at the Federal level was confounded with still another agency; the Fed, the agency that over the years has been the most sensitive to competitive issues, was removed for the most part from regulatory responsibility. Indeed, the single responsibility left to it, the interpretation of the Holding Company Act, was seriously undercut by proposing that depositary institutions might engage in activities that the Fed permits to holding companies. (For thrift institutions, these activities might be offered only to individuals and nonbusiness entities.) This would leave in the hands of each of the primary supervisors the authority to interpret Fed regulations and

[1]See the closing remarks of Donald Jacobs and Almarin Phillips, p. 19, for a contrasting view.

thereby establish still another opportunity for the regulated to play one regulator against another. Except now the thrift institutions would also be in the game.

The "structure" proposals are of much the same character. The Federal chartering of mutual institutions is still another device for weakening regulatory control. Also the Commission importunes the states to allow statewide branching for depositary institutions but speaks in a much softer voice when encouraging chartering authorities to charter more freely in a way that would increase competition. There is more concern shown for the needs of existing bankers than for potential bankers. Indeed, the appeal to the states is no more than a piety. If the Commission were interested in strengthening competition significantly, it could have proposed the repeal of the McFadden Act which at one stroke would lay the groundwork for a competitive nationwide financial system.

The proposal to eliminate Regulation Q is pro-competitive, but why did the Commission hesitate to recommend ending the prohibition of interest on demand deposits? This, too, is a regulated deposit interest rate ceiling that happens to be set at zero. I would guess because now that thrift institutions would have checking account powers, there was no reason to give up an advantage from which all could benefit.

All this is to say that the Commission could have made more competition-stimulating proposals. But as I indicated, the fair question to ask is, did the Commission do "well enough" in furthering the public interest? And I again agree with Don Baker that the report offers us "an improved model of the status quo rather than a grand plan for the next generation" but there are worthwhile improvements for all that.

With respect to the structure proposals, I trust I have indicated that the Commission should have been bolder and perhaps doesn't deserve all the praise it has received for its good thoughts in recommending statewide branching. Nevertheless, the failure is not as damaging as it might appear. The social and economic forces are rapidly eroding the effects of restrictive structure laws. To name a few: the Supreme Court in its one man-one vote ruling has drained power from rural areas whose bankers are most opposed to liberalized structure laws. This increases the likelihood that we shall in fact see more positive action at the state level. Second, the holding company movement: we shall see interstate penetration by nonbank subsidiaries performing near-banking activities. Also, about two-thirds of the states allow holding company formation and once the

holding company expansion in a state results in effective statewide penetration, the objections to statewide branching dissolve. We see this beginning to happen in New Jersey.

Wider Banking Markets

At the same time there are forces that are making for widening banking markets. In the future, we shall be less dependent on convenient location and that undercuts the significance of restricted entry. Electronic banking – the instant debiting and crediting of accounts – is hardly widespread but we can see the shape of the future. Pre-authorized loan lines for consumers – credit cards, check credit and the like – make locational convenience less important. The growth of urban areas in many places has eliminated the value of home-office protection. The population often has grown beyond the limits of the politically defined area to which home-office protection applies. And now center-of-town locations are often not the best ones. Indeed, the growth of the suburbs in the postwar period brought city banks and suburban banks into competition because commuters might choose between their "near-work" banks and their "near-home" banks. Suburban growth, of course, was also an important stimulus toward liberalizing structure laws to allow city banks to branch out to follow their customers.

Turning specifically to Don Baker's paper I find his reaction to the report ambivalent. He likes its direction but not its distance – and yet his own deep commitment to stimulating competition seems also to be guided by practical expediency and his resolve frequently falters.

For example, he says that the Commission did not examine closely the questions of why we regulate bank structure and how should it be done. While he asks the questions, he does not provide answers that would have formed the basis for his own reaction to the report. But he suggests answers that should have made him more critical of the report as insufficiently concerned with competition. He suggests, for example, that bank structure regulation is perhaps primarily for the purpose of preventing bank failures and protecting weaker competitors. He goes on to say that neither purpose is any longer valid. If logic will out, it seems that he would take a position in favor of "free-banking" – and if that is the position from which Don views the Hunt Commission report, he could not be as kind as he is.

Don's support for the McFadden Act is particularly puzzling considering his endorsement of at least limited interstate or metro-

politan area banking. To leave this to the states suggests very slow progress even in its consideration. Also, his argument in favor of retaining the McFadden Act is not convincing. I respect his sensitivity to the populist convictions of the people of Illinois and might even accept an argument based on expediency but the argument that it is only local banking competition that will suffer subverts the philosophy of the *Phillipsburg* case. I shall hoist him on his own quotation from the 1970 *Phillipsburg* decision:

> "Indeed, competitive commercial banks, with their cluster of products and services, play a particularly significant role in a small community unable to support a large variety of financial institutions." The alternative, said the Court, "would be likely to deny customers of small banks – and thus residents of many small towns – the antitrust protection to which they are no less entitled than customers of large city banks. Indeed, the need for that protection may be greater in a small town. . ." where the alternative institutions are more limited.*

His suggestion that entry statutes should contain positive language that would give chartering and branching preference to new competitors is a good one. It is a recognition that the statutes should begin to accept a regulatory philosophy that stimulates competition subject to a bank safety constraint and not the other way around.

Let me also suggest that the considerations that guide our decisions on the merger of potential competitors stand in need of greater competitive thrust. Don outlines the three conditions required to find a Section 7 violation in a bank merger case:

> "(1) the acquiring defendant is one of but a fairly small number of capable potential entrants legally eligible to enter a market; (2) the acquired bank is a leader in a concentrated local market; and (3) the acquiring defendant has an alternative means of entry (e.g., either the market is growing fast enough to support additional banking facilities *de novo* now or in the future or a small competitor is present in the market as an entry vehicle)."†

I would add as a consideration, whether there are a reasonable number of banks that are probable purchasers and preferable as merger partners. Someone will say that I am suggesting that the bank

*pp. 27-8. Baker's citations for the quoted opinion are 399 U.S. at 358 (1970) and 399 U.S. at 361-2 (1970), respectively.

†p. 30.

supervisor or the Department of Justice should "play God." But if size and share of the market are indexes of the strength of a bank as a potential competitor, shouldn't we attempt to increase the competitive strength of less dominant banks by "saving" attractive acquisitions for them? A policy of this sort would, for example, increase the number of strong potential competitors in a state and enhance competition in all markets in the state. In other words, competitive issues in a particular case relate not only to the single market involved but all other markets where acquiring banks are eligible to enter.

Don takes a much more aggressively pro-competitive view on preemptive branching. Preemptive branching by a dominant competitor, he argues, should be carefully policed. In effect he would "save" attractive locations for smaller – and therefore preferable – banks. The argument for "saving" attractive acquisitions for smaller – and therefore preferable – banks is, in my view, even stronger.

Concentration Ratios

Just a final short word on "concentration ratios." The kinds of concentration ratios one can easily calculate from published figures should be used very carefully. They can't be given fixed meanings. The larger the geographical area covered, the less certain they have any meaning. Concentration ratios for carefully defined markets are useful. Local areas come closest to being true banking markets and concentration ratios may be useful. However, state and national figures are treacherous. Don indicates that statewide figures have three uses. They can suggest whether a reasonable degree of choice exists within a state's borders; they are an appropriate market measure of certain "wholesale type" services offered on a statewide basis; and finally the share of state market may be a measure of the strength of a potential competitor. None of these propositons holds up very well. First, where customers search for, or find, banking alternatives is not usually related to state lines. Also, markets are not apt to follow state lines even for services offered on a statewide basis; out-of-state banks may offer services over state lines. Finally, share-of-market figures are so affected by the structure laws in a state that their use as indexes of potential competitive strength is not recommended.

The treachery of state figures is evidenced by the case of New Jersey prior to the 1969 change in that state's structure laws. The

state ranked among the half-dozen least concentrated states in the nation, largely because branching and merging were limited to county lines. County concentration ratios were very high. The low statewide ratios for the leading banks did not mean that New Jerseyans had wide choices. Also, because of the happenstance of the county of location, a bank's share of state deposits might be a poor indication of how aggressive a competitor it might have been if merging and branching opportunities had been available.

Expanded Powers for Depositary Financial Institutions

FRANK WILLE*

One service the Hunt Commission has performed for us all has been to remind us how interrelated many aspects of the nation's financial system are. I do not mean by that to suggest that each of its numerous recommendations must be adopted if any one of them is, because this is manifestly not the case. I am suggesting that once the Commission made the basic policy decision that it would seek to promote competition in the same market on substantially equal terms for all depositary institutions, the thrust of its basic recommendations, particularly those dealing with interest rate ceilings on deposits, operating powers, reserve requirements and taxation, could have been predicted. What must now be decided is whether the financial system proposed by the Commission – compromises and all – will serve the country significantly better than the system we now have – a system one bankers has tagged as "balanced inequality." If we have doubts on that score, can the framework for reform suggested by the Commission be improved?

The Commission was formed, as we know, after two relatively lengthy periods of tight money in which deposit institutions had lost a significant volume of funds because the ceiling rates allowed to be paid on deposits were well below market rates on long-term investments. This deposit outflow adversely affected the funds available for residential housing and smaller businesses throughout the country. It was not surprising, therefore, that the Commission was given a broad general mandate to recommend improvements in the nation's financial system with more specific mandates in three areas: (i) mortgage financing, (ii) the role of interest rate ceilings, and (iii) the need for flexibility on the part of deposit institutions to permit a sensitive response to changing demands. While the Commission's report includes a number of relatively minor reforms in mortgage lending practices that should be implemented regardless of what

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happens to the rest of its recommendations,[1] the fundamental changes it proposes are the eventual removal of deposit rate ceilings, a wider authority for all institutions to bid for lendable funds, and much broader asset powers for the so-called specialized deposit institutions, namely mutual savings banks and savings and loan associations.

Removal of Regulation Q Ceilings

The most basic of these recommendations is the eventual removal of Regulation Q-type ceilings for all deposit institutions. If implemented, the change would remove the discrimination that presently exists between depositors with more than $100,000 and those with less than $100,000. It would also abolish the distinctions that presently exist between the rates which thrift institutions can pay and those which commercial banks can pay — a distinction that inhibits the growth of commercial banks without ready access to nondeposit sources of funds. More to the point, this change would give all deposit institutions an opportunity to compete effectively with market instruments in future periods of monetary restraint thereby blunting the forces of disintermediation, attendant liquidity strains, and sudden reductions in the availability of lendable funds. These benefits could not be realized, however, unless deposit institutions were in a position to respond promptly to increases in market rates particularly on instruments attractive to depositors. Their ability to do so will obviously depend on yields in their asset mix, their cash flows, the speed with which they can change to higher yield investments if this should be necessary, and the level of retained earnings available for temporary use if current earnings cannot meet a significant increase in the interest expense on deposits.

In order to bid competitively for deposits in a world without ceilings, deposit institutions would all have compelling incentives to maximize earnings. A high level of earnings on a current basis relative to other competitors would allow an institution to move upwards in rate as quickly as possible when the market required, and if market

[1] E.g., authorization for variable rate mortgages, the removal of administered ceilings on FHA and VA mortgages, the repeal of state usury ceilings and other unreasonable restrictions on residential mortgages, simplification of the legal work in mortgage originations and foreclosures, permitting loans to be made on properties anywhere in the United States, further encouragement for secondary market operations for mortgages and the abolition of "doing business" barriers which some states place on out-of-state institutions lending money on or holding real property within their borders.

rates allowed some stability in interest expense, maximum earnings would permit an institution to add to its retained earnings for possible use at some future date when income on a current basis might be insufficient to meet a rapid upswing in interest expense. The necessity to maximize earnings so as to be ready for upward movements in market rates – whether precipitated by monetary conditions or the actions of a competitor – makes me question the distinctions that would remain, even under the Commission's recommendations, in the asset powers of different types of institutions.

Asset Powers

I would have thought the logic of the Commission's recommendation on deposit rate ceilings would have led to a recommendation that all institutions have exactly the same asset powers. Such a recommendation would also have been more consistent than the Commission's actual recommendations with its guiding principle of equality for all competitors in the same market. As it is, some important differences remain – dictated presumably by considerations of historical emphasis or political acceptability. Thus, commercial banks would continue to be the exclusive suppliers of short-term credit to American businesses and only they could offer checking account services to business firms. As a result, the average commercial bank might continue to have a loan portfolio of relatively shorter term than the average thrift institution, with consequent advantages when interest rates are rising and corresponding disadvantages when interest rates are falling. Mutual savings banks and savings and loan associations, on the other hand, would have under the Commission's proposals an authority denied to commercial banks to invest for their own account in equity securities listed on a national exchange, as well as fewer restrictions than commercial banks on the use of the proposed "leeway investment" authority. Unlike commercial banks, however, thrift institutions would be subject to a limit of 10 percent of assets in consumer loans. It seems hardly likely, under these circumstances, that all deposit institutions would have the same ability to respond in the face of rapid increases in the rate demands of their depositors. Those that could not meet the highest rates offered by competitors in the same market might well experience precisely the disintermediation, liquidity strains and loss of lendable funds that the removal of deposit rate ceilings was intended to avoid.

Ways of Acquiring Lendable Funds

Besides freeing up rate competition for deposits, the Commission has proposed greater latitude for all deposit institutions as to the ways in which they can acquire lendable funds. Deposit thrift institutions would be allowed to offer a wider variety of deposit accounts varying with respect to maturity and withdrawal power as well as rate — a power commercial banks already have subject to rate ceilings. Presumably, the highest rates of interest would be reserved for deposit accounts of the longest maturity and the most restrictive withdrawal provisions. Thus, an institution whose earnings or surplus position might not be conducive to paying a competitive rate on all its accounts uniformly would then have the option of paying such a rate to depositors willing to take some risks as to market levels during the term of the account and upon maturity. This effort to segment the deposit base and lengthen average maturities has been helpful, in states where it is now allowed, in matching increases in interest expense with increases in current earnings and has served to hold existing deposits that might otherwise have been attracted to other investments. The experience to date, of course, is not a clear indication of things to come, because deposit rate ceilings were applicable. But even if a larger percentage of total deposits moves more quickly into such accounts in the future, the rise in interest expense should be more gradual than it would be if all accounts had to receive the market rate, and liquidity strains should be diminished by longer average maturities. This process should smooth considerably the flow of funds into all deposit institutions.[2]

[2]Commercial banks would have some additional capabilities for acquiring lendable funds during the initial five-year period when differentials in deposit rate ceilings could still exist between different types of institutions depending on whether or not third party payments were being made. Thus, they could incur non-deposit liabilities through temporary or contingent sales of assets and not have them classified as deposits subject to the rate ceilings. Similarly they could create bankers' acceptances without being subject to a statutory limit based on capital (although possibly still subject to administrative limits). Both proposals reflect the view, as does the basic proposal to abolish deposit rate ceilings, that policies of monetary restraint can be more effectively implemented by means other than deposit rate ceilings broadly applied — a view most economists seem to share. Commercial banks and thrift institutions would also be free to issue short-term subordinated debt instruments as well as the seven-year instruments currently authorized, so long as they were bona fide additions to capital. As a practical matter, only the largest institutions might be able to market these noninsured capital instruments if regular deposit accounts were also competitively available at market rates. The Commission is unclear as to whether such short-term instruments could be offered before, or only after, deposit rate ceilings are removed. If before, their offering to depositors could easily subvert the ceilings still in force.

Asset Diversification Proposals

Most of the Commission's asset diversification proposals can be supported on grounds either of increased competition or of increased public convenience, whatever problems they may otherwise present. Consumer credit markets, for example, are demonstratively imperfect resulting in higher than necessary rates for many borrowers. Permitting mutual savings banks and savings and loan associations to make consumer loans would markedly increase the number of credit sources available to borrowers, and the increased competition sure to result would encourage the lowest possible interest costs consistent with efficient operation. Permitting such institutions to make construction loans in the same manner as commercial banks or to make loans on mobile homes should have the same result as well as benefiting the housing markets they presently serve. A limited "leeway investment" power could benefit some borrowers by permitting loans to perfectly creditworthy applicants whose collateral is unusual or not technically in compliance with the requirements of statutory or administrative policy. The management and sale of mutual funds, including commingled agency accounts, would broaden the financial services offered to bank customers and permit investment talent within offering banks to be more completely utilized – although even the largest banks may shy away from the risks of customer dissatisfaction in the event of unfavorable performance. Checking account services at thrift institutions would consititute another form of deposit competition and might serve as a convenience for some thrift institution customers who do not utilize commercial banks. To the extent these services attract or retain deposit customers, the stability of deposit structures should be smoother than might otherwise be the case.

Some Reservations

I would be remiss, however, if I failed to indicate my reservations with regard to some of the Commission's asset recommendations that would introduce a far greater degree of risk into the financial structure than we have today. Those that could have serious repercussions on safety and soundness, at least in the form proposed by the Commission, include the following:

1. *The power to make direct investments in real estate.* The Commission states this recommendation in terms of a limitation equal, in most cases, to 30 percent of an institu-

tion's net worth, but a close examination of other recommendations would indicate that the limitation is illusory. For example, additional investments up to another 30 percent of net worth would appear to be authorized under the "leeway" investment provisions. And it would appear that no limitations would be imposed upon the investments a thrift institution or a commercial bank could make in a subsidiary which engaged in real estate development or ownership. Because real estate can fluctuate significantly in value and is one of the most difficult assets to sell if liquidity is needed, the potential for loss has historically been considered greater than for many other investments. An effective limitation substantially less than 100 percent of net worth should apply to all direct investments in real estate, including bank premises, regardless of the form of the investment.

2. *The power in deposit thrift institutions to invest up to 100 percent of net worth in equity securities listed on a national exchange.* While mutual savings banks in some states today have a similar power, and state-chartered commercial banks not members of the Federal Reserve System in some states may also own equity securities for their own account, the pressures to maximize profits will, as we have seen, be greater in a world without deposit rate ceilings than they are today. In addition to normal risks of loss in stock market investments, these pressures may encourage undue speculation in order to gain an edge over competitors or to overcome the edge of other institutions. The exposure of an institution's capital funds should be significantly less than 100 percent in my judgment, even if the basic recommendation is retained.
3. *The power to engage directly in nonbank activities presently being authorized for bank holding companies by the Federal Reserve Board.* The objections to a general grant of authority along these lines, on the grounds of safety and soundness, are well stated by Dr. Chase in his paper, although undoubtedly some activities being authorized by the Board of Governors for bank holding companies could be carried out by deposit institutions directly without significant increase in the risk to which they are presently subject. To those who say that the

> Commission's recommendation contemplates a review by the Administrator of National Banks for national banks, the Administrator of State Banks for state banks, and the Federal Home Loan Bank Board for savings and loan associations before such authority is granted, I think the clear expectation of the Commission had to be that all the activities being authorized for bank holding companies by the Board of Governors would be authorized for direct operation by deposit institutions. There are clear exhortations for a liberal interpretation of the Bank Holding Company Act Amendments of 1970 and the divided review contemplated by the Commission almost guarantees this.[3]

With these exceptions, the Commission's recommendations for expanded asset powers are likely to increase competition and public convenience without substantial increase in risk to the financial structure as a whole. They should also assist deposit institutions in maximizing earnings, while the Commission's liability proposals should smooth out the peaks and valleys in the flow of funds to such institutions. But I think it overstates the effect of these recommendations to claim for them as well an inevitable, beneficial effect on credit flows to residential housing in future periods of tight money. At best such an effect can only be indirect — through increased earnings, through the ability thereby to pay competitive market rates on deposits, and through increasingly stable and predictable deposit flows. Even under such circumstances, a net plus for housing would

[3]To the extent the three agencies differ in their authorizations under this recommendation in any competitively meaningful way, there would be every incentive to convert to the jurisdiction of the most lenient supervisor. At least two different ways of administering the provision would avoid that result:

(i) the Federal Reserve Board itself could be assigned the job of determining which of the related activities being authorized for bank holding companies might properly be conducted directly by deposit institutions or their subsidiaries, and under what conditions; or

(ii) Congress could enact a "positive" laundry list of related activities authorized to be performed directly by supervised institutions, prescribing any necessary conditions by statute, and supplementing the provisions periodically.

Obviously the first alternative has advantages in terms of flexibility and is the only one which assures that the same criteria being applied by the Federal Reserve Board in determining the approved activities of bank holding companies will also be applied in determining the activities to be authorized for direct operation by banks and their subsidiaries.

be felt only if institutional managements were determined to commit new funds to residential housing in such proportions that the total would approximately equal the percentage of total assets presently invested by all deposit institutions.

My doubts that this will be the case stem from the fact that there appears to be only an inverse correlation today between the degree of diversification permitted to an institution and its commitment to the residential housing sector. The average commercial bank, with the broadest capacity to diversify loans and investments, devotes a far smaller percentage of its total assets to residential mortgage loans than the average savings bank, and the latter, which has significant but limited opportunities to diversify its loans and investments, devotes a significantly smaller percentage of its total assets to such loans than the average savings and loan association — the institutional type with the least opportunity to diversify at the present time. Of the three, the $200 billion savings and loan industry, at least in recent years, has been the principal supplier of funds to the residential housing sector, both in dollar volume and as a percentage of total assets.

Those of us from New England and New York, where the $90 billion in the mutual savings bank system is concentrated, tend to overlook the relatively greater contribution and commitment made by savings and loan associations to the residential housing market. Since many savings banks in these states already have the power to make nonresidential mortgage loans on commercial property, consumer loans up to some limited percentage of assets, investments without limit in corporate or municipal debt obligations, and limited investments in common stocks or leeway investments, and since they still invest on the average 59 percent of their total assets in residential mortgage loans, we tend to assume that the added powers proposed by the Commission will not have any perceptible effect on the flow of funds to residential housing. Yet the same proposals also apply to the nation's savings and loan associations that presently invest about 85 percent of their assets in residential housing. If that much larger industry, in utilizing the same powers under the same competitive conditions, were to reduce the percentage of its total assets committed to residential housing to the same 59 percent of assets presently invested by the savings bank industry — even if this occurred gradually over time — the effect on the residential housing sector could be noticeably adverse despite improved flows of funds.

To its credit, the Commission appears to have recognized this problem by suggesting in its new scheme of things a direct govern-

ment incentive, either by way of tax credit or direct subsidy, which would maintain present high levels of investment in residential housing; but the details of any such incentive have not yet been spelled out and it would appear impossible for observers at this stage of the game to speak with authority on the impact which implementation of the Commission's recommendations would have on the funds available for residential housing. The most that can be said is that if present levels of investment are maintained by deposit institutions throughout the nation, residential housing should not suffer and might indeed benefit from the more even flow of funds which the Commission's recommendations on the liability side are designed to encourage. But this would seem to me to be a big "if" until the magnitude and relative attractiveness of the incentives to be proposed becomes known.

DISCUSSION

EDWARD S. HERMAN*

Since I received Mr. Wille's paper very late in the game, and find myself in substantial agreement with it in any case, I would like to offer some independent and rather general comments on several aspects of financial, and particularly bank, diversification. My frame of reference will not be marginal additions to the list of assets that may be acquired or liabilities that may be issued, but rather the more substantial extensions of function, frequently by a proliferation of corporate entities within an increasingly complex structure, such as are at stake in the Bank Holding Company legislation of 1970 and in the recent spate of bank-sponsored real estate investment trusts. I hope to focus, if only briefly, and provocatively, on some neglected – and sometimes anticompetitive – facets of recent diversification decisions and trends. I have put them in the form of eight notes or points of comment.

Proper Scope of Financial Institutions

1. There is no scientific basis for decisions as to the proper scope or rate of diversification of financial institutions. It is a debatable point as to whether a reasonably scientific judgment could be made concerning, say, the effects on competition alone of bank diversification into mortgage banking, especially long-term and potential effects. (See further, points 4 and 5 below.) But it is clearly beyond the capacity of science to weigh in the additional effects of diversification on efficiency, customer convenience, potential conflicts of interest, and the social and political impacts of such structural change. In principle, but not in fact, probable consequences could be estimated for each of these variables; but weighing them in order to arrive at a policy finding is beyond science even as a matter of principle.

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Legislative Instructions to Regulatory Bodies

2. Legislatures nontheless establish "laundry lists," or instruct regulatory bodies such as the Board of Governors of the Federal Reserve System to establish diversification limits on the basis of certain stipulated factors. On what basis do these bodies arrive at their conclusions if science offers too little in the way of sustenance? This brings us quickly into the sphere of politics and value systems, which supplement, if they do not overwhelm, technical economics – these three are blended together in complex ways to yield a decision, which is sometimes a true witches brew. The ingredients of the brew include: (a) the particular values, preferences, economic theories, ideologies, and personal influence of the individual regulators; (b) the political climate of opinion and distribution of political power, which determine both the choice of regulators and the economic issues thought to be relevant[1]; (c) the strength and energy of the contesting parties, measured in part by their capacity to lobby, litigate, and ultimately bargain for their right to compete or to avoid certain forms of competition[2]; (d) the degree of past encroachment into an area, or accumulated vested interest – if the diversifying institution is already a significant occupant of a turf, there is a strong propensity to find it "closely related" as a matter of *fait accompli*. It would be very surprising to find a regulatory body declaring an activity to be not "closely related," and ordering its disassociation, where substantial penetration had already occurred.

Celerity of Regulatory Action

3. The influence of political and power considerations in regulatory decision-making processes is sometimes reflected in the

[1]For example, safety and the avoidance of conflict of interest in the 1930s; competition in the more buoyant 1970s.

[2]For example, in contrast with some larger and better financed industry groups, the association of businessmen in the computer software field has suffered from a limited financial capacity to litigate against policies of the Comptroller, or to prepare adequately for hearings or to appeal unfavorable decisions by the Board of Governors. This may well influence the extent to which banks will be able to enter their field. Another example may be found in the investment company area, where the relatively greater ability of banks to form real estate investment trusts, as opposed to investment companies dealing in ordinary stocks and bonds, can be explained to a great extent as a function of the relative political weight of pre-existing occupants of the field.

In brief, the ability of "related businesses" to prevent competitive entry into their turf tends to be a positive function of their power (which is probably correlated with the social need for such entry).

celerity of regulatory action. The regulated industry may be eager to expand and the pressures which it exerts on the authorities to make rapid decisions are then intense. The only thing that should constrain a regulatory body from rendering quick decisions is that the substantive issues are often extremely complex, and the long-term effects of such decisions tend to be essentially irreversible and permanent. One would assume that serious investigations and research, plus extensive and careful deliberations, would be very much in order and would take considerable time – a minimum of say two years. When the lag between legislation and regulatory decision is shorter – much shorter – a question must be raised whether the decision is based on a solid groundwork of fact, analysis, and reflection.

Effects of Diversification on Competition

4. There is a curious tendency observable in the Hunt Commission report, in Board decisions, and elsewhere, to assume that diversification by entry into closely related fields, even via merger, is procompetitive, or at worse neutral in effect. One deficiency in this view is that it rests on an unduly narrow time horizon. If General Motors enters the fields of bus or locomotive engine manufacture, the short-run effect will very likely be to enhance competition; the long-run effect of the presence of such a powerful force in a market is, at a minimum, much more obscure.[3] Even *de novo* entry, which will very likely be procompetitive or neutral in the short run, may in the long run have no positive competitive benefit to offset what may be regarded as an adverse social impact. (It may even have a negative competitive effect in the long run.) Where decisions are being made that are likely to be irreversible and very possibly cumulative in character, exclusive emphasis on short-term effects would seem singularly inappropriate.

Effects of a "Close Relationship" on Competition

5. Antitrust standards are violated by employing the concept of "closely related" as a major consideration favoring an application for merger or even *de novo* entry. If another business is "closely

[3]Its competitive power may permit it to establish a kind of limited hegemony, and at the same time to raise barriers to new entry. This may facilitate a better organization of the market, a system of mutual forebearance on sensitive behavior variables (e.g., price), and a more effective defense of the industry in the public and political arenas.

related," this suggests: (a) some degree of existing competition where the products are substitutes;[4] (b) the possibility of potential competition at some future date; and (c) an environment strongly conducive to the development of tie-ins. Since these considerations unfavorable to competition are extremely difficult to measure *ex ante,* the standard in question involves a major built-in bias favorable to the rapid growth of conglomerate financial power centers,[5] contrary to antitrust principles.

Parenthetically, it may be noted that although the Hunt Commission Report and policy perspective are oriented toward improving the financial system via stimulating competition, very little attention is paid in the Report to the anti-competitive aspects of some of the recent laws, rulings, and trends that have facilitated the surge toward financial conglomeration. I also fail to see in the Report any recognition of the fact that existing structural conditions may be detrimental to competition – for example, the extensive interlocking relationships between savings banks, savings and loan associations, insurance companies, and commercial banks – and may require remedial action. Phillips and Jacobs tell us in their paper that political realities led to recommendations "designed with the goal of not imposing competitive costs in excess of the value of competitive benefits conferred, on any broad segment of the deposit intermediaries." Breaking down pre-existing structural obstacles to competition which operate across the spectrum of major institutions would not meet the political realities suggested by this statement – it would confer benefits only on the consumer!

Effects on Integrity of the Regulatory Process

6. Where diversification is permitted in industries that are publicly insured and regulated, the effect of diversification on the integrity of

[4]If expansion into "closely related" businesses were consistently restricted to markets not presently occupied by the expanding firm, these strictures would have to be qualified, but no such consistent limitation is evident in the decisions of the Board of Governors. See, for example, "First Chicago Corporation, Chicago, Illinois, Order Approving Acquisition of I. J. Markin & Co.," *Federal Reserve Bulletin,* Feb. 1972, pp. 175-177; "First Bank System, Inc., Minneapolis, Minnesota, Order Approving Acquisition of IDS Credit Corporation," *Federal Reserve Bulletin,* Feb. 1972, pp. 172-175; "First National Holding Corp., Atlanta, Georgia, Order Approving Acquisition of Dixie Finance Company," *Federal Reserve Bulletin,* May 1972, pp. 503-504.

[5]Since each step in the accretion process shifts the margin of institutional interest outward, we may assume that new frontiers of "closely related" fields will continue to open up and be occupied.

the regulatory process is a relevant consideration. Diversification may affect the capacity of regulators to audit, to see that law is adhered to, and to keep potential conflicts of interest under reasonable control. Such matters do not seem to have been given much weight in recent legislative and regulatory developments, or in the Hunt Commission Report. My own investigations of the commercial banking business and the savings and loan industry suggest to me that examination and supervision invariably lag in coping with changes in industry scope and practice – with the severity of the lag closely related to the speed and extent of the changes, the complexity of the organizational structures developed, and the severity of the conflicts of interest which are built into those structures. Frequently, inadequate funds and limited legal powers to investigate compromise supervision, and result in the institutionalization of a rote type of examination that is incapable of coming to grips with serious problems. The industry also may lobby and bargain to protect itself from serious supervision. One effect of all this may be an increase in problem cases; but far more important is the potential weakening of the entire fabric of the industry which may result from token regulation, rendering it more sensitive to adverse external changes.

Effects on Conflicts of Interest

7. The regulatory process is ill-suited to cope with severe, built-in conflicts of interest. An examiner can hardly police the distribution of new mortgages as between a bank mortgage portfolio and that of a managed and controlled real estate investment trust. There is also very little that examining authorities can do to prevent tie-ins that are not recorded on printed forms or in writing (and few of them are so recorded). The Hunt Commission recommendations with respect to bank trust departments also impose an unrealistic burden on the regulatory process – the idea that examiners are capable of determining that trust department brokerage is used for best executions, and is not used at all to buy deposits, is, I believe, quite unreasonable.[6] These burdens are imposed on regulators because of

[6]Similarly, the Hunt Commission's recommendations that the trust departments of the larger trust banks "deny trust department investment personnel access to commercial banking department credit information," and that "no director, officer or employee of a corporate fiduciary recommends or initiates any purchase or sale of securities on the basis of insider information," gets at the problem of inside information in banks in a manner reminiscent of King Canute's method for handling an objectionable incoming tide. See further, Edward S. Herman and Carl F. Safanda, "The Commercial Bank Trust Department and the 'Wall'," *Boston College Industrial and Commercial Law Review,* Vol. 14 (forthcoming).

an unwillingness or inability to create or to recommend structures free from serious conflict of interest. They are inherently tokenistic, a gesture in the direction of virtue where the real solutions are thought to be impractical for political or other reasons.

Effects of Interest Payments on Demand Deposits

8. There is a widely held view that an inappropriate degree of diversification is a result, in part, of the legal prohibition of the payment of interest on demand deposits. This prohibition, it is argued, enhances the profitability of demand deposits, and thus induces banks to add and subsidize services, like pension fund management, that will help pull these deposits in. The conclusion drawn is that elimination of the prohibition on interest payments would eliminate the profit margin that induces the unwarranted additional services.

This theory contains a germ of truth, but that germ is insufficient to sustain the inference about diversification, or the policy conclusion. It rests on the implicit assumption that perfect competition would exist in the market for demand deposits in the absence of the prohibition; otherwise, a favorable profit margin conducive to subsidized diversificaiton should continue to exist. If the margin were reduced, however, wouldn't the inducement diminish? The answer is that this is by no means obvious. The banks might push into outside activities even more aggressively in order to compensate for the reduced profit margin. The rush of the larger banks into bank holding companies, and into the non-banking activities permitted those organizations, has often been explained as a consequence of the pressure of the rising costs of time money[7] – which suggests that the effect of the abandonment of the prohibition of demand deposit interest payments might be exactly the opposite of the proposed in the hypothesis under consideration.

There are other objections to this hypothesis that I can only mention in passing here. One is its tendency to neglect the complexity of the customer relationship, which makes a tie-in effect and the marketing of a "full line" advantageous on the basis of the profit to be derived from a variety of services. A second weakness is in the assumption that the peripheral services are necessarily

[7]For example, see John R. Bunting, Jr., "One-Bank Holding Companies: A Banker's View," *Harvard Business Review,* May-June 1969, p. 100.

unprofitable, or need remain so in the long run. A third is its failure to take into account changes that have reduced or extinguished the surpluses formerly more conspicuous in corporate demand deposit balances – especially the improvements in business cash management and the availability of a wide array of money market instruments for the investment of surplus funds beyond those needed to compensate the bank for desired services.[8]

Finally, the hypothesized effect of the freeing of competition on the profitability of demand deposits, and on the willingness of banks to diversify and to subsidize peripheral services, is not supported by the historical record of the era prior to the Banking Act of 1933. In the 1920s and earlier competition never succeeded in reducing profit margins on demand deposits to a point causing banks to lose interest in them or to slow down the long and steady process of bank diversification.[9] Complaints about trust department (and other service department) subsidization and unprofitability in the interests of the commercial arm were as common before 1930 as after.[10] The trust company movement and the integration of trust companies into national banks were major developments of the period before the Act of 1933. It may be argued that institutional changes, including the activation of antitrust in the financial sector, make competition potentially more acute today than before 1930, but this is debatable.

[8]On the assumption of unrestricted competition in the market for demand deposits – except for the prohibition of interest payments – corporate customers should obtain full value for any demand deposit surpluses in their purchases of ordinary services, including lines of credit. It is easy to construct a model conforming to these assumptions in which there would be no advantage to the banks arising out of the prohibition, and no surpluses that would induce any non-price competition.

[9]See Albert H. Cox, Jr., *Regulation of Interest Rates on Bank Deposits,* University of Michigan, 1966, Chaps. 1-2.

[10]In the mid-twenties, for example, it was a common view "that in many instances the trust department was very frankly organized simply as a service department and that it was not the intention to put it on a sound profit and loss basis, the theory being that the expenses of the department would be more than compensated for by further strengthening the relation of the customer with various other divisions of the commercial bank." (John C. Mechem, "Trust Department Earnings: Adequate Fees and Practical Systems of Cost Accounting and Allocation," *Trust Companies,* October 1926, p. 400.) An unsigned editorial in the same journal said: "Even allowing for the patient novitiate stage it is no secret that many trust departments are operated at a loss. Numerous trust companies and banks justify trust departments mainly as 'feeders' or as adjuncts to other departments for competitive reasons. A large volume of trust assets is in fact a liability. There are not a few trust departments which have have been established for a sufficient number of years to justify expectations of profit which are barely self-sustaining." (*Trust Companies,* July, 1925, p. 128.)

