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INTEREST RATE DISCRIMINATION, SAVINGS FLOWS, AND
NEW PRIORITIES IN HOME FINANCING

Remarks

By

Andrew F. Brimmer
Member
Board of Governors of the
Federal Reserve System

Upon Acceptance of the
Alumnus Summa Laude Dignatus
Award for 1972

Presented by the
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Andrew F. Brimmer^{*}

I am both pleased and flattered to have been selected as the Alumnus Summa Laude Dignatus of the University of Washington Alumni Association for 1972. I know that this is the highest honor which the Association can bestow upon an alumnus. Moreover, by long-standing tradition, the University of Washington itself does not award honorary degrees. So in another sense, this Award is also the highest distinction which can be granted in association with the University.

Once I was informed of my selection, I gave a great deal of thought to the ways in which I might express my appreciation for the approval which this University community has shown for the meager efforts which I have been making in the public service. If I were a musician, perhaps I could have composed a symphony to express my gratitude. If I were a poet, perhaps I could have written a sonnet to demonstrate the humility with which I accept the Award.

But I am neither of these. Instead I am an economist involved in the formulation and implementation of national economic policy. If I have any skills at all, it is in that area that they must be exploited. Consequently, I concluded that it might be appropriate on this occasion for me to focus on at least one aspect of public policy which has concerned me a great deal in recent months. From my position of sharing responsibility

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I am indebted to several members of the Board's staff for assistance in the preparation of these remarks. Mr. James Kichline had overall responsibility for coordinating the staff's contributions. Mrs. Barbara Opper assisted with the assessment of the effects of interest rate ceilings on savings flows and the behavior of lenders. Messrs. Fred Taylor and Bernard Freedman helped with the analysis of developments in home financing.

However, the views expressed here are my own and should not be attributed to the Board's staff--nor to my colleagues on the Board.

for the nation's monetary policy, I have become increasingly troubled by the extent to which the Federal Government's control of maximum rates of interest which can be paid on savings deposits in financial institutions has developed into discrimination against small savers. Moreover, that discrimination appears to be the principal source of a private subsidy which accrues mainly to middle-class borrowers who obtain mortgage funds for the purpose of purchasing suburban housing.

Thus, public policy which set out more than 35 years ago to strengthen a group of financial institutions with the further aim of fostering improvements in housing for the nation's citizens has in this case evolved into a policy which today runs counter to certain of our basic housing and other economic objectives. These objectives for low- and moderate-income housing were given a high priority in the National Housing Act of 1968. This divergence in national policy aims is also occurring at a time when one part of our housing goals--that part aimed at enhancing better housing opportunities in our central cities--is lagging behind.

So, after a careful examination of the linkages among interest rate ceilings, savings flows, and the distribution and availability of home financing, I have concluded that the time has come for the Federal bank supervisory agencies to consider eliminating the limitations on interest rates which financial institutions can pay to attract savings. At the same time, however, I realize that these restraints cannot be removed at once. Nevertheless, I think we should not lose any more time in adopting measures which will induce these institutions--especially savings and loan associations which have benefited from rate ceiling protection--to undertake the reconstruction which is a precondition if they are to survive in the years ahead.

In the remainder of these remarks, I will examine each of these points more fully.

Origins and Scope of Interest Rate Ceilings

The prevailing structure of maximum interest rates payable on consumer-type savings and time deposits at commercial banks, mutual savings banks and savings and loan associations is shown in Table 1, attached. These specific ceilings have been in effect since January, 1970. Several features of this structure are worth noting. The rich variety of instruments offered by the three types of institutions stands out. Essentially, the depositaries have attempted to tailor the forms of accounts offered to appeal to the liquidity (roughly measured by maturity) and yield preferences of particular segments of the saving public. The structure of maximum rates is essentially identical for mutual savings banks (MSB's) and savings and loan associations (S&L's).

At commercial banks,^{1/} the ceilings vary from 4.50 per cent on passbook accounts to 5.75 per cent on consumer-type certificates of deposits^{2/} with a maturity of 2 years and over. The lowest rate is

1/ It should be noted that maximum rates that may be paid by member banks are established by the Board of Governors under provisions of Regulation Q; however, a member bank may not pay a rate in excess of the maximum rate payable by State banks or trust companies on like deposits under the laws of the State in which the member is located. Beginning February 1, 1936, maximum rates that may be paid by nonmember insured commercial banks, as established by the FDIC, have been the same as those in effect for member banks.

2/ It should be remembered that the discussion at this point is restricted to consumer-type deposits. In the case of certificates of deposit of \$100,000 and over (CD's) the ceilings in effect beginning January 21 through June 23, 1970, were 6-1/4 per cent on maturities of 30-59 days and 6-1/2 per cent on maturities of 60-89 days. Effective June 24, 1970, maximum interest rates on these maturities were suspended until further notice. On CD's of 90 to 179 days, the ceiling is 6-3/4 per cent; on CD's of 180 days to 1 year, the ceiling is 7 per cent, and on maturities of 1 year or more it is 7-1/2 per cent. The latter two rates have been in effect since January 21, 1970.

assigned to passbook savings in partial recognition of the high degree of liquidity possessed by these accounts. Other rates are scaled upward as maturities lengthen.

In the case of MSB's and S&L's, the passbook rate is set at 5.00 per cent, and for other types of instruments the range is from 5.25 per cent to 6.00 per cent for deposits of 2 years and over.^{3/} The spread favoring S&L's and MSB's (0.50 percentage point on passbook accounts and 0.25 percentage point on other instruments) is intended to adjust for the inherent advantage commercial banks have in attracting savings and time account customers.

While a great deal of attention has focused on the interest rate ceilings in the last five or six years, the ceilings affecting commercial banks have been in effect for over 36 years. From January 1, 1936, until January 1, 1957, the maximum rate payable on savings deposits and on time deposits with maturities of 6 months or more was unchanged at 2-1/2 per cent. Time deposits of 90 days to 6 months had a maximum rate of 2 per cent, and those of 30 to 89 days had a ceiling of 1 per cent. In 1957, all of these rates were raised by 1/2 percentage point--except for the 30-89 day time deposit rate which remained at 1 per cent. This new schedule remained intact for five years--until January 1, 1962. From the latter date, the passbook rate remained at 4 per cent until January, 1970,

^{3/} The maximum rates for mutual savings banks are set by the FDIC, except in Massachusetts. For savings and loan associations, the ceilings are set by the Federal Home Loan Bank Board. Until September, 1966, that Board had no legislative authority to fix such rates.

when it was raised to 4.50 per cent. In contrast, the maximum rate on some form of time deposit was changed each year through 1968 (except for 1967).

