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PROTECTING AGAINST RISKS AS INTEREST RATES SHIFT

Remarks of

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It is a great pleasure to address this final general session of the U. S. Savings and Loan League's 75th Convention.

The Federal Reserve System and the savings and loan industry have many common goals and objectives. We all want the U. S. to have the best possible savings and credit system. We want to see our economy increase its output of useful goods as rapidly as possible with a minimum waste of productive resources. I, like most of you, am particularly concerned with the problem of building a better urban environment and am mindful that it will require a vast amount of physical capital investment made possible by mortgage and bond financing based on a rising flow of savings.

At the same time, we all are troubled by the threat of inflation. A long period of relatively stable prices did much to stimulate the great expansion of your industry. In the United States, in contrast to many countries, thrift institutions have flourished because depositors have known that they would get their money back and that when returned it would be worth as much as when deposited. Any threat to price stability is a threat to your industry.

While we have had to wage repeated battles with inflationary pressures, recently this fight has turned more critical. Halting inflation will require a great effort on the part of the whole country. Either the burden of this battle will be shared evenly by all, or it will be paid for by disproportionate sacrifices on the part of individual industries and specific sectors of the economy.

Because of the strong forces now at work in the economy, no matter which method of fighting inflation is adopted, you, as savings and loan executives, will not find your tasks simple. Today, I want to discuss one approach to your dilemma. Speeding up innovations and improving the management of the relationships between your assets and your liabilities--or more simply your portfolio policies--can greatly ease these problems.

Interest Rate Movements

Over the past two and one-half years, we have seen interest rates rise to record levels. The entire postwar period has witnessed increased fluctuations in interest rates. How can your associations meet the problems raised by these fluctuations?

Before discussing this major question, let me answer briefly a separate question often asked. Since monetary changes have frequently produced sharp shifts in interest rates, why can't the Federal Reserve keep interest rates down and stop these fluctuations?

In posing these questions, I recognize that some--I hope a small minority--probably will think that the answer is simply the Federal Reserve. It is not, in fact. But when I meet such a viewpoint, I must admit I am torn. I am never certain whether I ought to wish that the Federal Reserve could control interest rates, or whether I should be happy that the Federal Reserve doesn't have to bear the weight of trying to decide the level of interest rates in addition to its existing burdens.

The reasons behind interest rate shifts are both simpler and far more complex than the incorrect answer--the Fed. The simple answer is that interest rates rise when either more capital and credit are desired or less is furnished. Unless an equivalent increase occurs in the amount people save or in the amount of money being created, when people decide to invest or spend more or change the type of assets they hold, interest rates rise. The complex answer requires an understanding of a large number of complicated relationships that lie behind this simple statement.

Controlling Interest Rates

Changes in the flow of Federal Reserve funds can cause considerable shifts in interest rates primarily because they are often at the margin and tip the whole scale.

Changes in one or all of the underlying forces which determine rates may either be exaggerated or offset for short periods by shifts in expectations. Sharp short-run changes in interest rates come primarily from speculation (more politely, changes in expectations). Such expectational shifts cannot continue independently to dominate interest rates. If not validated by events, sooner or later they fade away. The degree to which interest rates over a longer period can be held down by bank creation of more money is limited. It may also be very expensive to the fabric of our economy.

People rarely hold money for itself, but rather for what it can buy. What money will purchase depends on how rapidly it is spent compared to the amount of goods that can be produced. More money increases demand. It can bring about lower interest rates only if the economy has sufficient resources to turn out enough goods to more than satisfy this demand. If the ability to expand supply is limited, newly created money merely raises demand faster than output. Prices rise in consequence. Such rising prices for goods and services can themselves stimulate new desires for credit.

At the same time, if prices are rising, this means the value of money is falling. People will be less interested in holding cash and some will be willing to retain deposits or savings and loan shares only at the higher interest rates that will compensate them for the loss in purchasing power of such assets. Thus, while the demand for credit spirals upward, the willingness of savers to supply funds at the old interest rates diminishes. Interest rates rise. Experience in many countries has been that the faster money was created the faster interest rates rose. If all resources are fully employed, increasing money faster than the ability to produce goods raises prices and, therefore, interest rates.