It should be remembered that it was during the early 1930s and after that the banks were able to develop and sustain a "prime rate convention" that is hard to reconcile with the notion of unrestricted competition in banking.

Competition in the financial sector should be encouraged, by all means. But it should be encouraged within a framework of some conception of a desired market structure toward which we wish to move, and a reasoned belief that the growth and integration processes now under way are carrying us in that direction. Furthermore, it would be a mistake to assume that most financial markets ever came close to conforming with the competitive model, or that they could be brought very much closer to that ideal without a truly radical reconstruction of the financial structure. It would be an even greater error to assume that marginal steps toward competition, or even substantial movements in that direction, will not create their own complications, and that they are the philosopher's stone that will solve the problems which our financial system is finding so intractable.

DISCUSSION

GEORGE R. HALL*

Chairman Wille's paper discusses three fundamental features of the Commission report. These are:

1. The relative priorities given the social goal of competition versus maintenance of traditional regulatory arrangements.
2. The relationship between competition in the markets for funds on the one hand and the markets for assets on the other. Especially important here are the impacts of changes in competition in one set of markets on the other set of markets.
3. The implication of the Commission's recommendations for structural change on the risk exposure of financial institutions.

More Competition Versus Established Regulatory Arrangements

The Commission did not try to maximize competition in the financial sector by sweeping away all the many and long-standing constraints on competition. The Commission's goal of defining politically feasible recommendations precluded such an objective. Nonetheless, as Chairman Wille points out, the Commission did place its priority on obtaining more competition rather than on minimizing the adjustments to the structure of the financial regulatory mechanism that has been developed over the years. Given this priority, as Chairman Wille stated, few of the Commission's recommendations come as a great surprise.

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The Commission apparently adopted its viewpoint because of three considerations. First, regulation creates inequalities in periods of monetary restraint. Second, increased competition would help eliminate inefficiencies in the financial sector. Third, more competition would make response to technological change easier.

I share this viewpoint and believe Chairman Wille concurs. Nonetheless, it goes counter to the spirit of many other attempts to improve our financial structure and the structure of regulation within which competition takes place. Traditionally, reform has aimed at creating or encouraging specialized institutions to meet new or specialized needs rather than depending upon existing institutions to expand into new areas or into areas not now well served. Moreover, instead of encouraging diversity in regulation, the usual goal of reformers has been to try to centralize and coordinate financial regulation.

Mr. Barr's paper makes the case for the traditional approach, so little more need be said here about the basic philosophical approach. Instead, let us continue with the two other points that I cited earlier. These raise operational questions about implementing the Commission's recommendations.

The Link Between Fund Markets and Asset Markets

Chairman Wille questions the parity between the Commission's treatment of competition in the markets in which financial institutions obtain funds and competition in the markets in which they provide services or acquire assets. Financial institutions are intermediaries. Much of the confusion about competition in the financial sector stems from failure to distinguish between the markets in which financial institutions obtain inputs and the markets in which they sell outputs. Financial institutions all seek funds and, as the 1960s demonstrated, depositors are willing and able to switch from institution to institution or type of institution to type of institution with impressive speed.

Asset markets and the markets for financial services other than deposits are less competitive. There are problems of oligopoly, credit standards, credit rationing, and the other structural and behavioristic characteristics that make it less easy for a customer to switch from institution to institution. Most important for the present discussion, institutions practice product differentiation by specializing in different types of assets.

The Commission would free up some of the constraints that in part cause this specialization. Nonetheless, Chairman Wille suggests that even if all the Commission's recommendations were implemented, more controls would remain over asset competition than over deposit competition. Put differently, the Commission would, in Chairman Wille's opinion, increase competition more on the liability side of the balance sheet than on the asset side. He would expect to see more specialization of assets than of deposits.

Chairman Wille is bothered by the logic and equity of this difference in treatment. It seems to me that this difference already exists and at worst the Commission's recommendations would merely heighten the competitive difference. It also seems to me that the Commission's treatment can be explained by its desire for feasible recommendations. Increasing competition in product or asset markets is harder than increasing competition in markets for funds and it is not surprising that the report reflects this difference.

Chairman Wille also suggests that asset specialization combined with more competition for deposits would create problems of disintermediation, illiquidity, and the other difficulties encountered in the 1960s. He argues that institutions will have to respond faster to changes in the supply or price of deposits. Institutions with liquid assets will be in a position to respond faster than those specializing in long-term assets.

What does this imply for public policy? It is hard to see that maintaining Regulation Q and like controls is a superior alternative to the Commission's recommendation merely because some institutions will find it easier than others to respond to heightened competition for deposits. The important point, in my opinion, is that increased competition in fund markets will not insure against disintermediation and liquidity problems. It is unlikely that all institutions will be in the same position with respect to the liquidity of their assets, and they will differ in their abilities to structure their portfolios as they might wish to do in the absence of regulation.

Risk Exposure

Three Commission regulations would, according to Chairman Wille, increase the risk exposure of financial institutions. These are the recommendations relating to:

1. Direct investment in real estate
2. Equity investments by thrift institutions

3. Increased authority for banks to engage in activities now permitted holding companies.

These may be the direct impacts but I think that if the Commission's recommendations were implemented there would be a general increase in risk exposure due to a heightened likelihood that any firm's market might be invaded by another institution and other increased competitive pressures.

A competitive environment implies failure of firms. In general, financial regulation has sought to minimize the rate of failure of financial institutions. We need not debate the wisdom of this policy. The important point here is that it is a key feature of the current regulatory system. Financial entrepreneurs can assume relatively low rates of failure and can assume regulatory action to make this happen. The report deals with the mechanics of deposit insurance but it did not really deal with the question as to the extent to which we should permit the rate of failure to increase in order to obtain more competition, or how to imbed this policy in operational rules such as examination standards.

I would enjoy hearing Chairman Wille discuss the extent to which we should permit more failures and how we should respond to failures. The Commission report rejects the notion of variable insurance rates. I understand the objections but am still concerned about the result of uniform rates in an environment with more competitive risk. The cautious institutions will be paying for the bold, adventurous firms with the higher failure rates. I don't know the answer to this problem but believe that if the Commission recommendations are implemented insurance and failure rates will become more important policy issues than they are at present.

I am totally in agreement with a policy that would reverse the thrust of regulatory policy so that success will no longer be measured as the inverse of the number of institutions that fail. I wonder, nonetheless, about the resulting operational problems, specifically:

1. Are insurance funds sufficiently adequate to cope with the new environment?
2. How many failures can we have before we encounter systemic failures?
3. Will bankers, S&L officials and other financial officials really believe that the government will let them fail? Or will they assume that the federal agencies will bail them out and make their decisions on this basis?

4. Will the federal authorities bail out financial failures? Put differently: How many failures will the regulators allow before they step in?

I don't know the answers to these questions but I wish that the Commission or Chairman Wille had answered them. The point I want to make is that if we are going to talk about policies for more competition, we have to talk about policies toward liquidity and capital problems of firms. These are two sides of the same coin.

The Bank Holding Company—A Superior Device for Expanding Activities?

SAMUEL B. CHASE, JR.*

Is the bank holding company a vehicle that ought to be used for purposes of *public policy* to permit banking organizations to perform functions that ought not be performed by banks *per se?* Or is the bank holding company structure merely an entity with no social function – an historical and political accident? The latter view seems to have pervailed in the deliberations of the Commission on Financial Structure and Regulation, which recommended

> after public hearings by the appropriate regulatory agency and application of the same criteria as apply to bank holding companies, commercial banks and their subsidiaries be permitted, upon individual application, to engage in a variety of financial, fiduciary or insurance services of the type, but not more extensive than those approved for bank holding companies by the Board of Governors under the Bank Holding Company Act.[1]

Although the supervisory agencies (the new Administrators of National Banks and of State banks, if the Commission had its way) would have discretionary powers to limit the activities of banks *per se* more narrowly than the Federal Reserve limited the powers of registered bank holding companies, the Commission seems quite clearly to have intended – or expected – that the limits on banks would not be significantly more narrow than those on holding companies. For, as the *Report* explains:

> The Commission believes that bank holding companies should not be the only vehicle through which services may be extended. The Commission would extend to banks and subsidiaries of banks, with the

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[1] *Report of the President's Commission on Financial Structure and Regulation,* p. 43.

> same procedural requirements, including the requirement for individual applications to the appropriate regulatory agencies, powers of the type, but not more extensive than those approved for bank holding companies by the Board of Governors under the Bank Holding Company Act. The Commission urges the Board to be as liberal as possible in approving new classes of service.[2]

In short, the *Report* reflects a belief that there are no important social questions at stake in the corporate structure of banking and bank-related operations, other than those that would be taken into account in the *private* decisions made by the banks themselves. These private decisions would, I presume, be made – quite legitimately – mainly on the basis of serving the interests of stockholders.

It can, however, be argued that the organizational form within which expanded activities that entail substantial risks are pursued really does make a difference in terms of public welfare. The reason is that, the holding company form of organization can permit greater flexibility for banking organizations while minimizing threats to the stability of the banking system. It should not be forgotten that much of the resistance to the "break-out" of banking from old restrictions during the 1960s came from supervisory authorities who feared the effects of expanded activities on the stability of the banking system. The Commission itself recognized on the very first page of the text of its *Report* that there is tension between the goals of lessened regulation and stability:

> For well over a century the American public has insisted that its financial institutions be both competitive and sound. The two objectives are not easily reconciled, and yet both must be achieved if we are to avoid, on the one hand, a highly concentrated financial structure and, on the other, a system unable to withstand the vicissitudes of economic change. The public is entitled to the benefits of a dynamic and innovative system responsive to shifting needs. Yet the public also should be able to rely on the strength and soundness of the system.
>
> Inevitably, difficulties are encountered in balancing these objectives.[3]

But the *Report* does not indicate that the Commission considered this tension a problem as far as expanded activities for banks, as opposed to bank holding companies, are concerned.

[2] *Ibid.*, p. 54.

[3] *Ibid.*, p. 7.

New Activities, New Risks

Expanded activities raise new risks and hence complicate supervision. Historically, bank supervision has dealt primarily with limited types of credit risks and risks of illiquidity.

Several of the new activities being pursued (and contemplated) by bank holding companies fall well-outside the traditional purview of bank regulation. That is, they raise different kinds of risks from those commonly encountered. Some "expanded" activities entail possible operating losses which might in some cases be substantial. It is difficult, (but not impossible) to imagine, say, a bank-operated travel agency incurring sizeable losses. But, say, selling computer services, or insurance underwriting could entail substantial risks of operating losses. Expanded activities may also entail significant exposure to costly damage suits. For example, a bank-connected insurance agency could be sued by a customer who had been told, incorrectly, that he is insured; a computer services operation could be sued by a customer who suffered losses due to faulty service. Many mortgage banking, factoring, and sales finance subsidiaries of bank holding companies are operated in ways that would baffle experienced bank examiners, and raise classes of risk not traditionally encountered in banking operations.

The main purpose of bank supervision and regulation is, in the first instance, to protect the interests of depositors and of the Federal Deposit Insurance Corporation. More broadly it is to preserve public confidence in the ability of banks to meet their obligations. The major sources of protection, aside from sound monetary policy are, first, the cushion provided by bank capital and positive net earnings flows, and, second, the legal and regulatory limitations on the extent to which bank resources are exposed to risk of loss.

New types of risks complicate the job of determining and enforcing standards of capital adequacy and of drawing lines beyond which banks cannot go. Although, as G. R. Hall points out, a new activity may, in fact, reduce the overall risk exposure of a bank, as a practical matter it is more likely that the opposite will be the case.[4]

Once it is admitted that there is a *public* stake in the prevention of bank failures, expanding activities pose complex problems of regulation. It is true, of course, that solutions are not difficult to find

[4]"Anticompetitive Impacts of Expanded Bank Service Lines," paper prepared for the Commission on Financial Structure and Regulation, February 1971, p. 24.

conceptually. A bank's capital could be made to vary directly and precisely with the magnitude of the overall risk it ran, so as to make the probability of failure independent of the amounts and kinds of risks taken. Or, even better, variable deposit insurance premiums could be used to charge banks fully for the risks to which they expose the deposit insurance fund, and the public at large through a collapse of confidence, while holders of uninsured deposits policed the banks in their own behalf. Banks could take all the risks they wanted, provided they paid the full price.

These possible approaches are interesing and useful to contemplate, because they force the analyst to specify precisely the problems he is dealing with. But they are not adequate as a practical matter. Either would require something approaching omniscience and omnipotence on the part of supervisory agencies. Even without an expansion of bank activities beyond traditional boundaries, the actual job of setting and enforcing standards of capital adequacy, or of prescribing variable deposit insurance rates, would be beset with enormous difficulties. Assuming the "right" approaches were found, new legislation would be required, and the history of banking legislation does not suggest that enactment of such theoretically complex solutions is likely.

In my view, to the extent that it is allowed to create increased fears of financial instability, the expansion of bank activities will call forth a muddled, inefficient extension of supervisory and regulatory activities. This would tend to defeat the basic purpose of granting wider powers to banking organizations – to permit them to meet real social needs. The holding company form of organization, properly used, provides a useful way of insulating the resources of banks from risks occasioned by expanded activities – and hence of minimizing regulatory interferences with these new pursuits.

Corporate Separateness – Real or Imagined?

In the eyes of the law, every corporation is a separate "person;" a holding company and each of its subsidiaries are therefore separate legal entities. Legally, then – with exceptions to be noted later – losses of one member of the family have no direct effect on either the profits or the capital of another. If one subsidiary should go into receivership, neither the parent nor sister subsidiaries are legally obligated to make good on its obligations. Likewise, if the parent corporation should go into receivership, only its equity interest in subsidiaries is available to satisfy claims on the parent. This means

that, in principle, the resources of a banking subsidiary are not exposed to risks run by the parent or by nonbanking subsidiaries. Failure of the parent would lead to a change in equity ownership in the bank, but would not directly affect the bank as a going institution.

If this were the whole story, supervisory authorities would have no need to interest themselves in the risks run by parent bank holding companies and their nonbanking subsidiaries. Expansion of activities could proceed withour concern over their effects on bank soundness as long as the expanded activities were carried out by nonbanking affiliates, rather than by banks themselves. The tension between the goals of freedom of banking organizations to expand their services and innovate, on the one hand, and protection of the interests of depositors, the deposit insurance corporation, and confidence in the banking system on the other, would be resolved. (Of course, to the extend that requiring separateness interfered seriously with the efficiency with which the organization pursued expanded activities, such enforced separation would entail a social cost to be balanced against this gain in freedom.)

In addition, as matters stand, both deposit insurance and the faith of holders of uninsured deposits that, *as a matter of social policy,* bank failures will be made "rare events," give banks an advantage in borrowing funds. They thereby relieve banks of much of the "policing" that might otherwise be performed by private creditors. The holding company route of expansion, with enforced corporate separateness, would automatically guard against banks' taking advantage of their privileged position as borrowers, stemming from Federal guarantees of deposits and faith of holders of uninsured deposits that, as a matter of policy, bank failures will be held to a minimum.

In practical terms, however, the usefulness of the holding company approach is much less certain. Doubts can be raised on two grounds:

1. The legal separateness of affiliated corporations might turn out to be fictional because courts would "pierce the corporate veil," treating the holding company and all its subsidiaries as one legal person in the event that one subsidiary fails.

2. Holding companies would not, in fact, be willing to "walk away" from bankrupt subsidiaries but would use all of

their resources, including those of banking subsidiaries, to meet the obligations of a failing subsidiary.

Neither argument is entirely correct or incorrect, and it is necessary to examine both in some detail.

Legal Insulation — "Piercing the Veil"

When is a subsidiary corporation not a separate legal entity? When are its debts also debts of its parent, or of sister subsidiaries? That is, under what conditions might a court "pierce the corporate veil?"

This is a perplexing question and a critical one. If the courts could be expected routinely to hold that the separateness of holding companies and their subsidiaries was a fiction, the holding company form would provide no insulation at all. In that case, no advantages, in terms of protecting bank resources, reducing the need for regulatory interference, or preventing unfair competition, would be gained by restricting the activities of banks more narrowly than those of bank holding companies.

One can get differing opinions from lawyers on this question. After consulting with several, I have come to the following conclusions:

1. Courts would not ordinarily pierce the corporate veil, although the law and guiding precedents differ among the 50 states so that generalizations are hazardous.
2. The probability that a court would pierce the veil is smaller when the parent company or nonbanking subsidiary in trouble:
   a. Has a board of directors that does not entirely overlap that of the banking subsidiary under fire.
   b. Keeps separate books.
   c. Employs separate management.
   d. Has a name that is not easily confused with the name of the bank.
   e. Uses its own letterhead.
   f. Conducts its own advertising.
3. "Piercing crosswise" would be less likely than "piercing upward." That is, if a nonbank subsidiary failed, the likelihood that a banking subsidiary would be held liable for its debts is considerably smaller than the (already small) likelihood that the parent holding company would be held liable.

It therefore seems reasonably safe to say that, for banking organizations as well as for other corporations, piercing would be the exception, not the rule, as long as steps were taken to make nonbank subsidiaries separate in substance as well as in form.

Practical Insulation

Given that corporate separateness, in the strict legal sense, can be maintained, the achievability or even desirability on insulating banking resources from the fortunes of nonbank operations is still open to question. The fact is that bank holding companies would rarely choose to "walk away" from failing subsidiaries. Rather, at least within the limits of the law, they would use all of the resources of their organizations to meet claims against any part of it.

Two recent experiences illustrate the point. The American Express Company stepped in to assume liability for claims against its subsidiary, American Express Warehousing, Ltd., that arose out of the salad oil scandal of 1963. (The warehousing subsidiary, with capital of about $100,000, was subject to claims in the neighborhood of $60 million because it had issued warehouse receipts for oil that was supposedly stored in tanks, but that actually didn't exist.) More recently, United California Bank, a subsidiary of Western Bancorporation, assumed responsibility for debts of its Swiss subsidiary, United California Bank of Basel, after the Swiss bank had suffered enormous losses mainly connected with illegal use of its resources for speculation in cocoa futures.

The unwillingness of both American Express and United California Bank to attempt to take advantage of the limited liabilities of their subsidiaries may have been partly a matter of pride, but more compellingly, it was good business judgment. "Walking away" would have profoundly affected the reputations of the parent companies. In finance especially, reputation is a paramount asset. As Howard L. Clark, then President of American Express, put it:

> Our success is based on good will and the belief in our integrity and soundness. The immediate acceptance of travelers checks, money orders, credit cards, and the maintenance of bank deposits are all a basic necessity to the prosperity of the company.[5]

[5] "The Future of American Express," *Fortune,* April 1964, pp. 158-159 and 254-260. Quote from p. 260.

There have, of course, been instances of corporations "walking away." For example, in 1968 the Raytheon Company's Italian subsidiary, Elsi, declared voluntary bankruptcy. This case was, however, surrounded by special circumstances. As *The Economist* put it, "Normally, no major company would avoid standing behind the debts of foreign subsidiaries."[6] And it is important to remember that Raytheon is not a financial corporation.

Only in very unusual cases would bank holding companies *choose* to abandon failing subsidiaries, given the option. If it is to be real, insulation of the resources of banking subsidiaries from potential misfortunes of nonbank affiliates must rest on externally-imposed restrictions on the use of banking resources to meet claims on the affiliates.

Resources of banking subsidiaries might be tapped in three ways. First, the bank (or banks) could extend credit to troubled nonbank subsidiaries, or to the parent to be reloaned to the subsidiaries. Second, banks could pass funds "upstream" to the parent through dividend payments. Third, the banks could buy some or all of the assets of a failing affiliate.

Loans to Affiliates. Extensions of credit to affiliates are limited by the Federal Reserve Act, as amended.[7] Loans of insured banks to individual affiliates may not exceed 10 percent, and loans to all affiliates combined, 20 percent, of the bank's capital and surplus. Further, with certain exceptions, such loans must be secured by collateral in the form of "stocks, bonds, debentures or other such obligations" having a market value (at the time the loan is made) at least equal to the amount of the loan.

Dividends. Upstream dividends are limited by laws that restrict the size of bank dividends generally. The National Bank Act, as amended, requires a national bank to obtain approval of the Comptroller before (a) paying dividends out of capital and surplus[8] or (b) paying dividends in any one calendar year in excess of the sum of net profits for that year and retained net profits for the two preceding years.[9] The Federal Reserve Act imposes identical restrictions on state member banks, except that in their case, approval must be

[6] "Raytheon and the Mayor of Palermo," June 22, 1968, pp. 69-70. Quote from p. 70.

[7] 12 U.S.C. § 371c.

[8] 12 U.S.C. § 56, § 59.

[9] 12 U.S.C. § 60.

obtained from the Board of Governors.[10] State banking laws generally restrict payment of dividends out of capital.

In addition, supervisory authorities (including the Federal Reserve, the Comptroller, the state banking commissions) can apply pressure on banks to maintain or increase capital. Although these pressures do not have the force of law, they do exert moral suasion that is hard to resist, at least for an extended period. And institutional holders of uninsured deposits pay a good deal of attention to the level of bank capital as a source of protection.

Thus the possibility of using dividends of banks to meet reverses of nonbank subsidiaries, while limited, is by no means ruled out. Since retained earnings are the chief sources of growth in bank capital, the potential use of extraordinary dividends to meet such reverses intensifies the problem of enforcing standards of capital adequacy.

Sales of Assets. The third possible route by which the resources of a banking firm could be used to bail out a failing nonbank subsidiary is the direct purchase of assets. There are, of course, limitations on the kinds of assets banks can purchase. Moreover, the law restricting loans of insured banks to affiliates mentioned earlier defines extension of credit so broadly that the Federal Reserve Board has taken the position that it covers generally the purchase of assets.

In addition, the Federal Reserve persumably has additional powers, under the Bank Holding Company Act, to police and restrain such activities. Still, it would probably be hard to distinguish between "legitimate" and "illegitimate" purchases, especially when they were made to salvage a nonbank subsidiary whose precarious condition was not yet apparent to the regulators.

Summing Up

It seems safe to say that, under present law, requiring some or all "expanded" activities of banks to be performed by holding companies rather than by banks *per se* would tend to insulate the resources of banks from risks entailed in expanded activities. But the insulation would not be complete, and its effectiveness would vary from case to case.

It should be noted that requiring that expanded activities be carried on by subsidiaries of banks (rather than by nonbank subsidiaries of bank holding companies) would also provide some

[10] 12 U.S.C. § 324.

protection of banking resources from the risks occasioned by expanded activities. But the insulation would be distinctly inferior because

a. the bank would stand to lose at least its equity investment in the subsidiary in the event that the subsidiary failed;
b. the possibility of piercing the corporate veil "upward" to a parent bank is greater than "crosswise" to a bank that is a subsidiary of a holding company; and
c. the incentives to use the bank's resources to "bail out" a failing nonbank affiliate are probably even greater in the case of a direct subsidiary than in the case of a sister subsidiary of the same holding company.

Pros and Cons of "Enforced Separateness"

This section summarizes the arguments for and against confining expanded activities to bank holding companies and their nonbanking subsidiaries.

Advantages of Separateness

To the extent that the separation of risks occasioned by expanded activities from those of "banking" more narrowly defined is achieved, the potential danger that these activities will interfere with "bank soundness" is reduced. This reduces the conflict between expansion of activities and bank safety and relieves the supervisory authorities of the need to police the activities, issue regulations pertaining to them, develop machinery for determining and enforcing standards of capital adequacy for holding companies, and face additional difficulties in enforcing standards of capital adequacy of banks. Furthermore, the requirement of separate accounting would make the financial status of each separate operation more visible, both to management and to supervisors.

Enforced separateness also reduces the possibility that banks can finance expanded activities at subsidized rates by, in effect, borrowing the required funds through Federally guaranteed deposits.

Distinct separation of expanded activities from banking operations would have another advantage not directly related to bank safety. It would probably reduce the occurrence of (illegal) "tied sales," since the more separate were the managements of banks and nonbank subsidiaries, the more likely they would be to attempt to maximize their own profits, rather than joint profits.

Disadvantages of Separateness

The case for widening the powers of banking organizations hinges partly on alleged advantages from economies of joint-supply, joint-demand, and larger-scale operations that permit spreading certain costs (such as research or computer costs) over a broader range of activities. Enforced corporate separateness is likely, at least in some cases, to interfere with achievement of these advantages, for the very reason that it impedes complete integration of operations.

Finally, it is possible that enforcing separateness would, in some circumstances, contribute to instability. Even though the bank's resources would be *legally* insulated from risks associated with expanded activities, if the inability of a holding company to use those resources to meet adversities encountered anywhere within the organization meant the difference between bankruptcy and survival for a nonbank subsidiary (and perhaps the holding company itself), the result might be to weaken confidence in banking subsidiaries even though their resources were not directly at stake. This possibility would be smaller the more clearly it were understood by depositors that holding company banks were not legally responsible for the debts of parent corporations or sister subsidiaries, and that law and regulation prevented the use of resources of holding company banks to bail out affiliates.

It is this latter consideration that probably argues most strongly against enforced separateness. It is often contended that desirable as it might appear in theory, enforced separation would not work. The explanation most often cited is that the public would almost always identify the bank with its affiliates and vice-versa. In other words, separation would not exist where it probably counts the most – in the public's mind. If this assumption is correct, then it follows that holding companies should probably not be considered very different from banks as far as regulation and supervision is concerned.

The critical issue, therefore, is whether it is possible to enforce separateness in the minds of the public as well as in regulation.

Would a legislated prohibition against making banks liable for the debts of their affiliates, perhaps together with tightened controls over the remittance of excessive dividends from banking subsidiaries, make the public's faith in banks independent of the fortunes of their nonbank affiliates? If so, there is much to be said for enforced separation. If not, then the Commission's view – that commercial banks and their subsidiaries be permitted to do anything that holding companies can do – makes sense.

DISCUSSION

PHILLIP E. AREEDA*

Postulate that those who control a commercial bank have decided to expand their activities beyond banking. With some limits, they might choose to do so through several different forms: they might choose to form a holding company in which the bank would be a wholly-owned subsidiary. Or, according to recommendation 20 of the Hunt Commission, the bank might, with appropriate regulatory approval, conduct such expanded activities either directly by itself or by its own corporate subsidiaries. Mr. Chase's paper asks whether variations in the form matter. There are several different senses in which it might matter whether the parties utilized a single banking corporation for all activities or formed a bank subsidiary or holding company.

(1) Which form facilitates efficient operation of the whole enterprise at least cost and maximum output?
(2) Which form best assures the security, stability, and safety of the banking operation?
(3) Which form best protects the several markets involved from "unfair" competition?

I shall follow Mr. Chase's example and merely note that requiring separate corporations for the incremental activities might impair efficiency in carrying out joint functions and flexibility in undertaking new functions. Accordingly, management may not be indifferent to these questions of form. Whether society – understood as the "public generally," the disinterested academic, the Federal

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Reserve Board, a hypothetical czar of the universe, or Congressman Patman – should be indifferent depends on answers to the second and third questions.

Insulating Bank Assets

Focusing on the second issue, Mr. Chase notes one respect in which corporate separateness might prejudice a bank's health and stability: the failure or weakness of a non-banking affiliate or subsidiary – which it is assumed the separate bank could not bail out – might infect public confidence in the bank, no matter how separate the two corporations. The implication is that the bank might best assure public confidence in itself by conducting its non-banking activities within the banking corporation and thereby answering for the sins and losses of the non-banking activities. But I wonder whether "public confidence" in this context bears more on prosperity for the shareholders than on solvency or protection for the depositors. If corporate separateness helps protect depositors against the non-banking use of bank assets, the shareholders of the enterprise are not entitled to use the bank to reduce the risk of engaging in non-banking activities. In short, society does not owe bank shareholders a rose garden in which they can reap the profitable benefits of undertaking non-banking activities without bearing the risk that some expanded activities will sour and reduce public confidence in the enterprise.[1] Those who manage non-banking activities badly have no just complaint when the public doubts their financial wisdom.[2] Now it may well be true that the public will make this identification regardless of the corporate forms. But that is the bank's risk of expanding into other areas and certainly not an argument against corporate separateness.

Thus, one critical question is that which Mr. Chase emphasizes: is corporate separateness likely to help insulate the bank's assets from the financial risks of engaging in the incremental activities? The risks are several: the new operations might be unsuccessful and generate losses or even destruction of the capital devoted to them. The new divisions might suffer substantial contractual or tort liabilities to

[1]I note, in passing, that one of the benefits for the shareholders may be the carry-over to non-banking activities of the public convenience and confidence in dealing with the bank.

[2]Even if the managers are distinct, common ownership implies that there will be some common directors supervising the different managers.

creditors or other persons whom it has negligently or otherwise injured — to say nothing of possibly large, and perhaps innocently won, liabilities under the federal Securities or Antitrust laws.

Intra-Corporate Liabilities

For ordinary tort and contract liabilities, Mr. Chase is, I think a bit too pessimistic on the power of corporate separateness to insulate the bank from the liabilities of its subsidiaries, its sister corporations or a parent holding company.[3] I must, of course, disclaim any assurance that a court would not "pierce the corporate veil," "lift the corporate skirts," or otherwise "disregard the corporate fiction." And I readily acknowledge that judicial rhetoric offers little basis for prediction. There is much talk in the cases of disregarding corporate separateness when one corporation is the "agent," "instrumentality," or "alter ego" of another. The fact is, however, that disregarding the corporate entity is a rather rare phenomenon. Four situations are worthy of note.

First is express or implied suretyship. Certainly, one corporation will be liable for another's obligations where it expressly agreed to act as surety. Implied suretyship is also possible. If, for example, two corporations impliedly "hold themselves out" to be a single entity, the law may treat them as such. Common advertising, common letterheads, or confusingly similar names may be sufficient to create such implied suretyship. But there is little danger on this score when management is, as it ought to be, scrupulous to avoid misleading creditors into believing that a deal with, say, the First National Banking Corporation is a deal with the First National Bank.

Second, and not entirely distinct from implied suretyship, is "unified operation" of separate corporations. Mere common central direction is not enough, for owners are expected to control, and the authorities are unanimous that mere ownership or control is not sufficient to make a parent corporation or owner liable. The primary sin here is commingling of assets. And when the owners mingle the assets of two corporations for their purposes, the courts will do the same for the benefit of creditors.

As a possible third and ill-defined category, the court may disregard corporate separateness when the owners disregard corporate formalities. Most of the cases in this category seem to involve

[3]There are some differences among these three different situations involving separate corporations, but the confines of a "comment" preclude great detail.

(1) confusion of the affairs of the two companies, or (2) operating one as a "mere division of the other," or (3) improperly diverting the assets of one corporation, or (4) abusing control to the prejudice of minority shareholders. A lack of complete identity in the directors of the several corporations will, if the non-overlapping directors are reasonably attentive, help protect against these sins.

Fourth, the corporate entity may be disregarded when the troubled corporation is severely under-capitalized. The courts see a fraud upon the public when one corporation launches another with capital grossly insufficient for the ordinary business risks.

Now it is true that most cases in this area have "pierced the veil" in order to hold a parent responsible for a subsidiary's obligations or to subordinate the parent's claims to those of unaffiliated creditors. Although somewhat harder, the subsidiary could also be held liable for the obligations of its parent or sister corporations. And, importantly, a bank might find its claims against a failing sister corporation subordinated to outsiders' claims. Nevertheless, and for all the qualifications, it can be said with some confidence that banking assets are more secure from the creditors and victims of non-banking activities when performed by separate sister or even subsidiary corporations than when performed by the banking corporation itself.

Intra-Corporate Dealings

A related issue concerns "improper" use of banking assets for non-banking purposes. Now, as Mr. Chase points out, there are statutory and regulatory limits on lending and on dividends. And corporate separateness has the advantage of increasing the "distance" between banking and other activities and thereby increasing the formality and visibility of transactions between the bank and the non-banking parts of the enterprise.

Although corporate separateness may thereby help in controlling improper use of bank assets, it does not eliminate the danger. For obviously, the bank may deal with a sister, parent, or subsidiary corporation in circumstances and on terms where it would not deal with a similarly situated but unaffiliated corporation.

Insulating Markets

Finally, the few words that time allows about the possible anti-competitive consequences of expansion by banks or bank holding

companies into non-banking activities. I am not impressed with the danger of "unfair" allocation of credit to non-banking activities which, arguably, obtain the benefit of the bank's federally-guaranteed — and therefore cheaper — money which unaffiliated borrowers do not obtain. To lend to an affiliate is necessarily to forego the return otherwise available on the market and is therefore a real economic cost to the enterprise. There would, I suppose, be opportunities for the bank to allocate "tight" credit to affiliates where custom or law prevented the interest rate from rising sufficiently to allocate the available supply of credit to reliable borrowers willing to pay a market-clearing price.

But the main competitive threat of expanding activities by banking enterprises is the potential for the use of leverage in the form of tying or reciprocity. The fear is that the banking conglomerate will gain an unfair competitive advantage in its non-banking markets by "pressuring" borrowers to take their shared-time computer services, travel tickets, or whatever from the banking conglomerate. To that extent, an "alien factor" would displace "competition on the merits" for the second product. An express agreement of that sort would be a clearly unlawful tie in violation both of Sherman Act § 1 and the Bank Holding Company Act.[4] But perhaps the "pressure" would be subtle enough to escape antitrust condemnation and yet strong enough to influence borrower behavior. The legal issue in such a case would turn on whether a jury would reasonably infer from the circumstances that the loan was conditioned, in any formal or informal sense, on the borrower's accepting other products or services.

Similarly, competition in banking services might be affected to the extent that suppliers to the banking conglomerate believed that banking with the conglomerate was a *sine qua non* or at least an aid to selling to it. Again, the express agreement would be clearly unlawful. And again, the legal issue in most cases would be whether one could infer from the circumstances that reciprocity was being practiced.

[4]12 USCA § 1972. The latter section is not limited to bank holding companies or their subsidiaries. It prohibits tying or reciprocity by any bank. Indeed, its language is so broad as to arguably cover many "legitimate" or at least customary banking activities. The statute does, therefore, give the Federal Reserve Board the authority to exempt transactions from the full sweep of § 1972. A Federal Reserve Board exemption from § 1972 however, would not immunize a transaction from the antitrust laws. Both the Senate Report and the Conference Report make clear that public and private remedies for the enforcement of § 1972 are not meant to be exclusive of otherwise available antitrust remedies to private parties or to the government. See 1970 U. S. Code Cong. and Adm. News 5519.

Now it is clear that illegality under the antitrust laws does not depend on the corporate form chosen. Nor do treble damages for violation of those laws. Indeed, the bank which is involved in such a violation would itself be liable quite apart from the corporate form.[5]

Nevertheless, corporate form might be relevant in two respects: to help minimize the likelihood of the violation and to help reduce the inference of tying or reciprocity from the circumstances. Separate corporations with separate managements, each responsible for its own profits, reduce somewhat the likelihood that either would base its decision on any factor other than its corporation's profits, regardless of the second corporation's profits. If those who buy supplies for other divisions of the conglomerate are formally and physically isolated from the lending officers, the chances of procurement personnel being influenced by the source of a supplier's borrowings is much reduced.

Accordingly, the distance between the banking and non-banking activities would reinforce the financial insulation of banking assets and also help reduce the likelihood of tying and reciprocity in violation of the antitrust laws. In both respects, corporate separateness helps establish such distance. But, of course, corporate separateness cannot necessarily guarantee either financial or antitrust immunity.

[5]Similarly, the Securities Exchange Act of 1934 imposes various liabilities on those who control a corporation regardless of the corporate form.