Rationale for Interest Rate Ceilings

However, the real story of interest rate ceilings in recent years begins with a decision by the Federal Reserve Board in early December, 1965. At that time, the Board decided to raise the maximum rate payable on time deposits to 5-1/2 per cent for all maturities from the previous levels of 4 per cent on accounts of 30-89 days and 4-1/2 per cent on deposits of 90 days and over. In response to that decision, numerous commercial banks promptly posted higher rates in a vigorous effort to attract funds. While some of the increased inflow at commercial banks through the Summer of 1966 represented new savings as well as funds diverted from the securities markets, a substantial proportion was pulled out of S&L's by the higher rates offered by banks.

The intensity of this competition for funds among banks and other institutions led to the passage of legislation in September, 1966, granting authority to the Federal Reserve Board, the FDIC, and the Home Loan Bank Board to coordinate interest rate ceilings on deposits. These supervisory agencies promptly established a structure of rate ceilings that remained generally unchanged until January 1, 1970.^{4/}

^{4/} The ceilings set in September, 1966, were: 4 per cent on commercial bank passbook accounts and 5 per cent on their other consumer-type deposits; 5 per cent on all mutual savings bank deposits; and 4.75 per cent on regular accounts and 5.25 per cent on term accounts at savings and loan associations, with some geographical exceptions.

When maximum interest rate ceilings on deposits were first instituted for all three types of depositary institutions, the objective was to moderate the loss of savings funds suffered by the nonbank intermediaries. As already indicated, part of the loss represented their inability to compete with commercial banks for funds from a public increasingly aware of the rising alternative yields available on market instruments. In addition, another part of the loss simply represented direct shifts of savings accounts from all deposit-type assets to higher-yielding market instruments. Imposition of deposit rate ceilings coordinated for all three of the major savings account intermediaries could not insulate them from the relative attractiveness of current yields on market instruments. But the ceilings could--and did--protect the nonbank institutions from engaging in rate competition with commercial banks under conditions disadvantageous to the nonbank institutions. At the time, it seemed clear that--given the historically high level of market interest rates and the far greater responsiveness of commercial banks' earnings to current market yields--any effective effort on the part of nonbank depositary institutions to meet the interest rate competition exerted by commercial banks would have eroded seriously the financial viability of MSB's and S&L's.

In the short-run, the basic objective of protecting the nonbank depositary institutions by means of coordinating ceilings was the maintenance of stability in the financial sector of the economy.

Over the long-run, the aim was the continuation of relatively specialized institutions providing home mortgage credit.^{5/} In other words, the service to the public provided by these coordinated deposit rate ceilings was perceived as a relatively steady and ample supply of home mortgage credit available at more reasonable cost than would otherwise have been possible.

Market Competition and Deposit Flows

The impact of market yields on deposit flows at financial institutions--and indirectly the effects of yield differentials on the availability of home mortgage funds--is illustrated by the experience of the S&L's. To assist in that assessment, several statistical measures were calculated for each quarter for the years 1965-71:

- (1) the average offering rates on total S&L deposits (shown in Table 2);
 - (2) the differential between these average rates and the yields on 6-month Treasury bills; and
 - (3) deposit growth at S&L's.
- The results of these calculations (which cover several interest rate cycles) are shown in Chart I.* The bottom panel of the chart (tracing the excess of S&L deposit rates over Treasury bill yields) represents the relative attractiveness of S&L claims compared with market instruments.

^{5/} Behind this rather explicit statement, other--perhaps more subtle--reasons also helped to form the basic rationale for setting the coordinated ceilings. Free competition on deposit rates would no doubt have led to the failure of some large nonbank depositories, particularly given the nonliquid state of many of them in the Fall of 1966. Any such occurrences would have further destabilized financial markets already suffering from considerable uncertainty. Moreover, evening-out the sectoral impact of restrictive monetary policy by some convenient method was desirable to permit policy to focus more on aggregate conditions less encumbered by inherently unstable sectoral conditions.

*Charts I and II follow Table 5.

In the top panel of the Chart is shown the parallel quarterly rate of growth in deposits at these institutions.

In general, the parallelism between S&L deposit growth rates and the relative attractiveness of the instruments offered by S&L's is striking. The inflow tends to accelerate when the yield spread turns in favor of (or becomes less unfavorable to) S&L deposits-- compared with the rate of return available on alternative outlets for short-term balances. Of course, the observed pattern reflects the expected response of wealthholders to changes in comparative yields.

On the other hand, close inspection of the Chart indicates that the general parallelism between deposit growth rates at S&L's and relative yields is not perfect, nor is it repeated exactly cycle after cycle. For instance, a decline to a near-zero quarterly growth rate in deposits occurred during both 1966 and late 1969. However, the earlier experience was accompanied by an adverse yield spread of less than 100 basis points--while the latter was associated with a nearly 300 basis point adverse yield differential. More recently, during the third quarter of 1971, deposit growth was maintained at historically high rates--even during just that part of the quarter preceding the New Economic Policy in which the yield spread had actually become adverse to S&L claims.

One development which may have helped thrift institutions to maintain deposit growth in the face of adverse changes in yield spreads is the sizable increase in accounts with minimum term requirements. These accounts currently represent about 45 per cent of total S&L claims and about 20 per cent of mutual savings banks' deposits. Prior to 1970, the proportions were insignificant. The restrictions in these accounts limiting withdrawal prior to maturity-- or the penalty costs imposed where any withdrawal is possible--imply that shifts prior to maturity either would not occur or would tend to occur only if the financial gains from shifting would more than outweigh the penalty costs.^{6/}

Moreover, with the considerable increase in term accounts, existing passbook account holders may now be a more homogeneous group. Correspondingly, existing passbook account holders are no doubt far less interest-sensitive than those prior to the January, 1970, rate ceiling changes that established the present term account structure. Prior to 1970, passbook account holders manifested varying and often, in the aggregate, contradictory motives for maintaining those assets; some persons used them to store contingency funds, others as a risk-free investment, and others--at least at times--as the highest yielding of all generally comparable available financial alternatives. Since

^{6/} In other words, on minimum term accounts where withdrawal is possible with a penalty payment, the implication is that the yield spread required to elicit a shift would have to be larger than that required to draw funds from a simple passbook account, the difference being the discounted value of the penalty.

those accounts were in effect demand claims, when there was a significant change in their yields compared with yields on other types of assets, there occurred a corresponding--and rapid--shift in flows. Since the 1970 rate ceiling change, however, there have been sufficient internal shifts of funds at depositories so that the remaining passbook account holders may no longer be especially responsive to changes in market yields. They either have predominantly non-yield motives for holding those claims (such as the desire for a safe contingency fund) or they register little effective demand for other financial assets because their individual balances are too small.