Suggestions have been made at this Convention as to possible basic changes in relationship of the Federal Government and the Federal Reserve to the mortgage market and your industry. The Federal Reserve demonstrated by action its resolve to assure the continued liquidity of all sound financial institutions. At the same time it is concerned when suggestions are made for additional indirect subsidies from the Federal budget to housing, your industry, or any other group.

A great deal more thought is required of the logic and procedures to be used when public measures are adopted in an attempt to ease directly the impact of tightening general credit conditions on the availability or price of residential mortgage credit. Care must be taken to insure that such measures do not have undesired results opposite to those intended through increasing prices and inflationary pressures. Furthermore, we believe that the extent and form of the subsidy element involved in such proposals should be carefully considered and revealed. Many schemes which involve subsidized credit may work to penalize those most in need of housing while subsidizing those with more than adequate funds to cover their own requirements.

The Long and Short of It

An examination of the supply and demand for funds leads to an optimistic view of the intermediate and long-run future for low interest rates. While people's saving and spending desires change sharply for short spells, they have been stable over longer periods. Unless these desires shift radically, the Government's budget and monetary policy--the so-called fiscal/monetary mix--should be the primary determinate of interest rates in the next several years. Firmer tax and spending policies together with easier monetary policies can give lower interest rates.

Most projections of the economy show that with normal growth and a more balanced fiscal policy, in 1970 interest rates should be far lower than in the past two years. Because of their basic value to the economy, I hope we have the courage to vote for the mix that will bring lower interest rates. With government saving up, lower interest rates can make it easier to mount a vigorous attack on some of our most critical problems--the need for better housing, better cities, and a more rapid capital expansion.

Some people worry about a shortage of mortgage money over the long run, but I don't. A mortgage shortage can be caused only by a failure to live up to our fiscal responsibilities. I don't think we will fail now or in the future. When the war in Vietnam ends, we are more likely to find the situation similar to '63 and '64 when mortgage money was in surplus than we are to suffer through shortages of mortgage money.

This optimistic view of the longer run future need not, of course, apply to any specific shorter period. Interest rates will continue to move up and down as businesses, individuals, and the Government demand or offer more funds to the market. In fact the postwar period has witnessed a more stable economy accompanied by more frequent shifts in interest rates--almost certainly not unrelated phenomenon.

Discussing the short-run action of interest rates reminds me of the famous story of the financier, J. P. Morgan. He once offered to do a favor for a friend to repay one done him. The man eagerly jumped at the offer. He said, "Mr. Morgan, you are known as one of the most successful investors in Wall Street history. I've accumulated some savings but not enough to retire on. Tell me what will happen to the stock market--I want to be able to retire early." Morgan gave him an immediate and complete answer, "Predicting what the stock market will do is simple--it will fluctuate!"

Interest Rate or Income Risks

Knowing that the stock market will fluctuate may not be very valuable information for the average man. The analogous knowledge that interest rates will fluctuate is, however, one of the most valuable pieces of knowledge available to a savings and loan executive. Yet use of this knowledge has frequently been neglected. Recent history shows far too few S&L's developing strategies or portfolio policies aimed at reducing the costs and offsetting the risks of fluctuating interest rates.

This neglect has been expensive. It may grow still more costly if it continues. To make certain that it doesn't, thrift institutions individually and as an industry need to reexamine their strategy of meeting interest rate fluctuations.

<u>Why Is a Portfolio Strategy Necessary?</u>

The reason a strategy is needed should be clear.

-- When interest rates rise, long-term assets carrying rates fixed previously become worth less.

-- To the extent associations' income is limited to prior interest rates on outstanding mortgage contracts, they have no earnings gains out of which to increase their payments to shareholders.

-- Funds withdrawable on demand can and may be transferred to the bond markets or the money market where higher rates are available.

