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Monetary Restraints and the Flows of Funds to Savings Institutions

Remarks of George W. Mitchell

Member, Board of Governors of the Federal Reserve System

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The staff in the Federal Reserve System often presents economic data and analyses to policy makers on the Board of Governors and the Federal Open Market Committee in the form of a chart show. I find this technique indispensable to an adequate grasp of the quantitative background of many problems. It is especially appropriate to my topic this evening, so I have drawn heavily on the analytical and expositional skills of our staff for my presentation.[1/]

We are concerned with the vulnerability of financial intermediaries to monetary restraint and the role of ceilings in moderating that vulnerability. There is also the more basic problem of the adaptability inherent in various types of financial intermediaries to effective and continuing competition with the capital and money markets. We start with one chart on the background of relative growth by financial intermediaries.

1/ Especially James Kichline and Barbara Opper, of our Division of Research and Statistics, and Mack Rowe, of our Division of Data Processing.

The market for consumer savings deposits has changed dramatically in the postwar period. During the first decade, commercial banks did not actively seek savings accounts and the interest rates they offered consumers were significantly less attractive than those paid by other financial institutions. Consequently, the banks' share of the total stock of savings accounts declined.

Chart 1
Consumer Savings Deposits

By the mid-1950's, however, commercial bank attitudes began to change. With limited demand deposit growth and increasing loan demands, banks came under greater pressure to find additional sources of loanable funds. The market for consumer savings was viewed as an attractive source of funds and interest rates on deposits were raised. When Regulation Q ceilings were increased early in 1957, banks had the opportunity to compete actively for savings and time deposits. Through 1964, the more aggressive behavior of banks--accommodated by successive liberalizations of Regulation Q ceilings--resulted in banks maintaining their share of the rapidly expanding savings market.

But since 1964, the environment in which all types of depositary institutions have been competing has changed markedly. The level of interest rates has risen and the greatly expanded demand for funds by corporations, the Federal government and State and local governments has changed competitive relationships not only among savings institutions but between the institutions and marketable securities.

Economic activity advanced sharply in 1965 with expansion of the Vietnam involvement and an emerging capital goods boom. The resulting upward pressures on prices and costs, as well as burgeoning credit demands, called for a tighter stance of monetary policy, another important environmental shift.

<u>Chart 2</u>
Interest Rates

The brisk pace of economic activity and monetary restraint has been reflected in upward pressures on interest rates. These sharp increases in yields in 1965-66 and again in 1967-68 brought market rates far above those rates that most depositary institutions were willing or prudently able to pay on deposits.

<u>Chart 3</u>
Household Purchases of Market Securities

The public responded to these changed rate relationships by rechanneling a larger share of their funds directly to credit markets. Household purchases of market securities exceeded $10 billion in 1966, more than triple the volume of direct market instruments acquired the year earlier. With the downturn in market rates through part of 1967, households were net sellers of securities. But in 1968, as in 1966, interest rate relationships induced the public to acquire a sizable volume of market securities.

<u>Chart 4</u>
Rate of Growth in Savings

The counterpart of the public's increased acquisition of market securities is reflected in the slower growth of intermediary claims. Commercial banks, savings and loan associations, and mutual savings banks all experienced a decline in their rate of growth in savings during 1966. Inflows to all three institutions rebounded sharply in 1967, reflecting not only lower market rates but also such factors as rising personal income coupled with an extraordinarily high personal savings rate of 7.5 per cent. With rising market yields, inflows began to taper off again late in 1967, and conversely public purchases of market securities were large in 1968.

Chart 5
Patterns of Savings Growth

In part, the growth of consumer-type deposits at commercial banks was in some degree at the expense of nonbank claims--particularly before the introduction of coordinated rate ceilings in September 1966. Commercial bank performance was stronger relative to the thrift institutions largely because banks took advantage of the higher ceiling rates on time deposits that had been established late in 1965.

At the beginning of 1967, about one-fourth of the outstanding volume of consumer savings at commercial banks was in time deposits, offered at rates above those on passbook savings accounts. This was a much larger proportion than at either of the thrift institutions, which helps to explain the greater resistance of commercial bank savings patterns during 1966. Since that time, for the institutions with a differentiated rate-ceiling structure, these higher rate accounts have provided virtually all of total savings growth.

The ceiling structure for savings banks prevents them from offering special accounts at rates above the regular rate. Unlike the commercial banks and savings and loan associations, the savings banks have found their regular accounts to be important elements of their savings growth.

Chart 6
Yield Spreads and Savings Flows

In spite of the interest-awareness exhibited by the patterns of savings growth, and in spite of the sharp increase in consumer purchases of market securities last year, savings growth at the thrift institutions was quite stable in 1968. The relatively favorable 1968 inflows could not have been predicted on the basis of previous experience. Intermediary claims were at least as unattractive in 1968 as in 1966. The average rate offered by savings and loan associations was well below the 6-month bill yield during both years. Yet inflows did not decline as far as in 1966.

Several elements probably contributed to the maintenance of inflows during 1968. Although much of the large dollar flow of personal savings was invested directly in market securities, a fair amount invested in intermediary claims likely represented a liquidity haven from financial uncertainty, the surcharge, and the future course of the economy.

