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MONETARY POLICY, INTEREST RATE CEILINGS AND THE FUTURE OF RESIDENTIAL FINANCING

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Monetary Policy, Interest Rate Ceilings and the Future of Residential Financing

Monetary management and residential financing, after enduring a year of mutual agony, have again been cast in central roles on the stage of national economic policy. Monetary policy, having borne the brunt of the campaign to moderate inflationary pressures in 1966, has been following a course in recent months designed to ensure that the availability of credit is adequate to see the economy through a period of inventory adjustment and on to a path of balanced expansion, with reasonable price stability and without serious aggravation of the U.S. balance of payments position. As projected in the President's Economic Report in January, residential construction is expected to be a major source of economic growth during the second half of 1967. An increase in the volume of funds flowing to financial institutions -- and their availability to potential mortgage borrowers at rates of interest below those prevailing in late 1966 -- is a necessary component of this basic strategy.

Thus, the overall task for economic policy in the months ahead is both difficult and critical. Precisely for this reason, it is important that there be no misunderstanding of the role of monetary policy and its impact on residential financing in 1966. Nor should there be unwarranted expectations about the potentialities of policy for housing in 1967.

- It is contended, even by usually most careful observers, that most of the trouble in the housing industry last year can be traced to the aggressive competition of commercial banks for personal savings aided and abetted by the Federal Reserve. This view, aside from giving an inaccurate picture of the task of central banking, clearly overlooks the decisive role of high and rising yields on market securities against which all financial institutions found it extremely difficult to compete.

- Moreover, while all lenders reduced their acquisition of mortgages in 1966, commercial banks maintained their participation in residential financing to a greater degree than other depository-type financial institutions.

- Finally, contrary to widely held convictions, the sharpness of the shrinkage in residential financing was not solely a reflection of the policies of the Federal Reserve System. Rather, given the need to adopt a policy of monetary restraint to help check general inflationary pressures, structural defects inherent in our basic arrangements for residential financing made it inevitable that the burden would fall most heavily on this sector.

Looking ahead in 1967, the prospects for a revival of home building appear promising.

- As yields on market securities have declined in response to the relaxation of credit restraint, financial intermediaries once again are experiencing sizable gains in deposits and share capital. New commitments to lend are also rising.

- However, the legacy of previous yester-year still lingers in some localities: many potential home buyers apparently are unaware of the improved conditions, and there are lags in assembling labor and resources needed for new housing ventures.

- But on the whole, the quickening pace of financial flows does suggest a substantial expansion in home building activity as the year progressed.

- In other words, the same structural features that cause housing finance to suffer more from monetary restraint also leads it to benefit first and possibly most from monetary ease.

Simultaneously, however, a less comforting chorus is also being heard. Increasingly, Federal supervisory agencies are being urged to hasten the downtrend in interest rates -- including those on real estate mortgages -- by reducing the maximum rates which commercial banks, mutual savings banks, and savings and loan associations can pay on deposits and share accounts. In my opinion, this suggestion -- that Federal agencies should lead the market down -- goes astray in several significant ways.

- In the first place, interest rate ceilings were adopted by Congress last September primarily as a means of moderating excessive competition for deposits. They should not be used to regulate the rate setting decisions of private financial institutions too closely and thus to abridge the responsibilities of their own managements.

- Moreover, if the structure of rates paid by financial institutions were forced down ahead of the general market, these intermediaries could again find themselves unable to compete for deposits. As a result, the promising revival of housing might turn out to be more of a promise and less of a revival.

- Instead of dwelling on rate ceilings as a means of providing permanent insulation of particular institutions from the forces of competition, or insulating housing from the shifting composition of the public's demand for goods and services, all of us would do well to get on with the task of modernizing our basic arrangements for residential financing to ensure their viability during future periods when monetary policy may again be called upon to help counter inflationary pressures.

