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Savings and the Price and Quality of Credit

Remarks of George W. Mitchell

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Savings and the Price and Quality of Credit

The American economy has been on a savings binge for about the past two years. A binge of special interest to you, I should say, because the most spectacular savings rise has been in the funds placed with financial intermediaries. From the standpoint of these institutions, investment of the expanded flow of funds has posed a major challenge to the skill and ingenuity of management, particularly since the demands for credit in the last year or so lacked a comparable buoyancy. It is a far different operating environment from that of the middle Fifties when problems of credit rationing were uppermost and lenders could pick their borrowers. Today, questions of credit quality are emerging and borrowers can be more choosey about their lenders.

Housing markets are also in transition. The days of waiting lists, materials bottlenecks, and other signs of a general seller's market have long passed in most areas. Selling the old house at a substantial capital gain in order to buy another one and upgrade one's housing standard is an opportunity that no longer knocks so loudly. Booms in home construction have given way to a new boom in apartment units.

These and other developments in our economy have produced shifts in outlets for investment, changes in sources for expansion, and new subjects to view with concern. Consequently, savings institutions--as well as mortgage bankers who participate as intermediaries in our nation's capital markets--are now confronted with tough policy alternatives. Both savings and investment are involved.

Economic growth, by which I mean a rising per capita output of goods, services, and voluntary leisure, has always been an implicit goal of the American economy. In recent years we have come to view some rate of achievement in this regard as an explicit national policy. But even with attention fastened on this objective, we seem to find an acceptable rate of growth more difficult to achieve than we did when it emerged as a result of doing what came naturally. As we look at growth analytically, it turns out to be quite a complicated process in a free enterprise economy. But we feel fairly sure that one of the requisites to growth, though not a sole requisite, is a high rate of saving. Meanwhile we have developed the most elaborate and pervasive arrangements for encouraging savings of any country in the world.

In the current situation, as I have pointed out, this aggressive promotion of savings is tending to create a surplus of funds relative to new investment opportunities. Maintaining a full portfolio of profitable investments under these circumstances calls for careful, continuing reassessment of the mix of policy alternatives available to investment managers. Such alternatives range from the promotion of traditional lending activities, through liberalizations of terms, reductions in credit standards, and markdowns in the price of credit, to a broadening of lending activities into new types of credit and new geographic areas. Of course, there is also the option of reducing the price paid for savings.

Pressures from a large supply of funds for investment are being felt in virtually all credit areas. But nowhere do the effects seem more pronounced than in the mortgage field, mainly because it is a market on which surplus investment funds are converging. This is hardly surprising considering that, measured in terms of annual net debt expansion, the mortgage market is by far the largest of all credit outlets. It also is a field well suited to institutional investment and one where institutions are the dominant factors.

Among the more diversified financial institutions once again moving more actively into the mortgage field are the banks and insurance companies. Commercial banks have had to cope with a mounting total of funds to invest as a result of their enhanced capacity to compete for time money, facilitated by the change in Regulation Q at the beginning of last year. Though they have placed large sums in municipal securities, consumer credit, and business loans they have also made a record volume of mortgage loans. Insurance companies have continued to invest heavily in corporate obligations and are making more foreign investments, but also have taken on rising amounts of mortgages. Savings and loan associations and, to a lesser extent, savings banks, in view of their more limited and specialized investment powers, have had little alternative other than to meet this competition head on.

The inevitable result has been the more intensive competition for mortgage outlets of all kinds. Yields and rates on home mortgages have been gradually declining for more than three years--the longest period of downtrend since the 1930's. Other lending fees and charges

have also been under downward pressure. Average loan-to-value ratios, loan amounts, and loan maturities on home loans have generally increased. There is widespread suspicion--and some evidence--that credit standards have given ground, too. Meanwhile, the investment base of lending has widened. Specialized mortgage lenders are making a greater variety of loans, and are participating more frequently in out-of-state lending.

These and other developments have been accompanied by record mortgage activity. Last year, lending on nonfarm homes, as reflected in mortgage recordings of $20,000 or less, exceeded $34 billion, a new high. Total mortgage debt outstanding increased by a record amount of more than $24 billion. Multi-family, commercial and other mortgage credit accounted for over $9 billion of this rise, reflecting the boom in such construction. But loans on 1-4-family properties, where no such construction boom occurred, also expanded by a record amount of more than $15 billion.

In view of the large increase in the volume of mortgage lending and borrowing--facilitated by the mounting savings flow to lending institutions--it is small wonder that questions about the quality of mortgage credit are in the foreground. And the general uneasiness in this regard has been augmented by signs of temporary overbuilding in some areas, talk of concessions in real estate prices and rents, and scattered reports of financial difficulties in some real estate ventures.