In other words, the securities markets offer higher rates than the associations because the income of the associations is relatively frozen by existing contracts with borrowers. Savings are withdrawn to move into market assets. If the associations have to sell long-term assets their problem is compounded. They will sell on the basis of current market interest rates. This may mean having to show sizable capital losses on balance sheets. (For those not too familiar with how to analyze this problem, I might suggest you borrow a copy of my book <u>Financing Real Estate</u> (McGraw-Hill 1965) from your library. It deals with this problem in some depth.)

I have never understood why this point--that fixed long-term assets carry a risk of losses caused by interest-rate shifts--has been neglected by so many institutions. I suppose it was because past interest rate fluctuations came when the margins between mortgage and share rates were much larger and thus pressures were less. It also may be because under our accounting conventions, we don't show the loss in capital values which occur with rising interest rates. It is assumed that with sufficient liquidity long-term assets won't have to be sold. The fact that interest is lost compared to current reinvestments is neglected.

The Neglected Costs

By failing to recognize this risk that capital values and relative income will fall as rates fluctuate, institutions make incorrect decisions. They fail to consider all the costs of long-term loans in comparison to maintaining greater liquidity.

This confusion is clearest in some recent debates. When long-term rates were much higher than short-term rates, managers thought it was too expensive to maintain liquidity. They invested too much in long-term mortgages or bonds. They made wrong decisions because they failed to include an allowance for the cost of illiquidity in their calculations. Our accounting conventions allow us to show higher income by neglecting these risks. They force us to report lower incomes if we take the safer steps which probably increase long-run profits.

Since interest rates will fluctuate, an interest-rate risk exists. Failing to insure against this risk is like failing to insure against other risks. For a period, anyone may save money by not carrying fire or car insurance. When the insurance isn't needed he has a higher income and lower expenses. We frown on such an understatement of expenses because we know that in most cases it pays to insure. In case of fire, the house or business will be lost.

The same is true of interest-rate risk. We are not forced to carry insurance against this risk. If we don't adopt a safe policy our income looks higher. If interest rates change, however, we suffer from a lack of protection. The losses can be severe enough to threaten the entire institution. In most cases, insurance against these risks as against others is worthwhile.

How to Insure Against Interest Shifts

Tremendous strides have been made in recognizing how these risks can be insured against. Most of the ideas put forth still require a good deal of work and analysis. Some have been adopted; some not. The three which I feel have shown greatest promise are:

- -- Maintaining greater liquidity.
- -- Obtaining variable interest rates on mortgages.
- -- Offering a greater variety of intermediate-term certificates and long-term bonds.

Let me discuss each briefly.

Greater Liquidity

The advantages of liquidity are manifold. Short-term assets don't fluctuate in value as interest rates shift. If cash is needed, they can be liquidated without capital losses. If rates change, liquid assets are reinvested at the higher rates. Banks have traditionally held far more liquidity than S&L's because of their different historical backgrounds. Do such large differences still make sense if an association is buying its funds in a broad or national savings market?

Liquidity can be gained in many ways. It can be pooled as in the Home Loan Banks. Without discussing the many technical problems in this sphere, it can be pointed out that when considered as insurance, liquidity costs far less than many believe.

Variable Interest Rates

The advantages to lending institutions of variable mortgage interest rates are also clear. If carefully drawn and explained, the variable rates are fair to borrowers also. They enable the borrower and the lender to share gains and losses as interest rates shift. Thus, they reduce the need for insurance against the risks which arise if one or the other is not protected in the mortgage contract. Doing away with a risk is a real saving. Everyone is better off.

Most discussion has been concerned with variable rates on the single family mortgage. Winning acceptance for a new idea is hard. It takes work and understanding. Progress will be made, but it may be slow. Meanwhile, let me suggest an innovation which might be simpler to adopt.

Why shouldn't interest rates on mortgages on income properties vary with the income from those properties?

On the surface, such an idea doesn't seem difficult to implement. Such mortgages could require that higher interest rates be paid when the income of the property rises. They might also have a prepayments penalty which increases with the amount of capital gain made when the property is sold or re-financed.