Monetary Policy and Residential Financing in Perspective: the Record for 1966

The details of monetary policy in 1966 have already been placed before the public, and there is no need to repeat these here. It will be sufficient to recall that, under the stimulus of quickening outlays for military activity in Vietnam, the economy began to develop marked inflationary tendencies in the last half of 1965. To counter these pressures, a policy of monetary restraint was announced in early December of that year. This policy was reinforced as the new year unfolded and became particularly restrictive during the third quarter of 1966. Fiscal policy also was directed toward the same goal of countering inflation; but, on balance, the major share of the load was carried by monetary policy. As aggregate demand built up, the quest for funds on the part of the private borrowers (especially corporate business) exerted enormous pressure on the level of interest rates. Moreover, the Federal Government also registered sizable demands on securities markets. The net result was that interest rates rose to the highest level in 40 years.

In this environment, all financial institutions lived through trying times, but as you know, mutual savings banks and savings and loan associations were under substantially greater pressure than they had experienced in earlier post-war periods of cyclical restraint. Because of the strategic role these institutions play in residential financing, their lesser inflow of new funds was reflected progressively in fewer new commitments and loans and hence in a sharp decline of housing starts. From an annual rate of 1.5 million units the first quarter of 1966, starts had dropped to a post-World War II low of less than 900 thousand in October.

At this point, it may be helpful to review the pattern of 1966 mortgage flows and the respective roles played by different types of financial institutions. With sharply rising market yields, consumers stepped up their purchases of securities last year to a record $11.5 billion -- four times their acquisitions in 1965. To make these purchases, they reduced their rate of accumulation of deposits in banks and other intermediaries. The rate of growth of time and savings deposits of consumers at commercial banks declined somewhat, but consumer acquisitions of other deposit-type claims declined even more steeply. Indeed, such acquisitions represented the smallest proportion of the increase in consumer financial assets since the early 1950's. In absolute terms savings and loan inflows dropped to the lowest volume since 1952 and at mutual savings banks to the slowest pace since 1962. In both April and July, S&L's(savings and loan associations) suffered large withdrawals as investors shifted their funds to other more attractive assets. Following the April outflow, these institutions began to cut back sharply on new commitments.

With inflows to many mortgage lenders reduced by the shift of consumer savings to higher yielding market securities, total net home mortgage financing in 1966 declined by almost 30 per cent, and -- reflecting the drop in new commitments -- from fourth quarter to fourth quarter net mortgage growth declined by 50 per cent. At savings and loan associations and mutual savings banks, the decline from fourth quarter to fourth quarter was about 75 per cent. Moreover, life insurance companies -- with their lendable funds reduced by a sharp increase in policy loans and a reduction in prepayment of existing real estate loans -- also cut their mortgage commitments sharply in 1966.

In contrast, commercial banks reduced their mortgage purchases by only a third from the end of 1965 to the end of 1966. Moreover, these banks increased sharply the proportion of their loans and investments allocated to mortgages. In 1966, residential and other mortgage loans accounted for 30 per cent of total commercial bank loans and investments compared with an average of about 20 per cent during the previous five years.

Another way of looking at shifts in residential mortgage markets in 1966 is to compare shares of the market. On average from 1961-65, depositary-type savings institutions had accounted for 70 per cent of the market; by the fourth quarter of last year, their share was 32 per cent. Insurance companies and pension funds increased their share of the smaller market; while they accounted for less than 10 per cent in the first half of the 1960's, they took almost 14 per cent last year.

Commercial banks, however, almost doubled their share -- from 15 per cent during 1961-65 to 28 per cent in 1966. But the big residual lender was the Federal Government. Federal agencies supplied over one-fifth of the funds to the home mortgage market in 1966 after a mixed but essentially neutral average contribution in the first half of the decade.

The West Coast Experience

The impact of monetary restraint in 1966 was pervasive, but on the West Coast it was particularly severe. However, to some extent, this relatively weak West Coast performance can be traced to a number of special circumstances. Many West Coast institutions prior to 1966 had sought -- and attracted -- a large volume of the most interest-sensitive funds. Moreover, with these very large inflows to the West Coast (including heavy borrowing by California S&L's from the Federal Home Loan Bank at the very time of large share inflows), housing had gone through a period of overbuilding. In fact, the pace of new starts had actually turned down in 1964-65 -- before the development of severe credit stringency last year. Indeed, California State authorities for some time had been concerned about the quality of mortgage credit -- particularly at the S&L's -- and were emphasizing more prudent lending standards.

