

SOME ASPECTS OF THE MORTGAGE INTEREST RATE STRUCTURE

ADDRESS BEFORE THE  
EASTERN REGIONAL CLINIC OF THE MORTGAGE BANKERS ASSOCIATION  
New York, New York, April 4, 1949

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Mr. Walker and Gentlemen: The course of interest rates would be less difficult to forecast if we could achieve stability in the national economy. No one, however, dares hope for even substantial stability as long as the world settles its international disputes by going to war. World War II not only destroyed lives and property but also destroyed economic and financial relationships. Prior to both World Wars, total debt in this country was about 10 per cent public and 90 per cent private. Today, it is about 55 per cent public and 45 per cent private. While all public debt is not in marketable form, it is, nevertheless, true that the volume of United States Treasury obligations far overshadows the aggregate of all private debt securities.

There were times in the past, not so far back in the life of this Nation, when the Government was under the necessity of negotiating with the private financial community, usually the New York money market, as to the amount of money it might obtain as well as the interest rate it would have to pay. When the Government debt was small and budgetary deficits were almost unheard of, except in time of war, it was quite natural that the Government should conform to the pattern of private borrowing.

Today, however, the Federal Government is the dominant factor in finance. Thus we have a reversal of the earlier pattern. Today, and for a long time in the future, private finance must largely conform to the pattern of the borrowings of the United States Government. At this point, it is necessary to avoid any misinterpretation of such a statement. A member of the Federal Reserve Board would be the last to pretend that the monetary authorities have the power to control the supply and cost of money. In many public utterances, as well as in reports to the Congress and testimony before its Committees, the Board has emphasized that its powers can influence the money market but cannot control it. It has been repeatedly pointed out that the fiscal policy of the Government generally has a more powerful effect than strictly monetary measures. To put it more tritely, the monetary authorities cannot prevent an inflation if Congress appropriates one.

It may be supposed that the converse would likewise be true. That is, if Congress should adopt measures of deflationary impact, policies of the monetary authorities could have only modest effect in the opposite direction. This last proposition is, of course, highly theoretical under today's prospects, since pressures in both the international and domestic fields seem to point in the direction of inflationary rather than deflationary fiscal policy. At any rate, while the Federal Government is the dominant factor in finance, we should not confuse the term Government, which includes Congress, with the monetary authorities of the Government, which at times play a relatively minor role in shaping financial conditions. With the foregoing clarification, let us examine the

relationship of monetary policies to the interest rate structure.

While this audience is chiefly interested in the long-term mortgage rate, a brief discussion of the short-term rate would seem to be desirable. There is little doubt that monetary action can be very effective in the short field, since the Federal Reserve System in particular has important powers that affect the supply and cost of commercial bank credit. Such credit is predominantly of short maturity, although in recent years commercial banks have engaged to an increasing extent in term financing.

The traditional weapons for influencing bank credit are discount rates, reserve requirements, and open-market operations. Since the beginning of World War II, the first two weapons have become increasingly subordinate to open-market policy. This is due to the fact that the methods pursued by the Treasury in financing the war resulted in very large holdings of marketable Government obligations by commercial banks, life insurance companies, mutual savings banks, and other institutional savers. The bond support program was an outgrowth of this situation, about which more will be said later. Suffice it to say that a pattern of rates was established for all marketable Government securities, initially at three-eighths of one per cent for 90-day bills and two and one-half per cent for the longest restricted bonds.

So long as this pattern was rigidly adhered to there was no opportunity for the short-term or bank rate to rise.

Following the war, at the initiation of the Federal Reserve, there was a gradual breaking away from the artificially low short-term rate which had been fixed during the war. First, the preferential discount rate of one-half of one per cent on Government securities was abolished. Thereafter, the bill rate and certificate rate were permitted to rise by successive stages from three-eighths of one per cent to about one and one-eighth per cent for bills and from seven-eighths of one per cent to one and one-quarter per cent for one-year certificates. At the same time, the discount rate was moved upward in harmony with the foregoing and is now at one and one-half per cent. The effect of these moves upon the rate for prime commercial borrowings is shown by the following table:

		9-12 month Treasury certificates of indebtedness	Federal Reserve Bank rediscount rate	Rates on prime commercial loans at banks
(per cent per annum)				
March	1946	.79	1/2	1 1/2
June	1946	.83	1	1 1/2
June	1947	.85	1	1 1/2
December	1947	1.04	1	1 3/4
March	1948	1.09	1 1/4	1 3/4
September	1948	1.18	1 1/2	2
February	1948	1.22	1 1/2	2

This brief discussion shows the close relationship between the rate on short-term Government securities and the short-term borrowing rate in private finance. Let us now turn to a consideration of long-term rates.

There was a time when the bulk of long-term investment was done directly by the man who had saved some money. Today, there is more likely to be an institution of some sort between the saver and the ultimate investment of his funds. Nevertheless, direct investment is still a factor, as, for instance, in the case of small business, and mortgages on single-family dwellings. The rise of investment institutions, such as life insurance companies, savings banks, savings and loan associations, and investment trusts has had a substantial effect on the market for long-term funds, and on the structure of long-term interest rates. There would seem to be every prospect that such institutions will become more important as repositories for savings, and consequently will attain still greater influence on the long-term market.