DISCUSSION

EUGENE M. LERNER*

The underlying theme of Dr. Chase's paper is that if a subsidiary of a holding company fails, the failure may possibly have an impact upon the safety of the deposits of a bank also belonging to the holding company. He asks whether some activities could be better carried on within the bank itself or in the holding company. He concludes that the more risky activities ought to be carried on in the holding company. But, since the failure of one of the subsidiaries of the holding company may lead to trouble in the bank itself, Dr. Chase comes face to face with a problem that is dear to the hearts of a regulator: How much freedom should management have to take risk if it can lead to failure? I would like to suggest that there is a serious misemphasis in this point of view.

Holding Company Activities

I am not a lawyer, but my understanding is that holding companies can enter into activities that are financially related to banking. I suspect that if Dr. Chase had his way there would be another criterion: the activity should not only be financially related to banking but it ought not to jeopardize the profitability of the bank itself. More specifically, the bank ought not to pay too high a price for the subsidiary that it acquires.

Let me elaborate on this point. Take an activity, such as financial consulting. Banks engage in financial consulting all the time. No customer can get a personal loan without the banker asking whether he needs the money, how much he needs, what his plans are for its use, and so forth. And based upon the information he develops, a program is established for repayment of the loan. This is financial

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consulting in the nitty-gritty sense of the term. We can cite a second example. A builder comes into the bank to get a loan for a proposed development. The banker may visit the site with the builder and say, "You know it looks like a nice property, but have you done a survey to determine whether or not there is any need for an apartment building where you want to put it?" Both the builder and the banker may examine the vacancy rate of two or three-bedroom apartments in the community, the trend of population, the location pattern of new highways, etc. This too is financial consulting and it is an activity that many many banks carry on. In spite of the fact that banks are continuously consulting with their clients, the Board recently ruled that bank holding companies could not engage in management consulting.

I don't know why the Board reached the conclusion that bank holding companies could not do what banks can do, but I have a hunch. My hunch is that the price that the holding company was willing to pay for these new acquisitions was too high. The management consulting firms which were to be acquired were going to command a premium over book. I suspect that other things being equal the Board would prefer new acquisitions to be at low rather than high prices.

Methods of Paying for Acquisitions

The reason for the preference is straightforward. There are two ways in which you can acquire a company. One is to buy it for cash, and that raises the question of where the money came from. The other way is to swap paper, an exchange of shares. Consider the first method, an exchange for cash. Where is the bank going to get the money? One likely answer is that the holding company sells a bond issue. Now what? Well, interest has to be paid on the debt and if the company borrows too much, in some years it may possibly not earn enough to pay the interest. It is a matter of judgment as to how much of a debt a firm can afford to carry, but I submit that the Board has a bias against too much debt in the capital structure of the holding company.

Now consider the second way to make an acquisition, through the exchange of shares. If I pay a premium – that is, if the company I acquire sells at a higher P/E ratio than the bank – then if I am to continue my per share dividend payments, I require that a larger percentage of my earnings be paid out. The implication is that not enough capital will be accumulated and retained and a failure may result.

Low Price of Bank Stock

Where do these speculations lead us? The answer, I think, is simply that the price of bank stock is too low. If the price of bank stock were higher, many of these consequences of acquisitions would disappear. But this only leads to the question: Why are bank stocks selling at such a low price? Why is the P/E ratio so low? I think there are several reasons. First, I think that one reason for the low P/E ratio is tough regulation. It almost seems that every time a bank gets a good idea and wants to do something that will be innovative and profitable, a regulator arises who says it cannot be done. I think if this activity continues and if the regulators are hostile because of some deep concern about deposit safety, bank stocks may possibly sell for less than book value. This condition now prevails in other regulated industries and I do not see why it could not happen to banks.

Second, I think that bank stocks sell at a low P/E ratio because of the industry's relationships with the Congress. Who wants to invest in an industry that gives the impression of constantly bickering with the legislative body?

Third, and perhaps most important, banks don't really advertise themselves very well. There was a glorious column a little while ago by Eric Heinemann in the New York Times that discussed what I consider to be one of the finest days of the commercial banking system. It was right after the Penn Central failed and we had a major panic pending in the commercial paper market. There began to be a run on Chrysler and the day-by-day and hour-by-hour development were described by Heinemann. The commercial banking system advanced Chrysler almost a billion dollars over the space of three days and as we know no crisis erupted. The banks stood there, put their money on the line and saved the day.

Aside from the New York Times, no one else talked about these developments and about the major public service that the industry performed. I think if the story were told, investors would be willing to commit their funds to companies with such foresight and courage.

To summarize, I believe bank stocks are selling at a low P/E ratio, because of hostile regulations, because of poor relations with Congress, and because banks themselves do not properly tell their story. So long as bank stocks continue to sell at low P/E ratios, acquisitions by holding companies are going to be challenged. The kinds of problems that Sam Chase talks about – about whether acquisitions can lead to failure – are going to remain. My own

sentiment is that the way to promote better banking is for the Federal Reserve to go out and tell America to buy bank stocks, because they are tremendous investments.

The Implications of the Proposals of the Hunt Commission for the Mortgage and Housing Markets: An Empirical Study

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Part I: Introduction

The Report of the President's Commission on Financial Structure and Regulation [19] (hereafter the Hunt Report) recommends important changes in the regulation, supervision, and operation of all major financial intermediaries. A common thread throughout the Hunt Report is the view that financial institutions should operate under the minimum necessary regulation. In this regard the Hunt Report proposes (1) eliminating Regulation Q and related time deposit rate ceilings, (2) authorizing a wider range of asset and deposit powers for the financial intermediaries, and (3) extending many of the service functions that financial intermediaries wish to provide. The Hunt Report acknowledges the concern that may be raised by such proposals in view of the social priority for an ample flow of funds into housing investment, but it argues that the question of the efficiency of financial markets should be separated from the question of the subsidization of socially desiable expenditures. In particular, the Report points out that housing construction may be most efficiently stimulated by direct subsidies legislated by the Congress.

An unfortunate aspect of the Hunt Report is that there is practically no attempt to quantify the likely magnitudes that would be involved if the proposals were adopted. This drawback is particularly severe in the discussion of the mortgage and housing markets. That is, even if one were to agree with the principle of limited regulatory

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intervention and direct subsidization of social priorities, some indication of the magnitudes that are likely to be involved would appear a critical input for any pragmatic evaluation of the Hunt Report.

It is with this background that we have attempted to prepare a paper describing some of the the likely quantitative implications of the Hunt Report for the mortgage and housing markets. In Parts II and III of the study the Federal Reserve–MIT–Penn Econometric Model (hereafter the FMP model) is used to evaluate many of the recommendations of the Hunt Report. Although the FMP model is the most comprehensive model available for this purpose, it should be noted at the outset that the proposals of the Hunt Report are sufficiently far reaching that models estimated using historically available data may not apply to the new regimes of the Hunt Report. The possibility that a model may not be appropriate when applied to new regimes is in fact quite apparent in much of the institutional structure of the FMP model, since the model sharply distinguishes between different financial intermediaries. Under the recommendations of the Hunt Report the distinctions between financial intermediaries will be blurred, and, perhaps, even eliminated. We have, in fact, been sufficiently concerned about this point that in Part IV an alternative analysis that does not depend on current institutional structure has been attempted. Not surprisingly, the conclusions that can be drawn from the more general analysis are not as precise as those that come from the established FMP model.

It should also be stressed at the outset that in evaluating the implications of the Hunt Report for mortgages and housing, we have considered only part of the Report's proposals. In addition to the three sets of proposals noted above, the Hunt Report also makes significant recommendations for the supervision, chartering, and branching of financial intermediaries, for the operation of trust and pension funds, and for changes in reserve regulations and tax treatment of the institutions. We have considered these proposals, but have restricted our discussion to the proposals regarding Regulation Q, to the proposals for extended borrowing and lending powers, and to the proposals for extended service functions.

Part II: Mortgage and Housing Market Effects from the FMP Model

A. *The FMP Model*

The results of this section are based on simulation experiments using the Federal Reserve–MIT–Penn (FMP) econometric model. A general discussion of the overall model is being prepared by Ando and Modigliani [2]. Preliminary reports on the general structure of the model can be found in Ando and Modigliani [1], deLeeuw and Gramlich [7], [8], and Rasche and Shapiro [18]. These preliminary reports provide a sufficient discussion of the general structure of the model to permit the interpretation of the results reported here.

With respect to the savings-deposit, mortgage, and housing sectors of the FMP model, the sectors used most intensively in this study, detailed discussions are available in Gramlich and Jaffee [14]; see also Appendix A. It is useful, however, to review the main structure of these three sectors. As a broad scheme, the main equations of these sectors may be summarized: (signs above symbols indicate expected partial derivatives)

$$(1)\quad TD_i = TD_i\left(RT_i^{+},\ RT_j^{-},\ RCB^{-},\ NW^{+}\right)$$

$$(2)\quad RT_i = RT_i\left(RM^{+},\ RCB^{+},\ RT_j^{+},\ \text{Reg Q Ceiling}^{+}\right)$$

$$(3)\quad M_i = M_i\left(RM^{+},\ RCB^{-},\ TD_i^{+}\right)$$

$$(4)\quad RM = RM\left(RCB^{+},\ M/H^{-}\right)$$

$$(5)\quad H = H\left(RM^{-},\ PH^{-},\ \triangle M^{+},\ \text{Demand Variables}^{+}\right)$$

Symbols are defined:

RT_i : time deposit rate of ith intermediary

RM : mortgage rate

RCB : corporate bond rate

NW : net worth of household sector

TD_i : time deposits of ith intermediary

M_i : mortgages held by ith intermediary

M : total mortgages held

ΔM : change in total mortgages held

H : housing stock

PH : price of housing

The explanation of these equations will be provided as the analysis proceeds.

B. *Description of Experiments*

Due to the large number of Hunt-Report proposals that may directly affect the housing and mortgage markets, it was decided to implement the proposals one by one. The following notes describe each experiment and how it was implemented in terms of equations (1) to (5). A precise description of the experiments is provided in Appendix A.

(1) *Elimination of Regulation Q.* The FMP model explicitly accounts for the effect of the Regulation Q ceiling on commercial bank deposit rates, and thus the effect of eliminating the ceiling can be ascertained over historic periods by simply raising the ceiling above the relevant level. In terms of equation (2), it can be seen that raising the ceiling directly allows the commercial bank time deposit rate to rise. The time deposit rates of the savings institutions (savings and loan associations and mutual savings banks) will also rise, but to a lesser extent. The net effect on deposits levels (as seen in equation (1)) will be a shift in deposits away from the savings institutions and to the commercial banks. Because all deposit rates rise, it is possible that the aggregate effect will be a net increase in deposits, indicating some bidding of funds away from other capital markets ("re-intermediation"). The effects of the deposit changes on mortgages and housing then follow from equations (3) to (5).

The Regulation Q ceiling experiment assumes that only commercial bank deposit rates were constrained by the ceilings. Savings institutions have also, however, had ceilings placed on their deposit rates, and it has been a matter of debate whether these ceilings

actually inhibited the deposit-rate setting of the savings institutions.[1] It has been found in the FMP model, for example, that the model simulates values well above the actual rates in the late 1960s for the savings institutions. This suggests that binding ceilings also did affect the savings institutions. Thus we have carried out a second experiment in which we first constrain the savings institution deposit rates to their historic values, and then release their rates and the Regulation Q ceiling on commercial banks at the same time. The general effect of this experiment should be the same as the first, but we would expect the savings institutions to fare relatively better since they are also being released from a constraint.

(2) *Extended Service Benefits for Savings Institutions.* The Hunt Report extends the service functions allowed savings institutions in many ways. The two most important factors appear to be the consumer loan powers and the third party payment functions allowed the savings institutions. More generally, however, it seems the intention of the Report to allow savings institutions to compete with banks in all consumer related functions that may be termed "one-stop banking."

In order to evaluate this effect, we note that savings institutions have historically paid deposit rates of from 50 to over 100 basis points more than commercial banks, and that this spread has been attributed to the "one-stop banking" advantages available to the commercial banks. We should thus expect the Hunt-Report proposals to create a significant shift in time deposits from commercial banks to savings institutions if this spread is maintained. In the experiments we have shifted the demand functions for time deposits faced by the commercial banks and savings institutions such that the spread necessary to achieve the currently observed distribution of deposits is smaller. In particular, we have decreased the necessary spread by two amounts: 25 basis points and 50 basis points.

(3) *Portfolio Composition Effect of Extended Lending Powers.* The Hunt Report recommends significant extensions in the lending powers of the savings institutions. Perhaps the most important power is the consumer loan function. In addition, lending powers have also been extended to corporate bonds, state and local securitites, and equities. The lending powers in each of these areas are limited,

[1] See Vernon [22] for a discussion of ceiling regulations and deposit rate setting of non-bank intermediaries.

typically to 10 percent of assets, but their cumulative effect certainly may be quite significant. An important question is thus to what extent these powers will actually be used.

One indicator of the degree of use of these powers can be found in the experience of mutual savings banks. In several states with mutual savings banks, for example, the institutions have consumer loan powers. The experience has been that most of these institutions use these powers in the range of 3 to 8 percent of assets, whereas in most cases the legal maximum is at least 10 percent. Similarly, mutual savings banks already enjoy powers with respect to corporate bonds and equities. As of December, 1971, mutual savings banks held 20 percent of their assets in such corporate securities.

In attempting to translate this information into a reasonable assumption for the portfolio substitution effect of the extended lending powers, several considerations must be noted. First, at issue is a complicated portfolio adjustment in which the substitution of the new assets need not go only against mortgages; to the extent that the extended powers allow for more diversified, more liquid, or more marketable portfolios, we might well find a significant part of the substitution effect going against the liquid asset holdings of the institutions. Second, the savings institutions would still maintain, by virtue of their established expertise, a comparative advantage in the origination of mortgage contracts. Thus, there should be no presumption that they will necessarily use the extended powers to the full limit, or even to the degree they are used by other institutions (for example, by life insurance companies and commercial banks). Finally, it must obviously be pointed out that savings and loan associations are likely to make significantly more use of the new powers than mutual savings banks since the latter already have at least some of these powers.

To estimate the portfolio substitution effect, we shall carry out two experiments in the hope that our results will at least bound the likely outcome. For savings and loan associations we assume that the supply of mortgages is reduced by (i) 10 percent and (ii) 30 percent. For mutual savings banks we assume respectively (i) 5 percent and (ii) 15 percent.

In terms of the simple equation system above, these assumptions are introduced by reducing all the parameters determining the equilibrium mortgage stock of the institution by the appropriate amount. These shifts in the mortgage supply function will then induce an increase in the mortgage rate, leading to some increase in mortgage lending, and to an increase in the deposit rate (because the mortgage

rate rises), leading to a larger portfolio size with a resulting increase in mortgage lending. Thus, although the total effect for mortgage lending from this source is likely to be negative, it will be less than the original amounts specified, and our results will indicate the magnitude of the offset.

(4) *Portfolio Expansion Effect of Extended Lending Powers.* The previous discussion has just indicated that a rising mortgage rate will induce a rise in deposit rates, and thus a rise in portfolio size that may offset portfolio composition changes. The extended lending powers may also have a more direct effect on the ability of savings institutions to compete for deposits. Specifically, by obtaining a more optimal portfolio distribution, the savings institutions should be able to increase either the safety of their portfolio (with its yield constant), or the yield of their portfolio (with risk constant), or some of both. In any of these cases, the changes should place the savings institutions in a more competitive position in the deposit market.

To evaluate these effects, we assume that funds transferred from mortgages to other extended lending powers will provide the institutions on average a gain of one percentage point in yield. This value is, in fact, roughly the net yield advantage of consumer loans over mortgage loans after accounting for all cost and default losses (see Fand [13]). In terms of the average yield on the portfolio, for an institution shifting 10 percent of its assets out of mortgages, for example, the effect on the total portfolio would be a yield gain of .1 percentage points.

In implementing this experiment, we have tied our assumptions to the respective cases for the portfolio substitution effect. It will be recalled we assumed, for savings and loan associations, portfolio substitutions of (i) 10 percent and (ii) 30 percent; thus the corresponding expansion effects are an increase in the deposit rate of (i) .1 and (ii) .3 percentage points. Similarly, for mutual savings banks, we assume, in the respective cases, increases in the deposit rate of (i) .05 and (ii) .15 percentage points.

The impact of these shifts in deposit rates will be increased savings flows into the institutions, the funds coming both from the commercial banks and the general capital markets. These markets may compete, of course, and this competition in rates will drive the rates even higher and will reduce the net flows to the institutions. Whatever the amount, however, the increased deposit flows will stimulate the supply of mortgages.

(5) *Flexible Loan Rates on Policy Loans of Life Insurance Companies.* During the 1966 monetary tightness, life insurance companies experienced a significant and sudden increase in the flow of funds to policy loans. The reason for this sudden increase was that the loan rate on policy loans is generally fixed, typically at 5 percent, and thus sophisticated policy holders will take out loans when market rates rise above these fixed levels. In response to this problem, the Hunt Report recommends that life insurance companies be allowed a flexible policy with respect to the interest charges on policy loans. While the intent of the proposal is not to eliminate policy loans – they would be still used by individual policy holders as an available source of funds – a flexible rate policy would eliminate the "hot money" aspect of these funds.

Fortunately, the implementation of this policy is straightforward in the FMP model since the model is intentionally estimated with the spread between market interest rates and the fixed charge of life insurance companies. Thus, this variable is set to zero in testing for the effect of the flexible loan rate policy. The effect of the change should, of course, be a reduction in the flow of funds away from life insurance companies in periods of rising and high interest rates.

(6) *Variable-Rate Mortgages.* The Hunt Report's recommendation for variable-rate mortgages is perhaps one of its most controversial features. The use of variable-rate mortgages entails considerable change in the habits and expectations of both the borrowers and the lenders. Because of the basic changes required, we feel it is beyond the scope of the current experiments to attempt a full investigation of variable-rate mortgage effects. However, one obvious impact of variable-rate mortgages would be that they allow deposit rates of savings institutions to respond more quickly to changes in the market yield on mortgages. Currently, in the FMP model, on the other hand, deposit rates respond only with a long lag to changes in mortgage rates. Thus, to test the magnitude of the changed response of deposit rates to mortgage rates, we have eliminated all lags in the estimated relationship while maintaining the same cumulative effect. The result should be a more responsive deposit rate, although there should be no effect on average unless mortgage rates have a trend over the sample period. It is worth repeating, however, that there are many other aspects of variable-rate mortgages that should be considered in a full evaluation of this proposal. In particular, our analysis does not take into account the effect of changed cash flows that would result from variable-rate mortgages.

C. *The Implementation of the Experiments*

As already noted, a technical description of the experiments is provided in Appendix A. There are, however, certain features of the experiments that should be stressed:

(1) *Dynamics and Lead Time.* The FMP model has been carefully estimated to account for short-term dynamic relationships in the capital markets. Thus any impulses that shock the system will have short-run impacts that vary in magnitude, and sometimes even in direction, from the long-run impact. In implementing the experiments used here, we have shocked the system by the full amount of the change all at once. One can thus observe how the system dynamically adapts to the change on its path toward the final equilibrium. In particular, we show the results of the shock roughly one year after the impact (the short run), five years after the impact (the intermediate run), and 10 years after the impact (the long run).

With respect to dynamics, it should also be noted that the Hunt Report has generally recommended that its proposals be adopted on a gradual time basis. We have not attempted to capture this proposed phasing-in because of the complications created in programming the actual policies. However, it should be noted that a phasing-in lag should be added to the internal dynamics in evaluating the actual timing of the effects of the proposals.

(2)*Mortgages and Housing in the FMP Model.* A second point of note concerns the relationship between mortgage flows, mortgage interest rates, and housing investment in the FMP model. As shown in equation (5), changes in both the mortgage interest rate and the flow of mortgages will affect the amount of housing investment. Increases in the mortgage rate increase the cost of capital for housing investment, and thus lead to long-run decreases in the desired housing stock. Increases in the mortgage flow increase the availability of funds for housing, and thus stimulate housing investment.

It should be stressed, however, that the mortgage-flow effect on housing and the mortgage-rate effect on housing are mutually exclusive; that is, they both cannot be operating at the same time. The mortgage-flow effect can operate only when the mortgage market is in disequilibrium such that, at the quoted mortgage rate, the demand for funds exceeds the supply; in this situation the availability of funds will influence housing investment and the rate will be irrelevant. On the other hand, only the mortgage-rate effect will

operate whenever the mortgage market is in equilibrium; in this situation the demand for funds must equal the supply of funds and thus availability effects will not matter. The relative importance of the mortgage-flow and mortgage-rate effects thus depends critically on whether the mortgage market is in equilibrium. While available evidence indicates the mortgage market may have significant deviations from equilibrium in short-run dynamic contexts,[2] there is no evidence to suggest that equilibrium is not generally attained in the intermediate or long run.

An important implication of this structure in the model is that policies affecting the mortgage market will induce long-run changes in the housing stock only to the extent that these policies change the mortgage interest rate. This factor is important because the FMP model is also characterized by a very high elasticity in the response of the demand for mortgage funds to interest rate changes.[3] That is, small changes in the mortgage rate will induce large changes in the demand for mortgage funds. The implication of these factors can perhaps be best understood with the example of a purchase of mortgages by FNMA. In the short run, assuming the mortgage market is in disequilibrium, the impact of a FNMA purchase will directly increase housing investment, because of the unsatisfied demand for mortgage funds. In the long run, however, FNMA purchases will effect housing only by their impact on the mortgage rate. Now, it could be expected that FNMA purchases would tend to lower the mortgage rate; however, because of the high elasticity of demand, small declines in the mortgage rate create large demands for funds, and thus the net effect of FNMA on the mortgage rate may be very small. Taking this one step further, one can see therefore that the long-run impact of FNMA on the housing sector may be very small.

The upshot of this discussion is that policy changes in the FMP model that result in large changes in the flow of mortgage funds may at the same time result in relatively small changes in the flow of housing investment. This is the result of the structuring of the model. It is, however, a somewhat controversial feature of the model, and thus in discussing and evaluating our results, we shall take care to show both the effects on mortgages and the effects on housing. (See Section II.D. (8) below.)

[2]See Fair [11] and Gramlich and Jaffee [14].

[3]This aspect of the mortgage sector is discussed in Gramlich and Jaffee [14], Chapter 5.

(3) *Experiments Done in Real Time.* The results obtained in this part are derived from comparative simulations of the FMP model. This means that a Hunt-Report proposal is coded into the FMP model, the model is simulated over some time period, and then the results are compared with either historic data or the results of other related simulations. The sample used in all these experiments is 1960:1 to 1970:3, and the shocks to the system generally occur in 1960:2. The results are then available on a quarterly basis for a little over 10 years after the shock. In reporting the results we have used actual dates as a convenient numbering system; for example, most of the results are reported for 1961:1, one year after the shock; for 1965:1, five years after the shock; and for 1970:3, roughly 10 years after the shock.

(4) *General Equilibrium Simulations.* The simulation experiments have been carried out in the context of the full FMP model (see Appendix A for details). This means that the results obtained for any shock to the system include all general equilibrium ramifications of the shock. For example, a shock that stimulates housing investment will, via the GNP multiplier, have feedback links to the savings-deposit, mortgage, and housing sectors, and these feedbacks will be taken into account in the final reported results. Similarly, the general equilibrium links among the savings-deposit, mortgage, and housing sectors are included in all the simulation experiments.

D. *Results of the Experiments*

(1) *Simulation Fit of the FMP Savings-Deposit, Mortgage, and Housing Sectors.* Table 1 provides results for the historic values, simulation values with the Regulation Q ceiling in effect, and summary statistics for the savings-deposit, mortgage, and housing sectors of the FMP model. The variables listed in the table are defined:

Interest Rates

RTB	Treasury bill rate
RM	Mortgage rate
RTP	Commercial bank time deposit rate
RSL	Saving and loan deposit rate
RMS	Mutual savings bank deposit rate

Deposit Levels

MP	Commercial bank time deposits
MSL	Savings and loan deposits
MMS	Mutual savings bank deposits
MIS	Life insurance company reserves

Mortgage Levels

MKCB	Commercial bank mortgage holdings
MKSL	Savings and loan mortgage holdings
MKMS	Mutual savings bank mortgage holdings
MKIS	Life insurance company mortgage holdings

Housing Investment and Stock

EH$	Current dollar housing investment (at annual rates)
KH$	Current dollar housing stock (single and multi family)

The actual historic values for these variables at three points in time 1961:1, 1965:1, and 1970:3 -- are shown in Table 1A.

Table 1B shows the simulated values that result from a dynamic simulation of the full FMP model (see Appendix A) with Regulation Q ceilings in effect. The time period for the simulation is 1960:1 to 1970:3. The initial point was chosen as essentially the earliest point at which the full system could be simulated. The end point was chosen to avoid the effects of the 1970:4 automobile strike.

Overall, the system simulates the historic data very well. Table 1C shows the means of the historic series and the root-mean-squared errors (RMSE) between the historic series and the simulated series for the full sample. It can be seen that interest rates are simulated with an error in the order of 15 basis points, deposits are simulated with an error in the order of $4 billion, mortgages are simulated with an error in the order of $4 billion, housing investment is simulated with an error of $2 billion, and the housing stock is simulated with an error of $4 billion. Perhaps the main point of error in this simulation occurs late in the sample (see 1970:3) where RSL, MSL, MMS, MKSL, and MKMS are too high and MP and MKCB are too low. This is apparently the result of not placing any ceilings on the rate-setting of savings institutions; consequently, they simulate too high in their rate setting, their deposit levels, and their mortgage levels; similarly, the commercial banks simulate too low in their deposit levels and mortgage levels. This result will be discussed further below.

Table 1

HISTORIC VALUES AND STANDARD DYNAMIC SIMULATION WITH REGULATION Q CEILING

($ billions)

	1A: Historic Values			1B: Simulation			1C: Summary Statistics	
Variables	1961:1	1965:1	1970:3	1961:1	1965:1	1970:3	Mean	RMSE
Interest Rates								
RTB	2.35	3.89	6.33	2.48	4.16	6.30	4.17	.22
RM	6.11	5.83	8.60	6.10	5.90	8.22	6.55	.18
RTP	2.66	3.83	4.75	2.72	3.72	4.75	3.80	.06
RSL	4.03	4.32	5.55	4.06	4.29	5.95	4.56	.14
RMS	3.68	4.17	5.91	3.68	4.04	5.86	4.38	.12
Deposit Levels								
MP	61.9	109.9	171.5	63.6	108.0	155.3	112.1	4.8
MSL	64.3	104.1	142.9	63.7	105.6	160.3	102.2	6.5
MMS	37.1	50.1	69.7	37.2	49.6	76.7	51.2	2.1
MIS	97.6	119.1	153.6	97.7	119.7	158.3	121.8	1.5
TOTAL	260.9	383.2	537.7	262.2	382.9	550.6	—	—
Mortgage Levels								
MKCB	28.8	44.6	71.4	29.4	45.2	57.6	47.2	3.4
MKSL	62.0	103.6	146.5	61.3	105.3	157.8	101.6	5.0
MKMS	27.6	41.7	57.2	28.1	40.3	66.0	41.7	2.4
MKIS	42.4	56.4	73.8	42.2	57.5	77.4	57.2	1.3
TOTAL	160.8	246.3	348.9	161.0	248.3	358.8	—	—
Housing								
EH$	21.7	27.4	28.7	21.5	27.8	29.7	26.6	2.0
KH$	488.6	564.3	829.3	488.0	564.5	821.8	601.0	4.0

(2) *Removing Regulation Q Ceilings.* Table 2A shows the changes introduced with respect to the simulation with ceilings (Table 1B) when Regulation Q is removed from the commercial banks. Since the ceiling did not bind the banks (in the model) until 1968:1, the table shows results only for three recent points – 1968:1, 1969:1, and 1970:3. Before 1968:1 there were no changes compared with simulation with ceilings in effect.

Looking first at the impact on mortgages, we find that the mortgage holdings of the non-bank intermendiaries fall, by a total of $14.7 billion in 1970:3, while the holdings of commercial banks rise, by $4.7 billion in 1970:3. Thus the net effect of removing Regulation Q from the commercial banks is a decline in total mortgage holdings of $10 billion in 1970:3. The effect on housing is a decline of $1.8 billion in the stock of housing in 1970:3.

The mortgage changes have their source in the deposit rate and deposit flow changes introduced by the removal of the ceiling. It is seen that commercial banks raised their deposit rates in 1970:3 by 95 basis points and received additional deposits of $27.7 billion. The non-bank intermediaries also raised their deposit rates in order to compete, but still lost deposits by 1970:3 in the amount of $17:3 billion. Total deposits of the intermediaries thus rose by $10.4 billion in 1970:3. We thus have the result that total deposits of the intermediaries rose (obtaining funds from other markets) but that mortgage levels fell; the explanation, of course, is that there was a shift in deposits toward the less mortgage-intensive commercial banks.

The effect on housing is in part due to the decreased mortgage flows, but, quantitatively, the increase in the mortgage rate by 20 basis points in 1970:3 is the major source. The mortgage rate rose, in turn, in part because of the shift in the supply of mortgage funds, but, quantitatively, the major source of the rise is due to the increase in the Treasury bill rate by 42 basis points. The change in the Treasury bill rate is worth explaining at this point since a similar effect will be observed in experiments below. The change in the Treasury bill rate is the result of the increased level of time deposits at the commercial banks. The mechanism is that increased commercial bank time deposits require additional reserve funds, and thus the narrowly defined money supply must fall. This decline in the narrowly defined money supply results in the rise in the Treasury bill rate.[4]

[4]The money demand-money supply sector of the FMP model is described in detail in Modigliani, Rasche, and Cooper [17].

Table 2

SIMULATED VALUES: WITHOUT DEPOSIT RATE CEILINGS

	2A			2B			2C		
	No Ceilings on Commercial Banks: Deviations from Table 1B			No Ceilings on Any Intermediary: Deviations from Simulation (not shown) with Ceilings on all Intermediaries			No Ceilings on Any Intermediaries Simulated Levels		
Variables	1968:1	1969:1	1970:3	1968:1	1969:1	1970:3	1961:1	1965:1	1970:3
Interest Rates									
RTB	.01	.52	.42	.01	.49	.31	2.48	4.16	6.72
RM	0	.04	.20	0	.02	.03	6.10	5.90	8.42
RTP	.02	.37	.95	.02	.37	.95	2.72	3.72	5.70
RSL	0	.09	.38	0	.21	.78	4.06	4.29	6.33
RMS	0	.15	.57	0	.25	.52	3.68	4.04	6.43
Deposit Levels									
MP	.1	5.4	27.7	.1	4.5	21.7	63.6	108.0	182.9
MSL	0	−2.3	−11.5	0	−1.2	1.1	63.7	105.6	148.8
MMS	0	−.9	−3.8	0	−.3	−1.0	37.2	49.6	72.9
MIS	0	−.1	−2.0	0	−.1	−1.2	97.7	119.7	156.3
TOTAL	.1	2.1	10.4	.1	2.9	20.6	262.2	382.9	560.9
Mortgage Levels									
MKCB	0	.3	4.7	0	.3	3.0	29.4	45.2	62.3
MKSL	0	−1.8	−10.6	0	−1.1	1.4	61.3	105.3	147.2
MKMS	0	−.6	−3.1	0	−.2	−.6	28.1	40.3	62.9
MKIS	0	0	−1.0	0	0	−.7	42.3	57.5	76.4
TOTAL	0	−2.1	−10.0	0	−1.0	3.1	161.1	248.3	348.8
Housing									
EH$	0	−.5	−1.3	0	−.3	−.2	21.5	27.8	28.4
KH$	0	−.2	−1.8	0	−.1	−.3	488.0	564.5	820.0

Table 2B shows the changes introduced when deposit ceilings are removed from all financial intermediaries. We observed above that the basic FMP model does not have ceiling effects on non-bank intermediaries; furthermore, we observe that the basic simulation shown in Table 1B indicated that at least since 1968 the non-bank intermediaries were behaving as if ceilings were binding them to some extent. To obtain some quantitative measure of this effect we performed an additional "standard" simulation in which, since 1968:4, RSL and RMS were constrained to the observed historic values. This is interpreted as constraining the savings and loan associations and mutual savings banks to ceiling levels. The deviations shown in Table 2B are then the difference between the simulation without any ceilings (the same simulation underlying Table 2A) and the simulation with savings and loan associations and mutual savings banks constrained to ceiling (historic) levels.

Comparing Table 2B with Table 2A, we find that the non-bank intermediaries fare better under 2B, with the result that the mortgage stock actually rises by $3.1 billion in 1970:3 and the decline in the housing stock is a negligible $.3 billion in 1970:3. The difference in the results is the expected outcome of assuming that the non-bank intermediaries were constrained historically by rate ceilings and then calculating the effect of removing the ceilings.

Thus, in evaluating the total effects of removing Regulation Q we obtain at least somewhat different results depending on whether non-bank intermediaries were also constrained by deposit-rate ceilings. If only commercial banks were constrained, then Table 1A indicates that removing the constraint will, in 1970:3, result in a decline in mortgages of $10.0 billion, a rise in the mortgage rate of 20 basis points, and a decline in housing of $1.8 billion. If it is assumed all intermediaries were constrained, then Table 1B indicates that removing all constraints will, in 1970:3, result in a rise in mortgages of $3.1 billion, a rise in the mortgage rate of 3 basis points, and a decline in housing of $.3 billion. If these results are compared with the historic values in Table 1A, however, it is seen that for both assumptions the actual changes are quite small. We feel that this should be the major implication drawn from these results; *the removal of deposit-rate ceilings from depositary institutions will have minor quantitative effects on mortgage levels and housing and even the direction of the change is in doubt.*

We now turn to consider other proposals of the Hunt Report. In evaluating these other proposals we shall use as our standard of comparison the simulation of the FMP model when no ceilings are

present.[5] This is the assumption used in obtaining Tables 2A and 2B. For purposes of reference, the levels simulated under this no ceiling assumption for the periods 1961:1, 1965:1, and 1970:3 are shown in Table 2C. Since these results are already implicit in preceding tables, they require no further discussion.

(3) *Extended Service Functions.* Table 3A shows the effect of allowing savings institutions extended service functions. This is implemented, as discussed above, by changing the necessary rate spread between savings and loan association deposit rates and commercial bank deposit rates, and mutual savings bank deposit rates and commercial bank deposit rates. In the case of Table 3A, the spreads are changed by 25 basis points wherever they enter the deposit demand functions.

The principal effect of this change is a large decrease in commercial bank deposits and a large increase in savings institution deposits. By 1970:3 the magnitude of the changes are − $25.7 billion for commercial banks and $32.2 billion for savings and loan associations and mutual savings banks. In percentage terms, this indicates that commercial bank deposits decline and that savings institution deposits rise about 15 percent 10 years after the change. There is also a large shift in deposits from savings and loan associations to mutual savings banks, but this is primarily a function of the way the equations were estimated, and consequently we have shown only the sum of the effect.

The response in mortgage holdings follows the same lines, taking into account that the mortgage rate falls by 30 basis points in 1970:3. In percentage terms, by 1970:3 commercial bank mortgages have fallen by almost 20 percent and the non-bank intermediary holdings of mortgages have risen by over 15 percent. The net absolute effect is positive because the shift in deposits has been toward the more intensive mortgage issuers.

The response in housing capital is also quite significant. By 1970:3 the housing stock increases by $9.2 billion, which is over 1 percent of the stock. The explanation for why the housing change is much smaller than the mortgage stock change has been given above.

[5]This avoids multiple counting of the Regulation Q ceiling effects. It should also be stressed that each of the following proposals are implemented one by one without an attempt to calculate directly the cumulative effect.