The effects of interplay of supply and demand forces in the West is clearly evident in the statistics. At the large weekly reporting banks in the San Francisco Federal Reserve District, the deceleration in the growth of time and savings deposits was far less than in the rest of the Nation.

At the largets banks the West, 1966 inflows were 65 per cent of 1965 inflows compared with 27 per cent for large banks in the rest of the country. However, the decline in their real estate loans exceeded that of the large weekly reporting banks with the other 11 Federal Reserve Districts; their 1966 real estate loans were only 37 per cent of 1965 volume, whereas real estate loans at banks in other parts of the Nation were 62 per cent of their 1965 volume. This more severe decline clearly reflected not only the reduced pace of inflows to West Coast institutions, but also the previous overbuilding.

At S&L's, financial developments even more sharply reduced the inflow of funds and the extension of mortgage credits. But housing activity per se was so low in California that S&L's in the San Francisco FHLB district actually repaid advances to the FHLB in 1966 -- despite their greatly reduced inflows.

In looking back on their 1965-66 experience, a number of participants in West Coast savings and loan and homebuilding industries have volunteered the judgment that the further reduction in activity in the West in 1966 was in part a necessary adjustment that was required in any case. While there are still some overbuilt situations, many of the adjustments needed here as well as in the savings and loan industry have been accomplished -- putting both industries on a sounder basis to move forward from here.

The 1967 Outlook for Residential Financing

Since monetary policy shifted from restraint to ease last fall, inflows to financial institutions have increased sharply. Declining market yields have increased the relative attractiveness of bank time deposits and S&L shares.

In December and January, inflows of the S&L's rose at a 6.2 per cent seasonally adjusted annual rate, a dramatic turnaround from the earlier pace in 1966. At mutual savings banks, net inflows rose at a 7.8 per cent annual rate. This was somewhat above their summer and fall pace, which had already accelerated due to higher offering rates by the major institutions at midyear. And at commercial banks, inflows of time and savings deposits rose at an annual rate of about 10 per cent in December, and 20 per cent in January-February. Negotiable CD's accounted for a large part of this latter growth, but consumer-type deposits also rose sharply.

Inflows to California commercial banks were at least as good as those for banks in the rest of the Nation. At S&L's in California, inflows were considerably better than for the country as a whole.

With larger inflows to financial institutions, the tone of the residential mortgage market has improved considerably. Mortgage rates as measured by the FHA secondary market series declined about 35 basis points from November through February. In fact, in January and February the series showed the largest rate decline for any months in the history of the series. Rates on conventional mortgages have also declined substantially.

However, recent impressions relayed to us at the Federal Reserve from participants in the mortgage lending and housing industries suggest that the legacy of the recent past may delay the translation of recent yield and flow developments into new residential construction. Although new mortgage lending is generally expected to pick up over the next few months, the pace of the expansion may be dampened somewhat by continued hesitancy on the part of some borrowers. Some of this attitude seems to have been due to expectations of still easier conditions. But other borrowers have apparently not been sufficiently aware of the easing that has already taken place. Even more important the technical lag in gearing up the production of new homes after a period of very low activity is continuing to slow the pace of expansion in new construction.

On balance, these impressions suggest that housing starts may not show any pronounced rise until after mid-year, after allowing for the usual seasonal increases which are particularly sharp in the spring. The recently released figures on housing starts for February which as you know showed a 15 per cent decline from January to a seasonally adjusted annual rate of less than 1.1 million units, lend some support to this view. However, the housing starts statistics frequently show sharp month-to-month changes, and one should not attach much weight to a one-month decline. Over the preceeding three months, home building had registered gains, and a further expansion particularly after mid-year, seems assured in view of the recent expansion of flows to mortgage lenders.

Moreover, since February (when interest rates on some market securities moved up in anticipation of the heavy volume of securities to be digested in March), the Federal Reserve has provided reserves liberally through open market operations and by a reduction in reserve requirements. These circumstances are clearly favorable for a strong increase in home building in coming months.

Structural Defects and the Vulnerability of Residential Financing.

As I have already indicated, the difficulties encountered in home financing in 1966 were due as much to structural limitations in the institutions of residential financing as to monetary policy. Mortgages in general, and residential mortgages in particular, are rather special financial assets. Moreover, for a variety of reasons Government policy and regulations have tended to make them even more unusual. This is the root of the "mortgage problem", and 1966 is simply the latest example -- but perhaps the most striking example -- of how these peculiarities can magnify credit market pressures and lead to stresses in the entire residential financing fabric.