I should like at this point to indicate briefly the extent and trend of the activities of these savings and investment institutions.

Since the beginning of 1940, individuals have saved an estimated total of 165 billion dollars. Of this amount, 62 billion dollars was invested directly in securities -- mainly Government obligations; 53 billion was held in larger cash balances and demand deposits at commercial banks, and 20 billion in time deposits. In addition, 43 billion dollars was entrusted to insurance companies, mutual savings banks, and savings and loan associations. While the sum of these figures is somewhat in excess of 165 billion, we also know that some individuals went into debt during this period or drew down direct investments.

The investment by the American people of 60 billion dollars in obligations of the Federal Government was a striking achievement. For my present purpose, however, I wish to direct your attention to the approximately 100 billion dollars which found its way into all types of institutions supplying loan funds, and particularly to the 43 billion dollars which went into institutions supplying funds on long-term commitments. These institutions are, principally, the life insurance companies, savings banks, and savings and loan associations, which I shall hereafter refer to as institutional investors. I may note here that, although people have been spending heavily out of savings as well as out of current income since the end of the war, about 19 of the 43 billion dollars has been invested during the past three years.

How did these institutions use the funds put at their disposal? During the defense and war period they absorbed nearly one-sixth of the securities issues by the Federal Government, a total of 25 billion dollars, or roughly the amount of the increase in their assets in this period. But, since mid-1946 institutional investors, particularly life insurance companies, have sold or redeemed in cash at maturity some 6 billion dollars of their Government security holdings. These funds have been largely reinvested in higher-yield mortgages and business securities, which of course are higher-risk than Government securities. By the end of 1948, institutional investors held nearly one-half

of the total of corporate bonds and real estate mortgages outstanding as compared with a prewar 1929-39 average of less than one-third.

The net increase since the end of the war in the amount of corporate bonded indebtedness and real estate mortgages held by institutional investors has amounted to about two-thirds of the total increase in these two types of debt in this period. Indeed, the increase in the corporate bond holdings of life insurance companies alone has exceeded the increase in corporate debt outstanding, indicating that these companies acquired old securities from other investors as well as most of the new issues. By contrast, the increase in the holdings of real estate mortgages by all three types of institutions was only about two-fifths of the estimated increase in real estate mortgage debt.

Life insurance companies, mutual savings banks, and savings and loan associations accept and invest, as insurers or depositories, the savings of individuals. However, the investment problems and policies of a company that insures persons against loss of life or earning power are different from those of an association engaged exclusively in home financing. Within the limits prescribed by statute, these differences in functions are reflected in the investment portfolios and capital market activities of different institutions.

Among these various institutions, life insurance companies play the leading role in business financing, as I indicated earlier. In part, the dominance of life insurance companies is attributable to their larger resources, which in 1948 were roughly two-and-a-half times those of mutual savings banks and four times those of savings and loan associations. Also, it reflects the nature of life insurance contractual liability, which permits the investment of funds over long periods of time, as well as a somewhat wider range of permissible investments.

Since institutions generally are restricted by law to investment in what supervisory agencies regard as relatively riskless assets, practically all of their business financing takes the form of obligations, evidenced by bonds, mortgages, or notes. In order to obtain investment outlets for a continually growing volume of funds, life insurance companies have in recent years engaged extensively in lending directly to business, including the private purchase of entire bond and note issues. Also, they have recently expanded their commercial and industrial real estate holdings on an equity or risk basis.

An important development of the past two generations which has stimulated the growth of these investment institutions is the shift in emphasis from attractiveness of return to safety and liquidity. In school arithmetic in earlier days, six per cent was the lowest rate used in problems, and that was the rate many savers thought they ought to get on their money. Today, savers put their money in time deposits at commercial banks at around one per cent, in savings banks at around two per cent, in Government bonds at under three per cent, in life insurance policies at not more than three per cent, and in savings and loan associations at from two and one-half to three and one-half per cent. The amount of individual savings that goes into other channels,

apart from unincorporated business, is relatively small.

Availability of funds to investing institutions at such low rates means that funds are available to borrowers at low rates, compared with earlier standards. The difference is not all net, of course. Institutions have no way of escaping management costs as has the individual investor in many cases.

But there have been other changes, too. The market is not the same as it was when institutional investors were less important. The theory of the long-term interest rate used to teach that funds would be available, no matter for what period or to undertake what risks, if only the interest rate were sufficiently high. This may have been true when investment was predominantly direct. It seems to be true today only within very narrow limits and with many qualifications. There is a good deal of evidence, for example, that institutions, while usually insisting upon some minimum rate of return, are more interested in the quality of the risk than in the amount of interest return above such a minimum.

There have been widespread complaints recently of a shortage of mortgage credit. To the extent that the shortage exists, it seems to have come about largely because lenders have become more selective about the risks they will accept, and to a lesser extent because lenders have posted higher rates for the risks they do accept.