Table 3

SIMULATED VALUES, ALLOWING EXTENDED SERVICE FUNCTIONS; DEVIATIONS FROM TABLE 2C

	Rate Spreads RSL-RTP and RMS-RTP Reduced by:					
	3A: 25 Basis Points			3B: 50 Basis Points		
Variables	1961:1	1965:1	1970:3	1961:1	1965:1	1970:3
Interest Rates						
RTB	−.08	−.20	−.29	−.15	−.39	−.53
RM	−.04	−.21	−.30	−.08	−.42	−.55
RTP	−.01	−.01	−.13	−.02	0	−.19
RSL	−.01	−.11	−.22	−.02	−.22	−.29
RMS	−.01	+.18	−.30	−.02	+.24	−.55
Deposit Levels						
MP	−1.9	−11.0	−25.7	−3.7	−21.6	−49.7
MSL+MMS	2.4	16.8	32.2	4.7	34.8	63.9
MIS	1.2	.9	5.6	.1	1.7	9.1
TOTAL	1.7	6.7	12.1	1.1	14.9	23.3
Mortgage Levels						
MKCB	−.1	−4.5	−11.6	−.2	−8.9	−21.9
MKSL+MKMS	1.3	18.4	34.8	2.6	37.8	68.5
MKIS	0	.2	3.4	0	.4	5.5
TOTAL	1.2	14.1	26.6	2.4	29.3	52.1
Housing						
EH$	.3	.8	.8	.5	1.8	1.8
KH$	0	2.5	9.2	0	5.0	19.7

Table 3B presents the results when the rate spread is changed by 50 basis points. The shock to the system is thus twice as large, and it is apparent that the resulting changes are roughly proportional by a factor of 2.

In summary, we place the expected effects of the extended service functions as somewhere between the results of Tables 3A and 3B. In either case, the results are somewhat surprising in that they indicate that *extending service functions to the non-bank intermediaries will result in significantly increased mortgage lending and, given the elasticities of the FMP model, relatively large increases in the housing stock.*[6]

(4) *Portfolio Substitution Effect of Extended Lending Functions.* Table 4 shows the results of reducing the supply of mortgage funds by savings institutions on account of the opportunities for investment in other earning assets. Using Table 4A as the example, it is seen that savings and loan association mortgages decline by slightly more than the initial 10 percent, whereas mutual savings bank mortgages actually rise. The explanation for both of these results is found in the behavior of their respective deposits: MSL declines, thus reinforcing the shift away from mortgages by savings and loan associations; MMs rises, and in fact, rises enough to offset completely the initial shift against mortgages by mutual savings banks. The total impact on mortgages remains negative, but it is considerably less than the initial shifts would indicate. In addition, the mortgage rate shows only a short-run effect of importance, and thus in the long run, by 1970:3, the effect on KH$ is negligible.

Table 4B illustrates the same type of shifts against mortgages, but the magnitudes are roughly three times as great. Even in this case, the total change in the stock of mortgages in 1970:3 is less than 15 percent of the outstanding stock, and the change in the housing stock is a small proportion of the housing stock. The evaluation of the importance of the portfolio composition effect thus depends on which case is considered relevant – 4A or 4B – and on whether mortgages or the housing stock is considered the relevant indicator. It may be concluded, however, that the *total portfolio substitution effect, including general equilibrium ramifications, is substantially less than the magnitude indicated by the initial shifts.*

[6]While the interest rate elasticities of deposits in the FMP model are high, they are within the range of other studies. For further discussion see Gramlich and Jaffee [14].

Table 4

SIMULATED VALUES, PORTFOLIO SUBSTITUTION EFFECT OF EXTENDED LENDING FUNCTIONS; DEVIATIONS FROM TABLE 2C

	Mortgage Supply Reduced by:					
	4A			4B		
	Savings and Loans: 10% Mutual Savings Banks: 5%			Savings and Loans: 30% Mutual Savings Banks: 15%		
Variables	1961:1	1965:1	1970:3	1961:1	1965:1	1970:3
Interest Rates						
RTB	−.02	.01	0	−.02	.08	.05
RM	.12	.03	.01	.30	.18	.13
RTP	0	.06	.04	−.01	.14	.08
RSL	.03	.04	.02	.06	.13	.11
RMS	.03	.26	.11	.08	.20	.18
Deposit Levels						
MP	0	.7	−.5	0	3.8	3.2
MSL	.1	−1.2	−2.0	.2	−5.3	−5.0
MMS	0	1.8	6.3	.1	1.8	6.4
MIS	−.1	−.3	−.1	−.3	−1.1	−2.2
TOTAL	0	1.0	3.7	0	−.8	2.4
Mortgage Levels						
MKCB	.2	.9	.3	.5	3.1	3.6
MKSL	−5.3	−11.8	−16.9	−13.9	−35.3	−48.5
MKMS	−1.5	−.1	4.8	−2.5	−4.9	−2.0
MKIS	0	.2	.1	0	2.5	−.7
TOTAL	−6.6	−10.8	−11.7	−15.9	−34.6	−47.6
Housing						
EH$	−1.3	0	.1	−2.4	.4	.5
KH$	−.9	0	−.4	−1.2	−1.7	−2.4

(5) *Portfolio Expansion Effect of Extended Lending Powers.* Tables 5A and 5B show the expansion effect of deposit-rate shifts that correspond to the substitution effects of Tables 4A and 4B. In both Tables 5A and 5B, RSL and RMS rise by 1961:1 by roughly the amount of the shift. As the deposits of these institutions expand, however, the deposit rates decline, and by 1970:3 the changes are quite small and for mutual savings banks they are actually negative. The resulting changes in deposits, including the induced effects on commercial banks and life insurance companies, in 1970:3 are $10.3 billion in Table 5A and $31.0 billion in Table 5B. The corresponding changes in mortgage stocks are $12.2 billion and $37.0 billion. In the case of Table 5A this change in mortgages more than offsets the decline observed in the portfolio substitution experiment 4A, while in the case of 5B the offset to 4B is not quite complete. In both cases, however, the summed effects of experiments 4 and 5 on the housing stock are positive. Thus, in summary, the combined results of our portfolio substitution and portfolio expansion experiments is that *the net effect on mortgages may be either positive or negative depending on the magnitude of the shift, while the net effect on housing is always an addition to the housing stock.*

(6) *Flexible Rate on Life Insurance Company Policy Loans.* The results of allowing flexible rate setting on policy loans by life insurance companies are shown in Table 6A. The effects of the proposal were negligible until the very end of the sample period, and thus we have shown the results only for the last observation, 1970:3. Even then, it can be seen that the total change in life insurance company reserves net of policy loans is only $2.1 billion. The induced changes in mortgages and housing are thus not significant.

This conclusion may seem surprising in view of the publicity given to the unexpected policy loan withdrawals faced by life insurance companies. It is thus useful to review the actual behavior of policy loans during the 1966 monetary tightness. During 1966, policy loans of life insurance companies increased from $7.7 billion to $9.1 billion, a change of $1.4 billion. Of this amount, roughly $.5 billion can be attributed to the natural growth in life insurance policies outstanding (this, for example, was the increase in policy loans in 1965), leaving $.9 billion as the unexpected component. This number is quite consistent with the FMP model, which simulates an unexpected increase in policy loans of $.7 billion during 1966. Clearly, the magnitude is small relative to the levels of outstanding policy loans and life insurance reserves. It thus appears reasonable to

Table 5

SIMULATED VALUES: DEPOSIT EXPANSION EFFECT OF EXTENDED LENDING FUNCTIONS, DEVIATIONS FROM TABLE 2C

	Deposit Rates Increased by:					
	5A			5B		
	Savings & Loan: 10 b.p.[a] Mutual Sav. Bank: 5 b.p.			Savings & Loan: 30 b.p. Mutual Sav. Bank: 15 b.p.		
Variables	1961:1	1965:1	1970:3	1961:1	1965:1	1970:3
Interest Rates						
RTB	0	−.05	−.07	.01	−.13	−.21
RM	−.02	−.05	−.09	−.04	−.16	−.27
RTP	.04	0	−.02	0	0	−.06
RSL	.11	.08	.04	.34	.24	.12
RMS	.07	.04	−.01	.21	.11	−.04
Deposit Levels						
MP	0	−1.7	−5.6	0	−5.0	−17.0
MSL	.6	5.3	12.2	1.6	16.4	38.7
MMS	.2	.7	2.0	.5	2.0	4.8
MIS	0	.2	1.7	0	.6	4.5
TOTAL	.8	4.5	10.3	2.1	14.0	31.0
Mortgage Levels						
MKCB	0	−.7	−2.9	0	−2.0	−8.4
MKSL	.4	5.2	12.1	1.3	16.0	38.2
MKMS	.1	.7	2.1	.2	2.0	4.9
MKIS	0	0	.9	0	−.1	2.3
TOTAL	.5	5.2	12.2	1.5	15.9	37.0
Housing						
EH$	.1	.1	.2	.3	.4	.6
KH$	0	.5	2.4	.1	1.7	7.3

[a] b.p. equals basis points.

Table 6

SIMULATED VALUES, (A) FLEXIBLE LIFE INSURANCE POLICY LOAN RATE AND (B) VARIABLE-RATE MORTGAGE

	6A	6B		
	Flexible Policy Loan Rate	Variable Rate Mortgage		
Variables	1970:3	1961:1	1965:1	1970:3
Interest Rates				
RTB	0	0	0	−.13
RM	−.01	0	.01	−.18
RTP	0	0	.02	.01
RSL	0	−.07	.04	.14
RMS	0	−.09	−.03	.15
Deposit Levels				
MP	.1	0	.4	−6.9
MSL	−.1	.1	−.3	16.5
MMS	−.1	−.1	−1.5	5.6
MIS	2.1	0	−.1	2.0
TOTAL	2.0	0	−1.5	17.2
Mortgage Levels				
MKCB	0	0	.3	−3.1
MKSL	−.1	.1	−.3	14.5
MKMS	0	−.1	−1.8	5.2
MKIS	1.2	0	0	.7
TOTAL	1.1	0	−1.8	17.3
Housing				
EH$	.2	0	.1	.7
KH$	.1	0	−.2	2.4

conclude that *the flexible rate proposal will not have any important aggregate effect on mortgages and housing.*

(7) *Timing Effects of Variable-Rate Mortgages.* Table 6B shows the effects on deposit rate-setting of allowing for the faster response adjustment that would be expected in the presence of variable-rate mortgages. From the results for RSL and RMS, it can be seen that in the early part of the period, these rates were below the simulation norm, whereas late in the period they rose above the simulation norm. This behavior mirrors the simulated changes in the mortgage rate: early in the period mortgage rates were steady and actually fell slightly, whereas late in the period mortgage rates rose significantly. The implication, of course, is that over time, given that the mortgage rate has no long-run trend, there can be no net gain from the timing implications of variable-rate mortgages. Over the historic period 1960 to 1970, however, *there would have been a net gain, due to the trend in the mortgage rate, but there are no grounds for expecting this trend to continue necessarily into the future.*

(8) *Summary of the Results.* Table 7 provides a summary of the results of our experiments for mortgages and housing, 10 years after the simulated implementation of the Hunt Report. The results of the life insurance rate flexibility and the variable-rate mortgages have not been included since there is no presumption that these proposals would influence the long-run levels of mortgages and housing.

Table 7

SUMMARY OF THE MORTGAGE AND HOUSING RESULTS
($ billion)

Proposal	Effect 10 Years After Implementation	
	Mortgages	Housing
Remove Deposit Rate Ceiling (Tables 2A and 2B)	−$10 to +$3.1	−$1.8 to −$.3
Extended Service Function (Tables 3A and 3B)	+$26.1 to +$52.1	+$9.2 to +$19.7
Portfolio Substitution and Corresponding	−$47.6 to −$11.7	−$2.4 to −$.4
Portfolio Expansion (Tables 4A and 4B and 5A and 5B)	+$37.0 to +$12.2	+$7.3 to +$2.4

We feel that *these results indicate that the implementation of the Hunt Report would not have serious repercussions for the mortgage and housing markets.* Looking first at housing, given the magnitude of the positive effect on housing from the extended service function proposal, the net effect of all the proposals could well be positive. Even neglecting this effect, however, and choosing the lower bounds on the other estimates, the final effect on housing would be negligible. Turning to mortgages, the positive effect of the extended service function proposal also dominates these results, and the net effect would be positive. If the extended service function proposal is ignored, and the lower bounds on the other estimates are used, it is then possible that a decline by as much as 10 percent of the mortgage stock would be observed. This would be a "worst of all worlds" case, however, and thus a negligible effect would appear to be the reasonable conclusion.

Stating this conclusion in a slightly different way, our results indicate that the Hunt-Report proposals create only a minor net shift in the total mortgage supply function of the private financial intermediaries. This aspect of our conclusion is important because it suggests that our results are not significantly dependent on the specific interest elasticities for mortgages and housing that are built into the FMP model. These elasticities become critical when there are significant shifts of the demand and supply functions. Our results, however, indicate that the Hunt-Report proposals do not create an important disturbance from the initial equilibrium, and thus there is not a significant degree of further adjustment needed to restore the equilibrium.

For a similar reason, our results indicate that the short-run adjustments to the Hunt-Report Regime would not be difficult. It is, of course, possible for short-run changes in flows to be large and yet for the long-run equilibrium to be unchanged. Assuming, however, that all aspects of the Hunt Report are implemented at the same time, and given the adjustment speeds estimated in the FMP model, there is no indication that any short-run "bottlenecks" would occur. In addition, of course, the Hunt Report recommends that the proposals be implemented slowly, and this would provide a further safeguard.

Part III: The Direct Subsidization of Housing and Mortgages

A. *Housing as a Goal of Public Policy*

The analysis of this section is based on the assumption that private markets will not provide, say over the span of the next 10 years, the socially desirable increment to the stock of housing. Given this assumption, our analysis is an attempt to quantify the relative costs and efficiency of some of the alternative subsidy schemes that are available. Before preceeding, however, we feel that several *caveats* with respect to this assumption should at least be noted:

(1) *Housing as a Separable Goal of Policy.* It is important to distinguish three possible objectives of public policy: the well-being of financial intermediaries, subsidization of the mortgage market, and subsidization of housing investment. In many discussions of public policy in these areas, the three objectives become inseparable: in order to promote housing investment, we must stimulate the flow of mortgage funds; but the provision of mortgage funds strains the intermediaries operating in these markets; and thus further regulations and subsidies are required for the intermediaries. The Hunt Report has argued, and we believe correctly, that these issues should be separated. The social objectives for housing may be determined and then acted upon without recourse to mortgage subsidies or aid to the financial intermediaries. Indeed, the causation may run the other way, since direct subsidies to housing may increase the demand for mortgage funds and thus stimulate the mortgage market and the position of the financial intermediaries. For this reason, our results for housing subsidies may be considered independent of the Hunt-Report proposals for financial intermediaries.

(2) *Analysis Applies to Long-Run Effects on Housing.* Even taking the social priorities for housing as given, one must still distinguish between the cyclical movements and the long-term trend growth of housing. Our results in this section apply only to the long-run effects of subsidy schemes on housing. We shall argue in the following section that the cyclical movements in housing are the result of at least two factors: first, imperfections in the mortgage market that lead to short-run rationing of mortgage credit; and second, the high interest elasticity of the demand for housing. The Hunt-Report proposals move in the direction of perfecting the mortgage market, and it could be hoped that this would reduce the cyclical movements

in housing that result from short-run rationing of credit. The cyclical variations that result from the high interest elasticity of housing are not, however, dealt with in the Hunt Report. At a cost of some oversimplification, two remedies for this form of cyclical variation are available: first, require the Federal Reserve to maintain more stable interest rates, or, second, shield the housing market with policies that offset Federal Reserve actions. The difficulty, of course, is that both remedies would seriously impair the impact of monetary policy as a contra-cyclical tool of stabilization policy.

(3) *Aggregate versus Disaggregate Subsidy Schemes.* In discussing the policy objectives for housing, it is critical that one distinguish programs of aggregate subsidization from programs aimed at specific parts of the housing stock. It appears that public policy has been increasingly directed at the latter. This is important since, as our results below indicate, the efficiency of subsidization may be significantly greater when the objective is only part of the housing market.

B. *Direct versus Indirect Subsidization*

The Hunt Report argues in favor of *direct* subsidies for housing; for example, page 117, ". . . the Commission recommends that, in the event a properly functioning intermediary system leaves housing goals unmet, subsidies should be provided directly to those citizens qualifying for assistance." The distinction between direct subsidies, and the alternative, presumably indirect subsidies, is however not made precise in the Hunt Report.

To be explicit, we shall use the term *direct subsidies* to refer to three forms of subsidization of housing: (1) subsidies of construction costs and implicit or explicit rental payments; (2) subsidies of mortgage costs to borrowing units; and (3) subsidies of mortgage yields to lending institutions. *Indirect subsidies,* in contrast, take the form of constraints and regulations that force or induce financial institutions to lend in the mortgage market without directly affecting the interest cost of mortgages. The Hunt Report argues, and we proceed under the assumption, that indirect subsidies are not efficient. Our intent in this section is thus to evaluate the relative merits of various direct subsidy programs.

C. *Evaluation of Three Direct Subsidy Programs*

(1) *Direct Housing Subsidies.* Table 8 provides data for evaluating various programs that directly subsidize housing investment. The first row of the table shows the simulated values for housing investment, the housing stock, and the mortgage stock, for 1970:3, assuming only that there were no deposit rate ceilings. These data come directly from Table 2C. The following rows in the table show the results in 1970:3 for various policy changes undertaken in 1960:2. Subtracting these results from the simulated values in row 1 thus yields the differential that may be attributed to the policy after roughly 10 years.

Table 8

DIRECT SUBSIDY OF HOUSING
SIMULATED VALUES 10 YEARS AFTER IMPLEMENTED (1970:3)
($ billions)

	Program	Housing Investment (EH$)	Housing Stock (KH$)	Mortgage Stock (Total Private)
(1)	Simulated Value (Table 2C)	28.4	820.0	348.8
(2)	10% Direct Subsidy of Construction Cost	29.7	840.6	352.3
(3)	25% Direct Subsidy of Construction Cost	31.1	881.4	357.9
(4)	25% Decrease in Personal Property Tax Rate	29.4	842.2	352.5
(5)	25% Increase in Income Tax Rate	29.5	825.4	338.9
(6)	$1 Billion Open Market Purchase by Federal Reserve	32.4	839.2	358.9

Row 2 in the table shows the results of a 10 percent direct subsidy on construction costs. It is assumed in this experiment, in other words, that the construction cost of a house, as viewed by the builder, is subsidized 10 percent by the government. The results are that housing investment rises by $1.3 billion (at annual rates), the housing stock rises by $20.6 billion, and the mortgage stock rises by $3.5 billion. The low incremental mortgage-to-house ratio is due to an increase in the mortgage rate which reduces the demand for mortgage funds. It can be seen in the table that a relatively small increase in the outstanding mortgage stock is a characteristic of all the programs except the Federal Reserve open market purchase (row 6).

In order to evaluate the policy, some indication of the costs necessary to achieve the $20.6 billion increment to the housing stock is necessary. The most optimistic appraisal follows if it assumed that the subsidy is paid on the incremental housing investment. In this case, the cost would be 10 percent of the $20.6 billion increment, and the efficiency would be exactly 10:1.[7] This case might apply if the subsidy only were to some form of housing that would not otherwise have been built. A less optimistic appraisal is derived if it is assumed that the subsidy is paid on all housing construction during the period. For example, the initial value of housing at the time of the policy was simulated to be $485 billion and the end value is $840 billion; 10 percent of the difference is thus $35.5 billion or an efficiency of roughly 2/3:1. This calculation overstates the cost, however, because although the price of housing has been rising, the subsidy would not be paid on the capital gains that accrue over time. If the same calculation is made in real terms, the efficiency ratio is slightly greater than 1, but this, of course, overstates the efficiency. Thus, it appears reasonable to assume that if all additions to the housing stock are subsidized, then the efficiency of the program is roughly 1.

Row 3 in the Table 8 shows the same experiment as row 2, but with the subsidy rate at 25 percent. Evaluating the housing stock effect, we find an increment to the housing stock of $61.4 billion. If the subsidy were paid only on this increment, then the efficiency would be 4:1. In other words, *if direct housing subsidies are paid only on the incremental housing stock, then the efficiency falls as the subsidy rises, but, of course, a larger effect is obtained for larger subsidies. On the other hand, if the subsidy must be paid on all housing constructed during the period, the efficiency then remains at roughly 1.*

Rows 4 to 6 in the table show the results of alternative programs that operate in a similar fashion to the construction cost subsidy just described. Row 4 shows the results of a 25 percent decrease in the aggregate property tax rate. This stimulates housing because it decreases what is essentially a tax on the capital, and it can be seen that the effect is roughly the same as the 10 percent construction cost subsidy. Row 5 shows the effect of a 25 percent increase in the effective personal income tax rate. This stimulates housing because mortgage payments are tax deductible, and thus an increase in the

[7] That is, $10 of housing construction would be obtained for each $1 of subsidy payment that is made.

tax rate decreases the relative cost of capital for housing. It can be seen that this policy has a relatively small effect on the housing stock. Row 6 shows the results of a Federal Reserve open market purchase of $1 billion of government bonds that is carried out in 1960:2 and then maintained throughout the period. It is apparent that this policy is also roughly equivalent to the 10 percent construction subsidy, although it leads to a significantly greater mortgage stock.[8]

(2) *Direct Subsidies of Mortgages.* Table 9 provides results for evaluating the effectiveness of programs that directly subsidize the mortgage market. Row 1 of the table provides the basic simulation values and is the same as presented in Table 8. Row 2 of the table shows the results of providing a 10 percent subsidy to mortgage borrowers. In other words, it is assumed for this program that the government rebates, in one form or another, 10 percent of the interest cost of mortgage loans. The results are not very surprising: the policy stimulates an increase in mortgage demand and the mortgage stock of almost $60 billion, but an increase in the housing stock of less than $5 billion. The efficiency of the policy for stimulating housing depends on whether the subsidy iis paid on all mortgages or only on the increment induced by the policy itself. In either case, however, it is clear the program is significantly less efficient than the direct subsidy program for housing discussed in the previous section.

Table 9

DIRECT SUBSIDY OF MORTGAGES
SIMULATED VALUES 10 YEARS AFTER IMPLEMENTATION (1970:3)
($ billions)

	Program	Housing Investment (EH$)	Housing Stock (KH$)	Mortgage Stock (Total Private)
(1)	Simulated Value (Table 2C)	28.4	820.0	348.8
(2)	10% Borrower Subsidy	28.7	824.7	408.7
(3)	10% Lender Subsidy	28.7	824.5	405.6

[8]The larger mortgage stock is obtained because the Federal Reserve actions reduce interest rates, including the mortgage rate, and thus the demand for mortgages is directly expanded. This effect is even more evident in the direct mortgage subsidies discussed below.

Row 3 of Table 9 shows the results of providing a 10 percent subsidy to the lenders of mortgage contracts. That is, it is assumed under this program that the lenders received, in one form or another, 10 percent more interest than the borrowers are paying at the market determined rate. The results of this policy are almost identical to the mortgage borrower subsidy. Thus we may conclude quite generally *that direct subsidies for housing are significantly more efficient than direct subsidies for mortgages in stimulating housing investment.*

Part IV. Housing Fluctuations in Perfect Financial Markets

A. *Introduction*

The first half of this paper has been concerned with analyzing within the context of the FMP model the effects of each of the Hunt-Report proposals. The conclusions reached in the first half of the paper are subject to two main possible sources of error: (1) The FMP model may not have been specified correctly over the period for which it is intended to be relevant; (2) The regime proposed by the Hunt Report may differ so radically from the present regime that the use of a model that has been specified for the present regime (even if specified correctly) may not be adaptable for analyzing questions concerning the properties of the new regime. The seriousness of these two possible sources of error is, of course, unknown, but fortunately there is a second approach that can be taken in analyzing the Hunt Report. Since the main brunt of the Hunt-Report proposals is to make the financial markets more perfect, one can carry the proposals to their logical conclusion and ask the question of what the economy would be like if there were no restrictions of any sort on the financial markets, i.e., if the financial markets were perfect markets. If the conclusions reached by this exercise are similar to the conclusions reached by analyzing the properties of the FMP model, then more confidence can be put on the basic conclusions of the paper. The purpose of this section is thus to consider what the economy would be like if there were no restrictions on the financial markets. Particular attention will be placed on analyzing the effects that perfect financial markets would have on housing activity.

B. *The Model*

The four major types of real assets in the economy are the following:

1)	the value of the housing stock, H	$ 834 billion
2)	the value of the stock of consumer durable goods, D	306 billion
3)	the value of the corporate capital stock, K	1,343 billion
4)	the value of the government capital stock, G	?
	Total value of assets	$2,483 billion + ?

The figures given for the value of the assets are estimates in current dollars for the end of 1971. The figures for H and D were obtained from estimates in the FMP model, and the figure for K was obtained from Kaufman and McKeon [16], Tables I and IIIC, by adding the value of corporate bonds, the value of corporate stocks (market value), the value of business loans, and the value of open-market paper. The sum of corporate bonds, corporate stocks, business loans, and open-market paper is roughly the market value of corporations, and so this sum can be considered to be an estimate of the market value of the corporate capital stock.[9] A value for G will not be needed for the work below, and so no attempt was made to estimate a value for G.

Each of the major assets can be considered to have a demand schedule associated with it. The demand for housing, say H^d, is likely to be a function of population, of income or expected future income, and of the price of housing services relative to other prices. One aspect of the price of housing services is the cost of borrowing the resources to finance the purchases of the house or, alternatively, the opportunity cost of putting resources into housing stock as opposed to, say, putting resources into corporate capital stock. The

[9]To be more precise one should subtract from the sum the non-physical assets of corporations (such as corporate holdings of currency, demand deposits, Treasury bills, certificates of deposits, and the like) to get an estimate of the market value of corporate capital stock, but sufficient data are not available to do this. Data, for example, are not available on corporate holdings of currency and demand deposits. Fortunately, non-physical assets of corporations are a small proportion of total assets, and little is lost in the following analysis by not adjusting for non-physical assets.

demand for consumer durable goods, D^d, is also likely to be a function of population, of income, and of the price of consumer durable goods relative to other prices. One aspect of the price of durable goods is the borrowing cost. The demand for corporate capital stock, K^d, is likely to be a function of expected future sales on the part of firms and of the size of the wage rate relative to the cost of capital. One aspect of the cost of capital is the cost of borrowing resources. It will be assumed for simplicity that each of the three demand schedules just described is linear in interest rates, and the three schedules will be written as:

$$(1) \quad H^d = a_1 + b_1 r_1$$

$$(2) \quad D^d = a_2 + b_2 r_2$$

$$(3) \quad K^d = a_3 + b_3 r_3 .$$

The a coefficients denote all other factors that influence demand aside from the interest rates. Each r variable is the relevant interest rate corresponding to the demand for the particular asset in question. With respect to the government, it will be assumed that the demand for government capital stock, G^d, is not a function of interest rates, and the demand schedule will be written as:

$$(4) \quad G^d = a_4 .$$

The coefficient a_4 denotes all of the factors that influence the demand for the government capital stock.

Turning to the supply side of the market, the supply of resources to meet the four demands comes from current and past savings. Let Y_t be the total output of the economy in period t, let CON_t be private consumption in period t, let GOV_t be government consumption in period t, and let DEP_t be depreciation on all forms of capital during period t. Then net saving during period t, S_t, is:

$$(5) \quad S_t = Y_t - CON_t - GOV_t - DEP_t .$$

The change is wealth during period t is thus:

$$(6) \quad W_t - W_{t-1} = S_t ,$$

where W_t is aggregate wealth, and so aggregate wealth is:

$$(7) \quad W_t = \sum_{i=0}^{\infty} S_{t-i} \cdot$$

Interest rates and income, among other varibles, are likely to affect S_t and thus W_t, but for now W_t will be taken to be independent of income and interest rates. This assumption will be relaxed later.

In equilibrium the supply of wealth must equal the demand for assets, and so in equilibrium it must be the case that

$$(8) \quad W = H^d + D^d + K^d + G^d = a_1 + b_1 r_1 + a_2 + b_2 r_2 + a_3 + b_3 r_3 + a_4 .$$

So far no mention has been made of any debt instruments in the system. Equation (8) equates the supply of real resources to the demand for real resources. In practice, of course, much of the real wealth in the economy is financed by debt instruments of one sort or another. It will be convenient for the following analysis to assume that *all* of the wealth in the economy is financed by debt instruments. Let HB denote the debt instrument used to finance the housing stock, DB the debt instrument used to finance the consumer durable stock, KB the debt instrument used to finance the corporate capital stock, and GB the debt instrument used to finance the government capital stock. Then it is assumed that

$$(9) \quad \begin{aligned} HB^d &= H^d \\ DB^d &= D^d \\ KB^d &= K^d \\ GB^d &= G^d , \end{aligned}$$

where the superscript d denotes the demand for the debt instrument in question. The assumption in (9), that all assets are financed by the issuing of debt instruments, is made only for convenience and is not really restrictive. Units which in practice, for example, do not issue debt instruments to finance their housing stock, but rather finance the stock directly out of their own savings, can be considered to have issued debt instruments to themselves, from which they both pay and receive interest payments.

In practice there may also be more than one type of debt instrument used to finance one type of asset. Corporate capital stock, for example, is financed in part by corporate bonds, in part by corporate stocks, and in part by other instruments. Likewise, government capital stock can be considered to be financed in part by government

bonds and in part by currency. For purposes of the present analysis the different types of debt instruments that are used to finance one type of asset are assumed to be aggregated into one instrument. For the perfect-markets case described below, this assumption is not restrictive, since in this case all of the instruments are perfect substitutes for each other and it really does not matter how many different types of instruments there actually are in the system.

Now, if no restrictions were placed on the asset and liability powers of financial intermediaries, one would expect that the interest rate differentials between various types of debt instruments (such as the differential between HB and KB) would reflect only the different attributes of the instruments. If, for example, instrument HB was more costly to purchase in terms of transactions costs or was more risky than instrument KB, then the interest rate corresponding to HB should be higher than the interest rate corresponding to KB by the amount necessary to make financial intermediaries or other investors indifferent between purchasing HB and purchasing KB. If the differential were higher than this amount, investors would be expected to try to move out of HB into KB, which would drive the differential down to the appropriate level. If the attributes of the various debt instruments remain the same over time, then the differential between any two pairs of instruments should remain constant over time. The overall effect of the "perfect-markets" case is thus that the debt instruments become perfect substitutes for each other from the point of view of the lenders. In this case there is in effect only one interest rate to be determined in the system. Let r denote "the" interest rate, chosen in any convenient way. Then the actual interest rates on the four debt instruments will differ from r by constant amounts:

$$(10) \quad r_i = r + \bar{r}_i \quad , \quad i=1,2,3,4,$$

where the $\bar{r}_i$ are constants. (r_4 is the interest rate on debt instrument GB.) The $\bar{r}_i$ coefficients reflect the different attributes of the debt instruments. It should be noted that the perfect-markets case does require that the interest rate on GB be allowed to vary. This means that if currency is one of the means by which the government finances its capital stock, then the interest rate on currency must not be fixed at zero, as it is now, but must be allowed to vary along with all of the other rates in the system.[10]

[10]There will also be welfare gains from allowing the interest rate on money to vary. See the "optimal supply of money" discussion in, for example, Clower [4] and Johnson [15].

Equation (8) turns out to be easy to analyze for the perfect-markets case. Substituting (10) into (8) yields:

$$(11) \quad W = a_1 + b_1 (r+\bar{r}_1) + a_2 + b_2 (r+\bar{r}_2) + a_3 + b_3 (r+\bar{r}_3) + a_4 .$$

Since there is in effect only one interest rate in the system, equation (11) determines the interest rate. The determination of the interest rate can be seen graphically in Figure 1. The demand components are graphed consecutively in Figure 1 so that the curves reflect the sum of the components as indicated. The equilibrium interest rate is r*, and once r* is determined, the demand for the individual assets can be determined from the graph.

Figure 1

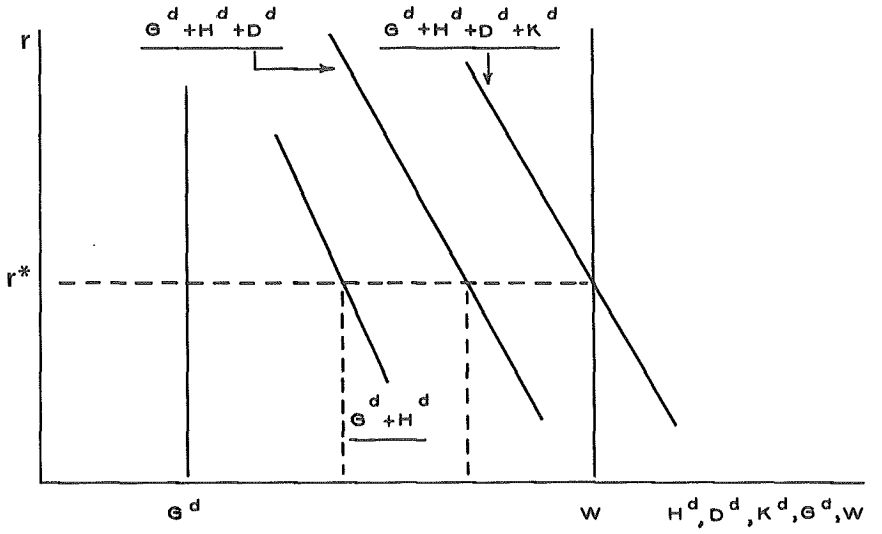

Figure 1 or equation (11) can be used to analyze what happens when one or more of the demand schedules shift. Assume, for example, that the demand for government capital stock increases (a_4 increases). This shifts the G^d curve to the right in Figure 1, which has the effect of shifting all of the other curves (except W) to the right as well. If W remains fixed, then the interest rate must rise in order to achieve a new equilibrium in the market. Since individual interest rates differ from each other by constant amounts, the new equilibrium will correspond to all interest rates being higher. Likewise, if

the demand for, say, K^d increases (a_3 increases), the new equilibrium will correspond to higher interest rates. Because of the higher interest rates, the actual increase in K^d will be less than the size of the initial shift of the curve, since there will be a movement back along the curve. If W shifts to the right, this will, other things being equal, correspond to lower interest rates and thus to higher levels of H^d, D^d, and K^d.

C. *The Effect of Perfect Financial Markets on Housing Activity*

The above framework can be used to analyze the effects that perfect financial markets would have on housing activity. First, equation (11) can be solved for r to yield:

$$(12)\quad r = \frac{1}{b_1+b_2+b_3}\left[W-a_1-b_1\bar{r}_1-a_2-b_2\bar{r}_2-a_3-b_3\bar{r}_3-a_4\right] .$$

Since r_1 in equation (1) is equal to $r+\bar{r}_1$ (from equation (10)), (12) can be substituted into (1) to yield:

$$(13)\quad H^d = a_1 + b_1\bar{r}_1 + \frac{b_1}{b_1+b_2+b_3}\left[W-a_1-b_1\bar{r}_1-a_2-b_2\bar{r}_2-a_3-b_3\bar{r}_3-a_4\right].$$

Equation (13) can now be used to analyze the effects of, say, fluctuations in W on housing demand. Differentiating equation (13) with respect to W yields:

$$(14)\quad \frac{\partial H^d}{\partial W} = \frac{b_1}{b_1+b_2+b_3} ,$$

which says that if, say, W increases by one billion dollars, H^d will increase by $b_1/(b_1+b_2+b_3)$ billion dollars. The derivative of H^d with respect to shifts in the demands for other assets is $-b_1/(b_1+b_2+b_3)$:

$$(15)\quad \frac{\partial H^d}{\partial a_i} = -\frac{b_1}{b_1+b_2+b_3} , \qquad i = 2,3,4.$$

Given estimates of b_1, b_2, and b_3, therefore, it is possible to determine how sensitive housing demand will be to changes in aggregate wealth and to changes in the demands for the other assets.