Finally, there may also have evolved a more advanced stage of sophistication among depositors in thrift institutions--reflecting their earlier experience with switching from thrift claims into market securities. Perhaps they now know--if they did not know the first time they shifted out of deposit claims into market instruments--that there are real and sometimes considerable costs that also must be absorbed. Costs associated with market securities would include costs of safekeeping, absorption of market risk in the price or liquidity of the acquired asset, absorption of credit risk on some instruments, as well as transaction costs. In fact, these latter costs have increased (particularly with respect to Government securities) as many banks and securities dealers imposed charges for the first

time during the 1969 period when there was an extraordinary volume of individual activity in that market. This recognition of costs-- or more widespread recognition--would suggest that market yields now would have to be higher than deposit rates by a clearly compensatory amount to merit switching.

Discriminatory Consequences of Interest Rate Ceilings

At this point, we can turn to a consideration of the inequitable effects of interest rate ceilings. As indicated above, the imposition of these ceilings did produce some public benefits. Yet, these benefits to the public were obtained at some costs to the public--costs which arose directly from the existence of deposit interest rate ceilings themselves. Because of these ceilings, financial and real resources were prevented from being fully responsive to prevailing demand and supply pressures. Let me stress, however, that these costs were recognized fully at the time ceilings were imposed. But on balance the ceilings were seen as necessary to achieve the larger goals of helping to protect secular and cyclical stability in the home mortgage market. One of the important costs involves the public's foregoing the difference between the ceiling rates and competitive (normally higher) deposit rates which the market would otherwise have determined. This loss of interest does not accrue uniformly, or proportionately, among different groups. The loss tends to have a regressive impact primarily because individuals and households with small savings balances have

few options with respect to earning assets among which they can choose. In fact, their range of choices was further restricted by action taken in February, 1970, by the Federal Government raising the minimum denominations of Treasury bills and Agency issues from \$1,000 to \$10,000. Thus, while depositors with larger balances may effectively weigh the market yield differentials against the generally greater safety, liquidity, and convenience of deposit claims, account holders with smaller balances do not have those alternatives available.

The resulting inequity would by definition be less pronounced if the benefits accrued among groups symmetrically with the loss of interest. There are two main groups that are the prime beneficiaries of below-market deposit ceiling rates: (1) the owners of the institutions operating under these ceilings and (2) the recipients of home mortgage money made available through the protection afforded by the ceilings. For the most part, these beneficiaries are not the same persons as those who lose interest on deposits--at least not contemporaneously.

The factors which might produce this divergence can be traced more fully. Taking the two groups of beneficiaries separately, one should focus first on the profit position of the institutions operating under protective deposit rate ceilings. To the extent that coordinated ceilings keep deposit rates below what they would have been in the absence of restraints, the cost of funds used by the institutions is kept artificially low. If the yields earned by these institutions would have been the same regardless of the presence or absence of deposit rate

ceilings, the artificially low cost of funds created by the ceilings produces a "surplus" or private "subsidy" that accrues to the owners of the institutions.

Secondly, in attempting to identify the presence (or size) of a deposit-ceiling surplus, it is necessary to determine whether the returns on investments held by the financial institutions vary in a fashion that is parallel to the differential between a market-determined deposit rate and the ceiling rate. In other words, if a private subsidy is produced by the insulation of the depository institutions from inter-industry competition, at least part of the windfall gains of the financial intermediaries would probably be passed on to borrowers in the form of mortgage interest rates below those which the market would normally generate. The rate ceilings clearly have shielded those institutions specializing in home mortgage lending. Moreover, the evidence suggests strongly that part of the benefits have been passed on to home buyers in the form of a greater volume of funds--which the borrowers got at below market rates.

Benefits of Interest Rate Discrimination

This logical case for the existence of costs and benefits of interest rate discrimination is also supported by the available statistical evidence. The first portion of this evidence is contained in Table 2, showing the relationship between the average interest rate on conventional mortgages written against new homes and the average rates offered by S&L's during the years 1964-71. It should be

noted that the margin between mortgage yields and rates paid by S&L's widened significantly after the imposition of coordinated rate ceilings in late 1966. This increase in the yield spread--on its face--suggests that these institutions gained significantly by realizing a larger "markup" between their cost of funds and the returns on available new investments. Furthermore, one can attribute a sizable proportion of the higher markup to the impact of the ceilings in an environment of generally high market interest rates that prevailed through 1970.

However, there is reason to believe that, during the period since 1966, the markup was actually smaller than it might otherwise have been without the deposit rate ceilings. It is clear that since 1966 home mortgage interest rates have behaved in a most unexpected manner relative to other long-term capital market yields. As Chart II shows, the differential between current interest rates on home mortgages and yields on both income-property mortgages and corporate bonds has changed drastically. Prior to 1966, home mortgages actually carried an interest rate consistently higher than that on corporate debt. Similarly, the differential was fairly narrow--but steady--between home mortgages and those on multifamily and commercial properties. Since 1966, it is dramatically clear that home mortgage interest rates did not keep pace at all with the size of the increases in these other long-term interest rates. To some extent, of course, state usury ceilings were a limiting factor on the size and rapidity of the rise

of at least some home mortgage rates. But even in states where usury ceilings posed no constraint, the general pattern still prevailed.

Given this evidence, it is reasonable to conclude that deposit interest rate ceilings affecting the dominant suppliers of home mortgage funds might have played some role. If one is to argue that coordinated deposit ceilings were successful in stabilizing flows to the nonbank institutions, then the implication is that they received more lendable funds than they would have in the absence of the ceilings. Since S&L's particularly have little alternative but to lend on home mortgages, it might be that the unusually low home mortgage interest rates during that period can largely be traced directly to the impact of the success of deposit ceiling rates.