Within broad groupings, many types of debt instruments other than mortgages are relatively homogeneous. For instance, investors usually view corporate bonds of the same maturity and quality rating as fairly close substitutes -- with only relatively minor yield differentials needed to encourage substitution. On the other hand, mortgages are differentiated in so many ways -- by maturity, credit worthiness of the borrower, legal characteristics of the State in which the property is located, etc -- that they are not clearly interchangeable. Federal guarantees and insurance tend to add homogenity. But less than one-fifth of all residential mortgages on new homes in the last four years have had this protection, and additional fees and rate limitations have also tended to reduce the effectiveness of plans for creating a genuinely competitive, nationwide financial asset out of the residential mortgage.

The institutional structure of mortgage markets has also limited the ability of the mortgage to compete with other financial assets. Rate limitations on mortgages established by the separate States and by Congress tend to make mortgages non-competitive in periods when generally rising interest rates force yields on market securities up against their limits. At such times lenders who have a choice naturally become less attracted to mortgages. While discounts can increase the yield on mortgages, many lenders find the use of discounts a difficult procedure for technical and other reasons. Moreover, both laws and administrative regulations inhibit their use, and the cash effect on the seller or builder is often so large that it further reduces the use of discounts.

While mortgages have their limitations as a readily marketable debt instrument, as was demonstrated in 1966, perhaps the most serious weakness in the institutional structure of mortgage markets stems from the difficulty that major mortgage lenders have in obtaining funds in times of rising yields. The essential reason for their difficulty is clear. Over one-half of all home financing is usually supplied by S&L's; if mutual savings banks are added, the share rises to two-thirds. When their portfolios are heavily invested in older mortgages with rates below the current market, these institutions find it difficult to raise the rates they offer for deposits and shares and thus difficult to compete for savings against market instruments. While the new mortgages they acquire have a higher return, under existing practice when these institutions try to pay depositors more, they typically must raise the rate across the board on all deposits and shares -- even though they obtain higher earnings only on their new loans.

The problem of rate competition for these non-bank types of intermediaries has, of course, been intensified in recent years by the changed role of commercial banks. Banks, which had rather passively permitted other financial institutions to cut into their market during the 1950's, began to compete more aggressively for business and consumer savings in the 1960's. As you know so well, this change was encouraged by successive increases in the maximum rates which banks could pay on their time deposits; following the further late 1965 increase in this ceiling rate,banks made an especially vigorous effort to attract funds, with considerable further success.

Yet, despite these banks' efforts, the rate of growth in their savings and consumer-type time deposits slowed in 1966 as consumers allocated a greater proportion of their funds into higher yielding market securities. Thus, the general role of high yields on market securities should not be underestimated. For S&L's and mutual savings banks too, competition from the market seems to have been as large --
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if not/larger -- factor than the aggressiveness of commercial banks.

The key point of the above discussion is that housing bore a relatively large portion of the brunt of monetary restraint last year because of the inherent peculiarities of both the mortgage instrument and the major lending institutions active in home mortgage markets.

In these circumstances, simple logic suggests several alternative ways to minimize mortgage market problems in future periods of monetary restraint. One would be to refrain from the use of monetary policy to restrain aggregate spending because of its potential discriminatory effect on the mortgage capital. Clearly, this prescription cannot be followed, for monetary policy -- as was demonstrated last year -- is an indispensable tool in any period of excess demand and inflationary pressures. A second alternative is to try to improve the marketability of the mortgage instrument. This road has already been taken, with the development of insured and guaranteed mortgages and of secondary market support from the FNMA. But further innovations to develop a secondary market in conventional mortgages might be tried. A third alternative is to try to insulate the mortgage market from the effects of rate competition for savings. This road was traveled a bit further last fall when interest rate ceilings were established on time deposits in commercial and mutual savings banks and on shares in S&L's.