Results from other studies can be used to obtain estimates of the relative sizes of the b coefficients, but before discussing previous

results, it will be useful to examine the case in which the interest-rate elasticities are equal for the three assets. The elasticity of H^d with respect to r_1, $E_{H^d r_1}$ is:

$$(16) \quad E_{H^d r_1} = \frac{\partial H^d}{\partial r_1} \cdot \frac{r_1}{H^d} = b_1 \frac{r_1}{H^d} ,$$

or

$$(17) \quad b_1 = E_{H^d r_1} \cdot \frac{H^d}{r_1} ,$$

and similarly for D^d and K^d. If the four elasticities are equal (to, say, $\bar{E}$) and if the interest rates are all equal (to, say, r)[11] then $b_1/(b_1+b_2+b_3)$ is:

$$(18) \quad \frac{b_1}{b_1+b_2+b_3} = \frac{\bar{E}\frac{H^d}{r}}{\bar{E}\frac{H^d}{r}+\bar{E}\frac{D^d}{r}+\bar{E}\frac{K^d}{r}} = \frac{H^d}{H^d + D^d + K^d} .$$

In other words, in this case the ratio $b_1/(b_1+b_2+b_3)$ is merely the proportion of the housing stock to the total wealth in the economy exclusive of government capital stock. Using the above estimates of the value of each asset, the proportion is .34, which means that for each one dollar increase in wealth (holding government capital stock constant), 34 cents goes into housing stock. Likewise, for each one dollar increase in demand for alternative assets, holding aggregate wealth constant, the demand for housing stock decreases by 34 cents. It should be noted, of course, that if the three demand equations are linear in interest rates, as specified in (1)-(3), then the elasticities are not constant over time. Because of this, it would probably be more realistic to specify equations (1)-(3) in log form so that the elasticities are constant over time, but because of the complications that this involves for the rest of the analysis, the log

[11] The assumption that all of the interest rates are equal, rather than merely differing from each other by constant amounts, is necessary if $\bar{E}/r$ is to cancel out in equation (19). If, however, the interest rates are not all equal, the final answer in (19) is changed by only a small amount.

specification was not used. The linear specifications should therefore be interpreted as holding merely in a small neighborhood around the values of the variables in question.

The results from other studies can be used in an attempt to determine the actual sizes of the various elasticities. For example, deLeeuw in his survey article on the demand for housing [6] has estimated the price elasticity of the demand for housing to be between -0.7 and -1.5 (p. 9). In the FMP model, the elasticity of the demand for single family housing with respect to the interest rate is about -1.3. Coen [5] has estimated the elasticity of the demand for corporate capital stock with respect to the cost of capital to be -0.579 for one model and -0.292 for another (p. 209). For the equipment-investment equation in the FMP model, Bischoff [3] reports a long-run elasticity of demand with respect to the bond rate of -.360 (Table 5, p. 30). Evans in his review of investment functions [9] states that the elasticity of investment with respect to the interest rate is between -.25 and -.50 (p. 138). For the demand for consumer durables, Evans [9] estimates a price elasticity of demand of -1.5 for automobiles and zero for other nondurables (p. 171). In the FMP model the elasticity of the demand for consumer durables with respect to the interest rate is about -.90.

In terms of the effect on the $b_1/(b_1+b_2+b_3)$ ratio, the size of the elasticity of the demand for consumer durables is of less importance than the sizes of the elasticities of the demand for housing stock and for corporate capital stock. This is because of the relative small proportion of consumer durable goods in total wealth. Of much more importance is the size of the elasticity of demand for corporate capital stock relative to the size of the elasticity of demand for housing stock. Consider the following cases.

	$E_H d_{r_1}$	$E_D d_{r_2}$	$E_K d_{r_3}$	$b_1/(b_1+b_2+b_3)$	$b_2/(b_1+b_2+b_3)$	$b_3/(b_1+b_2+b_3)$
(1)	−0.7	−1.0	−0.4	.41	.21	.38
(2)	−1.0	−1.0	−0.4	.50	.18	.32
(3)	−1.5	−1.0	−0.4	.60	.15	.25
(4)	−1.0	−1.0	−0.3	.54	.20	.26
(5)	−1.0	−1.0	−0.5	.46	.17	.27

For all five cases the elasticity of demand for consumer durables has been assumed to be equal to -1.0. The elasticity of demand for corporate capital stock varies between -0.3 and -0.5, and the elasticity of demand for housing varies between -0.7 and -1.5. The

computations are based on the assumption that the interest rates are all equal (see footnote 11). The worst case for housing is case (3), where the elasticity of demand for housing stock is high. For this case the ratio is .60, which means that for every dollar change in wealth or change in demand for alternative assets, demand for housing stock changes by 60 cents. In this case, because of the sensitivity of housing demand to the interest rate relative to the sensitivity of the demand for corporate capital stock to the interest rate, housing activity would fluctuate by fairly large amounts as a result of changes in the supply of wealth or demand for assets.

The results from previous studies indicate that the demand for housing stock is more sensitive to interest rates than is the demand for corporate capital stock. Just how much more sensitive is difficult to say, but a reasonable case might be case (5) above, where the elasticity of demand for housing stock is twice as great as the elasticity of demand for corporate capital stock. For this case, the ratio of b_1 to $b_1+b_2+b_3$ is .46. An important question to ask in this regard is if a case like case (5) were true, would housing activity fluctuate more or less in a perfect-markets regime than it now does in the present regime. Although it is difficult to answer this question very precisely, a few observations can be made. Under the present regime it is the case that the mortgage rate fluctuates less than, say, the corporate bond rate. This in itself would indicate that going from the present segmented-market regime to a regime in which there was in effect only one interest rate would increase housing fluctuations. The interest rate in the new regime would presumably fluctuate more than the mortgage rate in the present regime does, which would mean more fluctuations in housing demand. On the other hand, there may be a significant amount of credit rationing in the housing market in the present regime, which if true means that the "effective" mortgage rate really fluctuates much more than the observed mortgage rate does. If credit rationing is significant in the housing market – and many studies indicate that it is significant[12] – then it is quite possible that housing activity would fluctuate less in the perfect-markets regime than it now does. In fact, Tucker's analysis [21] indicates that the speed of the effects of monetary policy on economic activity is likely to be greater if there is credit rationing than if there is not, which reinforces the conclusion here

[12]See Fair [11] for a review of previous studies of the housing and mortgage markets as they relate to disequilibrium effects, and see Fair and Jaffee [13] and Fair [10, Chapter 8] for empirical estimates of disequilibrium effects in the housing and mortgage markets.

that housing activity is likely to fluctuate less in a perfect-markets regime than it now does. If credit rationing causes the economy to respond more quickly to policy changes (or to other exogenous changes), then lack of credit rationing should cause the economy to respond more slowly and thus to fluctuate less.

In summary, therefore, the probability that fluctuations in housing activity would be less in the perfect-markets regime than they are in the present regime is greater the greater is the amount of credit rationing in the present regime and the smaller is the elasticity of the demand for housing stock relative to the elasticity of the demand for corporate capital stock. Since credit rationing does appear to be significant in the housing and mortgage markets, it is likely that fluctuations in housing activity would be less in a perfect-markets regime than they now are.

It should be remembered that housing activity will also fluctuate corresponding to fluctuations in variables other than the interest rate that affect housing demand, i.e. corresponding to fluctuations in a_1 in equation (1). The fluctuations in a_1 should not, however, be much different in the perfect-markets regime than they are in the present regime, and so for purposes of making comparisons between the two regimes, we can concentrate on flucutations in housing activity due to fluctuations in interest rates and credit rationing. It is true, of course, that in a perfect-markets regime fluctuations in a_1 will put less pressure on the overall financial market than fluctuations in a_1 now put on the mortgage market. Therefore, in a perfect-markets regime large increases in a_1 will not necessarily lead to large increases in the mortgage rate or to credit rationing as they now are likely to do. (See discussion in the next section on housing subsidies for a further elaboration of this point.)

D. *The Effect of Perfect Financial Markets on the Level of the Housing Stock*

So far attention has only been concentrated on fluctuations in housing activity. Unfortunately, in order to say anything about the effect of perfect financial markets on the level of the housing stock, one would have to estimate the $\bar{r}_i$ coefficients in (10) as well as the individual demand equations, (1)-(3). The $\bar{r}_i$ coefficients reflect the different attributes that debt instruments would have in a perfect-markets regime. The current interest rate differentials cannot be used as estimates of the $\bar{r}_i$ coefficients because the current differentials reflect in part the imperfect nature of existing financial markets. A

graduate student in the economics department at Princeton University is currently working on the question of trying to estimate what the $\bar{r}_i$ coefficients would be in a perfect-markets regime, but for now no results are available. All that can be said at this stage is that the greater is the spread between, say, the mortgage rate and the corporate bond rate (due to different attributes of the two debt instruments), the less will be the demand for housing stock relative to the demand for corporate capital stock. It should be noted, of course, that the demand for housing can always be subsidized if it turns out that the demand for housing stock in the perfect-markets regime is less than is socially desired. One possible way to subsidize housing demand would be to change the attributes of mortgages (say, by making them less risky or more liquid), which would have the effect of narrowing the spread between the mortgage rate and other rates.

Another way to subsidize housing demand would be to engage in activities that shift a_1 in (1). From (14) the partial derivative of H^d with respect to a_1 is $1\text{-}b_1/(b_1+b_2+b_3)$, which means that a one dollar increase in a_1, holding aggregate wealth constant, would increase housing demand by $1\text{-}b_1/(b_1+b_2+b_3)$ dollars. Housing demand would not go up by the entire dollar because the interest rate must rise to equate overall demand and supply. Note, however, that subsidies designed to shift a_1 are likely to be more effective in the perfect-markets regime than they are now. In the present segmented-markets regime, a subsidy designed to shift a_1 will put pressure on the mortgage market, which will either drive up the mortgage rate a lot or else lead to credit rationing. In the perfect-markets regime, funds will flow into housing to the extent that they are needed. There is in effect only one large financial market, and stimulating housing demand only requires that "the" interest rate in the market rise enough to equate overall demand with supply. In summary, then, subsidies designed to increase housing demand are likely to be more effective in a perfect-markets regime than they now are.

E. *Possible Extensions of the Model*

The perfect-markets regime that has been discussed here has obviously been simplified in a number of ways. Some of these simplifications will now be discussed, and suggestions will be made on how the model might be extended and some of the simplifying assumptions relaxed.

First, savings, and thus wealth, have so far been taken to be exogenous. Savings are in fact likely to be a function of income and interest rates, and in an extension of the model one could incorporate assumptions about the determination of savings and thus wealth in equation (11) and then proceed more or less as above. It seems unlikely that the addition of these assumptions would significantly change the above conclusions.

It is also useful to consider within the above framework the different effects that the government can have on economic activity. First, note that GB refers only to the sum of government bonds and currency used to finance real government capital stock. To keep this distinction in mind, let GBB denote the bonds of the government that do not back real capital stock. Now, government activity can affect the level of real wealth, W, in the economy in two main ways: through its effect on private consumption and investment, and by its own consumption and investment activities. There are a number of examples that can be considered. First, assume that the government merely gives people GBB bonds and takes nothing in return. This action will have no effect on W directly, but if people feel more wealthy by holding these bonds (even though real wealth is unchanged), they may consume more and save less, which will have the effect of lowering W and thus increasing interest rates. Private consumption, in other words, may be a function of both W and GBB bonds, and in this case issuing GBB bonds will indirectly affect real wealth and interest rates. Next, assume that the government issues bonds, takes real resources from the private sector, and *invests* the resources in real capital stock. If private consumption is not affected by this action, then W is unchanged, G and GB are higher, and so interest rates are higher since the G^d curve in Figure 1 has shifted to the right. If private consumption is affected by this action, then, of course, W will be changed. Considering a third case, if the government issues a bond, takes real resources from the private sector, and *consumes* the resources, then if private consumption is not affected, W is decreased and so interest rates are increased. In this case the bonds that the government has issued are GBB bonds, since the bonds do not back real capital stock. Since in this case there is less real wealth in the economy (although more GBB bonds), this may have a negative effect on private consumption, which will cause W to decrease less than otherwise. Finally, consider the case in which the government takes real resources from the private sector by taxing. If the government invests the resources, then W will increase unless all of the taxes paid by the public come out of private savings (in which

case W will remain unchanged). To make this situation consistent with the above model, the government must be considered in this case as issuing GB bonds to itself. If the government consumes the taxed resources, then W will decrease unless all of the taxes come out of private consumption (in which case W will remain unchanged).

It was mentioned above that the two main debt instruments of the government are government bonds and currency, and it was thus implicitly assumed above that the interest rate on currency is not fixed. The unique nature of currency, as Tobin [20] has emphasized, is that its interest rate is not allowed to vary. If the interest rate on currency is fixed, then one must separate GB into bonds and currency and introduce a postulate about what determines holdings of currency (usually called the demand for money). If currency holdings are made a function of income and an interest rate, then it is no longer the case that the interest rate can be determined from equation (11) independent of income. Therefore, even if savings and thus W were independent of income, the fixing of the interest rate on currency means that the determination of income and the interest rate must be considered simultaneously. Again, it does not seem likely that this addition would significantly change the above conclusions.

The model has also made no distinction between short-term rates and long-term rates. By assuming constant interest-rate differentials, the model has implicitly assumed that the yield curve does not change over time. Because the yield curve may be affected by expectations of the future level of rates, the assumption of constant interest-rate differentials between short-term and long-term debt instruments may not be realistic. This is an area in which more work would be useful.

Finally, it should be noted that the analysis in the above model is not dependent on there being any particular type of debt instrument in the system. All that really matter are the demand schedules for real assets. In the perfect-substitutes regime whether the housing stock is financed by things called mortgages or by something else is completely irrelevant. Therefore, in discussing the effects of the Hunt-Report proposals on housing activity, one should concentrate on the effects on real housing demand and not on the effects on mortgages. There is more than one way to finance the housing stock, and in a perfect-markets regime it is not important how it is financed.

F. *Conclusion*

The two main conclusions of this part of the paper are: (1) Fluctuations in housing activity appear likely to be less in a perfect-markets regime than they now are. This is because there would be no credit rationing in a perfect-markets regime, unlike the present situation where there does appear to be credit rationing in the housing and mortgage markets. (2) Subsidizing housing activity is likely to be easier in a perfect-markets regime than now because of the fact that there is in effect only one large financial market in the perfect-markets regime. Funds can flow much more freely and there is no danger of putting so much pressure on one particular market (the mortgage market in the case of housing) that credit rationing results.

Two other conclusions of this part of the paper are: (1) The effect of a perfect-markets regime on the level of the housing stock depends on the rate spread between the debt instruments used to finance the housing stock and the debt instruments used to finance other capital stock. (2) In analyzing the Hunt-Report proposals one should concentrate on the effects on the housing market and not on the effects on the mortgage market.

Part V: **Summary and Conclusions**

The major findings of our Study are:

1) With respect to the impact of specific Hunt-Report proposals on the mortgage and housing markets, the FMP model indicates:
   a) The removal of all deposit-rate ceilings from depositary institutions will have minor quantitative effects on mortgage and housing levels and even the direction of the change is in doubt.
   b) Allowing savings institutions extended service functions will result in significant increases in mortgage lending, and, given the elasticities of the FMP model, relatively large increases in the housing stock.
   c) Allowing savings institutions extended lending powers will result in a portfolio substitution, against mortgages, and a portfolio size expansion, favoring mortgages. The net effect of the two changes on mortgages is small and

may be either positive or negative depending on specific assumptions, while the effect on housing is generally positive, although small.

d) Flexible loan rates on the policy loans of life insurance companies will have only minor impacts on the mortgage and housing markets.

e) The implications of variable-rate mortgages for the short-run timing of deposit rate-setting decisions are favorable and important. We have not, however, been able to consider many of the ramifications of variable-rate mortgages, and thus have no final evaluation of this proposal.

2) With respect to the overall impact of the Hunt Report on mortgages and housing, the FMP model indicates that the proposals would not have serious repercussions for the mortgage and housing markets. Our results indicate that the housing market would probably, on net, gain under the Hunt Report, while the mortgage stock may gain or lose depending on the specific assumptions. In any case, the magnitudes involved are small relative to the current outstanding stocks of these assets.

3) We concur with the Hunt Report that *indirect mortgage subsidies* are not efficient. With respect to *direct* subsidies for housing and mortgages, the FMP model indicates that *direct subsidies in the mortgage market* are also generally not efficient—they subsidize mortgages, not housing directly—while *direct subsidies for housing* may be quite efficient. Furthermore, the efficiency of direct housing subsidies is greatest if the subsidies are paid only on those units that respond directly to the subsidy, and they are least efficient if the subsidies must also be paid on units that would have been produced in any case.

4) The results of analyzing the "perfect-markets" regime indicate that:

a) Fluctuations in housing activity appear likely to be less in a perfect-markets regime than they now are because there would be no credit rationing in a perfect-markets regime.

b) Subsidizing housing activity is likely to be easier in a perfect-markets regime than it is now.

c) The effect of a perfect-markets regime on the level of the housing stock depends on the rate spread between

the debt instruments used to finance the housing stock and the debt instruments used to finance other capital stock.

d) In analyzing the Hunt-Report proposals one should concentrate on the effects on the housing market and not on the effects on the mortgage market.

APPENDIX A

1. Description of FMP Model

The simulation experiments described in Parts II and III were carried out using a version of the FMP model known as *50B*. This was the version current during the Fall, 1971. Studies of the FMP model include Ando and Modigliani [1], [2], deLeeuw and Gramlich [7], [8], Gramlich and Jaffee [14], Modigliani, Rasche, and Cooper [17], and Rasche and Shapiro [18]. In particular, Gramlich and Jaffee [14] provides a complete analysis of the savings-deposit, mortgage, and housing sectors of the FMP model.

In carrying out the experiments, the full FMP model was used with the exception of three sectors: currency, labor, and employment. These sectors were kept as exogenous because of computer programming difficulties encountered at the time the experiments were being carried out. These problems have since been solved, but it was not felt necessary to rerun the experiments because the indicated changes were very small.

2. Description of the Experiments

The following notes describe the experiments undertaken in the text. Equation numbers refer to the model listing in Gramlich and Jaffee [14, Appendix B]. Symbols have been defined above, and a more complete list is available in Gramlich and Jaffee [14, Appendix A].

a) *Removing Regulation Q from Commercial Banks.* In determining RTP, the system uses the minimum of RTP* (equation B-12) and the ceiling rate. In this experiment, the ceiling rate was increased throughout the period by 20 percentage points, so it was not effective.

b) *Placing Ceiling Restrictions on Savings and Loan Associations and Mutual Savings Banks.* Equations (B-13) and (B-14) for RSL and

RMS, were omitted from 1968:4 to 1970:3. In their absence, RSL and RMS were set equal to the historic values.

c) *Extended Service Functions of Savings Institutions.* The variable (RTP-RA) in equation (B-8), for MP, was reduced by the indicated amount, and the variable (RA-RTP) in (B-9), for MSL + MMS, was raised by the indicated amount.

d) *Portfolio Substitution Effect of Extended Lending Functions.* The coefficients of the following variables in mortgage supply equations were reduced by the indicated amount in 1960:2:

Equation B-16: constant, MLS, (RM-ZRFH) MSL
Equation B-17: constant, MMS, $\Delta \overline{\text{MMS}}$, (RM-RCB) MMS
Equation B-20: constant, DUM, $\Delta \overline{\text{MSL}}$, MSL, ZAFH
Equation B-21: constant, DUM, $\Delta \overline{\text{MMS}}$, MMS

e) *Portfolio Expansion Effect of Extended Lending Powers.* The constant terms of equations (B-13) and (B-14) were raised by the indicated amounts in 1960:2.

f) *Flexible Rate Policy on Life Insurance Policy Loans.* The variable JR in the life insurance reserves equation (B-11) was set equal to zero.

g) *Timing of Deposit-Rate Setting with Variable-Rate Mortgages.* In equations (B-13) and (B-14), for RSL and RMS, the coefficients for lagged values of RM were collapsed into the current term, thus eliminating the lagged effect but maintaining the same cumulative effect.

h) *Direct Cost of Construction Housing Subsidy.* The variable PHCA in the housing starts equations (B-29) and (B-30) was reduced by the indicated amount starting in 1960:2.

i) *Decrease in Personal Property Tax Rate.* The variable TP in the cost of capital equations (B-27) and (B-28) was reduced by the indicated amount starting in 1960:2.

j) *Increase in Effective Personal Income Tax Rate.* The variable T in cost of capital equation (B-27) was increased by the indicated amount starting in 1960:2.

k) *Direct Mortgage Subsidy to Borrowers.* The coefficients of the first four variables in the mortgage rate equation (B-12) were raised by the indicated amounting starting in 1960:2.

l) *Direct Mortgage Subsidy to Lenders.* The RM variable was raised by the indicated amount, starting in 1960:2, in mortgage supply equations (B-15), (B-16), and (B-17).

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Impact of the Proposed New Financial Structure on Mortgage Markets

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Mutual savings banks and savings and loan associations have historically been granted special privileges in return for investing primarily in mortgages and providing a relatively high yield for the liquid savings of households and nonbusiness organizations. Thrift institutions have tax advantages, the protection of Regulation Q, and no reserve requirements against time and savings deposits. Also, they are not only permitted, but expected to invest almost entirely in long-term assets, even though they have primarily short-term deposits. All these privileges have enabled them to compete aggressively for deposits and to be the principal supplier of home mortgage funds during periods of normal financial conditions.

The Hunt Commission is now recommending that thrift institutions be granted much broader powers but that, simultaneously, they be stripped of their special privileges. While these recommendations have broad intuitive appeal, many observers, including spokesmen for home builders, the thrift industry, and consumers, are concerned about their impact on the supply and cost of home mortgage funds.[1]

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[1]For example, the National Association of Home Builders, in a policy statement made at its annual convention in January 1972, stated, "This thrust of the Commission's report troubles us. Its recommendations seem aimed in the direction of permitting conversion of housing-oriented savings institutions into institutions very much like commercial banks, which historically have been only nominally and infrequently interested in mortgage lending." The General Counsel of the Federal Home Loan Bank Board stated that "savings and loans would become underdeveloped commercial banks," if the report were adopted. *American Banker,* February 18, 1972, p. 12.

Also, Ralph Nader, the consumer advocate, stated that "Clearly, the Commission is leaving the housing market with the last call on the flow of funds available for investment." *American Banker,* March 2, 1972, p. 4.

In their paper, Professors Jaffee and Fair analyzed the long-run cumulative impact of the Hunt Commission recommendations and concluded that they would have no appreciable effect on the mortgage market. We tend to agree with them for two reasons:

1. Although savings and loan associations and mutual savings banks have had significant franchise privileges in the past, these advantages have gradually been reduced in recent years. Their Regulation Q shelter has been reduced along with their tax and reserve requirement advantages. It would appear, therefore, that thrift institutions no longer have a substantial advantage over commercial banks in intermediating between savers and mortgage borrowers.
2. Thrift institutions, particularly savings and loan associations, commit almost all their available funds to the mortgage market. If the total needs of the market are to be met, commercial banks, insurance companies, individuals, and (in certain years) Federal agencies must also invest in mortgages. The level of interest rates on home mortgages is, therefore, primarily determined by the supply schedules of these marginal lenders rather than by the intramarginal lending of thrift institutions. Although the Hunt Commission recommendations may increase the intermediation costs of thrift institutions, they will have little impact on the costs and availability of funds from these other lenders.

Thus, we agree with the Jaffee-Fair conclusions that substantial restructuring of our financial institutions should not have a significant impact on the long-run supply of mortgage funds. An important question remains, however. Do thrift institutions buffer the mortgage market during periods of severe monetary restraint? If the recommendations of the Hunt Commission are embedded in legislation and all financial institutions are permitted to expand their powers and decrease their specialization, would the home mortgage market be even harder hit during periods of restraint?

In our first section we attempt to answer this question when we make the extreme assumption that all thrift institutions successfully convert into commercial banks. Our second section is based on the more realistic assumption that thrift institutions are only given sufficient powers to become complete family finance centers. We also assume that they have the privilege of making variable-rate mortgages. In our last section we make the assumption that the government regulatory agencies take some positive action to reduce

the exposure of thrift institutions during periods of restraint. Here we consider adequate capital reserves, insurance against interest-rate risk, and the active use of variable-rate mortgages.

I. The Extreme Case: Total Conversion to Commercial Bank Operations

The Hunt Commission recommends that any thrift institution wishing to offer a full range of services for businesses must obtain a commercial bank charter. Stock thrift institutions could obtain either a national or state charter. Mutual thrift institutions could either obtain a national mutual commercial bank charter or first convert to a stock form of organization. If the extreme assumptions are made that most thrift institutions would (1) wish to engage in commercial bank activities, (2) succeed in obtaining commercial bank charters, and (3) be completely successful in obtaining business customers, it is possible that the Hunt Commission recommendations would have an adverse impact on the mortgage market during periods of severe monetary restraint.

Hodgman and others[2] have provided evidence that commercial banks give first priority to the loan requests of their regular commercial and industrial customers and that most other investments are residual uses of funds. This would appear to be logical behavior because the profits of most banks depend substantially on the low-cost demand deposits made available by business clients.[3] Chart I provides data on the acquisitions by commercial banks of business loans, tax-exempt securities, and home mortgages.[4] The

[2]Donald R. Hodgman, *Commercial Bank Loan and Investment Policy* (Champaign, Illinois: University of Illinois Bureau of Economic and Business Research, 1963), p. 18; Dwight M. Jaffee, *Credit Rationing and the Commercial Loan Market: An Econometric Study of the Structure of the Commercial Loan Market* (New York: John Wiley & Sons, Inc., 1971); Warren E. Moskowitz, "The Theory of Compensating Balances" (unpublished Ph.D. dissertation, Massachusetts Institute of Technology, 1971).

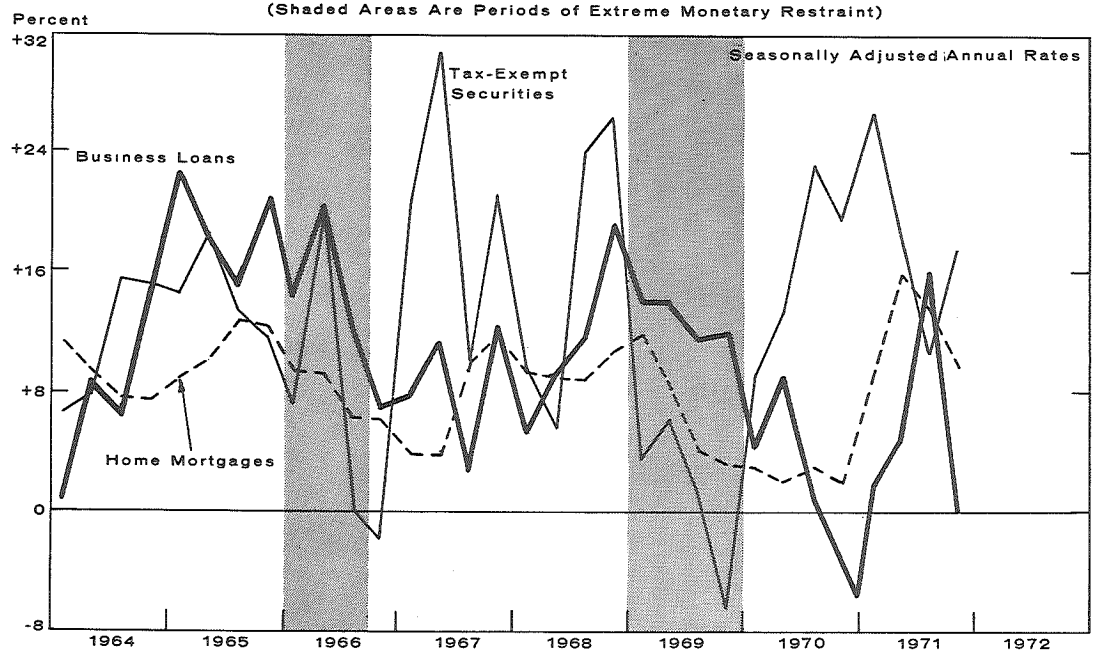
[3]According to the 1970 Functional Cost Analysis of the Federal Reserve System, the average cost of demand deposits (for banks with assets over $200 million) was 2.7 percent compared to 6 percent for time and savings deposits. This difference would have been even greater if the comparison had been between *business* demand deposits and other time and savings deposits. (Note: These costs were adjusted for differences in the reserve requirements imposed on demand and time and savings deposits.)

[4]Data for U.S. Government securities are not shown in Chart I. As is well known, however, these securities are always a residual investment. Large quantities of these securities were liquidated in both 1966 and 1969.

Chart I

CHANGES IN SELECTED ASSETS OF COMMERCIAL BANKS

(Shaded Areas Are Periods of Extreme Monetary Restraint)



Source: Board of Governors of the Federal Reserve System, Flow-of-Funds tables, Federal Reserve Bulletin, various issues.

Note: Tax-exempt securities are shown in the Flow-of-Funds tables as state and local obligations. Business loans are shown as bank loans n.e.c. to nonfinancial business.

chart shows that in the first 3 quarters of 1966 and in all of 1969 the rate of acquisition of tax-exempt securities declined precipitously while there was a smaller decline for business loans. Thus, Hodgman's thesis is supported by the data for tax-exempt securities.

The mortgage loan evidence shown on Chart I is not nearly as convincing, however. The acquisition rate of mortgage loans in the periods of restraint in both 1966 and 1969 declined only slightly more rapidly than that of business loans, but not nearly as fast as tax-exempt securities. It is surprising that commercial banks offered as much support to the home mortgage market as they did in those years; the Hodgman thesis would suggest that they would largely abandon the home mortgage market during periods of severe restraint.

There are a number of explanations for the moderately stable acquisition rate of mortgages by commercial banks. First, the largest commercial banks include among their highly valued customers insurance companies, mortgage companies, and thrift institutions. They temporarily buy or "warehouse" mortgages for nonbank financial institution customers, particularly mortgage companies and thrift institutions which have short-run liquidity problems. From October 1968 to October 1969 warehouse mortgage loans outstanding rose by 33 percent at large commercial banks, accounting for one-sixth of the growth in their total real estate credit.[5] Second, most of the largest commercial banks generally have very profitable construction loan operations.[6] For reasons of customer loyalty as well as the high net yields involved, commercial banks are reluctant to cut back on this type of lending. Finally, many small commercial banks are not affected by tight money and continue to invest in mortgages throughout periods of restraint. Chart II shows that many small banks (as represented by nonmember banks) provide more regular and steady support to the real estate market than do large commercial banks (as represented by Reserve city banks).

The evidence shown in Chart I suggests that commercial banks cut back slightly more on mortgage loans than on business loans during periods of severe restraint. We also know that thrift institutions

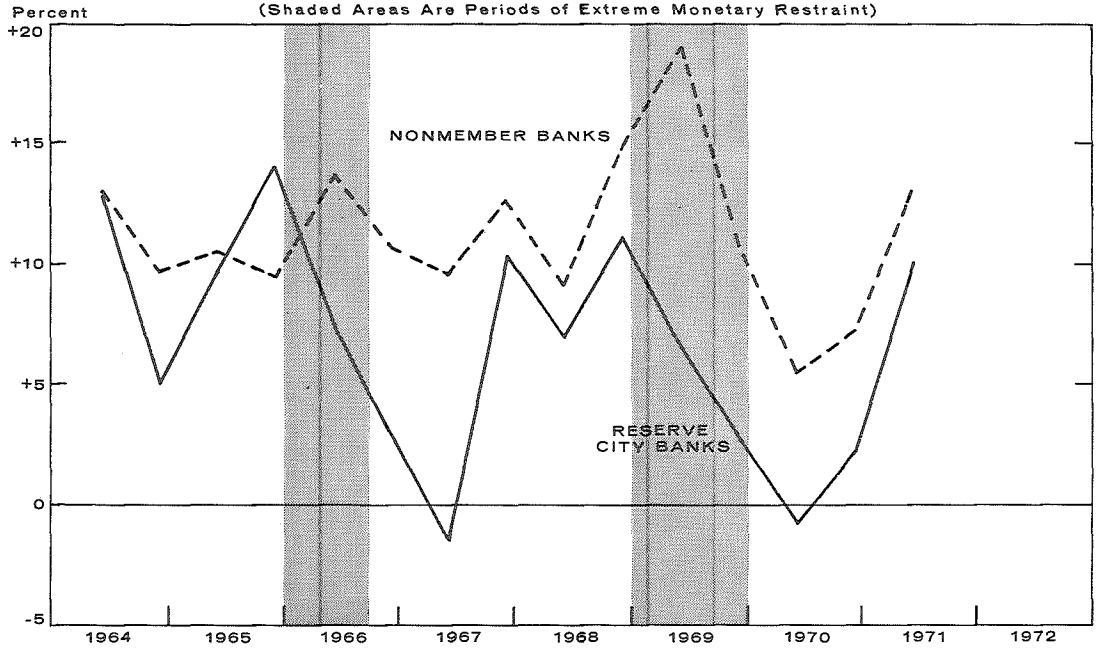
[5]"Credit Extended by Banks to Real Estate Mortgage Lenders," *Federal Reserve Bulletin,* December 1969, p. 921.

[6]Peter A. Schulkin, "Construction Lending at Large Commercial Banks," *New England Economic Review,* July/August 1970, pp. 2-11; and *Commercial-Bank Construction Lending* (Federal Reserve Bank of Boston, Research Report No. 47, September 1970).

Chart II

CHANGES IN RESIDENTIAL MORTGAGES AT RESERVE CITY BANKS AND INSURED NONMEMBER BANKS

(Shaded Areas Are Periods of Extreme Monetary Restraint)



Source: Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System and Office of the Comptroller of the Currency, Assets and Liabilities - Commercial and Mutual Savings Banks.

Note: The most frequent interval for which data are available by class of bank is semiannual. The change in total residential mortgages, rather than 1-4 family home mortgages, is used because the home mortgage component is not available prior to June 1969. However, the trend in home mortgages was very similar to that of total residential mortgages during the period in which these data are available.

almost always allocate the bulk of their net deposit flow to residential mortgages. It might be tempting to conclude, therefore, that the conversion of thrift institutions to commercial banks would harm the residential mortgage market during a period of severe restraint.

Such a conclusion, however, overlooks the fact that thrift institutions have great difficulty in attracting funds when interest rates escalate rapidly. Shown in Table 1 are the data for asset acquisitions of both commercial banks and thrift institutions during the periods of severe restraint in 1966 and 1969-70. The data clearly show that the home mortgage loan acquisitions of thrift institutions declined substantially more than those of commercial banks in 1966. During most of 1966, however, commercial banks were not severely restrained by Regulation Q ceilings. On the other hand, when thrift institutions benefited from the protection of rate ceilings in 1969 and early 1970, they were slightly more successful in maintaining their home mortgage lending than were commercial banks. However, about half of the home mortgage acquisitions of thrift institutions in this period can be attributed to Federal Home Loan Bank advances. If these advances were subtracted from their home mortgage acquisitions, thrift institutions would show a steeper absolute and relative decline than commercial banks.[7]

To summarize, the data show that thrift institutions – with their present structural weaknesses – have great difficulty in maintaining deposit flows during periods of severe restraint. Even when, as in 1966 and 1969-70, they have the help of restrictive Regulation Q ceilings on commercial banks and massive advances from the Federal Home Loan Bank system, their rate of mortgage loan acquisitions declined almost as rapidly as that of commercial banks. We conclude, therefore, that the complete conversion of thrift institutions (and the concomitant elimination of Federal Home Loan Bank advances) would do little harm to the mortgage market in periods of restraint.

II. The More Likely Case: Broader Powers for Thrift Institutions

In the previous section we made the extreme assumption that all thrift institutions would be converted into commercial banks. The

[7]If all thrift institutions were transformed into commercial banks, the revamped commercial bank industry would have a larger proportion of its assets in real estate mortgages. In this section, however, we have made the extreme assumption that in periods of restraint commercial banks would continue to give first priority to business loans, even though in normal times they acquired a larger volume of mortgage loans.