Credit quality is an elusive concept. It is frequently defined in terms of a number of symptoms. Deterioration in quality is often--and mistakenly in my opinion--considered to be synonymous with

liberalization in one or more credit terms. But quality of credit ultimately reflects the likelihood of repayment over the period and according to the original provisions of the loan. From this it follows that, at the time a loan is made, its quality--or likelihood of repayment as agreed--may differ greatly from what it may become at some later time as events change.

It is perfectly evident that loans of lesser quality can be safely made if the interest charge is sufficient to create an adequate reserve for losses. On this basis, even extremely risky loans can have a place in some investment portfolios. In a borrower's market, therefore, one of the alternatives available to the mortgage lender when rates are declining is to make riskier loans at established rate levels. But if he elects this choice he most certainly should not delude either himself or the investor he represents into believing that the default experience and after-loss return will be the same.

From a broader viewpoint, quality reflects the ability of borrowers to service a growing total of debt under prevailing and anticipated economic conditions. On balance, the record for the postwar years for the economy as a whole may be viewed as a demonstration of exceptional resistance to marked cyclical fluctuation. To the extent that this experience may be a portent of the future, it suggests that less risk may be involved than in prewar years in assuming larger debt burdens in relation to income flows and asset values. If we achieve our public policy objectives, inflation will not be the significant factor it was in lightening the burden of

mortgage commitments in the decade following the end of the war; neither will a depression like that in the 1930's undermine the general level of capital values now prevailing.

What has been the net postwar impact of more liberal terms upon the volume and price of new construction and of market transfers? What major changes have occurred during this period in credit terms on large residential properties and commercial developments? What has been the repayment, delinquency, default, and loss experience on these loans? What is the appropriate interest premium for varying degrees of risk? Answers to these questions are far from clear, and even opinions of market participants differ.

It is unfortunate that we must rely in many cases on rather fragmentary information about credit terms as well as lending practices and standards. Following experimental statistical studies at the Federal Reserve Bank of Chicago with the measurement of mortgage yields and associated credit terms, the Home Loan Bank Board has developed a new statistical series on conventional home loan terms and charges. These data will be available monthly on both a national basis and for major metropolitan areas, and are a commendable forward step in our economic intelligence in this field. These, and other efforts to extend our knowledge of changing terms and market conditions, I believe, merit the attention of all mortgage bankers in helping to provide the needed facts.

Mortgage Credit Terms

All in all, my impressions are that mortgage lending, particularly on homes, has come a long way down the road of credit liberalization over the postwar period. Doubtless, this trend has been spurred by the postwar needs for new residential construction, and by public policy decisions to stimulate the availability of credit to facilitate housing demand. Certainly, Government programs have been important factors in the liberalization of home-mortgage credit terms other than interest rates. As long as 13 years ago, if only for a brief period of time, 30-year no downpayment terms first became available on VA-guaranteed home loans.

Substantial liberalization has also occurred in the conventional home-mortgage area, partly for competitive reasons and partly because of the generally favorable FHA-VA experience. Liberalization in this area has continued into 1963, reflecting recent regulatory changes which have eased lending requirements for national banks and which would allow terms of up to 30 years and 90 per cent of value on a sizable proportion of savings and loan association portfolios.

The earlier liberalization of FHA-VA terms was accompanied by general inflation in land and home property values in the late 1940's and early 1950's, which certainly helped to minimize defaults and foreclosures. It is no secret, however, that in the past few years defaults and foreclosures have become more frequent, although their incidence is still well below prewar. Such problems, of course, have been more numerous where lending terms have been most liberal and where the economic environment has been least favorable. Today, both factors

are with us to a more pervasive extent than a decade ago. There is increased emphasis on liberal mortgage terms, while a slackened rate of economic growth has contributed to a proliferation of localized instances of economic difficulty. And housing markets are above all local phenomena.

In the private multi-family and commercial fields, information about loan terms and lending experience is more limited. This partly reflects the lesser role played by Government programs in such financing, even when allowance is made for FHA-insured projects. Also, until recently, multi-family and commercial construction was a small proportion of the total in most communities. But on FHA apartment projects, where reports are more readily available, default problems have developed in certain areas and in certain programs.

I think we are all aware of the caution signals blinking in real estate finance. For mortgage lenders, this means that close attention is being given to appraising the quality of existing loan portfolios, and in re-examining the adequacy of reserve positions. For mortgage originators, it means that particular care is needed in determining lending terms, in deciding on types of acceptable collateral, and in assessing credit risks. Fundamentally, it is the lender's judgment and on-the-site knowledge of a community's prospects and a borrower's creditworthiness that is the major defense against overliberalization of terms. Such decisions are made by thousands of lenders and their agents. In the aggregate, the recognition of their mistakes has an infinitely greater corrective impact on unwise lending than exhortation. Nonetheless, I believe

that you should be reminded that, for the custodians of the public's savings, our changing economic and real estate environment calls for both prudence and caution.