By extension, then, home mortgage borrowers during the period since 1966 also benefited because their borrowing costs were kept lower than previous yield relationships would have suggested. As indicated earlier these latter benefits accrued primarily to middle-income borrowers who purchased homes in the suburbs.

Relative Growth of Suburban Housing

The impression that suburban homeowners shared appreciably in the benefits provided by interest rate ceilings also gains support from the statistics relating to homebuilding activity. Ideally, to trace the tempo of homebuilding in suburban areas compared with the pace in central cities, one should have data showing the distribution of

housing starts between the two locations. Unfortunately, that information is available for metropolitan areas as a whole--and not for the suburbs and central cities separately. However, data relating to private building permits for new housing units do distinguish between central cities and suburban areas, and these can be used as a rough proxy for new starts.^{7/} These data are shown in Tables 3 and 4.

As these statistics indicate, the central cities' share of new housing production edged down slightly during the period 1962-67 while the suburban share rose somewhat. In 1962, the suburban areas of metropolitan areas (SMSA's) accounted for 60 per cent of the number of permits issued, compared with 40 per cent for central cities. By 1967, the suburban share had climbed to nearly two-thirds of the permits issued in SMSA's, and the central cities' share had shrunk to just over one-third. In terms of the value of new housing units, roughly the same pattern was evident.

^{7/} When using permit data as a proxy for housing starts, several limitations must be noted. These include: (1) Data on housing units authorized by building permits relate to the time of permit-issuance rather than to the actual start of construction. (2) Data on building permits currently cover 13,000 permit issuing localities. However, data on private housing starts cover all areas in the U.S., including those not covered by building permit systems. According to Census Bureau estimates, about 86 per cent of all private housing units were constructed in permit-issuing places in 1970. (3) Private housing starts include farm housing units, but permit data are treated as nonfarm although a negligible number of permits are issued for units located on farm properties. (4) Neither starts nor permit data include mobile home shipments. (5) Central city permit data first became available in 1962.

Beginning in 1968--a year in which the nation's housing goal was established and in which the landmark Housing and Urban Development Act was passed--the distribution of homebuilding activity between suburbs and central cities has remained essentially unchanged. However, in 1970, there was a temporary upsurge in central city activity as a result of a substantial increase in the production of subsidized units--particularly of units launched under Section 235 and 236 of the 1968 Act.

Of course, the long-term movement of population from central cities to suburbs would account for the bulk of the increased demand for mortgage funds in the suburban parts of metropolitan areas. But the central point made here still seems to hold: homebuilding in response to the middle-income suburban demand has been a special beneficiary of below-market rate mortgage funds made available by S&L's--which in turn could tap savings flows at a below-market cost of funds made possible by the existence of ceilings on the maximum rates of interest payable on deposits.

National Housing Goals: Targets and Performance

In a basic sense, the recent pattern of homebuilding--financed in the main by a flow of funds substantially insulated by interest rate ceilings--is not wholly consistent with the national housing goals established by Congress in the Housing and Urban Development Act of 1968. The targets set called for the production of 26 million new and rehabilitated housing units over a 10-year period

ending in 1978. As part of the 26 million unit goal, Congress specified that 6 million units (5 million new units and 1 million rehabilitated units) were to be provided for low- and moderate-income families. To promote this end, Congress established the Section 235 and 236 subsidy programs in the same Act.

Although there were no specified urban-suburban quotas established to dictate where the subsidized low- and moderate-income units were to be constructed, it was evident that the Congress expected to see a significant expansion in the housing supply in the inner-city. In the first place, the 1968 Act was passed following the 1966-1968 urban disturbances, and it was intended to meet one of the identified causes. In addition, the legislative history of the various housing Acts clearly reflects the intent of Congress to stimulate the construction of low- and moderate-income housing in the inner-city, particularly in connection with urban renewal programs.

In practice, housing production (which includes mobile homes) has had a mixed performance with respect to the stated goals, allowing for the fact that these have been raised as underlying conditions have permitted closer approximation of the decennial average. As shown in Table 5, during the fiscal years 1969-72, total production is estimated to have exceeded the goals by 8 per cent. The actual achievement has run ahead of the target in each year since 1970. In 1969 and 1970, a barely noticeable short-fall occurred--undoubtedly a reflection of the severe restraint on credit availability in that period. The total production

of housing is estimated to have exceeded the goal by 12 per cent in fiscal year 1971 and by 20 per cent in 1972.

However, when production of subsidized and unsubsidized units is examined separately, a divergent trend is evident: the output of subsidized units (intended to ease the housing problems of low- and moderate-income groups--particularly in central cities) has fallen behind schedule in three of the four years. Only in 1970 did subsidized production run ahead of schedule. In fiscal 1971, it dropped to 95 per cent of target, and in fiscal year 1972, production is estimated to have dropped further to 72 per cent of the objective. Within the subsidized units, the short-fall has been especially noticeable in the case of rehabilitated units. For the first four years of the national program, the supply of refurbished subsidized units was running at roughly two-thirds of the target. The supply of new subsidized units over the same period was about 8 per cent below target. However, this outcome was attributable primarily to the strong showing recorded in 1970. In the current fiscal year, production of new subsidized units is expected to reach only 73 per cent of the stated target.

In contrast, the production of unsubsidized units has met or surpassed the target in three of the four years ending in fiscal 1972. In the current year, total output in this sector is expected to exceed the goal by more than one-third--with new construction running ahead of target by two-fifths and mobile homes by one-fifth. For the four

years combined, it is anticipated that unsubsidized units may exceed the goals by 13 per cent. For new construction, output may surpass the target by 17 per cent, and for mobile homes the excess may be about 3 per cent.

Again, while focusing on the issue from a different perspective, these data also lend weight to the central theme of the argument presented here: our traditional approach to financing housing--based essentially on the mobilization and rechanneling of savings by S&L's and other depository institutions--is not ideally suited to meet the needs arising from the new priorities as they were recast in the Housing Act of 1968. If we are to attain those goals--particularly as they relate to low-income families in central cities--we will require a significantly enhanced effort by the Federal Government.

In the face of this prospect, I was personally distressed considerably by the recent disclosures of misconduct of public officials and private individuals involved in the Federally-supported programs undertaken with funds provided under Sections 235 and 236 of the 1968 Housing Act. I was equally distressed by the reported reactions of some of the top Federal Government officials with responsibility for the programs. At a distance, of course, I have no way of making an independent assessment of the difficulties associated with the subsidized housing effort. Yet, the need for the programs is clearly evident. Thus, I believe personally that it would be preferable to concentrate on discovering--

and punishing--the criminal elements--if any--that may have infiltrated into a small part of the overall effort--rather than to scrap the entire approach--as I understand some persons involved in the program are recommending.