Table 1

NET ACQUISITION OF FINANCIAL ASSETS AND HOME MORTGAGES BY COMMERCIAL BANKS AND THRIFT INSTITUTIONS

(Dollar amounts in billions, seasonally adjusted annual rates)

	1966				1969				1970	
	I	II	III	IV	I	II	III	IV	I	II
Commercial Banks										
Net Acquisition of Financial Assets ($)	18.5	35.9	10.6	15.5	18.7	35.5	14.9	9.3	31.9	30.5
Net Acquisition of Home Mortgages ($)	2.9	3.2	1.8	1.5	4.3	3.3	2.1	2.1	1.0	0.6
Home Mortgages as Percent of Financial Assets	15.7	8.9	17.0	9.7	23.0	9.3	14.1	22.6	3.1	2.0
Thrift Institutions										
Net Acquisition of Financial Assets ($)	12.8	5.9	4.7	6.0	17.7	13.7	10.0	8.9	8.1	17.9
Net Acquisition of Home Mortgages ($)	8.2	4.5	2.5	2.6	10.7	11.0	8.1	6.9	3.2	6.0
Home Mortgages as Percent of Financial Assets	64.1	76.3	53.2	43.3	60.5	80.3	81.0	77.5	39.5	33.5
Memo: Borrowing from Federal Home Loan Banks ($)	1.7	2.7	1.0	-1.7	2.9	3.1	5.3	4.8	4.4	0.8

Source: Board of Governors of the Federal Reserve System, Flow-of-Funds tables, *Federal Reserve Bulletin,* various issues.

Note: Thrift institutions equal savings and loan associations and mutual savings banks.

Hunt Commission did not recommend this transformation, but we assumed it in order to analyze the impact of the most extreme possible institutional change.

Some authorities might argue, however, that this "extreme" assumption is not unreasonable if all the recommendations of the Hunt Commission are implemented. If thrift institutions no longer have low taxes, reserve requirement advantages, and the Regulation Q shelter, why wouldn't they seek commercial bank charters? If they have all the competitive burdens of a commercial bank, why not attempt to reap all the benefits?

One reason is that a thrift institution franchise would still provide some advantages which most institutions would probably be unwilling to give up in order to compete with commercial banks in the difficult and risky business of lending to business customers. For example, most thrift institutions are not only permitted but are encouraged to collect short-term funds and invest them almost entirely in long-term mortgages. When the yield curve is sloping upwards, this privilege enables them to earn a relatively high average yield on their assets. Commercial bank regulatory authorities, on the other hand, do not permit banks to "reach for yield" in this fashion.

Also, thrift institutions are permitted to maintain relatively small capital reserves.[8] For example, savings and loan associations presently have capital reserves amounting to only 6.8 percent of their assets. The comparable figure for commercial banks is 8.3 percent. Even this comparison does not tell the full story. Since the savings and loan associations have minimal holdings of liquid assets, their protective capital reserves should be larger than those of commercial banks. If the standard capital adequacy formula that is used by the Federal Reserve System were applied to the average savings and loan association, it should have about 12 percent of capital reserves rather than the actual 6.8 percent.

Furthermore, most savings and loan associations (and a few mutual savings banks) can obtain credit from a Federal Home Loan Bank in periods of restraint. This is an important privilege which

[8]In this section capital reserves for savings and loan associations refer to general and other reserves (including Federal insurance reserve for asset losses), earned surplus and undivided profits, permanent stock, and current income not transferred to surplus at year-end (for those institutions whose fiscal period does not end December 31). Capital reserves for commercial banks refer to surplus, undivided profits, miscellaneous capital reserves, common and preferred stock, capital notes and debentures, and reserves for bad debt losses on loans (set up pursuant to Internal Revenue Service rulings).

they would relinquish if they became commercial banks. No comparable source of emergency credit is available to commercial banks.

Even if all thrift institutions should wish to convert, many of them would probably be unable to do so because chartering authorities are often reluctant to grant additional commercial bank charters. In many states there is concern that additional aggressive competitors would seriously weaken the financial position of existing institutions. Also, it is not at all clear that many thrift institutions could become successful commercial banks even if they were given the legal powers of such banks.[9] As we will subsequently demonstrate, thrift institutions often have difficulty penetrating new markets.

Thus, it appears to us that most thrift institutions are unlikely to achieve full commercial bank status within the next decade or two. In this section, therefore, we make the more likely assumption that all thrift institutions will be granted, and most will attempt to use, all the additional powers that the Hunt Commission has recommended they receive. We also assume that thrift institutions will continue to consider themselves primarily as specialists in mortgage lending, using their additional powers to become more effective competitors.

The Hunt Commission has recommended a great variety of additional powers for thrift institutions. The most important of these are demand deposit services, consumer instalment lending, the acquisition of corporate bonds and the optional use of FHA and VA variable-rate mortgages. In this section we will analyze the probable impact on the mortgage market of the use of each of these powers.[10]

Demand Deposits

It is obvious that thrift institutions would use demand deposit powers if they were granted. In the five states where savings banks now have checking account powers, four-fifths of the institutions which are permitted to do so offer checking accounts to individuals and nonprofit institutions. Numerous questions remain, however.

[9]This doubt is supported by the experience of Swedish, Belgian, and German savings banks. They possess broad powers but have retained their traditional orientation to savings deposits and mortgage loans. George J. Benston, "Savings Banking and the Public Interest," *Journal of Money, Credit and Banking,* February 1972, p. 141.

[10]The Hunt Commission also recommends additional investment alternatives such as stocks, owned real property, mortgage loans with "equity kickers" as well as a leeway provision. On the liability side, the Commission recommends greater use of long-term deposits and subordinated debentures.

Can demand deposits be a large source of funds for thrift institutions? Would the demand deposit function be profitable? Would the convenience of one-stop banking attract a large volume of savings and time deposits? Would demand deposits be a stable source of funds during periods of restraint?

An Important Source of Funds?

All mutual savings banks in Indiana, Maryland, and New Jersey (as well as one in Connecticut) have had the right to offer demand deposit services for many decades.[11] Mortgage lending institutions in Canada have also had this power since the turn of the century. The experience of these noncommercial bank intermediaries is useful in judging the possible impact of granting demand deposit powers to all thrift institutions in the United States.

The Hunt Commission recommends that thrift institutions offer demand deposit services to individuals and nonprofit institutions, who own only a quarter of total demand deposits. Even if thrift institutions attracted 60 percent of these demand deposits (the approximate share they now hold of total savings and time deposits of individuals and nonprofit institutions), demand deposits would amount to only 14 percent of their total deposits.

Table 2 shows that existing mutual savings banks with demand deposit powers have attracted only a fraction of this 14 percent share. Furthermore, demand deposits as a percentage of total deposits stayed relatively stable at most of the banks in the four states between 1960 and 1970. Canadian institutions have had a worse experience. Both trust companies and mortgage loan companies (the principal mortgage lending institutions in Canada) are permitted to offer demand deposit services to businesses as well as individuals. Furthermore, they pay interest on checkable savings deposits (as do chartered banks). Despite all these privileges, Canadian thrift institutions do not appear to have profited substantially from checkable deposits. In fact, such deposits comprised only 6 percent of the institutions' total deposits in 1970, down from 17 percent in 1963.[12]

[11] One of the two mutual savings banks in Delaware is also permitted to offer checking accounts, but is not discussed in this section because it did not offer this service until 1971.

[12] Two factors that are unique to the Canadian situation are at least partly responsible for much of this decline (which also occurred at chartered banks). First, the interest rate paid on these accounts has remained relatively unchanged at 3.5 to 4 percent while rates on regular noncheckable savings have risen from a range of 4 to 4.5 percent to a peak of 6.5 to 7 percent in early 1970. Second, many Canadian families have shifted from checkable savings to the more convenient regular demand deposits at chartered banks where cancelled checks serve as receipts and monthly statements are supplied.

Table 2

DEMAND DEPOSITS AT MUTUAL SAVINGS BANKS

	Number of Banks Permitted to Accept Demand Deposits		Number of Banks Accepting Demand Deposits		Demand Deposits as a Percent of Total Deposits of Banks Accepting Demand Deposits	
	1960	1970	1960	1970	1960	1970
Connecticut	1	1	1	1	9.0	6.4
Indiana	4	4	2	2	9.0	6.3
Maryland	5	5	2	4	0.4	1.5
New Jersey	21	21	10	17	1.8	1.6

The data in this table were derived from: National Association of Mutual Savings Banks, *Directory and Guide*; Federal Deposit Insurance Corporation, *Assets and Liabilities - Commercial and Mutual Savings Banks; Polk's World Bank Directory; Annual Report of the Bank Commissioner of the State of Connecticut*; and statistics compiled by the Savings Banks' Association of New Jersey. In some cases tax escrow accounts were classified in the source material as demand deposits. These amounts have been estimated and excluded from the table.

Lack of convenience is probably the principal explanation for the unfavorable demand deposit showing at U. S. thrift institutions and their Canadian counterparts. They have fewer offices than commercial banks. In the United States thrift institutions have 34 percent of the combined assets of depositary institutions, but only 25 percent of the total number of offices. Canadian trust companies and mortgage loan companies have even fewer branch offices. They hold 23 percent of the combined assets of trust companies, loan companies, and chartered banks, yet have only 9 percent of the total offices. Noncommercial bank mortgage lending intermediaries cannot afford as many offices because they generally do not service business accounts and offer fewer financial services. Therefore, any given branch office must service a somewhat larger geographical area if it is to generate a given amount of business.

Profitability

The small-size demand deposits that thrift institutions would be likely to attract would unfortunately not be low-cost funds, even though they earn no interest. For example, the funds provided by special checking accounts at commercial banks, which average $300 in size, cost about 5.0 percent a year. This is about as expensive as time or savings deposits and much more costly than the average of all demand deposits at commercial banks, which, of course, include large-size business demand deposits.[13] If thrift institutions were not able to impose service charges, the cost of their household demand deposits would be almost 10 percent. As more commercial banks institute "no service charge" checking, it will be more difficult for thrift institutions to attract demand deposits with service charges.

Thrift institutions may have other potential entry problems. Functional cost data show that the cost of handling checking accounts for a bank with 1,000 accounts is 50 percent higher than for a bank with 50,000 accounts. This suggests that small thrift institutions would have extremely high costs for a considerable period. Of course, some of the larger thrift institutions in metropolitan areas such as New York, Los Angeles, and Boston could handle checks at a competitive cost. And smaller thrift institutions in rural areas could compete very effectively with small commercial banks which also have high costs. Moreover, many thrift institutions would undoubtedly be able to attain an average demand balance

[13] See footnote 3.

which is substantially higher than $300 — the average for special checking accounts in commercial banks in the United States — and their profitability would be substantially improved. Nevertheless, providing checking services for small accounts will likely be little better than a break-even operation.

The Importance of "One-Stop" Banking

The right to offer checking services would be a plus factor for thrift institutions. Conceivably the convenience of such one-stop banking could reduce the estimated 50-basis point premium above the commercial bank savings rate that thrift institutions now must pay to attract savings. However, we interviewed authorities in many states as well as in Canada and received no evidence that thrift institutions reduced their relatively high rate on savings accounts after they obtained demand deposit powers.

Savings bank officials have suggested, however, that thrift institutions with checking powers might continue to pay a rate premium but use it to attract a more rapid savings inflow.[14] They cite the experience of the New Jersey savings banks as support for this view. As shown in Table 3, the 10 savings banks which were offering checking accounts in 1960 had on average faster deposit growth between 1960 and 1970 than did the other 11 savings banks. The seven banks that added this service between 1960 and 1970 averaged slightly lower growth than the 10 already described, while the four banks that still did not offer checking accounts in 1970 had only half of the growth of the 10 banks. However, further investigation of the data shows that the New Jersey experience provides no clear evidence. All four no-checking banks were small. The largest of the four showed a surprising decline in deposits over this period and in 1971 was merged with another savings bank. The average growth of the remaining three no-checking banks was much faster than that of the 10 and 7 bank groups with checking.

Although the New Jersey evidence is not convincing, we are inclined to believe that demand deposits will aid thrift institutions slightly in their competition for savings. Some large institutions with many branches may benefit significantly while others will receive little advantage.

[14]See, for example, Elliott Carr, "Presentation of Savings Banks Association of Massachusetts" before the Massachusetts Special Legislative Commission to Study Demand Deposits at Savings Banks, May 1, 1972.

Table 3

DEPOSIT GROWTH AND CHECKING ACCOUNTS NEW JERSEY MUTUAL SAVINGS BANKS

	Total Deposits ($ millions)		Growth in Total Deposits, 1960-70 (percent)
	1960	1970	
10 banks offering checking accounts in 1960:			
(1)	31.7	84.1	165.3
(2)	14.4	35.9	149.3
(3)	71.7	173.2	140.9
(4)	38.9	90.0	131.4
(5)	400.9	887.1	121.3
(6)	39.1	86.4	121.0
(7)	105.4	229.4	117.6
(8)	100.2	185.9	85.5
(9)	131.2	239.0	82.2
(10)	33.4	57.7	72.8
Group total	966.9	2068.7	114.0
7 banks initiating checking between 1960 and 1970:			
(1)	52.7	144.8	174.8
(2)	11.4	31.3	174.6
(3)	77.8	179.2	130.3
(4)	54.1	122.3	126.1
(5)	61.2	131.1	114.2
(6)	38.2	53.2	39.3
(7)	55.0	70.0	27.3
Group total	350.4	731.9	108.9
4 banks not offering checking accounts:			
(1)	4.0	14.6	265.0
(2)	2.2	4.9	122.7
(3)	7.8	14.7	88.5
(4)	15.3	13.3	-13.1
Group total	29.3	47.5	62.1

Source: *Polk's World Bank Directory*

A Stable Source of Funds

Demand deposits would be a stable, although small, source of funds to thrift institutions during periods of restraint. According to flow-of-funds data, demand deposit holdings of individuals and nonprofit institutions rose by 2 percent in 1966 and 4 percent in 1969, even though other demand deposits fell in 1966 and rose only 2 percent in 1969.

Consumer Loans

The Hunt Commission recommends that all thrift institutions be permitted to invest up to 10 percent of total assets in consumer loans. Although the Commission is not explicit, it probably assumed that thrift institutions could acquire a substantial volume of consumer loans, that these loans would be more profitable than mortgage loans, and that in periods of restraint they would provide a source of liquidity. Because consumer lending powers would make thrift institutions more complete family finance centers, they might also help attract a greater flow of savings.

Many states have already given consumer loan powers to mutual savings banks and state chartered savings and loan institutions. We have analyzed the performance of mutual savings banks with these powers in 10 states and discovered that they have not acquired a very large volume of these loans. Only in Maryland were mutual savings banks able to obtain consumer instalment loans in excess of 3.5 percent of assets. In most states the percentage hovered in the 1 to 2 percent range.

A lending institution can build up a large portfolio of consumer loans by purchasing instalment "paper" from vendors, such as auto dealers. But the dealer gets a good commission on these loans, which lowers the return to the lender. Direct loans to consumers are more profitable since there is no dealer's commission, but direct business takes a long time to generate. Maryland savings banks built up their consumer loans to about 8 percent of assets mainly by purchasing loans from dealers. Savings banks in most other states are not allowed to acquire indirect loans. They would be granted this right, however, if the spirit of the Hunt Commission report is followed.

While consumer loans (both direct and indirect) have high gross yields, they are expensive to handle; processing costs total about 4 percent per year. Since processing costs of mortgage loans are only

about 0.5 percent, the gross yield on consumer loans has to be 3.5 percentage points higher than on mortgage loans to have an equal net yield. Currently, the gross yield to lenders on purchased loans (after commission paid to dealers) is around 9 percent. Thus, mortgages at current rates of 7 to 7½ percent are clearly more profitable than purchased consumer loans. Direct loans, however, which yield lenders almost 11 percent gross on average, are about as profitable as mortgages.[15]

Consumer loans might, however, be viewed as a substitute for marketable short-term assets rather than for long-term mortgages and bonds. The average maturity of consumer instalment loans at commercial banks is 18 months, and as a result these consumer loan repayments provide a large and steady inflow of funds. During a period of restraint these repayments might be used to meet deposit withdrawals, or possibly to acquire high-yielding mortgages. As a substitute for liquid assets, consumer loans would augment the earnings of a thrift institution slightly during normal times because they have a relatively high net yield. But allowing consumer loans to run off to meet a liquidity crisis harms the long-run efficiency of the consumer loan department. Alternately activating and deactivating this department during periods of monetary ease and restraint make it difficult to maintain both personnel and patronage. This probably explains why commercial banks continue their consumer lending during periods of restraint.

The Acquisition of Corporate Bonds

The Hunt Commission recommended that *all* thrift institutions be allowed to invest in a wide variety of assets, such as corporate bonds, stocks, owned real property, and mortgage loans with "equity kickers." Judging from the acquisitions of mutual savings banks – which already have broad investment powers – the most important of these would be corporate bonds which now account for 11 percent of savings bank assets.

Before 1966 Aaa corporate bonds typically yielded 50-100 basis points less than conventional home mortgages (net of processing costs). In the 1966-71 period, however, rates on corporate bonds rose substantially faster than those on mortgages. As a result, the yield on corporate bonds was significantly higher than the net yield

[15]Data on costs and gross yields cited in this paragraph are from the Functional Cost Analysis of the Federal Reserve System.

on mortgages in 1969 as well as in much of 1970 and 1971. Such a rate relationship is likely to be typical of boom periods when corporations have an insistent demand for credit and when the government intervenes to slow the rise in mortgage rates. If all thrift institutions had the option of buying the higher yielding corporate bonds during such a period, many would obviously choose the bonds. On balance then, wider investment powers would marginally harm the mortgage market during periods of restraint.

Variable-Rate Mortgages

The Hunt Commission recommended that the Federal Government authorize a variable-rate option on both FHA and VA mortgages. The history of home financing in this country strongly suggests, however, that most borrowers and lenders are not enthusiastic about adjustable-rate provisions.

Borrowers naturally prefer a fixed-rate contract which protects them when interest rates rise. If interest rates decline, they have the option of refinancing. Lenders, on the other hand, have generally been unwilling to pay the costs of marketing variable-rate mortgages. If borrowers are to accept these mortgages, lenders must offer a lower initial rate. Lenders must also spend substantial time and money solving the practical administrative and public relations problems.

The Federal Reserve Bank of Boston's survey of financial institutions in New England demonstrated that most of them now have the authority to make variable-rate *conventional* mortgages.[16] About one-half of the surveyed New England institutions had at least a few mortgages with adjustable- rate provisions. However, the total volume of outstanding conventional variable-rate mortgages was small. The New England evidence suggests, therefore, that merely authorizing variable-rate options for FHA and VA mortgages (which have constituted about one-third of all home mortgages in recent years) would not have much impact. We believe this is unfortunate, because the variable-rate mortgage could have an extremely beneficial impact on the competitive position of thrift institutions during periods of restraint.

16. "Variable Rates on Mortgages: Their Impact and Use," *New England Economic Review,* March/April 1970, pp. 3-20.

Conclusions

The Hunt Commission's recommendations would greatly augment the powers of thrift institutions, but would have little influence on their competitive strength during periods of restraint. Demand deposits would provide a stable but small source of funds. Also, the history of savings banks with demand deposits suggests that this service offers little improvement in savings and time deposit inflows. Holdings of consumer loans would provide some additional liquidity without a sacrifice in income. This liquidity, however, could be used only at the cost of disrupting the consumer loan department. The privilege of purchasing corporate securities would augment the income of thrift institutions, but it would hurt the mortgage market during periods of restraint. Finally, experience suggests that a variable-rate option on FHA and VA mortgages would be used very little.

III. The Desirable Case: Adequate Reserves, Insurance or Variable Rates

The Hunt Commission members were predominantly leading executives from regulated financial institutions. Its outstanding staff was composed of economists who are well aware of the benefits of competition in a free market and the stultifying influence of unnecessary regulations. It is natural, therefore, that the final report should emphasize de-regulation and broader powers for all financial institutions. The net result of these recommendations – if implemented – would be a more competitive set of financial institutions. Consumers would benefit from better and lower cost financial services.

We have the nagging suspicion, however, that the Commission did not recommend sufficiently forceful measures to reform the structure of thrift institutions. It recommended the phasing-out of almost all the special competitive advantages of these institutions. It would, however, allow thrift institutions to continue to obtain interest sensitive short-term funds and invest them in predominantly long-term mortgages and securities. The Commission apparently assumed that greater competition will force thrift institutions to achieve a better balance between their assets and liabilities. We fear the reverse might well be true. Shorn of their special competitive advantages and forced to compete with commercial banks which have access to low cost business demand deposits, thrift institutions might choose to

rely increasingly on their single remaining competitive advantage — borrowing short and lending long. We are tempted to use the Commission's own words on page 15 of its report:

> Yet none of these problems is finally solved. . . .when expectations of inflation have abated and controls are abandoned, monetary policy will again have a major role. In future periods of monetary restraint, however, older methods may work even less effectively than in the past. Deposit rate maximums will surely be less effective in maintaining the supply of mortgage funds, and in protecting financial institutions from disintermediation. Thus, even if monetary policy is used more moderately, the problems of liquidity and solvency encountered by financial institutions could be as severe as those experienced during 1966, 1969, and 1970. Modifications in the structure and regulation of the financial system are urgently needed.

We think the Hunt Commission recommendations will essentially make savings and loan associations similar to mutual savings banks and, as we know, many mutual savings banks suffered acutely from disintermediation during 1966 and 1969-70, resulting in impaired capital reserves. Therefore, in a future period of severe restraint, the government will most surely use rate ceilings to help thrift institutions to the detriment of middle- and low-income savers. According to our calculations, in 1970 persons who saved at depositary institutions were deprived of almost $7 billion of income which they would have received had all mortgages been completely flexible.[17] Federal regulatory agencies precluded these institutions from paying market interest rates on their consumer time and savings deposits because they were concerned about the solvency of thrift institutions. Unfortunately, the cost of this financial institution protection program was borne almost entirely by middle- and low-income savers. Obviously such a tax cannot be justified. Furthermore, in the next period of restraint rate ceilings will likely be much less effective. In this event the Federal Government may impose detailed and onerous credit controls. We can see it coming; is it what we want?

Obviously, the answer is no. But the problem is that the measures needed to forestall the necessity of controls are likely to be unpopular and difficult to implement. We believe, however, that it

[17] Paul S. Anderson and Robert W. Eisenmenger, "Structural Reform with the Variable Rate Mortgage," *Housing and Monetary Policy*, Federal Reserve Bank of Boston, October 1970, p. 126.

would be possible for Federal regulatory authorities to force one or both of the following reforms on thrift institutions:

(1) fully adequate capital reserves or insurance against interest-rate risk
(2) the extensive use of variable-rate mortgages.[18]

Adequate Capital Reserves or Insurance Against Interest-Rate Risk

Adequate capital reserves (or a larger volume of liquid assets) would prevent the kind of insolvency that threatened thrift institutions in 1966 and 1969-70. To estimate what such adequate levels would be, we applied the Federal Reserve System's capital adequacy formula for evaluating member banks to the financial structure of an average savings and loan association. We do not claim this to be a definitive measure of the soundness of savings and loan associations; rather, we intend it to be an approximation of the magnitude of the task necessary to make thrift institutions fully viable in a credit crunch like the ones in 1966 and 1969-70. According to the Federal Reserve's formula, savings and loan associations would, with their present structure, require capital reserves of about 12 percent of total assets, almost double their actual reserves of 6.8 percent. Alternatively, present reserves would be adequate according to the formula if savings and loan associations acquired much more liquidity by reducing their mortgage holdings from 85 to 50 percent and substituting Treasury bills instead.

We assume that if all thrift institutions were required to achieve an adequate level of capital reserves, they would rather increase their capital reserves than decrease mortgages. For reserves to have been adequate in 1966, they would have had to retain additional earnings over the postwar period equal to one-half percent of total assets each year.[19] This would have given them an additional $10 billion cushion (over and above their actual capital reserves of $14 billion in

[18]Regulatory authorities might also require thrift institutions to issue predominantly long-term liabilities. This alternative, however, is very expensive. The Canadian trust and mortgage loan companies have historically depended on long-term time deposits. Unfortunately these deposits cost them an average of 150 to 200 basis points more than regular savings and raise the average cost of all funds at least 100 basis points above the regular savings rate.

[19]For simplicity, we ignore the unfavorable impact such an additional transfer to reserves would have on the competitive position of thrift institutions. This extra transfer would force them to increase rates on mortgages and decrease interest rates on savings, thereby making thrift institutions somewhat less competitive in both markets.

1966) which presumably they would have drawn down if in the absence of rate ceilings they had been forced to pay competitive rates on their savings in the 1966-70 period.[20] With the end of monetary restraint in 1970, thrift institutions would again start building up their reserve cushion.

The Commission suggested that Congress study the possibility of setting up an insurance fund to protect thrift institutions against the effects of credit restraint. In essence, adequate capital reserves are such a fund, and the required interest-rate risk insurance premium payments would be roughly equal to the extra retained earnings that adequate capital reserves require. Thus, the cost impact of insurance against interest-rate risk seems to be the same as that of adequate capital reserves. Both the adequate reserve and insurance plans would require strong supervisory enforcement. Presumably the Federal Deposit Insurance Corporation and the Federal Home Loan Bank Board would compel thrift institutions to build up their protective cushions.

Encouraging the Use of Variable-Rate Mortgages

Our second method for improving the viability of thrift institutions is the greater use of variable-rate mortgages. If most mortgage loans were on a variable basis, asset yields would move up rapidly when thrift institutions most needed extra income. (Asset yields would also move down when high rates on deposits are no longer needed.) Any public policy which would increase the use of variable-rate mortgages would therefore be useful. The Hunt Commission recognizes this fact and recommends variable-rate options for both FHA and VA mortgages. However, the Commission is also much concerned about consumer protection and suggests a series of five safeguards, the first of which is that every "borrower must be offered a fixed-rate mortgage alternative."[21]

We support all five of the Commission's proposed safeguards, but we would add one of our own which we believe is the key to borrower acceptance of variable-rate mortgages. We propose that every borrower must be offered two variable-rate mortgage alternatives at significantly lower initial rates: (1) If the borrower chooses

[20] As suggested by Professor James Tobin, this should be the purpose of reserves. See "Deposit Interest Ceilings as a Monetary Control," *Journal of Money, Credit and Banking*, February 1970, pp. 10 and 11.

[21] *The Report of the President's Commission on Financial Structure and Regulation*, p. 82.

a fully flexible-rate mortgage[22] where the rate moves up and down as much as the basic rate to which it is tied, his initial rate should be at least 50 basis points less than the fixed-rate option offered by the same bank. (2) If the borrower chooses partial variability where the rate varies only one-half as much as the basic rate, the initial rate should be at least 25 basis points lower.

Our judgment is that, given the option of a fixed-rate mortgage *or* a variable-rate mortgage with a lower initial rate (as well as all the safeguards suggested by the Hunt Commission), the large majority of borrowers would choose some type of variability. For example, if by 1965 one-third of the mortgage holdings of thrift institutions had been fully variable and one-third partially variable, by 1969 the average yield on assets of thrift institutions would have been one full percentage point higher than it actually was. If thrift institutions were strengthened in this way, we believe they could survive most periods of restraint.

Of course we could be too optimistic about the willingness of thrift institutions to market variable rates or the willingness of the public to accept them. To the extent that a thrift institution is unable or unwilling to attract a large volume of variable-rate mortgages, it should be forced to build up its capital reserves by an additional transfer to reserves of one-half percent of total assets each year until reserves reach an adequate level.

On balance we favor the variable-rate reform over the adequate capital reserve reform. We believe a compulsory variable-rate option with a lower initial rate has the important advantage of administrative simplicity. Financial regulatory authorities have historically had great administrative difficulty in enforcing capital adequacy standards.[23]

The variable-rate mortgage reform would also provide slightly more support for the mortgage market during periods of restraint than would the additional capital reserves reform. Although thrift institutions with a large volume of capital reserves could pay a competitive rate on time and savings deposits, their reserves would be

[22]The variable mortgage rate would be tied to the average national rate for new fixed-rate mortgages. Two such rates are regularly compiled and either should be satisfactory. These are the Federal Home Loan Bank Board series based on a sample survey of major institutional lender groups including mortgage companies, and the Federal Housing Authority series based on FHA field office opinion of typical interest rates for new home mortgages.

[23]See the paper by Samuel B. Chase, Jr. in this volume.

reduced and possibly depleted during periods of restraint. Such a decline in reserves would reduce the funds available for mortgages just as much as an equal dollar decline in deposits. To the extent that rising income from variable-rate mortgages enables thrift institutions to pay competitive rates, they need not suffer operating losses and reductions in reserves.

IV. Summary

In Section I of this paper we analyzed the extreme case where the Hunt Commission recommendations resulted in the complete transformation of thrift institutions into commercial banks. We concluded that such a transformation would do little damage to the mortgage market in periods of restraint. The evidence suggests that at such times thrift institutions are so vulnerable they provide even less support for the mortgage market than commercial banks.

An examination of the Hunt Commission's recommendations in Section II concludes that their implementation would be useful in promoting competition among financial institutions. But they would do little in periods of restraint to help either thrift institutions or the mortgage market.

Section III outlines a possible reform program that would bolster both thrift institutions and the mortgage market during times when interest rates rise substantially. Encouraging the widespread use of variable-rate mortgages not only helps middle- and low-income savers, but also has the advantage of administrative simplicity. Although the variable-rate reform would raise the cost of fixed-rate mortgages slightly, it would help maintain the supply of mortgage funds in periods of severe restraint. In addition, our proposal would protect the depositary insurance funds and would bring substantial reform fairly quickly. Finally, it would help the broad national interest by enabling the Federal Reserve System to formulate monetary policy without considering the short-run consequences to thrift institutions. All in all we believe that the widespread use of variable-rate mortgages provides the most effective way of achieving needed structural reform for thrift institutions.

DISCUSSION

HENRY C. WALLICH*

I should say right away that any resemblance in my views to those of the U. S. Treasury, past or present, is purely coincidental. I am happy to speak at this conference, but embarrassed to comment on two papers that agree with each other. There does not seem to be very much for the discussant to accomplish and if I were to put myself at odds with them I would likely be the loser. I take refuge in a third study that is not represented here – you were mercifully spared this big volume by Allan Meltzer which I regard as a close relative of the Fair-Jaffee paper, which hereafter I will refer to as the Jaffee paper. The Meltzer study says something that I think is pretty shocking to most people. The same shocking conclusion is implicit in the Jaffee study, although they are never compelled to come clean because of certain results in their simulations that do not compel them to take so advanced a position. Meltzer says that credit markets are so perfect that it does not matter greatly through what channel funds flow. Whether there is a great supply of mortgage funds, whether there are institutions that buy mortgages, it all makes little difference. The ultimate result in the real sector is likely to be broadly the same. If that is true, then much of our past efforts to help housing have been misdirected because they had been directed at housing credit rather than at housing. This approach was vested on the assumption, buttresed by the work for instance of Sherman Maisel, who has spoken at these conferences, that mortgage credit is a very important determinant of housing. It flies in the face of conventional wisdom and of political wisdom, to deny that if you want to help housing you offer a plentiful supply of mortgage credit.

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I approach this matter in a spirit of humility, and I would like first to lay bare my own prejudices which are rather similar to those embodied in these studies. In an obscure article that I wrote some years ago I likened the flow of savings to a river that goes into the sea of investment. It flows through a delta of many arms which are the intermediaries and other channels through which savings flow. Now it makes very little difference to the sea through which of the shifting arms of this delta the river of savings flows. It makes a tremendous difference to the people who are settled on the banks of the particular arms whether the water in them rises or not. And there is of course a question of how many of the users of credit are settled on the banks of particular arms of this delta and how many are settled on the sea and don't care how the river gets there. My own impression is that the important thing is that the river gets there; the arms of the delta are of secondary importance.

Now the Hunt Report more or less compels us to face the moment of truth. The Hunt Report says: let us cut loose the captive financiers of housing and let them do what competition commands; that is the economically right thing to do; that is what most of the people in the industry seem to want to do. This approach apparently happens to be politically negotiable among the members of the industry, which to me is amazing. It may not be a recurring opportunity. We should take a deep breath, tell ourselves that it probably will not hurt housing, and believe that it probably will help. I think so too, but God help us if we are wrong. Very serious consequences could follow. We need to check out these conclusions pretty carefully.

The Free Market Assumption

Let me make for the moment the contrary case. Everybody who has to do with credit is aware that the history of credit has been to make the non-bankable, bankable. Take some potential borrower, a household or some kind of business that is not bankable. Find a technical device, such as the instalment mortgage, or the chattel mortgage, or whatever technique would make this credit bankable. Anyone who has worked on credit in developing countries knows that there it certainly is not true that everything will get financed regardless of whether the right credit instruments and the right institutions exist. Where there is no mortgage bank, credit does not flow and housing does not get built. Where there is no agricultural bank, the farmer does not credit, or he gets it from the storekeeper

at 30 percent. In other words, there are situations where this perfect market assumption clearly is not justified. The question is whether we have progressed to a state in which one can assume that the real sector will get its financing even though the institutions that supply it shift around.

The Availability Effect

Continuing the search for market imperfections, there is the visual evidence we have all had – there have been credit crunches when money has been either hard or impossible to get. Allan Meltzer will have you believe that if in '66 or '69 there was little mortgage lending, it was because people did not want to build. People supposedly said that the interest rate was too high. I think that puts a lot of stress on small changes in the interest rates and ignores the availability effect. Now Jaffee, of course, does have the availability effect in his model, although he points out that the interest rate is an alternative. One cannot have availability and interest-rate effects at the same time. When one thinks of incidents in one's own experience, one is bound to wonder whether it is the interest rate effect that reduces mortgage lending or something else. I know about the mortgage policies of just one bank, and that bank in 1969-70 said "no mortgages – period." It did not matter what price was offered. I have friends who are real estate agents and who said that in 1969 there was no mortgage money in New Canaan, Connecticut. I said, "You mean you must pay a little more?" "No," they said, "there is no money – period." I said, "Go outside New Canaan." They said, "Outside New Canaan they tell you that they don't lend to New Canaan." These irrelevant spotchecks, however, leave one a little skeptical of the sweeping nature of the conclusions of Meltzer and to a lesser extent of Jaffee. We all know the nature of statistics. The model necessarily deals with nationwide aggregates – it is not very sensitive, as Dwight Jaffee told us, to short-term fluctuations. What happened in New Canaan in one quarter of 1966 or 1969 clearly cannot be expressed by the model. On the other hand, it takes just one good outlier three standard deviations away from the mean to start some sort of a run on the banking system, or a run of members of Congress on the administration, or of the voters on Congress. Broad generalizations are dangerous in a matter like this, when outliers can trigger events.

There are some questions that one can ask of the two studies that will help one to evaluate them. Let me begin with the Anderson-Eisenmenger paper.

Bearing on the Thrift Institutions

I find its most interesting conclusion the assertion that the Hunt Report promises far less for the savings and loan industry and to some extent the mutual savings banks than one might have supposed. This is because they do not assume massive conversions, which seems very plausible. Then the example of the existing savings and loans and similar institutions shows us that these institutions do not do a great deal with these powers when they have them. That is a real eye-opener, provided it is right. It is always thinkable that once a new mood or trend gets going the pattern might be quite different. The example of what happened in Indiana, Maryland, and where ever, is not binding just because those cases were only examples – they did not get a chance to acquire national pulling power. But when say, the Bowery Savings Bank does it, perhaps everybody else does it. Thus the Anderson-Eisenmenger finding is not completly conclusive.

I also find very interesting the conclusion that the really important changes that ought to be made by the thrift institutions are those least likely to happen; namely, variable mortgages and an insurance fund or the accumulation of capital.

I must confess I do not think that a capital fund is the same thing as insurance. I think that there would be a terrific outcry if institutions began consuming their capital on a large sacle, whereas there would be no such outcry if an insurance fund would be drawn down.

I love variable interest-rate mortgages. When I wrote about them in *Newsweek* some years ago, I got a number of letters saying that only a professor could think that anything of that kind could be considered by practical people. I am not even clear now whether we are thinking about a lengthening of the mortgage while the interest rate is raised, thereby leaving the monthly instalment unchanged – that is the British system as I understand it – or whether we are considering changes in the monthly payments. The latter seems to me to have very little chance of adoption because mortgages are usually refundable. Interest rates are always adjustable downward because the debtor can refinance. Hence, variable interest rates would then just mean a chance to raise the rate. The prospects of this device at least are questionable.

But the main conclusion of the Anderson-Eisenmenger paper is in line with the Jaffee paper. So let me end up by saying a few things about it.