Similarly, between the end of the war and the middle of 1947, many institutions were competing actively for mortgage loans almost regardless of distance from the home or regional office. Recently, they have been confining their competition more and more to their home counties and environs. As a result, borrowers distant from larger centers find loans harder to get, except at the higher rates at which local institutions may be prepared to lend.

Again, lenders have come increasingly to believe that further substantial increases in real estate values are unlikely for some time, so they offer loans for a smaller proportion of current price or require faster repayment. These changes have not always been accompanied by the demand for higher interest rates, but the rates to borrowers have risen because the higher-rate lenders have obtained a larger proportion of the business.

The plentiful supply of savings available for investment during the past few years has had a very important role in moderating the rise in long-term interest rates in the face of a huge capital investment boom. The fact that these loanable funds have been made available largely through institutions which have their own needs for safety, liquidity, and return, has also played a very important role in keeping rates down. Another factor in the recent situation which should not be overlooked is that there was a delay of several years between the time the savings were accumulated and the time they could be invested in anything except Government obligations. We entered the postwar period with a large stock of funds which had found only a temporary resting place in Governments, and a feeling on the part of lenders that their portfolios were over-burdened with these low-yield investments. The feverish search for

mortgages and corporate securities during the last year of the war, and for a year or more thereafter, produced a better balance on these scores, at least in the lenders' minds, but at the same time it brought about lower long-term interest rates than we could expect to see sustained. The lenders who were offering mortgage money at three and one-half per cent in those years, largely in the attempt to offset the heavy repayment of their mortgages, soon found that this was too much of a sacrifice in earnings. Happily for them, they were soon able to reconcile themselves to a somewhat higher return.

No discussion of this subject would be complete without a reference to the program of supporting long-term Government securities and the effect of that program upon the mortgage market. There is no necessity for my discussing the pros and cons of this most important matter. There are already in the record numerous statements by the Federal Reserve, as well as by other authorities, indicating that the program rests upon very solid official support. For instance, Chairman McCabe, in his statement before the House Banking and Currency Committee on August 2, 1948, said:

"It is my view that the System is obligated to maintain a market for Government securities and to assure orderly conditions in that market, not primarily because of an implied commitment to wartime investors that their savings would be protected, nor to aid the Treasury in refunding maturing debt, but because of the widespread repercussions that would ensue throughout the economy if the vast holdings of the public debt were felt to be of unstable value."

More recently, The Economic Report of the President, transmitted to the Congress in January 1949, contained as a part of "Legislative Recommendations" the following:

"The public debt will continue to be managed in a manner that will make a maximum contribution to the stability of the economy. An important factor in this program will continue to be the maintenance of stability in the Government bond market.

"Such stability in the Government bond market has been a most significant element in the smooth reconversion from a wartime economy to a civilian peacetime economy. It contributes to the underlying strength of the financial structure of the country. It engenders business confidence. It has made it easier for business and industry to obtain the capital funds necessary for their reconversion and expansion projects."

To say that the postwar pegging of the Government long-term rate is proper and indeed indispensable is not to say that it has lightened the tasks of the monetary authorities. On the contrary, it has complicated very materially the use of the traditional devices of monetary control. Perhaps the easiest way to drive this point home without entering into a technical discussion is to contrast the present situation with that obtaining at the close of World War I.

You will recall that following a substantial inflation in 1919 and 1920, there was a rapid decline in business activity and a drastic fall in the general level of prices. These developments were in large part the inevitable aftermath of inflation. The very large volume of borrowing at Federal Reserve Banks and the decline in the reserve ratios of these Banks, accompanying an unsound credit expansion, called forth action by the Federal Reserve to raise discount rates in order to restrict further credit expansion. As a consequence rates of interest, both short-term and long-term, rose sharply. You will recall also that the market price of Government bonds fell to the low 80's, but, since financial institutions did not hold Governments to any appreciable extent, this decline did not result in any direct distress to financial institutions. Individual citizens, however, wishing to sell the bonds which they had been induced to buy during the war suffered severe sacrifices. Thus monetary policy to bring about deflation (or "disinflation", if you prefer that term) was not interfered with by any necessity for supporting Government securities, and, as a matter of hindsight, it may be said now that support to the market, particularly after the downturn had begun, would have helped to mitigate the severity of the decline.

Today, however, it would be quite meaningless for the Federal Reserve to raise the discount rate substantially or to attempt to restrict rediscounting at Federal Reserve Banks. This, for the reason that member banks hold many billions of dollars of Government securities which they can sell on a supported market in order to expand credit, should they desire.

It is clear, therefore, that so long as the bond support program is continued the monetary authorities can take no action which would have a substantial effect upon the level of long-term interest rates. Let me again emphasize, however, that the fiscal policy of the Government is a much more formidable factor.

For the reasons indicated earlier in this paper, I should say that the future may well witness some appreciable fluctuation in the short-term rate. On the other hand, it seems to me that the existence of 200 billion dollars of public debt held outside the Federal Reserve Banks and the Treasury, together with Federal Reserve support of the Government securities market has had and will continue to have a very strong influence in preventing private long-term rates from rising or declining substantially.