Reconstruction of Savings Institutions

The problems surrounding the present subsidized housing program are mainly short-run--although the exceptional risks inherent in homebuilding in the inner-city are not likely to disappear in the near-term. In the long-run, I believe that we as a nation will have to revamp our savings intermediaries to enable them to serve our present and future requirements--rather than to serve past purposes which are no longer pressing. And on this agenda of change, the elimination of interest rate ceilings ought to have a high place.

As I have stressed several times, coordinated deposit interest rate ceilings were viewed as a practical means of protecting a sector of the economy during a period of high or rapidly rising market interest rates. I personally shared that view. At the time these ceilings were imposed, there was a general recognition of the price that would have to be paid because of the inequities involved. But on balance, that price was generally seen as acceptable. But that decision was made in the late Summer of 1966--nearly six years ago. In the environment that has now emerged, there no longer seems to be the need for the protection afforded by these ceilings. In my judgment, their costs now outweigh the benefits they can provide.

In the first place, current market interest rates against which deposit claims must compete are considerably below ceiling rates. Thus, for the most part, the ceilings currently are no practical constraint on the rates depositories would have to offer to attract funds. This conclusion is strongly implied by the currently large volume of inflows in response to interest rates at--or below--the present ceilings. In addition, the nonbank savings institutions are now in a much sounder financial position than they were in 1966 when they had to face rapidly rising competitive interest rates. They have had the intervening years to acquire high-yielding assets, and the results are quite visible. For example, the average gross return on S&L's mortgage portfolio increased from 5.79 per cent in 1965 to 6.38 per cent in 1970.

More importantly, savings institutions have undergone a noticeable restructuring of their deposit claims, and the result has been an increase in their resistance to interest rate competition. For instance, as mentioned above, accounts with minimum term requirements have grown from insignificant amounts five or six years ago to over two-fifths of S&L's deposit claims and to about one-fifth of mutual savings banks' deposits. Finally, the nonbank institutions have been granted (or have more fully utilized) broader alternatives with respect to both their sources and uses of funds. Among these, advances from the Federal Home Loan Bank Board now offer far more options as to maturity and prepayment features than was the case in the past. These advances have provided an important source of contingency funds--not

just for S&L's but also for a small but growing number of member mutual savings banks. More generally, the latter institutions have diversified their asset portfolios greatly since the mid-60's--most dramatically by acquiring large volumes of corporate securities. Savings and loan associations have been granted wider authority to make shorter-term loans for purposes such as education, mobile homes, and short-term construction financing.

In this changed environment, deposit interest rate ceilings begin to ~~assume~~ costs disproportionate to the benefits. These costs encompass considerations both of equity and efficiency.

As stressed above, the impact of coordinated rate ceilings is to limit the maximum return available on deposit claims, but the benefits that result from this limitation do not necessarily accrue to depositors. Thus, those individuals who choose deposit claims--for reasons of safety, convenience, liquidity, lack of alternatives, or similar motivations--are restricted from receiving the benefits (including higher yields) that can result from interest rate competition. Given the competitive structure into which coordinated ceilings have frozen the depository institutions, the public's deposits are attracted to a considerable extent by such ancillary devices as give-aways and location of branch offices. The depositing public's loss is reflected in a corresponding gain--which is variously divided (depending partly on the prevailing level of capital market yields) among home mortgage borrowers and the owners or managers of depository institutions.

By effectively eliminating price competition, rate ceilings actually force savers to subsidize the cost of deposit funds to intermediaries. As a by-product, the less efficient institutions are insulated from the market pressures normally generated by price competition on the part of thriving firms. Consequently, pressure on these less efficient firms to restructure their asset composition, to cut operating costs, or to otherwise become more efficient is dampened considerably. In the long run, this kind of protection is self-perpetuating, for the weaker firms remain weak and in need of continued special attention in order to survive.

If there were no other constraints--such as those that might be imposed by considerations of monetary and fiscal policy or factors related to wage and price controls--I believe that in the current environment rate ceilings could be eliminated. Of course, they would have to be phased out gradually to minimize disruption of capital markets, and particularly of the home mortgage market. But to forestall the need to reimpose ceilings if interest rates were to increase during some subsequent period, the nonbank institutions would need further restructuring--if they are to have the earnings flexibility needed to meet strong rate competition in the long-run. This basic restructuring would encompass a further diversification in both the nature and the term structure of their assets. In addition, perhaps further progress could also be made in the already striking diversification in the term structure of their claims.^{8/}

^{8/} This general theme and specific suggestions, of course, have been stressed many times by others as well--most recently by the President's Commission on Financial Structure and Regulation--known widely as the Hunt Commission.

Concluding Observations

Before concluding, one remaining question should be raised: how would the savings institutions respond in an atmosphere of freer price competition and wider asset choices. Specifically, would savings institutions--less encumbered by restrictive asset choices--be more active in providing funds not just to finance housing in general but to finance housing for low and moderate income groups--especially in central cities? There are two important reasons to believe that--left to themselves--they would if anything allocate less money to this high priority goal. In the first place, part of the restructuring that would be necessary for S&L's especially to remain viable in a world without ceilings would involve a significant increase in the percentage of their assets carrying short maturities, so that their average portfolio returns would be more responsive to changes in current interest rates. Secondly, with fewer restrictions, one would expect the institutions to respond even more fully than they currently do to relative yields--once the differential risks involved in central city lending are taken into account. Moreover, there has been strong indication that the net yield (adjusted for risk) on many of the loans in central cities is far below what would be indicated by simple contract interest rate comparisons.

In fact, the observed behavior of the private financial institutions to date suggests that--to meet some of the social goals inherent in inner-city lending--they have had to set aside a specific portion of their portfolio to be channeled into assets carrying

above-average risks. This behavior represents an attempt to override simple risk/return calculations in order to expand the supply of funds to areas with a high social priority--but which are economically unprofitable. Without these special programs, it seems clear that funds would not have been allocated to this kind of lending. The expected future return simply was too far below that which could be earned on other kinds of loans or on properties located outside of the inner city.

