Impact of the Proposed New Financial Structure on Mortgage Markets

PAUL S. ANDERSON and ROBERT W. EISENMENGER*

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]

*Assistant Vice President and Financial Economist, and Senior Vice President and Director of Research, Federal Reserve Bank of Boston

[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).

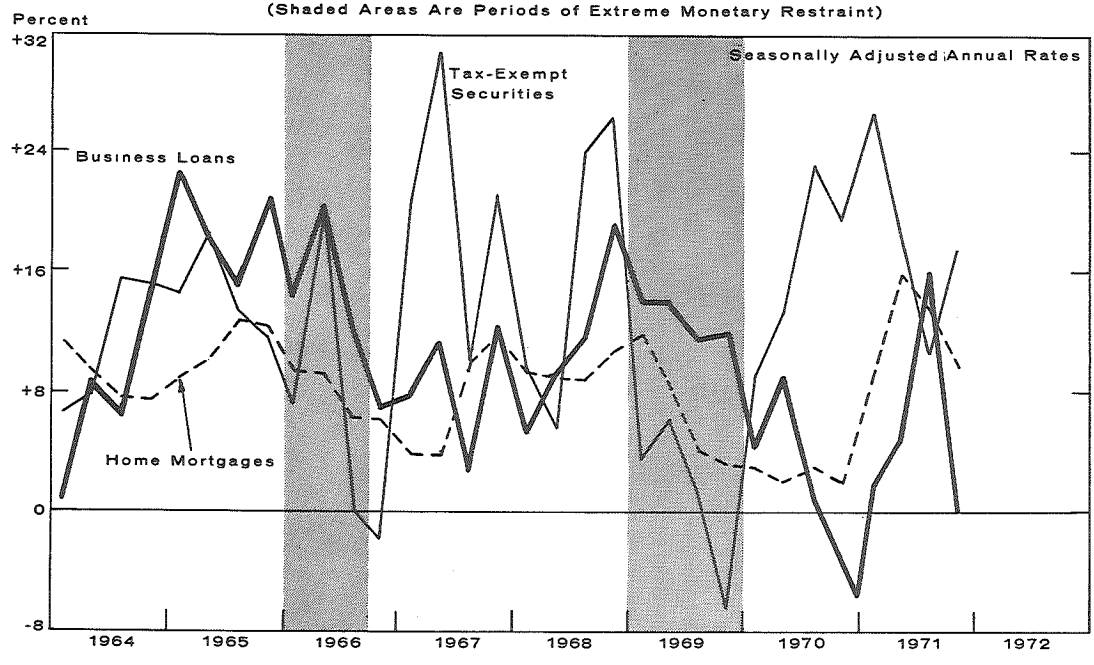
[3]According to the 1970 Functional Cost Analysis of the Federal Reserve System, the average cost of demand deposits (for banks with assets over $200 million) was 2.7 percent compared to 6 percent for time and savings deposits. This difference would have been even greater if the comparison had been between *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

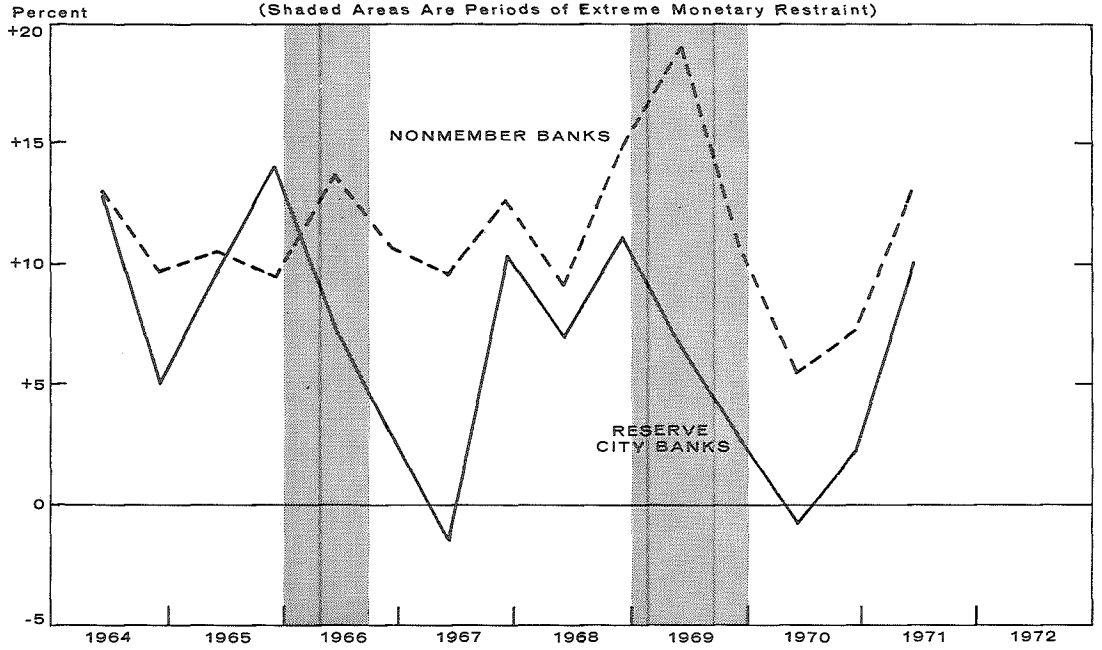
[5]"Credit Extended by Banks to Real Estate Mortgage Lenders," *Federal Reserve Bulletin,* December 1969, p. 921.

[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.

*Professor of Economics, Yale University

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.