The Importance of the Model

To begin with, I think it is obviously a great step forward to be able now to simulate the effects of legislation and get some idea of what might happen. The normal past procedure has been to propose legislation, hear diametrically opposing views on it expressed at hearings, with nobody in any position to make a quantitative judgment. We are all indebted to people like Dwight who does this kind of thing. The question is whether one should advise a policy-maker to place a great deal of weight on these findings. Should important economic and political decisions be made because a model has thrown up some kind of answer?

I am pretty hesitant to say yes to all this unless there is much broader support. One can, however, test out the reliability of the model by looking more closely at the procedures. Now, first, this simulation was done by people who are known to be competent and know their way around the model – they both worked on it. The model is our strongest financial model; it was designed for work like this. We know it has its peculiarities – monetary policy effects are powerful, but the lags are very long. There seems to be, if I may say it, no professional bias involved – the authors come from MIT.

Second, the authors have guarded against various pitfalls through their procedures. But one of the big difficulties is, of course, that the model was specified for certain institutional conditions pertaining to the thrift institutions. If you change these specifications of the institutions, the model is not necessarily applicable. But the authors have run two simulations: one that embodies the specifics of the industry, another that takes out these parameters. While the second is less convincing and less detailed, it broadly confirms what the first one found.

Third, we know that this model is always changing. There is no time when somebody talks about the model that somebody else does not speak up and say "Which equation are you using?" This pertains particularly to key equations like the demand for money and the stock market equation, and I think they use several. Again, therefore, they have protected themselves.

Fourth, an important element of protection arises from the fact that the sum total of the Hunt reforms does not shift the mortgage supply function very significantly. The authors are not dependent for their results, therefore, on the elasticity of the demand for mortgages as they would be if there were a massive shift in that function. The model, of course, contains that elasticity, but in this particular solution we do not need to rely on it.

There are other difficulties that I think are not so easily solved. One is the fact that there seems to be a small disagreement with Anderson-Eisenmenger on what the Hunt reforms would do to the deposits in thrift institutions. Jaffee sees a rise of 15 percent in 10 years as a result of one major change, namely the extended-service functions. A 15 percent (relative) increase in savings and loan deposits over 10 years is a great deal and it tends to dominate the effects of the model. They use that finding in some runs and leave it out in others. When they use it, everything looks rosy for the savings and loans and also for housing; when they drop it things look sort of neutral but certainly not bad. Anderson-Eisenmenger, on the other hand, seem to play down the effect of the Hunt changes on thrift institutions. This is a difference that deserves looking into.

The last thing is the question of the lags. The MIT model has very long lags, as we know. That leaves one very uncertain as to whether the events of 1968-69-70, when Regulation Q first began to bite, have really been captured in a run that could not go beyond that data of 1970. Maybe there are some repercussions of recent high interest periods which have not had time to work themselves through the model. Data for future years might show that the Hunt reforms would have somewhat different results.

Taking it all in all, it seems to me that these are two excellent studies. They support what one wants to do on general economic grounds — to free up competition and move toward more nearly perfect markets. I would not place 100 percent reliance on them, but they do go far in reassuring me. My overall conclusion is to go ahead with much of the Hunt Report and stand ready to use the Federal agencies that buy mortgages if something should go wrong.

Proposals for Rechanneling Funds to Meet Social Priorities

LESTER C. THUROW*

I support the primary and secondary thrusts of the recommendations of the President's Commission on Financial Structure and Regulation. The primary thrust of these recommendations is that each financial institution should decide for itself where its comparative advantage lies within the domain of financial intermediaries and that institutions that are doing the same things should be subject to the same regulations. The secondary thrust is that the amount of regulations should be substantially reduced. While it is easy to quibble about details and timing I think the Commission should be given the benefit of the doubt on these matters. They result from a balancing of objectives that no outsider can make and that no insider with vested interests should be allowed to make.

I do this despite my interest in channeling funds toward social priorities. First, the present institutions and regulations have not channeled funds toward social priorities in sufficient quantities to be worth the inequities that they have produced. The present arrangements are simply not worth preserving as a vehicle for meeting social objectives. Second, the present arrangements assume that you can compartmentalize financial intermediaries so that institutions that are under different regulatory handicaps do not compete with each other. This assumption has simply proven to be untrue. Moreover, there probably is no set of regulations that could stop poaching on the other guy's turf. As a result, all regulations should be across-the-board regulations on all intermediaries.

I also admit that all social priorities could be met with budgetary expenditures and/or tax credits (tax expenditures). I am convinced that in a perfectly functioning world most social priorities *should* be

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met with budgetary expenditures. Both complex tax incentives and financial regulations are apt to end up doing more for some intermediary than they do to promote the ultimate social objective. (Tax deductibility for state and local government bonds is probably the best current example of such a result.) The financial community is perfectly right in saying that in a perfectly functioning world, social priorities *ought* to be someone else's problem.

The recommendations of the President's Commission essentially spring from a vision of perfectly competitive capital markets. Each saver sends his savings into the capital markets and is paid a competitive (equal) rate of interest by the financial intermediaries. Financial intermediaries in turn allocate the savings to those lenders who are willing to pay the highest rate of interest. With the exception of allowing for differences in risk and the costs of making loans (economies of scale in handling large borrowers), all borrowers pay at the same rate of interest. Differences between lending rates and borrowing rates reflect the financial intermediaries' costs (including a necessary profit) of making loans. The level of the competitive interest rate insures that the demand for savings equals the supply of savings. In such a world no one cares to whom he lends or from whom he borrows. The same conditions are available everywhere. In such a world, social priorities are quite properly left in the government budget.

The question then becomes one of whether the real world is close enough to a perfectly functioning world so that we can afford to operate on the premise that the real world functions perfectly. Alternatively we could ask what changes would be necessary to bring the real world close enough to a perfectly functioning world to make the assumption valid.

Discrepancies

While a host of deviations between such a model and the real world could be noted, there are three major facts of life that are not in accordance with the ideal world. First, not all savings are allocated in the capital markets. In the ideal world they should be. Second, credit rationing is a pervasive fact of the real world. In the ideal world it does not and cannot exist. Third, customer relationships are thought to be important. In the ideal world the whole concept of a regular and valued customer does not exist. To some extent these are not three independent deviations. The latter two spring principally from the first.

Corporate retained earnings are the major source of unallocated savings within the capital markets. They enjoy special tax and legal advantages. They are subject to neither the allocation procedures of the capital marketplace or to the allocation desires of their owners (the individual shareholders). From the point of view of the arguments used to justify deregulation for financial institutions, all earnings (including depreciation charges) should be paid out as dividends and then brought back into the firm in the form of borrowings or equity issues. Corporate taxation could be abolished, but all dividends and depreciation allowances above the initial investment would be taxed as personal income. As a result, corporations would be forced to compete for all of their capital needs. Unless this is done, corporations have two major advantages in the country's capital markets. First, they have tied savings for which they do not have to compete. Second, their tied savings (cash flow) can be used as collateral to obtain extra funds in the capital markets. Conversely, the supply of savings for which others must compete is smaller than it should be.

Our actual financial markets are marked by credit rationing and by preferences for large regular corporate customers over small, irregular, non-corporate customers. Why? The answer lies in imperfect knowledge and in the tied savings of the corporate sector. Profit-maximizing financial intermediaries obviously want to cultivate the business of corporations with large flows of tied savings (cash flows). In our real world of oligopoly relationships, such a connection is the best method for maximizing long-run profits. Yet such long-run profit maximization will result in too few funds being allocated to the infrequent non-corporate borrower from the point of view of economic efficiency.

Logically all of the assumptions that lead to the actual recommendations of the Commission lead to the abolition of retained earnings. Single economic efficiency considerations demand it, yet the Commission did not recommend it. Politically, I understand why such a recommendation was not made, but its absence leads to a report which at best must be described as self-serving. Given this large imperfection in favor of corporate borrowers, there are *only* two options. Create equal preferences within the financial markets for non-corporate borrowers or stop the preferences for corporate borrowers. I am willing to stop the special preferences for corporate borrowers, but I suspect that realistically we must focus on equal preferences for non-corporate borrowers. Without such preferences, credit rationing will allocate too many funds to the corporate sector

and too few funds to the non-corporate sector. The question is how such a bias can be corrected in a manner that will not violate the primary and secondary thrusts of the Commission's recommendations. This is not a question of equity but of efficiency.

An Examination of Special Cases

Before examining the possible countervailing preferences that could be created for small, irregular, non-corporate borrowers, it is necessary to examine the special cases that are advanced for special financial regulations for special sectors. The areas usually cited include housing, state and local governments, agriculture, exports, and small businesses. In addition to its absolute merits, however, each case needs to be examined with an eye to alternative solutions. Are special financial regulations or institutions the best way to solve the problem?

A. State and Local Governments

The basic problem of state and local government finance is not one of borrowing power, but one of taxing power. The relevant question is not "How do we borrow more?" but "How do we raise more tax revenue?" Revenue sharing and more use of the personal income tax completely dominate special borrowing provisions as a method of solving the financial problems of state and local governments. States are large institutions that can compete in the credit markets and they can easily establish financial intermediaries to obtain borrowing economies of scale for small local governments in their jurisdictions. If the taxation problem were solved, the borrowing problem would not exist. Unless the tax problem is solved, there is no way to solve the borrowing problem.

B. Exports

Exports are a peculiar case in that arguments for special aid revolve around what is given in other countries. The operative problem then becomes one of countering these provisions with equal and offsetting preferences or by devaluations which take these incentives into account. From an efficiency standpoint it is clear that setting exchange rates in such a manner as to offset these special provisions is preferable. If this is not done, however, there remains a case for special financial provisions for exports.

C. Agriculture and Small Business

Agriculture and small business would benefit from any general program to insure equitable treatment for the small, irregular, non-corporate borrower, but the case for special provisions over and beyond this must rest on the argument that small independent enterprenuers contribute something to the country over and beyond their economic output. This may be true (it is a question of value judgements), but I think that I would agree with the President's Commission that the non-economic benefits different sectors produce should be rewarded in government budgets and not in regulations of the financial system. There simply is no method of regulation that yields everyone a gain equal to his non-economic benefits. In addition the whole society, not just savers, should be forced to compensate for such non-economic benefits.

D. Housing

If housing generates positive or negative externalities, private money markets will provide too little or too much housing since all of the benefits or costs of housing are not considered in each individual investment decision. Housing is probably subject to two types of externalities. First, a whole set of sociological externalities may flow from housing. These are popularly thought to include crime, alienation, and other factors. As a result, when social benefits are included, too little is invested in housing. Second, housing is subject to financial externalities through the neighbor's house. Knowing this, each individual in the neighborhood has an incentive to undermaintain his own home since doing so will have little effect on its value as long as all of the other homes in the neighborhood are well-maintained. Conversely, it does little good to maintain your own home if others are not maintaining theirs. The result of individual economic rationality, however, is collective irrationality. Too little is invested in housing maintenance and housing (and commercial properties) deterioate much faster than economic rationality would warrant.

Social costs and benefits are also created by the seasonality of construction in northern climates. Each person wishes to build his home in the good weather period when construction costs are lowest; each person legitimately ignores the social costs of idle resources during periods of bad weather. Some of these costs are absorbed by

the factors of production in the industry, but many are absorbed by society through unemployment compensation, inflation, and restrictive work rules. Rational social policies may call for much more bad weather construction than will ever occur as a result of individual decision making.

As a result, even in a world of perfect markets, some government program would be necessary to stop such collective irrationality from taking place. Individual housing decisions will lead to too little being invested in housing. Some form of incentive is needed to inject the sociological benefits of housing into the private economic calculus and to prevent the social costs of seasonality and neighborhood deterioration.

In addition, when a society decides upon its optimum distribution of private money incomes through its tax policies, society is defacto deciding on its optimum distribution of marketable economic goods. There may be goods, however, that society wishes to distribute in a different manner. Such goods are "merit wants" and the usual preference is to distribute them more equally than the general basket of goods and services. There is no method for doing this through the private market mechanism, however, since there can only be one distribution of money incomes. Consequently, these goods are furnished through government policies even though they do not meet the classical tests of pure public goods. The most common such merit wants are education, housing, and health care. In each of these cases society seems to have indicated that it wants these particular goods to be more equally distributed than other marketable economic goods. If you like, we are more communistic with respect to some goods than others.

Thus the question arises as to how housing can be more equally distributed than the distribution of money income. Private market mechanisms will never bring about such a distribution without government interference of some sort.

As a result, a strong case can be made that private market mechanisms will not lead to an optimum (from an efficiency or equity viewpoint) investment in housing or to an optimum distribution of this investment across the population even if the current preferences for corporate borrowers were eliminated. I agree with the President's Commission that the merit want, seasonality, and sociological externalities aspect of this question should most properly be handled through the government budget. They reflect social benefits. But what about the neighborhood financial externalities? Too little will be invested in housing simply from the point of view of private

economic efficiency. Given this situation, I think that it would be completely in accordance with the Commission's desires to improve markets if one were to establish special provisions for housing. Internalizing economic externalities is a completely legitimate and necessary role for government regulation of financial markets. According to the economic theory to which the Commission subscribes, these externalities *should not* be reflected in government budgets.

As a result, I would agrue that the Commission's own vision of perfectly functioning private capital markets should have lead it to recommend the creation of a general preference for small, irregular, non-corporate borrowers (or the elimination of retained earnings and depreciation allowances) and a special provision for housing to internalize the private economic externalities.

The Second Best

Considerations of the second best might also have lead the Commission to reflect a bit more on how society should engender the social benefits (as opposed to private benefits) that flow from some of these areas. Theoretically, it is clear that such incentives should reside in government budgets. This is the correct place to spread the burdens of paying for them. In a perfect world, taxing savers (by imposing special financial regulations) to pay for social benefits is unfair. In a less than perfect world, taxing savers may be a "better" (more progressive, fewer horizontal inequities, etc.) tax than the actual income tax. Perfect taxes are better taxes than perfect regulations, but actual regulations may be better taxes than actual taxes. To me it is not obvious that a general tax on savers would be more "unfair" than the current structure of taxes. A general tax certainly would be more progressive and have fewer horizontal inequities than the current tax structure. (Bad regulations may of course be worse than bad taxes.) In any case, the Commission has completely forgotten to think about what role financial regulation may play in our complete structure of taxes. It is a better tax or a worse tax than our current structure of taxes.

Tax reform (the Commission's recommendations are in fact a form of tax reform) is a perfectly appropriate consideration, but unfortunately it is impossible to recommend that a tax be eliminated without proving that the replacement taxes are better than the tax they are replacing. Financial regulations are not the world's best tax, but they may be better than most of the world's actual taxes.

Policy Options

Given the Commission's primary and secondary goals of letting each institution determine its own actions while equalizing and reducing regulations there are essentially two policy options. One is based on fiscal powers and the other is based on regulatory powers.

The fiscal option is the one recommended by the Commission. The government is simply told that it must raise taxes, capture some fraction of savings, and lend this money to those borrowers whom society decides to aid. Unfortunately, once again the Commission does not follow its own logic and spell out the tax implications. To the extent that the aid was designed to compensate for non-economic social benefits, taxes should be raised in accordance with the general structure of taxes. (If society started with an optimum tax system, an across-the-board surtax would be appropriate.) To the extent that the aid was designed to offset deviations in the financial markets from an economic optimum, across-the-board tax increases are not appropriate. To the extent that the fiscal mechanism is correcting for the preferences given to large corporate borrowers in the marketplace, the necessary taxes should be placed on corporate cash flows and corporate borrowings. The resulting revenue would then be lent to small, irregular, non-corporate customers. The taxes necessary to compensate for the financial externalities of property investments should properly be placed on existing property owners. Property taxes should be levied and the revenue lent to those maintaining or improving existing properties and those building new properties.

These special taxes are appropriate since they are the only taxes that will bring capital markets into conformity with perfect capital markets. The existence of large, tied corporate cash flows means that too much savings go to corporations. The fiscal mechanism for correcting this is taxes on corporate savings and lending that stop this excessive flow. Similarly, property owners should pay for the financial externalities of housing investments since they are going to reap the financial gains if property is well-maintained, improved, and well-built. This is the appropriate fiscal mechanism. In neither case is the appropriate mechanism a general tax increase.

Alternatively there is the asset reserve requirement. Under a system of asset reserve requirements, the government places a 100 percent reserve requirement of some fraction of each financial institution's assets unless this fraction is invested in the desired sectors. If national goals called for investing 25 percent of national

savings in housing and other preferred sectors, each financial institution would have a 100 percent reserve requirement on that fraction of its assets. As long as it invested 25 percent of its assets in housing, however, it would not have to leave any reserves with the government. If it had only invested 20 percent of its assets in housing, 5 percent of its assets would have to be held with the government as required reserves. If it invested nothing, 25 percent of its assets would be held as reserves. Thus, financial institutions are essentially given the option of making interest paying loans in the housing field or making an interest free loan to the government. Different asset reserve requirements are essentially different tax rates.

The asset reserve requirement has several advantages over the present system for aiding housing. First, it works. It can insure that housing gets whatever fraction of total funds policymakers think housing should get. Credit crunches have no effect on its effectiveness. Funds cannot flow away from housing since there are no financial institutions that can avoid housing investment. Every financial institution is required to be a housing institution to some degree. (This does not mean, however, that every financial institution must operate in the housing field at the retail level. Specialized housing institutions could issue bonds for those institutions with no expertise in housing and no desire to get into this business.) Second, it is a simple straightforward regulation that does not require the cumbersome and complex set of regulations necessary to maintain the present system. Third, it does not discriminate bewteen the small saver and the big saver. Each can receive the same interest returns. Fourth, institutions are not locked out of other areas. If a savings and loan society has a good industrial lending opportunity, it can make such a loan. Fifth, the government does not have to raise the taxes necessary to finance the fiscal alternative and does not need to build a bureaucracy large enough to manage a large direct involvement in the housing field. In sum, it is consistent with the equal regulation goals of the Commission.

To the extent that asset reserve requirements are used to correct the two capital market imperfections on which I have been focusing, they are regulations called for by simple economic efficiency. No equity considerations emerge. To the extent that asset reserve requirements were used to stimulate non-economic social benefits, there is an equity issue. It is fair to force savers to invest part of their funds for social, as opposed to private, goals. Once again this comes back to the previous second-best question as to whether an asset reserve requirement is a better or worse tax than other taxes that might be used to obtain the same goal.

The answer to this question is obviously a matter of value judgement that I have not been elected to make. Relative equity, however, is often easier to determine. Let me venture the hypothesis that a system of general asset reserve requirements that shifted into these sectors by the present system of regulations would be more equitable than the present system of rules and regulations. Horizontal inequities among savers would certainly be eliminated. Given the progressivity of savings rates, such a regulatory tax on savings would certainly be a progressive tax.

Finally, it must be noted that asset reserve requirements (formal or informal) are used in many developed countries. Based on two studies conducted by myself and some colleagues at M. I. T. for the U. S. House Banking and Currency Committee, they seem to be the only effective regulatory mechanism for moving funds into priority areas.[1] This does not eliminate the need to choose between the fiscal and regulatory approach, however, since the fiscal approach can also work. Nor would adoption of the asset reserve requirement allow the elimination of all budgetary expenditures for the same areas. Asset reserve requirements can move funds into particular areas, but they really cannot be used to move funds to particular individuals. If the goal is low income housing, as opposed to just housing, for example, expenditure programs and asset reserve requirements would need to be coordinated. Without programs to move the necessary funds into the desired areas, however, distributional policies simply cannot work. If there are no funds to build houses, new houses cannot be distributed.

Conclusions

Thus the country faces three choices – maintain the present complex, cumbersome, and ineffective regulations for aiding social priorities; nationalize social lending; or adopt general across-the-board asset reserve requirements. As an economist, I would opt for the nationalization of social lending with the appropriate surtaxes

[1] For the discussion of how various foreign countries attempt to aid sectors of social priority see:
Activities by Various Central Banks to Promote Economic and Social Welfare Programs. A Staff report of the Committee on Banking and Currency, U. S. House of Representatives, Dec. 1970.
Foreign Experiences with Monetary Policies to Promote Economic and Social Welfare Programs. A Staff report of the Committee on Banking and Currency, U. S. House of Representatives, 1972.

(i.e., taxes on corporate savings and borrowings, and taxes upon property owners). It is the most efficient economic solution. As a political economist, I would opt for general asset reserve requirements.

I do this because I think it is politically naive to believe in the possibility of abolishing all regulations designed to aid sectors of social priority without real compensation — i. e., a better system than the present one. In our political system the decisions to abolish financial regulations and substitute budgetary expenditures and taxes are not made by the same people at the same time and in the same place. Who would allow his favorable financial regulations to be abolished in exchange for a vague statement urging someone else to do something? The nationalization of social lending and the abolition of special financial regulations simply cannot be tied together to be voted up or down together. If they could, they might be a viable package. As it is, they are not. On the other hand, the elimination of the present regulations and the substitution of general asset reserve requirements can be considered as one package. The two sets of regulations are in the same domain, made by the same people at the same time and in the same place.

DISCUSSION

EDWARD J. KANE*

If a discussant's job is to foment controversy, there is a heaven for discussants and Lester Thurow's paper has brought me to its gates. I cannot imagine laying my hands on a professional-quality paper with whose anaylsis and policy recommendations I could disagree more. First, I dispute Professor Thurow's analysis of why large corporations receive advantaged access to credit in tight money. I trace this phenomenon primarily to the prohibition of interest on demand deposits, the maintenance of which is presumably one of the "details" of the Hunt Commission program on which Thurow urges us "outsiders" to give the Commission the benefit of the doubt. Although I will concede him his views on agriculture and exports, I further reject both his diagnosis of what constitutes the nation's fundamental housing problem and the specific reform which he proposes as a remedy. Finally, I find the empirical evidence on the success of asset reserve requirements abroad that he cites with such assurance to be thin and unconvincing. It consists ultimately of a casual review of data covering a handful of years in a single country whose continuing housing shortage is among the worst in the world (Sweden) and ignores a long record of U.S. experience with detailed intervention in capital markets under the Federal Reserve System. This latter record is so unremittingly dismal that, even if the success of the Swedish experiment were to be established scientifically, it is hard to see how or why a serious reformer would want to hand the Fed yet another selective control.

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The author wishes to thank Charles C. Brown, Kenneth A. Lewis, and Parker B. Willis for helpful comments on an earlier draft of this comment.

I. Corporations' Capital-Market Advantages

Professor Thurow attributes the favored treatment that large corporate customers receive in intermediary-loan markets to the existence of sizable tied savings in the form of undistributed corporate profits that do not flow explicitly through capital markets. Ignoring the concept of opportunity cost, he suggests that corporations planning capital investments do not have to compete for these tied savings. Surely corporate managements must weigh expected returns on such investments against those available from other uses. Stock-market pressures and competition in the market for corporate executives should see to it that managers who ignore opportunity costs are replaced.

I am also puzzled that Thurow would think that financial intermediaries would be dazzled by tied savings *per se*. What matters is not the *savings* flow, but the transactions flow and the deposit balances a firm must hold to facilitate its transactions. Whether profits are eventually distributed to stockholders or invested in new plant and equipment, additional funds accumulate between major disbursements. These temporary accumulations and regular transactions balances are what lead financial intermediaries "to cultivate the business of corporations." Moreover, with price competition ruled out for demand deposits and greatly restricted for time deposits, it is only natural that large depositors exact compensation in other ways.

This transferral of pressure from the demand-deposit market to the loan market illustrates the well-known principle that restrictions on competition in one market create pressure counter to the restriction in whatever related but unregulated markets happen to exist. It is akin to the way that squeezing one end of a balloon forces air to rush into the other or "unregulated" part of the balloon and to place it under strain.

Because banks are forbidden to pay explicit interest on demand deposits, they compete for profitable accounts through offers of *implicit* interest instead. This implicit interest takes the form of price and service concessions to valued demand-deposit customers in other areas of bank activity. As a kind of tied-sale agreement, a bank stands ready to perform special or routine accounting and financial services for valued customers at charges well below marginal costs. A bank is also expected to grant loans at favorable interest rates and/or to commit itself to furnish loan funds to these customers, no matter how tight the bank's current financial condition may be.

With these as its origins, it is plain that the favored treatment of large depositors would not be abolished by forcing corporations to pay out all profits in dividends. Nor do "economic-efficiency conditions demand it [this abolition]." Except for complications due to the preferentially lower tax rate on stockholders' capital gains, the direct investment of retained earnings is analogous to a farmer's reservation demand for his produce. Holding back enough product to meet his seed and consumption needs saves a farmer trucking and marketing costs. If invested according to marginal principles, retained profit contitutes a similar market bypass, one that reduces a corporation's capital-market transactions costs (including lender information costs). This saves resources, and the savings are greater the less competitive capital markets prove to be.

II. The Housing Problem

In view of the federal government's immense and long-standing efforts to assist would-be homeowners, mortgage lenders, and the construction industry, Thurow's pre-occupation with providing an abstract welfare-theory justification for singling out housing for special tax-transfer or capital-market assistance seems terribly out of focus. The operative policy problem is to determine in what specific ways current federal programs are failing and to design reforms to remedy these failures. To substitute for this question an abstruse welfare-economics exercise burlesques the very role of an advising economist.

Most observers (incluing the Kaiser Committee in 1968) hold that the overriding housing problem facing the United States today concerns how to provide more and better low-income homes. This requires increasing the production and rehabilitation of decent housing and somehow distributing it to persons who have traditionally been red-lined out of our nation's subsidized mortgage markets. The goal is to make available some income in kind and then (to avoid slips between the cup and the lip) to force feed it to the poor. In this process, financing is only one obstacle. It looms as a large obstacle primarily because of red-lining, a practice that makes subsidizing the mortgage market an ineffective way of getting at the problem.

What we want are both: (1) incentives to improve the quality of new and existing housing; ways to lessen the alienation the poor feel toward current and replacement homes so that these will be adequately maintained or even improved, and (2) incentives to undertake appropriate new construction; ways to give low-income persons

sufficient income to divert resources to meeting their housing needs, backed up by methods for insuring that the prospective income will in fact be spent on improved housing. Although Thurow neglects the first problem altogether, progress on the second problem should help to alleviate the first. Environmental alienation would be lessened by giving low-income persons tangible opportunities to link up with "visible" owners and to become owners themselves. Anyone who has been both a homeowner and a renter knows how differently one regards – and makes one's children regard – a dwelling unit that is one's own. For most individuals, an owned home becomes a veritable extension of oneself. Anyone who has done much renting also knows how differently one feels about a rental unit that is owned by an absentee landlord as against one whose owner lives nearby and takes an active interest in the condition of the place. Moreover, a move to resident ownership should increase the competition for occupants in low-income areas, competition that should in part take the form of product improvement. Replacing slumlords with owner occupants should therefore be high on the social agenda. The greater the extent to which low-income apartment buildings can be made owner-occupied, the more fully we can tap individual incentives to maintain and improve the low-income housing stock.

Better urban and rural environments require a better distribution of income: nothing more nor less than sizeable transfers of wealth. It is wishful thinking to suggest – with or without coordination with expenditure programs (see Thurow, p.p. 187-9) – that the problem can be approached with nearly equal efficiency by forcing financial institutions to hold more mortgages. The federal government has been subsidizing mortgages in this way for years. The evidence on the distributional effects of this policy is very dismal.[1] Low-income persons who wish to be either homeowners or resident owners of apartment buildings are consistently pushed out of the institutional mortgage markets by higher-income individuals of negligible default risk. Distributionally, it is bad enough that high-income persons get disproportionately more low-interest mortgages, ironically often to buy commercial property. But low mortgage rates also spell low returns for thrift institutions (currently constrained to specialize in mortgages) and for the low-income saver who has few alternative

[1]See the patterns of asset-holding and real-estate debt by income class tabled in my "Short-Changing the Small Saver: Federal Government Discrimination Against Small Savers During the Vietnam War," *Journal of Money, Credit and Banking, II* (Nov. 1970), pp. 513-522.

outlets for his savings. From the point of view of the average consumer, the great virtue of the Hunt Commission *Report* is that it recognizes the harm caused by placing this system of constraints on lenders and seeks to eliminate it.

Besides these distributional problems, mortgage-reserve proposals suffer from the fatal flaw that the mere use of real-estate collateral and a mortgage instrument in no way guarantees that the funds being borrowed are used to finance a real-estate venture of any sort. Even when they are, the funds may simply be marked-up by the borrower and passed along to higher-risk borrowers. In many cases, to become a resident owner of a low-income apartment building, an individual is forced to pay an inflated purchase price and usurious interest rate to a high-income seller who is his only realistic source of finance. With the building's rental income determining the terms of the sale and finance agreements, any advantage the lender might get by borrowing on real-estate collateral in subsidized markets is unlikely to be passed on to his low-income mark.

Financial markets can contribute to solving our low-income housing problems most effectively by lessening their tendency to discriminate against low-income persons. This requires relaxing existing restraints on the payment of interest on deposits of all sorts.

Discrimination against households in the market for commercial-bank loans is rooted in the prohibition against paying interest on demand deposits; the obvious first step is to repeal this prohibition. This would allow banks to compete openly rather than covertly for profitable demand-deposit accounts and should shift the competitive focus of banks and business customers away from the loan market. The second step is of course to free savings-deposit rates at all depositary institutions, both so that low-income savers who have few other accumulation opportunities can earn the opportunity cost of their funds and so that the specialized mortgage-lending industry can compete freely for funds and mortgages.

In contrast, introducing additional portfolio restrictions on mortgage lenders may well worsen the discrimination against low-income savers and borrowers. This possibility serves as the principal focus for the rest of my comments.

III. Second-Best Solutions

Professor Thurow's remedies for commercial banks' tendency to favor corporate customers and for the housing problem involve introducing new portfolio restrictions: prohibitive taxes or marginal

reserve requirements designed to force a particular response from the firms subject to the restriction. It seems to be an article of faith among social activists that any and all shortfalls in policy performance derive from society's not yet having seen the wisdom of giving government authorities still another set of controls. They seldom bother to investigage whether the policy difficulties can be traced to structural defects or excesses in the controls authorities already have: to an instrumental keyboard that is too big rather than too small. Interventionists typically act as if the contrapositive of the LeChatelier Principle holds in public administration: that one can improve processes of social and economic adjustment more by adding a new policy restraint than by relaxing a preexisting one.

Relying on the LeChatelier Principle, I believe that Thurow's reforms would make capital markets even less efficient and socially effective than they are now. What we need is not more interference with capital-market mechanisms but *less.* We need to wipe out corporations' privileged "relationships" with commercial banks at their source by abolishing the prohibition against paying competitive interest on demand deposits. Introducing price competition into the market for demand deposits would break the incestuous link between a bank's willingness to accommodate a customer's loan request in tight money and the deposits that the customer brings to the bank. This reform would increase the attractiveness of mortgages to banks at such times. Given the size of bank portfolios, even a small increase in banks' propensity to acquire mortgages in tight money would greatly ameliorate the cyclical instability of mortgage flows.

I regret having to harp on a single theme. I do so because demand-deposit interest was rejected by the Hunt Commission and its distributional and allocational effects so poorly analyzed in the Commission *Report* that apparently even well-trained and socially conscious economists fail to grasp just how this reform would improve competition for bank loan funds between the corporate and the noncorporate sectors.

IV. Asset Reserve Requirements

I have no quarrel with asking the Federal Reserve to concern itself with the distributional impact of monetary policy. This impact can and should be bettered. I take issue instead with two naive presumptions: (1) that introducing new restrictions on the detailed operations of U.S. capital markets is any way to improve this impact, and

(2) that the nation could rely on the "independent" Federal Reserve System to administer the new controls effectively.

On the contrary, it can be shown: (1) that much of the unequal impact of tight money on various sectors grows out of current restrictions on various institutions' ability to compete for deposit funds, especially on commercial banks' freedom to compete for profitable demand-deposit accounts; and (2) that (whatever its success in stabilizing the national economy) in its fifty-odd years of operation, the Federal Reserve System has proved spectacularly unsuccessful in its attempts to intervene in *specific markets.* Its efforts at detailed intervention – such as the real-bills discounting policy, the almost-identical February 2, 1929 and September 1, 1966 letters to member banks, and Regulations V, W, X, and (most recently) Q – have gone sour time and time again. Counting upon the Fed to regulate the flow of credit among competing sectors is like counting upon a major-league Washington baseball team to finish in first place. When the Capital's erstwhile Nats last became strong enough to vie for a pennant, they were bid away to Minnesota and replaced with a much weaker team. Then last autumn even this weaker team became valuable enough to be auctioned off to Texas. So too with the staff of the Federal Reserve. Before the Fed could assemble a team of administrators strong enough to handle the job Thurow seeks to thrust upon them, these able administrators would be bid away to richer positions in the private economy.

The Fed's staff is simply no match for the market economy. Consider how the Federal Reserve's efforts to enforce Regulation Q led to a veritable epidemic of controls, with each stopgap policy action begetting several others until the control system partially broke down (on large CD's) and the underlying problem passed away of its own accord. To plug leaks, new restrictions were introduced in markets for Eurodollars, Federal Funds, commercial paper, and Treasury bills; the U.S. savings-bond program was allowed to run down and its market invaded by bank mini-bonds and participation certificates, and threatened by Sears Roebuck and A.T.&T.; mortgage markets required huge injections of federal money even to operate at very low levels. When open-market rates fell below Regulation Q ceilings, new problems were revealed. The industry's former pattern of mortgage-rate and depositary-savings-rate price leadership had been destroyed, and with the backlog of mortgage demand, it proved almost as hard to get these rates to move down with open-market rates as it was to hold them down when open-market rates were rising.

No matter what bureaucratic obstacle the Fed placed in the market's way, survival demanded that firms locate a reliable loophole. With apologies to the exceptionally able and dedicated public servants gathered here today, loopholes were found because on balance private firms recruit better talent, train and motivate this talent more carefully, and when the going gets tough, can drive their staffs far harder. Employees and managers of private firms outnumber and have personally much more at stake than their counterparts at the Fed.

However, the economic case against the asset-reserve proposals goes beyond the Federal Reserve's institutional weakness and can be summarized in a few sentences. First, no one knows enough either about social priorities or about how credit, goods, and factor markets interact to use financial markets as an effective vehicle for allocating funds among competing sectors in accord with social priorities. Such programs as the tax-exemption of interest income on state and local securities and federal government interventions in the mortgage markets have on balance reduced the effective progressivity of our tax system and generally helped the rich at the expense of the poor. Second, besides having a miserable track record in administering selective controls, the Federal Reserve has allocated precious little research effort to the important task of learning from its individual past mistakes. Third and most importantly, specific restrictions tied to the amount borrowed or the size, purpose, or location of the borrower as envisaged in asset-reserve proposals are based on partial-equilibrium thinking: they can be justified only by ignoring affected parties' natural inclination to take actions directed at getting around the legislated restrictions. In particular, such controls can be largely and easily offset by bank and borrower adjustments in related markets, adjustments that lead frustrated regulators to extend the range of their controls to more and more loan instruments and lender activities. To this list of economic counterarguments, realistic political economists ought to add a fourth: New selective controls inevitably introduce windfall gains and losses, with these being shaped by legislative and administrative decisions closely influenced by the unsatisfactory current distribution of political and economic power whose correction is being sought.

The case for greater Federal Reserve intervention in loan markets has no firm economic foundation. Growing Congressional pressure on our "independent" Federal Reserve System to do something about the distributional problems tearing at our society grows out of popular pressures focusing increasingly on Congress. The problems

are fundamentally *political* ones and best handled by honest reform of our tax and welfare systems. Everyone should recognize that to assign these unsolved problems to the Fed is to compromise and politicize this institution to a degree that not only is inconsistent with its basic charter but even threatens its future viability.