That asset allocation behavior was probably affected (and then only marginally) by the existence of deposit rate ceilings in only one sense. To the extent that the ceilings kept the cost of funds artificially below the market cost of funds, the institutions could pass on part of that benefit by acquiring a larger portion of risky assets--similar to the way they in effect appeared to pass on the major share of this benefit to suburban home borrowers by operating with home mortgage interest rates lower than what they might otherwise have been.

In a world without deposit interest rate ceilings--particularly one characterized by strong demands for loanable funds--there is every reason to expect a general atmosphere of much keener price competition than now exists. Given that prospect--and in the absence of the umbrella afforded less efficient firms by the deposit rate ceilings--even greater weight would probably be given by lenders to relative expected yields as a determinant of asset allocations. Consequently, unless there were some way to improve the expected profitability of inner-city lending, the private allocation of funds to this sector could be expected to decrease.

For these reasons, while I favor removing interest rate ceilings at an appropriate time to lessen discrimination against small savers, I am also convinced that such a step would not improve the chances of attaining our national housing goals. On the contrary, those chances might actually be lessened. Thus, since the need to provide better housing for low- and moderate-income groups is still an urgent one, I am left with the conviction that we will require more-- rather than less--Federal financing assistance and other support for this purpose.

Table 1

Consumer-Type Deposit Rate Ceilings
(Effective January 21, 1970)
(Per Cent)

Type of Deposit	Interest Rate Ceilings		
	Commercial Banks	Mutual Savings Banks ^{2/}	Savings and Loan Associations ^{3/}
Passbook	4.50	5.00	5.00
30-89 day multiple maturity	4.50 ^{1/}	--	--
90 days to 1 year multiple maturity	5.00 ^{1/}	5.25	5.25
30 days to 1 year single maturity	5.00	5.25	5.25 ^{4/}
Multiple or single maturity certificates 1 year but under 2 years	5.50	5.75	5.75 ^{5/}
Multiple or single maturity certificates 2 years and over	5.75	6.00	6.00 ^{6/}

^{1/} Multiple maturity time deposits include deposits that are automatically renewable at maturity without action by the depositor and deposits that are payable after written notice of withdrawal.

^{2/} Massachusetts savings banks and savings and loan associations may pay up to 5.25 per cent on passbook accounts. Savings banks may pay up to 5.50 on accounts with a term of at least 90 days. Longer term accounts have the same ceiling shown above. (Effective August, 1970).

^{3/} Available in all states except note the above exception for Massachusetts S&Ls. The account paying 5.50 per cent in Massachusetts must carry a \$1,000 minimum and a minimum term of 180 days.

^{4/} 6 months to 1 year, \$1,000 minimum.

^{5/} \$1,000 minimum and 90-day penalty. Minimum may be waived to meet savings bank competition.

^{6/} \$5,000 minimum, 90-day penalty and 10 years maximum term. Minimum may be waived to meet savings bank competition.

Table 2

Relationship of Average Conventional Mortgage Interest Rates on New Homes
to Average Rates Offered by Savings and Loan Associations
(Per cent)

	(1) Avg. Conventional Int. Rate-New Homes- FHA Series	(2) Avg. Offering Rate on S&L Shares 1/	(3) Differential (1) - (2)
1964 - I	5.80	4.29	1.51
II	5.80	4.30	1.50
III	5.80	4.30	1.50
IV	5.80	4.31	1.49
1965 - I	5.80	4.32	1.48
II	5.80	4.32	1.48
III	5.80	4.32	1.48
IV	5.92	4.33	1.59
1966 - I	6.07	4.34	1.73
II	6.32	4.42	1.90
III	6.55	4.59	1.96
IV	6.68	4.71	1.97
1967 - I	6.52	4.78	1.74
II	6.45	4.79	1.66
III	6.53	4.73	1.80
IV	6.63	4.75	1.88
1968 - I	6.77	4.77	2.00
II	7.10	4.79	2.31
III	7.30	4.81	2.49
IV	7.32	4.83	2.49
1969 - I	7.60	4.84	2.76
II	7.83	4.85	2.98
III	8.18	4.86	3.32
IV	8.33	4.88	3.45
1970 - I	8.55	5.15	3.40
II	8.55	5.20	3.35
III	8.57	5.21	3.36
IV	8.42	5.21	3.21
1971 - I	7.77	5.23	2.54
II	7.63	5.23	2.40
III	7.83	5.24	2.59
IV	7.75	5.25	2.50

1/ Partially estimated by Federal Reserve Board staff.

Table 3

New Housing Units Authorized In Permit-Issuing Places
Number of Units (In thousands)

Year	Total	<u>Inside SMSA's</u> Total	In central cities	Per cent central city permits of total permits inside SMSA's	Outside SMSA's	MEMO: Private Housing Starts	Permits as a per cent of starts
10,000 Place Series							
1962	1,187	985	390	40	202	1,463	81
1963	1,285	1,059	406	38	226	1,610	80
12,000 Place Series							
1963	1,335	1,079	406	38	256	1,610	83
1964	1,286	1,035	380	37	251	1,529	84
1965	1,240	992	340	34	247	1,473	84
1966	972	775	264	34	197	1,165	83
1967	1,105	899	308	34	205	1,292	86
13,000 Place Series							
1967	1,141	918	308	34	223	1,292	88
1968	1,353	1,105	398	36	249	1,508	90
1969	1,324	1,074	386	36	250	1,467	90
1970	1,352	1,068	417	39	284	1,434	94
1971 ^{p/}	1,907	1,549	542	35	358	2,052	93

p = preliminary

Table 4

New Housing Units Authorized In Permit-Issuing Places
Valuation (In millions of dollars)

Year	Total	Inside SMSA's		Per cent central city permits of total permits inside SMSA's	Outside SMSA's
		Total	In central cities		
10,000 Place Series					
1962	13,438	11,161	3,988	36	2,277
1963	14,606	12,028	4,151	35	2,578
12,000 Place Series					
1963	15,213	12,288	4,154	34	2,925
1964	15,242	12,300	4,030	33	2,942
1965	15,385	12,411	3,783	31	2,974
1966	12,649	10,168	3,040	30	2,481
1967	14,509	11,829	3,471	29	2,679
13,000 Place Series					
1967	15,004	12,089	3,471	29	2,914
1968	18,319	14,947	4,517	30	3,372
1969	18,623	15,068	4,611	31	3,555
1970	19,169	15,170	5,351	35	4,000
1971 ^{p/}	27,870	22,536	6,943	31	5,334

p = preliminary

Table 5

Housing Goals and Production
(Thousands of units)