Variable income provisions are, of course, the basis of most current agreements between landlords and tenants in shopping centers. Various forms of so-called "sweeteners" are becoming more common in the lending agreements between income property owners and insurance companies, pension funds, and endowment funds. It might make a great deal of sense if they became part of lending practice on all types of income properties. It seems proper that there be a sharing of risks between borrower and lender.

Create a Greater Variety of Liability Instruments

While changing assets and the return to assets can give some protection against interest-rate risks, programs to create different types of liabilities seem more hopeful and immediate. Your associations have been experimenting with different types of certificates in the past several years. These programs should be expanded and shaped to meet your problems head on.

Sometimes I feel that not enough emphasis has been given these programs because their logic has not been fully explained. All deposit institutions should understand completely the purpose and potential gains from offering different maturities of shares, certificates, and debentures at varying interest rates. Only with such knowledge can they formulate a logical strategy for their use.

-- Because of interest-rate risks, the value of shares or deposits to an institution varies with the length of time they are certain to remain.

-- Longer term certificates may also create significant savings in marketing and other costs.

-- Savers have differing needs for rate of return, liquidity, and convenience.

-- A program to shape an association's liabilities to its customers' needs makes all better off. It may be fairer and cheaper to pay savers for giving up liquidity than to insure against their withdrawals.

-- Associations compete in many different markets. Some competition comes from other associations, some from banks, some from Treasury bills, some from corporate bonds. The best way to compete is to tailor a different instrument to compete with each of these markets, insofar as it is possible to do so. Each instrument may have to carry a separate rate.

You are all familiar with the differences among savers. Some are primarily concerned with liquidity and convenience. They are willing to sacrifice interest for these advantages. A passbook normally payable on demand meets their need. Others are more interested in yields. With larger sums to invest and more sophistication, they can search for higher rates.

When market rates rise an association's attempt to hold the money of rate-sensitive savers by increasing the rate paid on all shares is both expensive and inefficient. Losing their funds, particularly if it means taking capital losses, may be expensive also.

Recent trends in differentiating savings instruments ought to be pushed further. They should lead to a variety of different instruments, but also to greater penalties than now exist for liquidating longer term contracts. We might expect to see passbooks, six-month to three-year certificates, and 10- to 15-year debentures all being used side by side. Rates would vary with maturity. Penalties for obtaining cash prior to maturity would also vary depending upon the length of the initial contract.

I recognize that these are proposals involving not only changes in management policy, but also to some extent in supervisory attitudes, regulations, and in some cases even in applicable statutes. But the first step toward all these changes is insuring a clear understanding of how and why these changes can benefit the association, its savers, and its community. That is a job I would urge you to undertake.

Conclusion

The past several years have certainly been interesting (to say the least) for all financial institutions. Vietnam brought major shifts in the demand for funds. As total demands for goods and services fluctuated above and below the economy's ability to supply them, the amount of credit demanded and created by our financial system varied. Interest rates shifted rapidly. Most recently the course has been upward. Long-term rates have reached record high levels.

Most people would agree, I believe, that the country would be better off with interest rates that averaged lower over the long run. Whether they would also agree on taking the steps necessary to bring about those lower rates, I am not so certain, but I am an optimist on that score. Our housing and other urban needs are great. As a result I believe that we will support the fiscal/monetary programs necessary for lower rates. Over the long run, I don't fear a mortgage shortage.

While with an optimum policy mix the long-term trend of interest will be down, this may not be true in any specific period. Rates will continue to fluctuate above and below the trend line. This fact creates major problems for you as savings and loan executives. It must be faced up to unequivocally and consistently. Portfolio strategies must be adopted that will decrease your risks and enable you to fulfill your role as major mortgage lenders more consistently. Considerable progress has been made along these lines. I am confident that still greater improvements lie ahead. They will lead to a consequent strengthening of your associations, of the entire credit and financial sphere, and of our whole economy.