Cautionary Approach to Interest Rate Ceilings

As I noted above, an increasing number of persons, from various branches of the financial sector, are beginning to look longingly at rate ceilings on deposit-type claims as a means of achieving a mixture of objectives -- including leading the market to a generally lower level of interest rates, wider profit margins, and greater safety for particular institutions. In my judgment, all of us should be especially cautious in trying to employ rate ceilings for such purposes.

It will be recalled that, when Congress last September granted Federal bank supervisory agencies the authority to set rate ceilings on a variety of bases, the principal aim was to halt the competitive escalation of interest rates offered on savings by financial intermediaries which threatened to develop serious difficulties for the financial system as a whole. It should also be recalled that Congress, recognizing that legislation adopted to meet an urgent immediate situation might not be appropriate to meet long-run needs, set a one-year expiration date for the new authority. It was hoped and expected that the agencies would not only use their new flexibility to dampen the excessive rate competition -- but would make a serious effort in the interval to develop an approach to rate regulation which would also be suitable for the long run.

Immediately after the President signed the new law, the Federal Reserve Board, the FDIC and the FHLB Board -- after consultation together as required by law -- promptly set maximum ceilings for the institutions under their supervision. The Federal Reserve Board reduced to 5 per cent (from 5½ per cent) the maximum rate which member banks could pay on any time deposit under $100,000. The FDIC adopted the same ceiling on the same basis and also applied it to mutual savings bank passbook accounts; passbook ceiling rates for commercial banks remained unchanged at 4 per cent. The FHLB Board limited to 4-3/4 per cent the rate member S&L's generally could pay on passbook accounts -- except for associations in areas where 5 per cent was the prevailing rate, and units in California, Nevada and Alaska could pay up to 5¼ per cent. Those paying 4-3/4 per cent on passbook accounts could also issue certificates paying up to 5¼ per cent.

My own position is this: under normal circumstances, there should be no invariable ceilings set by Congress on rates payable by member banks. But given the possibility that competition among financial institutions for savings can at times become excessive and thus destabilizing to the entire economy, standby authority for regulatory agencies to set variable ceilings should be available to be used as needed.

I realize, of course, that some people have a very different view of what is needed -- even in the long run. They advocate a permanent, coordinated structure of rate ceilings on time accounts for all major kinds of depositary-type institutions. As I understand this alternative view, the principal supporting arguments are as follows:

(1) The unusually high rates currently being paid on depositary-type claims are too costly in relation to returns on mortgages, and hence are forcing a number of institutions to operate with net earnings that are too small to permit adequate additions to reserves.

(2) Unfortunately the operating status of different depositary-type institutions is so varied, however, that given institutions in local market areas are hesitant to cut rates paid on savings because they have no assurance that competing institutions will follow suit with matching rate reductions of their own. Past experience has shown that in the highly interest-sensitive market for personal savings, any individual institution which attempts to lead with a rate reduction risks a heavy loss of funds, if competing institutions do not follow.

For this reason, it is argued, an across-the-board roll-back of savings rates in a period of generally declining rates can be accomplished only when it is initiated by Federal supervisory agencies in the form of a coordinated reduction in the structure of rate ceilings for all types of depositary institutions. In the absence of such a coordinated rate roll-back, marginal institutions with already depleted reserve positions will be driven to the wall; moreover, the failure to reduce savings rates will tend to slow the downward adjustment of mortgage rates. And in present circumstances further cuts in mortgage rates are needed to help stimulate the recovery of residential construction activity.

(3) The preceding arguments concerned the immediate need for a coordinated rate ceiling policy. Beyond this, proponents of a permanent ceiling approach also argue that ceilings are needed to insure the long-run viability of financial institutions that specialize in home mortgage financing. They believe that both the savings and loan associations, and to a lesser extent the mutual savings banks, are at an inherent disadvantage when forced to compete for savings with the more flexible and diversified commercial bank lenders. Hence they contend that inter-institutional ceiling rate differentials have to be fixed on rates paid for savings in order to prevent the ultimate demise of the specialized lenders and a resulting reduction in the relative availability of funds for home mortgage financing. Finally, they assert

that rate differentials must be maintained between institutions of the same type in different geographic areas of the country, in order to continue to channel funds from capital surplus to capital deficit areas. This need is stressed particularly where lenders in capital deficit areas have relied so heavily in the past on rate differentials to attract interest-sensitive savings into their markets; any sudden reversal of this trend would be disruptive.