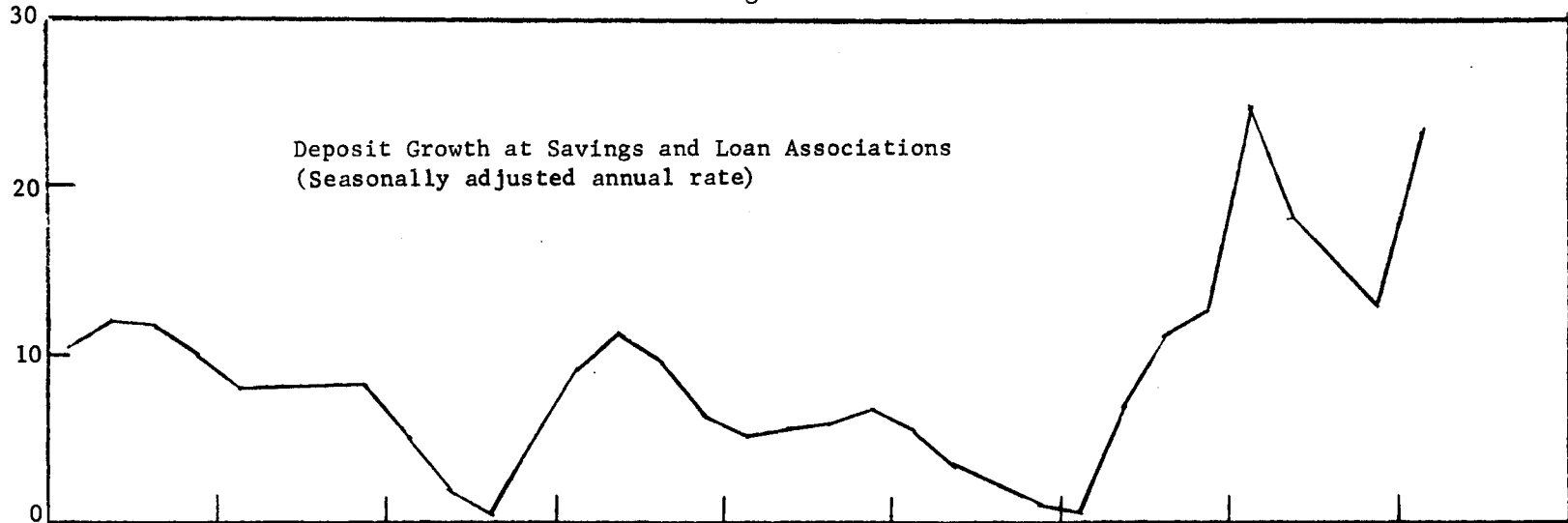
Fiscal Year:	Total Production	Subsidized Units			Unsubsidized Units		
		Total	New Construction	Rehabs	Total	New Construction	Mobile Homes
1969:							
Goal	2,001.0	198.0	155.0	43.0	1,803.0	1,440.0	363.0
Actual	1,997.2	191.6	162.9	28.7	1,805.6	1,436.9	368.7
% of goal achieved	99.8	96.8	105.1	66.7	100.1	99.8	101.6
1970:							
Goal	1,850.0	310.0	260.0	50.0	1,540.0	1,090.0	450.0
Actual	1,832.1	329.5	296.5	33.0	1,502.6	1,062.9	439.7
% of goal achieved	99.0	106.3	114.0	66.0	97.6	97.5	97.7
1971:							
Goal	2,040.0	505.0	445.0	60.0	1,535.0	1,060.0	475.0
Actual	2,275.7	479.8	438.8	41.0	1,795.9	1,358.8	437.1
% of goal achieved	111.6	95.0	98.0	68.3	117.0	128.2	92.0
1972:							
Goal	2,330.0	650.0	575.0	75.0	1,680.0	1,230.0	450.0
Actual ^{1/}	2,799.2	469.2	420.2	49.0	2,330.0	1,780.0	550.0
% of goal achieved	120.1	72.2	73.1	65.3	138.7	144.7	122.2
1969-1972:							
Total Goal	8,221.0	1,663.0	1,435.0	228.0	6,558.0	4,820.0	1,738.0
Actual ^{2/}	8,904.2	1,470.1	1,318.4	151.7	7,434.1	5,638.6	1,795.4
% of goal achieved	108.3	88.4	91.9	66.5	113.4	117.0	103.3

^{1/} Estimated by HUD
^{2/} Partially estimated by HUD

NOTE: All goal figures are those presented in the Third Annual Housing Goals Report, prepared by the Secretary of Housing and Urban Development, June 29, 1971.