V. Summary

I have argued that allowing freer competition among depositary institutions for all types of deposit funds is a far more promising way of reducing inequalities in sectoral access to funds than introducing still-another set of restraints on institutional portfolio allocation. I recognize that any movement to free interest rates at depositary institutions will be resisted by financial trade associations that pack considerable political muscle. But what is the alternative? Can anyone claim that the Fed would know how to manipulate asset reserve requirements so as to allocate funds and resources in accord with the social priorities even assuming that these priorities were clearly established? Can the Fed conscientiously count upon Congress to inform it as to social needs? I think not. In fact, I view Congressional interest in imposing responsibility for distributional problems on the Federal Reserve System as a cynical political gambit designed to buy time and reelection without having to confront the searing political problems of our time. The Fed cannot itself make the hard choices necessary to effect sizeable changes in the distribution of income and opportunity. It can only consent to serve as a scapegoat for particular Congressmen and for the powerful banking, defense, oil, and other lobbies that influence their decisions. Congressmen want to be able to assure their constituents that *something* is being done to improve the distribution of income and opportunity. At the same time, the lobbies wish to forestall any real change. The Fed's dismal record in administering selective controls in the past makes it a candidate that can meet both objectives, combining the appearance of action with little probability of success. In view of the electorate's lack of economic sophistication, the Fed's public acceptance of this new responsibility could carry Congress and the lobbies through another business cycle without open conflict.

If there were reason to believe that Congress would use this period of grace to develop a new workable consensus on national priorities, the game might be worth the candle. But as matters stand, I would recommend lighting a flame somewhere else.

DISCUSSION

ELI SHAPIRO*

I found Professor Thurow's paper an interesting and provocative one. It deals with an important and popular topic. His initial comments favoring the primary and secondary thrusts of the Hunt Report are views with which I would concur. There are many parts of his argument with which I disagree, however. In particular, I do not think that financial regulation in general and asset reserve requirements in particular ought to be advanced as a practical or effective way of furthering so-called social objectives.

My comments are in four parts. First, I have objections to many specific points in the paper; second, a more general comment on Thurow's analysis of the Commission's taxation proposals, or lack thereof; third, and most importantly, an analysis of what I believe to be a misconception by Thurow about the role played by savers in the savings-investment process which pervades the paper and which leads the author to several mistaken conclusions; and finally, a statement of my personal view about the problems of articulating social objectives and using the financial regulatory system to advance these objectives.

Specific Criticisms

There are many specific statements in the paper whose validity is less obvious to me than it seems to be to Professor Thurow. For example, he states that "present institutions and regulations have not channeled funds toward social priorities in sufficient quantities to be worth the inequities they have produced." First, I am not sure how to measure the inequities produced by the regulations affecting the savings institutions which have supplied the bulk of finance to the residential mortgage market. More importantly, it is also not clear

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that these institutions did not facilitate the development of substantial amounts of residential construction over the 1950's and 1960's. Admittedly, the past six or seven years have shown once again that the regulations exascerbate the cyclical swings in housing production. However, I know of some, though not very convincing, evidence that is inconsistent with the argument that our attempts to channel funds into housing have not produced more single family housing units on average over the past 20 years than would otherwise have been the case.

As a second example, Thurow argues that corporate retained earnings are "subject to neither the allocation procedures of the capital market place or to the allocation issues of their owners (the individual shareholders)." While the existing structure of corporate taxes does create an incentive for internal finance, it is not clear that these funds are not allocated and used rationally given this incentive. If share prices reflect the profitability with which retained earnings are used relative to the after personal income tax return requirements set by shareholders, and if corporate decision makers act in ways designed to maximize their share price, then Thurow's conclusions about no economic allocation are not correct. Under these conditions, corporations would be induced to use retained earnings as efficiently as any other form of finance. Given our uncertainties about how share prices are determined and the motivations of corporate decision makers, I think it premature to draw Thruow's conclusions on this point.

The Role of Taxation in Savings and Investment

The second major area of my comments on the paper relate to the discussion of the role of taxation in the savings and investment process. Thurow is quite correct in emphasizing the importance of this factor. He centers his discussion on the distortions caused by the current tax treatment of retained earnings. He argues that the Commission should have pushed its logic to the recommendation that current tax treatment of corporate earnings be abolished and that what he would define as corporate income should be imputed to shareholders and taxed as personal income. I should say in passing that Thurow defines corporate income to include depreciation. As such, he opens the whole question of taxation of capital or a possible capital levy.

He suggests that the reason that the Commission did not do this was political. One could perhaps be more charitable to the Commission's intellectual integrity. The current tax laws exert numerous effects on the savings and investment process. The different taxation of capital gains and income discriminates in favor of returns from equities and against debts, especially short debts. The existing tax laws induce individuals with marginal tax rates less than the corporate tax rate to buy shares in corporations which issue debt rather than issue that debt directly. They induce individuals in high marginal tax brackets to invest in mortgages through the acquisition of shares in REIT's rather than through the acquisition of, say, shares in publicly held savings and loan associations. On a larger scale, the use of a tax system based on income taxation discriminates against saving itself and thus has an obvious impact on the size of savings.

Perhaps, the Commission was well aware of these many ways in which the current tax laws affect the savings and investment process and deemed it beyond the scope of its responsibility to propose an overall tax reform package. Perhaps they were unable to isolate those few key provisions of the tax structure which caused the greatest distortions. It may have been for these reasons, rather than out of timidity that the Commission chose to limit its taxation proposals to those that directly affected financial institutions.

Image of Savers

The third of my comments relates to the image of the saver or wealth holder which is contained in this paper. Professor Thurow states that the saver "send his savings into the capital market." A more appropriate description is likely to be that wealth accumulators allocate new savings and existing wealth among competing alternative forms of real and financial assets in an attempt to maximize some objective. This mistaken image of savers as passive agents rather than as active decision makers leads Thurow into several problems. First, he sees (nonfinancial) corporations as almost evil, as savings hoarders. An alternate view is that savers see the benefits of saving through the corporate form and invest part of their wealth in corporate equities in full anticipation that those corporations will act in ways to benefit them as savers – retaining earnings and thereby postponing income tax payments as well as transforming what might be income into capital gains.

A second example of how this mistaken image of savers leads Thurow astray is contained in his remark that financial regulation has

not worked in the past because there is "no set of regulations that could stop (such) poaching on the other guy's turf." Rather than see the big bad financial institutions as "poachers," it might be more appropriate to see them as businesses which try to sell financial assets to rational and responsive savers who attempt to allocate their wealth among assets on the basis of risk, return, and liquidity. In such a competitive environment, "poaching" seems a strange term to give to the search for assets with better risk and return characteristics.

Aside from these relatively minor problems of semantics, however, the reality of savers as active maximizing decision makers causes even more serious problems for the asset reserve requirement which Thurow advances. He argues that, among other things, asset reserve requirements for financial intermediaries for the purpose of channelling funds to social priorities (1) will work, (2) are simple to administer, and (3) do not discriminate between the small saver and the big saver. I disagree with all three of these comments.

As Thurow describes them, asset reserve requirements will not work. Savers will still be free to acquire the debts and equities of real investors directly as well as to acquire the financial liabilities of intermediaries. Constraining intermediaries to invest a specific fraction of their (new?) funds in specific assets will not assure any specific dollar flow of finance or resources to that activity. Real investors who do not receive what they consider to be sufficient funds will be induced to attract savings by the issuance of direct securities (debt or equity). Households will be induced to buy these assets by their relatively attractive returns. Since the regulated financial institutions do not account for all of household financial asset accumulation (even excluding corporate retained earnings), controlling them does not control the total flow of savings.

Thurow also states that these asset reserve requirements would be simple to adminster. This is patently untrue. Take his example, that of housing. Someone must decide what kind of housing is to be financed – will it be single family, multi-family, apartments; and where – urban or suburban; or first home, vacation home; or high cost, low cost; or renovation or new construction? Will the financing of raw land acquisition, development expenses, or construction finance be acceptable or is it just mortgages? Beyond this myriad of choices as to the *activities* to finance, there is another nest of problems regarding the decision as to *which businesses* will be subject to the regulation? Within the more or less standard categories of financial institutions, will mutual funds be subject to these requirements? Will pension funds which are entirely in equities, such as

College Retirement Equities Fund? Will private finance companies, such as CIT? Will captive finance companies, such as General Motors Acceptance Corporation? What about corporations which finance accounts receivable without the explicit use of a finance company? With corporations extending about $200 billion of trade credit ($60 billion net trade credit) compared to commercial bank loans of $160 billion, this is no trivial problem.

From another point of view, will underwriters have to do a specified volume of their participation in fund raising for specific purposes?

Looked at realistically, establishing an administrative structure to deal with these problems in order to channel funds to housing is *not* simple. Neither would it be for education or health or any other of Thurow's objectives.

Finally, this asset reserve requirement need not result in equal treatment of small and big savers. For example, if the real asset acquirers who issue direct securities find that distribution costs require large unit sales, rather than widespread retail distribution, then savers with large amounts to invest will still have better alternatives than those savers who must acquire the financial assets created by the intermediaries subject to the asset reserve requirements.

Thus, the rational behavior of savers and real asset acquirers means that asset reserve requirements affecting only something called "financial institutions" are not likely to be simple or effective ways to allocate savings.

Social Priorities and the Design of Financial Regulation

Let me conclude my comments with some remarks on the general topic of social priorities and the design of financial regulation. First, social priorities are devilishly hard to establish. In addition, as the recent Brookings study reveals, we are often not at all sure how to allocate resources to achieve what we thought were our objectives. Second, implementing social objectives in the United States through financial regulations is likely to be especially difficult. As I have suggested, businesses which many people do not regard as financial institutions often perform the functions of those institutions. Regulating them all would be very difficult and regulating only some would be ineffective. Moreover, much of our regulation of financial institutions is divided between the federal government and the states. As such, any attempt to establish federal controls would have to

create a federal overlay over the state regulated agencies. Finally, savers are not constrained to acquire only the financial liabilities of what we formally think of as financial institutions. They are free to acquire real assets directly or to acquire claims to the income streams from real assets others acquire by direct investment.

For these reasons, it is my view that we should:

(1) set only modest objectives for allocating some expenditures differently from the pattern the income distribution would bring about and
(2) center our attempts in this direction on tax and expenditure policies rather than on financial regulation.

Professor Thurow seems to set up the alternatives of perfect competition or nationalization. Seeing the lack of perfect competition, he states that, as an economist, he is for nationalization. An alternative would be to try to improve the economic process so that it comes close to the competitive ideal. This was the Commission's view and it is mine. The way to make our financial system most responsive to whatever our social objectives may be is to make it as competitive as possible rather than hobble it with what would be an administrative nightmare.

A Revised Regulatory Framework

JOSEPH W. BARR*

The men who put together *The Report of the President's Commission on Financial Structure and Regulation* are men of good will and intelligence. I am also aware of the bitter in-fighting that inevitably erupts in any discussion of competing financial institutions. Having said this, however, I can only state my conclusion that the Report is dangerous from the viewpoint of public policy, inaccurate and misleading in its technical aspects (e.g. taxation), and unrealistic in terms of political viability.

Let me speak first from the viewpoint of public policy. I spent 10 years of my life in the Federal government as a member of the Banking and Currency Committee, as a Chairman of the Federal Deposit Insurance Corporation, and as a Treasury official. Over this span of time I was forced to ponder many of the issues faced by the Commission. I arrived at certain conclusions which may be wrong, but which I hold to with great tenacity. Now why do I contend that the thrust of the Report is dangerous and its implementation would be damaging to the financial well-being of the United States. I have two reasons.

I. The Report makes the following statement:

> The Commission believes that the widest feasible options among chartering and supervisory agencies should be created and maintained. When a particular type of financial institution can be chartered by only one agency – whether state or federal – a twofold danger emerges. First, the agency may become over-zealous in protecting existing firms, with the result that entry by new firms is effectively foreclosed. Second, the agency may not be as innovative and imaginative as it should be in exercising its authority. Opportunities for dual chartering and supervision mitigate these dangers and improve service to the public. . .

*President, American Security and Trust Company

[1] *The Report of the President's Commission on Financial Structure and Regulation*, p. 60.

As I read history I can find *no* precedents to support the above argument, I can find plenty which argue in the opposite direction – *that diffused power over financial institutions has caused this nation untold grief and anguish since the days of the Continental Congress.* Let me refresh your memories with some samples of history.

1. The chaotic money conditions that existed in the various states under the Articles of Confederation gave a powerful thrust to the federal concept and the provision in the Constitution that reads "*the Congress* shall have the power to coin money and regulate the value thereof." Clearly these realistic gentlemen were dictating a federal control over our financial matters and institutions.
2. When the First Bank of the United States was allowed to lapse, the country found it did not possess the financial muscle to fight the War of 1812.
3. When the Second Bank was killed it ushered in an era of monetary madness and "wildcat banks."
4. The Civil War drove home again the need for federal control, and we took another step in that direction with the National Banking Act.
5. This Act did not, of course, solve the problem and because of the financial upheavals of the early 1900s the Federal Reserve System was created.
6. Still a diffuse chartering and regulatory authority persisted and was a contributing factor in the failure of thousands of financial institutions in the 1920s and 30s.
7. The Acts of 1934 and 1935 moved much closer to federal control but the dangers inherent in a diverse regulatory system still exist. . .witness the bizarre events in Texas in the last year.

If the Commission had stated that it was probably impossible to change our current diffused regulatory and chartering systems, if they had gone ahead to warn that end runs such as the Texas legislature attempted were a real and present danger, then, if they had added that we could live with our present system, barring further dilution, I could have agreed. But to flatly *support* a system of competing and conflicting regulatory authorities is too much for me. It flies in the face of too much dismal history.

In fairness I must admit that the Report *does* back into a position of greater federal control by establishing a federal Administrator of

State Banks, and by requiring that all banks and some thrift institutions become members of the Federal Reserve System. But in doing so they seem to end up arguing with their original thesis that we need competing regulatory authorities.

II. My second argument against the public policy thrust of the Report is its casual disposal of institutions that have served the country well. Credit unions, savings and loans, mutual savings banks, and the Farm Credit Banks have served a useful social purpose in this country. If we permit this galaxy of specialized institutions to evolve into full service banks, I can only conclude that it will divert many millions of dollars from home and consumer loans – especially in times of tight money. This is clearly *not* the result which public policy seeks to achieve. Mr. Frank Wille in a recent speech to the savings banks came to the same conclusion.

I would think that public policy would be better served by making these institutions more effective. We *have* moved in that direction with the increased activity of the Federal National Mortgage Association, the Government National Mortgage Association, the Federal Home Loan Bank, and now the Federal Home Loan Mortgage Corporation. I *applaud* the Report's findings urging the abolition of state usury laws, their discussion of variable mortgage rates, and the possibility of some sort of federal insurance for long term mortgage rates. I *deplore* their support for *tax credit* for those holding mortgages. Our poor old income tax is now so riddled with preferences that it is no longer an acceptable means for raising our needed revenues.

I can only conclude that these recommendations are, on balance, reckless and, by the way, just what in Hell is a *mutual commercial bank?*

Taxation

A major theme of the Report seems to center on the uneveness of taxation between financial institutions with the clear implication that commercial banks pay much higher rates. In many cases this is simply wrong. Some commercial banks *may* pay higher effective rates than the thrift institutions because of the differing treatment of bad debt reserves. But the *largest* commercial banks are heading pell mell towards or have reached a zero U.S. income tax rate because of the use of accelerated depreciation and the investment credit in their leasing companies and the application of the foreign tax credit to

their foreign income. I have a strong suspicion that most savings and loans and savings banks are paying a considerably higher effective U.S. income tax rate than the 50 or so largest U.S. commercial banks. . .perhaps the top 100.

Frankly, I have concluded that we might as well forget about patching up the income tax as it applies to business and start thinking about some new system of taxation which will fairly raise from *all* business as well as individuals the additional revenues that this country will need in the years immediately ahead.

Politics

The Congress of the United States has been demonstrably reluctant to legislate in the areas of financial institutions unless forced to. We have had only three significant pieces of banking legislation in this century, the Federal Reserve Act, the Banking Acts of the early 30s and recent amendments to the Bank Holding Company Act. I can now see no real ground swell to change the rules. As a matter of fact, the old money machine seems to be working fairly well. Housing, consumers, small business, and the farmers fared *much* better in the *very* tight money conditions of 1969 and 1970 than in the much milder period of 1966.

I am afraid that this Report is doomed to the same fate as most Commission documents, but its demise should not seriously undermine the health of the Republic.

DISCUSSION

WILLIAM T. DENTZER, JR.*

I would like to offer some thoughts of my own on the revised regulatory framework suggested by the Hunt Commission before commenting on Joe Barr's remarks.

My experience as a bank regulator tells me that the public policy goals served by bank regulation are to sustain a safe and sound banking system and to achieve a much more competitive system than the present one. We have slowly started to move from the experience of the 1930s toward bank regulation that emphasizes more competition, but I would like to see that movement become more rapid.

I think the recommendations of the Hunt Commission with respect to regulatory framework do not reach the major issues of bank regulation today, though I do not think any sweeping regulatory change is in order.

Some have divided the field of bank regulation into four different categories:

Safety – the solvency of banks;

Structure – whether competition between banks is encouraged, thereby offering the consumer the best possible product at the lowest possible price;

Scope – what kinds of banking services should be offered by banks, especially "bank-related" or "nonbank" services; and

Monetary policy – which we don't have to worry about here today.

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Let us consider the major current issues in the dimensions of scope, structure, and safety.

Scope

Aside from the question of increased powers for thrift institutions, the major issue in this area is what "nonbank" services banks should be permitted to offer in the future. We talked about this yesterday at some length, and I want to associate myself very much with those who disagree with the Hunt Commission's recommendations on this subject. I would require a bank wishing to offer "nonbank" services to form a holding company and perform such services through holding company subsidiaries. This would insulate the bank as much as possible from the financial ramifications of "nonbank" activity. It also would free the bank holding company from certain restraints of cautious bank regulators. A bank regulator, no matter how pro-competitive he is – and I considered myself rather pro-competitive – in the last analysis has an overriding concern for bank safety. I wonder whether I and other bank regulators willingly would see a bank go down the pipe if it got into trouble on the "nonbank" side. The desire to bail out the bank management in order to save the bank would be strong when crises arose and, equally unfortunate, overly cautious restraints would be likely in order to prevent crises.

I think it important also to insulate the bank in the public mind from other, "nonbank" activities. Separate corporations with different names serve this purpose. Public confidence in bank safety is the important consideration here.

My final argument for separation is to make possible *uniform* Federal regulation of "nonbank" activities. I do not want to see a competition in leniency and differing interpretation of permissible "nonbank" activities among the three Federal bank regulatory agencies. There should be a single regulator for all such activities. The Federal Reserve is now that regulator because of its holding company responsibilities. Let us keep it that way.

Such a scheme still leaves room for debate about some "nonbank" activities that might be permitted within the bank, but this is a manageable sphere. The essential question is, as banks expand their services, where should these "nonbank" activities be placed? It is important, I think, that they be placed in the holding company and that decisions on their nature and extent be in the hands of a single regulatory agency – the Fed.

So much for scope. On to structure.

Structure

I would guess that the greatest influence on the banking structure of this country is going to be the bank holding company movement. Acquisition of banks by such holding companies are subject to approval by the Fed, but bank mergers are not. The very same reasons of uniformity of standards, equity as between applicants, and quality of decision-making which apply to regulation of "nonbank" activities and holding company acquisitions, argue that authority at the national level for all bank mergers ought to be lodged in the Fed and not divided among three federal regulatory agencies. We do not need two or three bank merger policies at the federal level. I believe the Federal Reserve has demonstrated more concern with competitive factors over a greater period of time than any other bank regulatory agency, and I would therefore propose that along with its holding company acquisition responsibilities, decisions on all bank mergers ought also to be moved there.

I would leave with the Justice Department the authority it now has with respect to intervening in bank mergers. The problems of weighing concentrations of economic power are sufficiently great to require another watchdog in the act.

Safety

On the issue of safety in bank regulation, I think there is little that can be done by legislative means though much can be done administratively. I personally am for giving managements more discretion on how they run their banks. I believe there is room for substantial deregulation on minor points so long as the essentials are carefully monitored. There is much streamlining to accomplish in the bank examination process in particular, but legislation is not the vehicle of improvement.

How does this analysis apply to the specific recommendations of the Hunt Commission with respect to regulatory agency restructuring? You recall that the Commission recommended the consolidation of the Federal examining and supervisory functions of commercial banks and mutual savings banks into two agencies, the Office of the Administrator of State Banks and the Office of the National Bank Administrator (now the Comptroller of the Currency). These two offices would also examine and supervise savings and loan associations with deposits subject to third party payment orders in excess of 10 percent of total deposit liabilities.

The Office of the Administrator of State Banks would assume the examining and supervisory functions currently performed by the F.D.I.C. and the Federal Reserve.

Consolidating two examing staffs into one is something, but not much, to cheer about. Hunt Commission members I have talked with seem to share my feeling. More importantly, I think that inertia, the essential viability of the present system for at least a while longer, and the elusiveness of the ideal regulatory structure to replace what we have now will combine to frustrate any major revision in the regulatory structure or the fruition of the Hunt Commission's recommendation. I personally would consider such a result no loss.

Let me turn to Joe Barr's remarks.

Joe strongly criticizes the Commission's general approach, which calls for the widest feasible options among chartering and supervisory agencies in order to guard against unimaginative regulation and agency tendencies to limit entry of banks into new markets out of over-zealous concern to protect existing banks there. I think his criticism that "defused power over financial institutions has caused this nation untold grief and anguish since the days of the Continental Congress" is not supported by evidence in modern times, however accurate it might have been earlier. That flabby regulatory activity or competition in leniency was the proximate cause of financial disaster in the twentieth century gets harder to sustain with the passage of each decade.

Need for Imaginative Regulation

Nevertheless, the dilemma of the options in our dual banking system remains with us. Unified bank regulation poses the problem of how to keep the regulatory agency from becoming either stultified, or captive, or both. Decentralized bank regulation on the other hand has offered few examples of imaginative regulation, but its chartering capability has provided avenues for bank entry into markets where entrenched banking interests may have been successful in convincing their regulators that the interest of the entrenched banks was identical with the public interest. Decentralization, however, fosters competition in leniency among regulatory agencies as they supervise what some of them regard as their constituencies, and this flexibility is seldom the desirable kind that permits imaginative bankers to respond to emerging needs of society. You are damned if you go one way, it seems to me, yet also damned the other way.

The Thrift Institutions' Need for Diversification

Joe also makes a major point of criticizing the Commission's recommendation that mutual thrift institutions be permitted to diversify. Here I speak as a supervisor who had among the institutions he supervised a very large number of savings banks and savings banks assets. Because of this, I speak out of great concern.

I have seen the condition those institutions came close to facing in the latest monetary crunch. This prompts me to worry about the turn of the next monetary screw, if we have to go down that road again soon. This is the same concern that very largely motivated the Hunt Commission to make its recommendations for broader powers for mutuals. As the Commission stated, and I firmly agree with it, "In future periods of monetary restraint . . . deposit rate maximums will surely be less effective in maintaining a supply of mortgage funds and protecting financial institutions from disintermediation." That has been belabored here earlier and I will not belabor it further. I will say simply that on the basis of my own regulatory experience, I strongly back the Commission's thrust for diversification of mutuals' powers. Otherwise I am afraid some of those institutions that Joe likes so much are going to blown sky high the next time monetary heat sends interest rates rising.

You have heard at this conference about the studies that have been done on the effect of such diversification on the housing market — the Anderson-Eisenmenger study and the Jaffee-Fair study. I would mention a related study which will be coming out soon, the author of which is among you.

Concerned about the problem confronted by savings banks and its proper resolution, I asked the Federal Reserve Bank of New York, particularly Al Hayes and Bill Treiber, to free up Leonard Lapidus and economists under him to look at this subject without prejudice, analyze available data, and conclude whether diversification of thrift powers made sense in the State of New York.

Len's conclusions in a study which will be published later this summer are that savings banks in New York ought to be allowed to convert to serving a range of household needs, including needs for loans and checking accounts for individuals. He would restrict them to household-type accounts in order to guard against the diversion of monetary flows away from the the home mortgage market, to make the consumer loan market more competitive, and to "play fair" with commercial banks.

Impact on the Housing Market

The impression is growing that the placing of barriers around the sources of housing finance is not an efficient means to feed the housing kitty. I do not know who decided that home buyers as a class were more worthy than lower- and middle-class savers. It is those small, lower- and middle-class savers whom we are penalizing by continuing the current structure. The present system just is no longer viable. Savings and loan assocations certainly were financial intermediaries in the late 1960s; they were intermediaries, as one wit put it, between the Federal Home Loan Bank Board, which provided them massive credits for mortgages, and Fanny Mae, which bought the mortgages they made.

As a former Secretary of the Treasury, Joe is understandably concerned about adding to the erosion of the income tax. I, too, was concerned when the Tax Reform Act of 1969 became the Revenue Loss Act of 1969. But the question really isn't whether further erosion of income tax revenues should be permitted by subsidizing mortgage lenders one way or another in the federal budget if that appears necessary in later years, but whether that is a more efficient way of addressing the housing finance problem.

I would agree with Joe that it is going to be impossible to convince Congress to expand thrift powers if it believes housing is going to be hurt in the process. My own experience with a state legislature is that if legislators think housing may suffer from changes in the system, it is impossible to get such changes adopted. This would be especially true if the pressures of the federal budget – which are likely to require a tax increase next year – are added to by provisions for a budget outlay or tax deduction to insure an adequate supply of mortgage money.

However, my own experience as a bank regulator indicates that if thrifts are allowed to diversify into household type accounts, without getting into commercial lending, the slowness with which this will occur will mean this diversification would have very little impact on housing for quite some time. Someone said yesterday, and quite properly, that the capacity of thrift institutions to move rapidly into consumer lending is quite limited and that the process of gearing up is going to take time. In addition, institutions which are specialized in housing finance, as thrifts are, even if no longer restrained by legislation are going to retain that specialization out of management choice. That is their expertise – what they are good at doing – and I think they are going to continue to do it as their primary function.

My major concern in this area, however, is about what will happen to a number of thrift institutions if we have to go through another bout of tight money soon. Another factor deserves mention as well, as I see it from the vantage point of my present post – the prospect of electronic transfers of funds. If we do not begin now to start dealing with present weaknesses in our financial structure, our task of adapting to future technology will be all the more difficult. As for the effect of diversification on the home mortgage market, we have heard two conclusions here – one that diversification would have no effect and one that it would have little effect. If Congress can be approached on that basis, I think the Hunt Commission proposals have a chance for success.

I think Pat Patterson and his colleagues on the Hunt Commission have done a great service in calling this problem of our banking structure to our attention now, while there is still time to act. I think they performed another service in saying that it should be addressed by a package approach and in a context of competitive equality between commercial banks and thrift institutions. And finally, I think it is unwise, as some have, to criticize the Commission for not having recommended nationwide branching. Even if all of us here favored it and were willing to accept the consequences to the dual banking system, that kind of recommendation simply would not pass the U.S. Congress and it would tend to drag down to defeat other important recommendations of the Commission. If that sounds to you like pragmatic incrementalism, I confess it. I was the executive secretary of a Presidential commission nine years ago, and I saw how reports of such commissions can be characterized and then scrapped by the Congress.

DISCUSSION

GEORGE J. BENSTON*

It was refreshing to read a paper from a successful former regulator and experienced banker and to see what he had to say on a subject about which many of us have attempted to write and think. Having read it carefully, I will try to address my comments to Mr. Barr's paper. To put the paper in perspective, I first discuss how, in general, one might examine the work of the Hunt Commission.

In considering the *Report* of the Hunt Commission, we should ask: Why is such a commission desirable? Which questions did they consider important and what problems were they trying to solve? Then we can evaluate their proposals. For this consideration, I suggest that we analyze individually the concerns of the public, the industry, and the regulators to which the *Report* is or should have been directed.

Concerns of the Public

The possiblility of bank failure is one concern of the general public, as Bill Dentzer points out in his *Comment.* Another concern is the availability of credit for housing, consumer loans, business loans, and, perhaps, for socially desirable projects or groups. The availability of services to consumers and businesses also is important: are financial institutions providing the public with a full range of services and are they developing new services to anticipate future demands? The availability of funds in general economic downturns also is listed as a concern of the public. They ask if the financial system is flexible enough to meet peoples' needs over varying financial situations. Finally, some ask if the financial system serves the public without discrimination or if it is biased in favor of one group as opposed to another.

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Concerns of the Industry

Issues that concern the industry revolve around questions of competition. Are financial markets organized and regulated so that institutions find survival difficult, managements feel threatened, and stockholders earn a lower return than expected? Are financial markets monopolized? Does the present set of regulations and taxes result in an inequitable advantage of one group of institutions over their competitors? Do regulations and/or the present structure of the industry and institutions allow them to meet the public's demands? Can financial institutions survive future credit crunches, inflations, and depressions?

Concerns of the Regulators

The regulators, who stand somewhere between the public, the industry, the lawmakers and their own self-interest, are concerned with improving and (certainly) with continuing their regulations. Structure for them means the structure of the regulatory agencies as much as the financial industry. Because failures were an important rationale for regulating the banking industry, prevention of failures through chartering, approval of mergers with banking, and examination occupies a large part of their energies. With the recent emphasis on consumerism, the scope of their concern may have widened somewhat.

The Commission's Philosophy

Perhaps to provide a means of balancing the sometimes conflicting demands of the public, industry and regulators, the Commission asserted a basic philosophy:

> The Commission's objective, then, is to move as far as possible toward freedom of financial markets and equip all institutions with the powers necessary to compete in such markets. Once these powers and services have been authorized, and a suitable time allowed for implementation, each institution will be free to determine its own course. The public will be better served by such competition. Markets will work more efficiently in the allocation of funds and total savings will expand to meet private and public needs. (p. 9)

In large measure, the *Report* answers most of the questions posed above by reference to this belief in the workings of the free market.

The public's concerns for service and loans will be answered by allowing thrift institutions and credit unions to compete with commercial banks for checking accounts and consumer loans. The Commission further believes that allowing thrift institutions to diversify their portfolios also will provide them with the flexibility necessary to withstand economic fluctuations. If funds available for mortgages are reduced, the Commission recommends direct subsidies to home buyers or, through tax incentives, to lenders rather than regulation of lenders' portfolios.

The free market also is seen as a solution to the industries' concern with monopoly and special privilege. In effect, the Commission recommends that most special regulations (particularly Regulation Q and restrictions on the powers of thrift institutions) be removed and, perhaps more important for a Commission, that new regulations not be imposed.

The regulators would not lose much, if any, of their domain, if the Commission's recommendations were adopted. The Fed would lose its bank examinations powers (but retain its control over holding companies), and a new regulator, "The Administrator of State Banks," would be formed. Regulation of thrift institutions would be combined more with commercial bank regulation, consistent with the increase in banking powers by thrift institutions.

In some important regards, the Commission does not follow its basic, free market, philosophy. They recommend retaining the prohibition of interest payments on demand deposits (despite a preamble which seems to argue for the opposite conclusion); tax credits are suggested for mortgages (which, admittedly, is more in accordance with free market decisions than is portfolio regulation); thrift institutions would not be permitted to make business loans; restrictions on entry into banking, particularly by state instituted restrictions on branching, would not be removed by federal law; and detailed supervision of financial institutions would be continued (on which, more later).

No Evidence Presented

I subscribe to the Commission's basic free market philosophy. But while those of us who agree are likely to say, "That's right – of course," those who don't will say " I disagree – that's not the way it is." My major criticism of the Commission's *Report* is that they asserted their position (and their recommendations) without referring to any supporting evidence. This omission is lamentable

because the evidence that supports most of the assertions and recommendations does exist. While I know a lot of reading, research and thought preceded and informed the inevitable bargaining, this is not reflected in the *Report* itself.

The disregard of evidence is particularly disturbing in an area of my concern, an area about which the public, the industry, the regulators and Mr. Barr also are concerned – the need for supervision to maintain "orderly" financial markets and prevent bank failures. Analysis would show that many of the original reasons for supervision no longer are meaningful (whether or not they ever were). Since the advent of Federal deposit insurance, the only people who are concerned about the failure of a bank and its mismanagement are the FDIC and FSLIC because they are the insurers, depositors with over $20,000 on account, and bank employees and stockholders. Even most depositors could be insured if the FDIC and FSLIC's coverage were raised to, say, $100,000. Considering that the FDIC assesses banks on their total deposits (whether insured or not), such an extension would be equitable. Consequently, controlled entry, exit and bank supervision is required only to protect the FDIC's insurance fund. There is no present need for the Federal Reserve, the states or even the Comptroller of the Currency to examine banks. More importantly, aside from the necessity of protecting the FDIC and FSLIC insurance funds, almost all regulations with respect to bank supervision should be scrapped. There is no basis for them any more. Bank failures are not a meaningful problem. While regulators are criticized if a bank fails, the public rarely is even inconvenienced since the FDIC comes in and pays off customers very quickly. Bank assets are among the easiest to transfer, and, if entry and branching were free, customers and employees would find new homes quickly.

Goals of Bank Examination

Bank examination, which is required, should be directed more towards preventing fraud and gross mismanagement. Examination today still is conducted as if the problems of the 1920s were the problems of the 1970s. I was disappointed that the Hunt Commission was not much concerned with bank examination since my interviews with bankers, in the course of my study, indicated that they really are "bugged" by examiners telling them what to do. Worse yet, the only time that the examiners really have power over a bank is when it wants to do anything new or wants to expand or

branch. At that time they may step in and say to a banker who is "troublesome," "Your application is not approved or is delayed." Consequently, only the innovative and the aggressive banks tend to be criticized. The banks who do nothing except avoid trouble are not bothered much. This seems a poor way to serve the public.

Diminishing Restrictions on Entry in Banking

These considerations lead directly to a criticism that Mr. Barr makes of the dual banking system. I think that most economists would agree that free entry is the key to a competitive market structure. One important aspect of the dual banking system, as I think history has shown, is its role in diminishing restrictions on entry via new charters and branching. Unfortunately the McFadden Act restricted branching of national banks. But at least states still could allow banks to branch. And, prior to Mr. Saxon's term as Comptroller of the Currency, the states often were the best source of new bank charters. But, what about Mr. Barr's fear of competition among the agencies that might result in lax regulation and consequent failure of financial institutions? As I discussed above, only the FDIC should be concerned about this. They have examiners and cease and desist orders. If they think those aren't powerful enough, they ought to request additional powers. While Mr. Barr presents some "examples from history" to support his opposition to the dual banking system, I confess that my recollection of banking history differs from his. I am sure that Mr. Barr can provide us with references to studies or data that support his assertions. To my knowledge, though, the evidence is to the contrary.

With respect to Mr. Barr's statements in section II of his paper, he makes a point that confuses me. Perhaps it was a typographical error or simply a problem of phrasing, but I cannot understand how allowing mutual savings banks and savings and loan associations to make consumer loans would divert money *from* consumer loans, even in times of tight money.

Perhaps because I just finished a study of mutual savings banking, I find it difficult to resist answering Mr. Barr's question, "just what in Hell is a mutual commercial bank?" I would like to rephrase his question, somewhat, to "what would mutual savings banks be like if they were given all the powers allowed commercial banks?" As part of my study I examined the "mutual" savings banks of Germany, Belgium, Sweden and Norway. Since these banks can offer any service offered by commercial banks, they can be called "mutual

commercial banks." Nevertheless, their balance sheets look much more like those of our thrift institutions than of our commercial banks. The reason is simple. They tend to do the things that they know best, which is to serve consumers. While they provide some loans and checking services to businesses and offer important competition to commercial banks in some markets, they basically accept savings and make mortgages. Consider, for example, the case of Sweden. In 1966 the Swedish savings banks were given all the powers of commercial banks. An examination of their balance sheets and income statements (and those of the Swedish commercial banks) for 1966 and 1970 shows virtually no change.

But even if thrift institutions do change, why should we object? As the Hunt Commission recognized, our objective should be a financial structure that results in assurance to the public of a wide range of services at the best possible prices. I think the *Report's* recommendations, if adopted, will move us strongly in this direction. I hope that Mr. Barr's assessment of its political life is overly pessimistic. In any event, although I and others may object to some parts, I think it deserves our support and our thanks.

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