The Press of Lendable Funds

Calls for prudence are far easier to make than to follow at a time when competition for suitable investment outlets is intense and savings funds are still rolling in. The recent record of savings growth at financial institutions is dramatic indeed. According to the Federal Reserve Board's flow-of-funds estimates, more than $41 billion was added last year to holdings of deposits and savings accounts, insurance investments, and private pension reserves. This rise followed at $35 billion expansion during 1961, and compares with an average annual increase of only $22 billion from 1956 through 1960. The pressure to invest these new savings, of course, is in addition to the need to reinvest the rising volume of loan repayments associated with the greater dollar amount of debt outstanding.

Interest rate relationships clearly have played a part in the acceleration of institutional savings inflows. Thus, the relative attractiveness of saving through institutions as versus direct market investment has increased appreciably in recent years. This reflects mainly the higher returns and more favorable bases of computation offered by the institutions. As a result, the flow of individual saving has shifted in relative terms from the markets to the financial intermediaries. In addition, the total of financial saving has expanded substantially. The extent to which this may have reflected higher

returns on saving, in addition to changes in economic conditions and family motivations and aspirations, is a moot question.

Under conditions of a supply-demand imbalance for institutional funds, a reduction in the interest rates paid to savers is one policy alternative available to management. Recently, there have been some scattered announcements of reduction in rates on savings. But it remains to be seen how widespread, or how large, such reductions will be. It also remains to be seen to what extent a reduction in rates may retard the inflow of savings into financial institutions. Some funds might be diverted to other types of investment alternatives, depending on rate relationships, but motivations for accumulating savings depend on far more than rates alone.

Whatever the case for lower interest rates on savings accounts, it is possible to work on the other side of the balance sheet and to attract borrowers through lower interest rates on loans as well as through the further liberalization of terms. Here, too, there is some evidence that more vigorous rate competition is developing as the mortgage rate structure appears to have come under increasing downward rate pressure. The expectation, of course, is that lower rates, like more liberal terms, will encourage expansion in financing needs and a stepup in related investment projects.

In my view, this is an appropriate time for managements of financial institutions to consolidate gains already achieved and to lay the ground work for substantial future growth. In the past, the responsiveness of mortgage markets to the needs of construction and property financing has contributed importantly to our economic growth.

Looking ahead, the prospects for continued growth seem favorable. Demographic factors are propitious, to the extent that they become translated into effective demand. And to the degree we can achieve our expressed national objectives to encourage investment incentives and higher rates of employment and economic growth, the whole range of real investment requirements will grow.

As these larger prospective demands begin to materialize, expansion in private credit is likely to accelerate. The higher level of financial savings we seem to have achieved will then find outlets more easily. Meanwhile, institutions may continue to face a situation where their savings inflows tend to outrun the demand for funds. During this period, I would far rather see a balance achieved through changes in posted rates--both for loans and, if necessary, for savings--and through a more frequent acceptance of lower yielding investment substitutes, including Government securities. To continue matching demand against supply by lowering credit standards and stretching for yields would threaten, as I see it, a competitive devaluation of non-interest rate terms which may, in the end, result in damage to the industry and to the economy.

Finally, we should consider the question of whether the present state of the quality of credit has anything to do with monetary policy or if monetary policy has anything to do with it.

Taking the last question first, I think it quite clear that general monetary policy has had relatively little impact on the quality of the mortgages in lenders' portfolios. The contribution of monetary creation, as measured by currency and demand deposit growth, to the

$76 billion two-year rise in savings at all financial intermediaries was about 12 per cent. It was only 8 per cent of the rise in 1962. Had monetary policy been sufficiently contractive to remove the press of funds that became so apparent in 1962, I believe consequences for the economy would have been serious. The phenomenon we have witnessed--an upsurge in financial saving--stems from basic underlying factors that the range of responsible monetary policy could hardly have reached.

From this view it is quite apparent that I do not believe that general monetary policy, nor selective credit controls for that matter, should be used to deal correctively with the present problem. Such problems, to the extent they call for regulatory action, fall properly in the sphere of examination procedure rather than in the conduct of monetary policy. The slow growth in the medium of exchange relative to the rise in economic activity, even giving weight to some shift in the public's preference for holding interest-bearing liquid assets in lieu of demand deposits, suggests that monetary policy has been as much of a dampening influence as prudence would allow.

But another and better reason for not bringing monetary policy into the quality of credit issue is that the free enterprise-price system has the mechanisms built into it that are needed to solve a problem of these dimensions. The major mechanism is price--the price for savings and the price for credit. Changing these prices is what makes free markets function. It is a fact that sometimes seems hard to believe, and in some quarters is even harder to accept, but this equilibrating function is capable of performing equally well when prices are falling as when they are rising.

In the infinite number of problems confronting the day-to-day operation of the free enterprise economy, there are really very few that are sufficiently critical to require intervention in the public interest. I believe we all need to resist, somewhat, the impulse to add to this list.