The above cases for permanent rate ceilings -- and for the immediate roll-back of existing ceilings --are admittedly worthy of careful consideration. But I believe personally that an even stronger case can be made for being cautious in following either line of action. In any system of fixed inter-institutional and geographic rate ceilings, the winds of economic change will always pose problems of equity and social priority in the allocation of funds. Efforts to resolve these conflicts would tend inevitably to extend the Federal presence increasingly into rate setting decisions which should be the prerogative of management in each firm.

Moreover, in my opinion, it would be a mistake to allow the broad principles of Federal policy on savings rate ceilings to be determined by what are essentially supervisory questions about the quality of management in the least viable firms in the segment of the thrift industry with the least capacity to compete against market securities. These supervisory problems should be approached directly through examination techniques, leaving savings rates free to be determined by competitive market forces. It is only in this way that flows of available funds can be allocated where they are most needed.

Moreover, efforts to insulate S&L shares from the pressure of competing liquid assets by holding down rates on claims of all depositary-type institutions will tend to be counter-productive in periods when rates on market secutities are attractive. Such an approach would simply accelerate the diversion of savings flows from depositary-type claims into market instruments.

There has already been ample illustrations of the types of problems that arise when rate ceilings are established for a financial sector with as many diverse and rapidly changing institutional and geographic charateristics as the thrift industry. For example, the management of some commercial banks and S&L's located in the New York City area have asserted that the initial relationship established last September between ceiling rates on savings deposits, S&L shares, and consumer-type time deposits at commercial banks gave an unfair advantage to the savings banks. Although the rate ceilings for S&L's were subsequently liberalized, there is little question that flows to savings banks deposits in New York City have recently grown more rapidly than those to similar types of claims at competing types of institutions. Setting of a "fair" structure of rate ceilings applicable to the New York situation was complicated by the fact that savings institutions in that area emphasize rather different types of instruments. Similar types of problems arise in attempting to fix a reasonable geographic rate differential for institutions on the West Coast compared with rates paid in other capital short areas.

Concluding Observations

Nevertheless, the 1966 experience stands as a haunting reminder that under existing institutional arrangements, S&L's (and to a lesser extent savings banks) do not have the capability to compete freely for savings with commercial banks and market instruments when interest rates rise sharply.

To resolve this problem, the proper solution would seem to be not to set permanent ceilings on all savings rates but rather to improve the competitive ability and management of the weaker types of institutions. This would involve changes in institutional arrangements which would permit both S&L's and savings banks to diversify the types and maturities of the assets they hold; to offer a wider range of savings instruments differentiated by maturity; and to borrow for longer terms from the Federal Home Loan Banks, using funds raised by these banks in capital markets.

One might reasonably ask just how some S&L's (which in many cases have encountered difficulties in managing a much more limited range of assets) could be expected to extend their range of operations efficiently to encompass even more demanding activities, such as consumer credit. Here the answer must be that many S&L's have exhibited a high order of management ability, and that further steps should be taken to encourage mergers of weak with strong institutions. This process could be accelerated through Federal chartering of mutual savings banks, since a number of the larger, more efficient S&L's would undoubtedly decide to take advantage of this option. This would be particularly promising if the asset and geographic investment flexibility of the mutuals were expanded at the same time.

I realize, of course, that S&L managements have often tended to resist the above approach to institutional innovation on the grounds that broadening of their asset options would operate to reduce further the availability of funds in mortgage markets, particularly in periods of general credit stringency. Recent experience suggests that this is not necessarily true. For example, as mentioned above, in a number of areas last year commercial banks proved to be the more permanent mortgage lenders. This suggests that a shift to broader lending capabilities by the S&L's and savings banks (in effect making them more like commercial banks) would create more general strength among financial institutions to adjust to monetary stringency and thus help to spread the impact of monetary actions more evenly throughout the financial sector.

Finally, if this result were accomplished, the chance of future experiences like 1966 would be minimized. This would mean that there would probably be less reason to require future use of stand-by powers to set rate ceilings. Likewise with relative financial strength more evenly distributed among types of financial institutions, there might be less need than in 1966 to use rate ceiling powers to curb the pace of bank credit expansion.

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