Chart I
Yield Differential and Deposit Growth at
Savings and Loan Associations

Per Cent



Basis Points

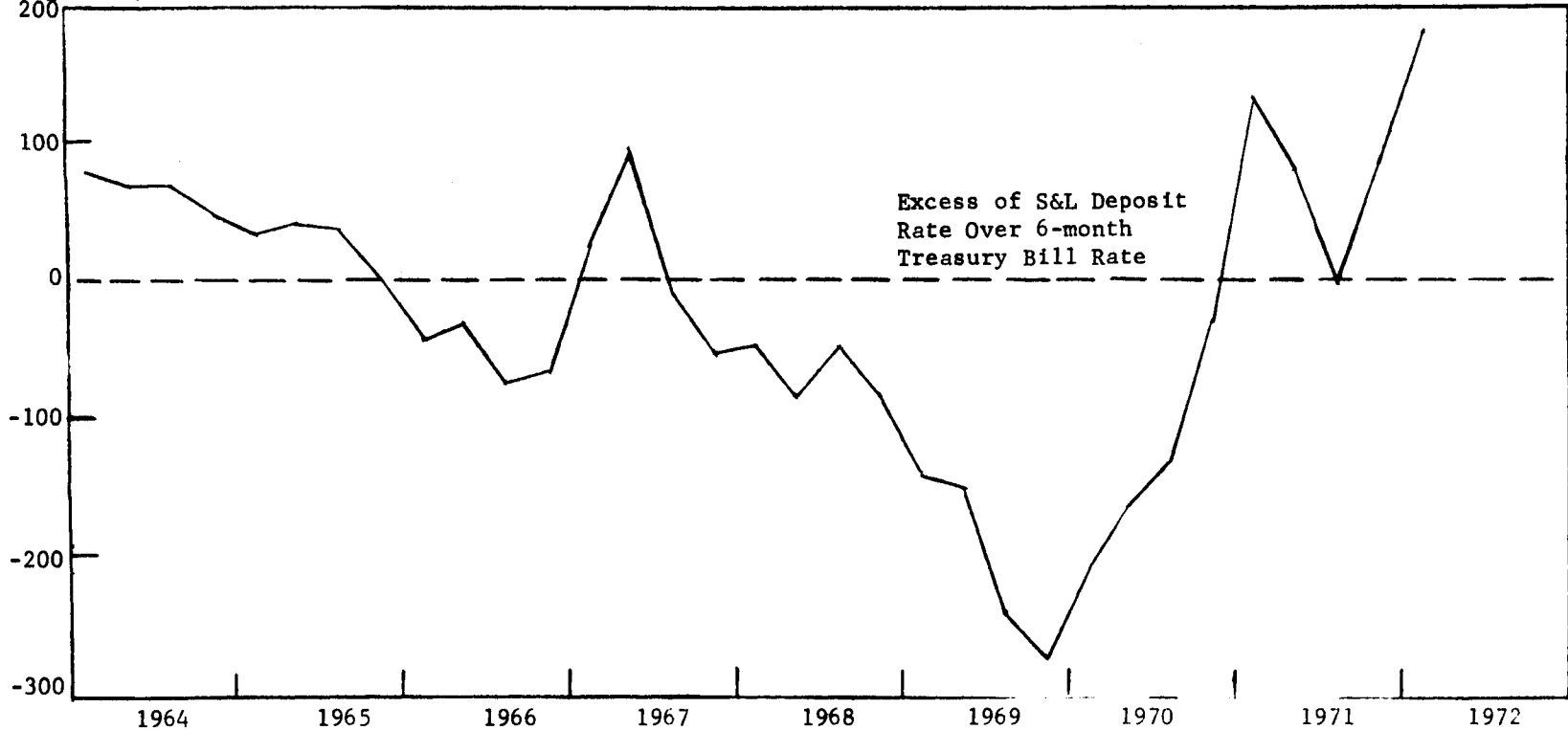
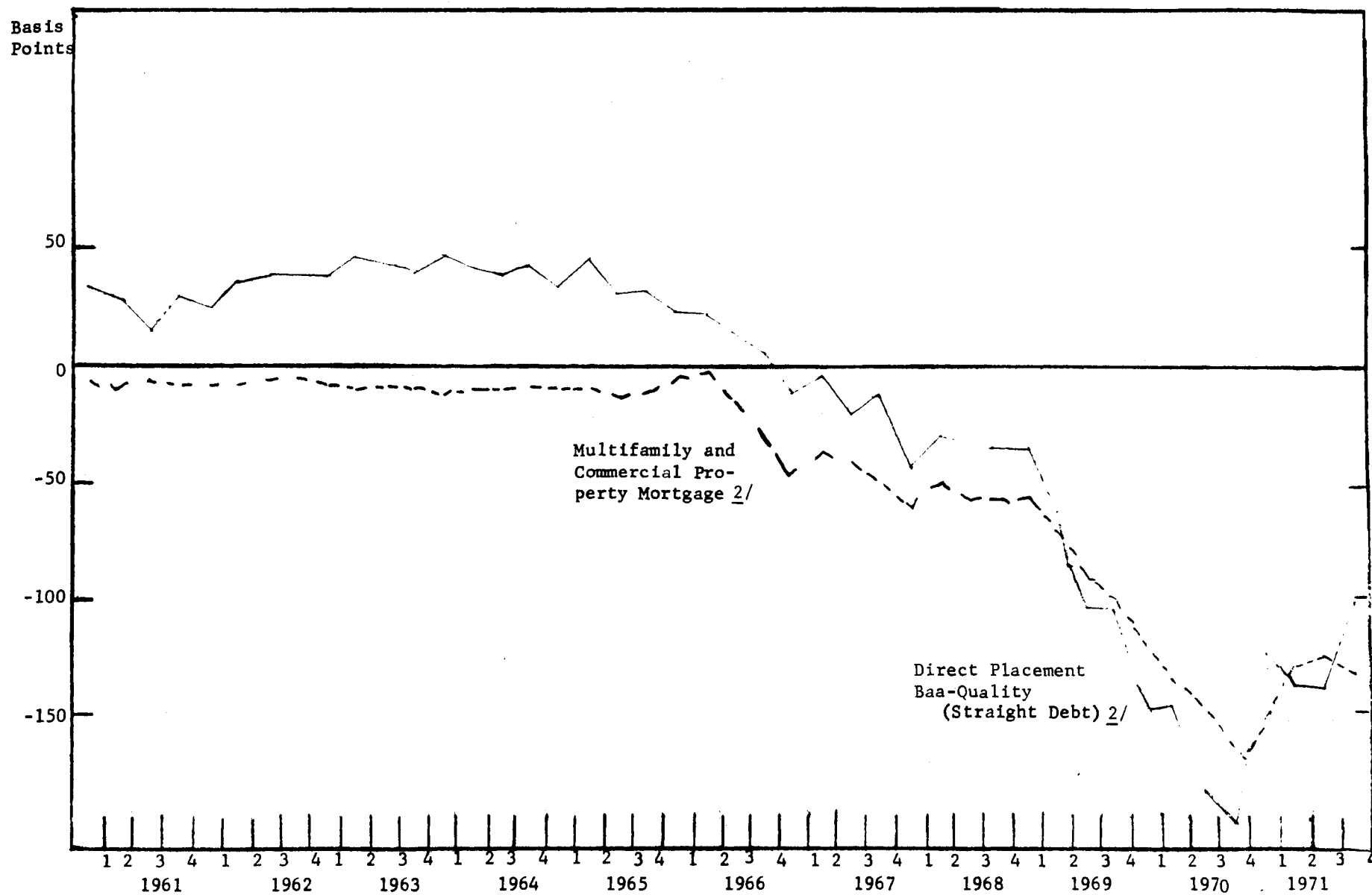


Chart II

Differentials Between Contract Interest Rates on Conventional Mortgages on New Single Family Homes 1/ and (1) Multifamily and Commercial Properties and (2) Corporate Bonds (In Basis Points)



1/ FHA Series (U.S. Average).
2/ Data for life insurance companies.