It seems probable, moreover, that the most interest sensitive depositors would not have been investing in intermediary claims throughout 1968; as early as the end of 1967, six-month Treasury bills were yielding 5.50 per cent, well above maximum ceiling rates. Thus, the depositors who remained during 1968--while interest-aware in their choice of accounts--probably had non-rate reasons for maintaining their savings allegiances. We are still not sure just how much savings flows are stabilized by such non-rate factors as convenience, safety, inertia, customer relationships, balance requirements for outstanding loans, lack of knowledge regarding alternative investments, and special liquidity features. But we have seen that the impact of monetary restraint and rising market yields on savings flows was substantially smaller than during 1966.

Credit and economic conditions influence the thrift institutions' lending capacity not only by way of savings flows, but also through return flows from existing investments. The optional portion of return flows from mortgage loans--prepayments in part or in full--has revealed itself to be both large and susceptible to disruption. The actual volume of combined savings bank and S&L mortgage repayments during 1966 was off by more than $3 billion from the 1965 pace. This, incidentally, was equivalent to one-half of the decrease in their savings inflows over the same period. More importantly, mortgage repayments still have not regained their pre-1966 vigor; during 1968 repayments to the thrift institutions were still about $2.5 billion below the 1965 rate, and only slightly above the depressed 1966 pace.

Chart 7
Gross Mortgage
Repayments

Total mortgage repayments also remain depressed in relation to mortgage portfolios. With mortgage portfolios growing, the flow of repayments would normally be expected to increase. But this return flow has not kept pace with earlier experience. During the 1960-1963 period, repayments averaged 15 per cent of mortgage portfolios. When this relationship is extended to 1968, the gap between projected and actual repayment flows continues to widen. In 1968, the difference amounted to $7 billion.

This pattern of mortgage repayments really creates a double-edged sword with savings flows, for instead of being complementary, the two sources of funds tend to be influenced in the same direction by the same forces. The high-interest rate conditions that ordinarily correspond to sharply curtailed savings flows also provide inducement for borrowers with existing (lower rate) loans to repay them as slowly as possible. Furthermore, as the availability of new mortgages is reduced, the volume of refinancing declines and the adjustment toward a higher level of earnings is retarded.

Thus, the patterns of gross flows into the depositary institutions influence their activity in two important areas. In the first place, new investment activity is related to actual and expected behavior patterns of savings and return investment flows, with short-run offsets available primarily from liquidity adjustments or borrowing. And secondly, new investment activity exerts an important short-term effect on earnings and thus on ability to pay high interest rates on claims.

Chart 8
Loanable Funds and New Mortgage Commitments

Although new investment activity is buffered in the very short run by both the backlog of existing commitments and short-run liquidity adjustments, new commitments are quite sensitive to actual and projected fund flows. New mortgage commitments were cut back sharply in 1966, and have just recently begun to approach their pre-1966 rate. In part, the profile of new mortgage commitments reflects the pattern in loanable funds determined by savings flows and mortgage repayments. Particularly in 1966 and 1967, when there were large fluctuations in loanable funds, the response of new mortgage commitments was really quite immediate.

Another important influence on new mortgage commitments is the structure of yields on mortgages relative both to bonds and to State usury ceilings, whereby the diversified lenders--the commercial banks and the savings banks--have allocated an important share of their funds into other investments. As a result of both constrained fund flows and unattractive mortgage yields, gross mortgage acquisitions now are running about 18 per cent of portfolio for the nonbank depositaries, down from 27 per cent in 1964. With the drop off in gross mortgage repayments, the resulting net addition to mortgage portfolios is now about 7 per cent, versus 11 per cent in 1964.

Chart 9
Return on Assets

Probably the most important point from the institutions' standpoint is the decreased gross activity in mortgage portfolios, not the lowered net acquisitions of mortgages. For this reduced gross activity implies that older loans, at low interest rates, are remaining on the books longer just when that kind of stability is least wanted. The Chart shows net earnings before income taxes as a per cent of average assets. The earnings profiles of the savings banks and the S&L's show the effect of the reduced portfolio turnover. With only 11 per cent of the existing mortgage portfolio of nonbank depositary institutions now being replaced each year, there is a sizable lag before average investment earnings begin to reflect the higher rates at which new loans are made. Earnings are estimated to have improved during 1968. Nevertheless, the savings banks and S&L's are caught in the classic squeeze: high and rising market interest rates, long-term portfolios, and short-term claims. The commercial banks' large shorter-term portfolio serves to insulate their earnings from swings such as these.

Chart 10
Incidence of
Ceiling Rates

The impact on nonbank institutions' earnings affects their ability to pay the higher rates on claims. Some firms have taken, in effect, a calculated risk that weathering the high rates required to attract savings is worth the short-term earnings drain in order to attract funds to acquire current high-rate mortgages. A rapidly-growing per cent of institutions are taking this approach. Of course, the earnings risk diminishes the longer the firm can invest at high yields while delaying a rate increase on its claims. But patterns of savings flows relative to offering rates indicate that there is real competitive need to pay high rates: since rate ceilings were instituted in the fall of 1966, savings inflows to S&L's have been sustained, on balance, by high rate special accounts, which received inflows while other accounts actually lost funds. Despite the implied leeway between offering rates and ceilings based on the number of institutions, it appears from the pattern of deposits that the institutions are really operating close to the ceilings. About 70 per cent of Federally-insured savings and loan share capital is at ceilings. At commercial banks, similarly, nearly all consumer type time deposits are at ceiling rates. Moreover, in the more interest-sensitive areas, the institutions are bumping against the ceilings: in California, all S&L's are offering ceiling rates on both regular and 3-year special accounts; and in New York State, virtually all of the savings banks have been offering ceiling rates for some time.

Conclusion

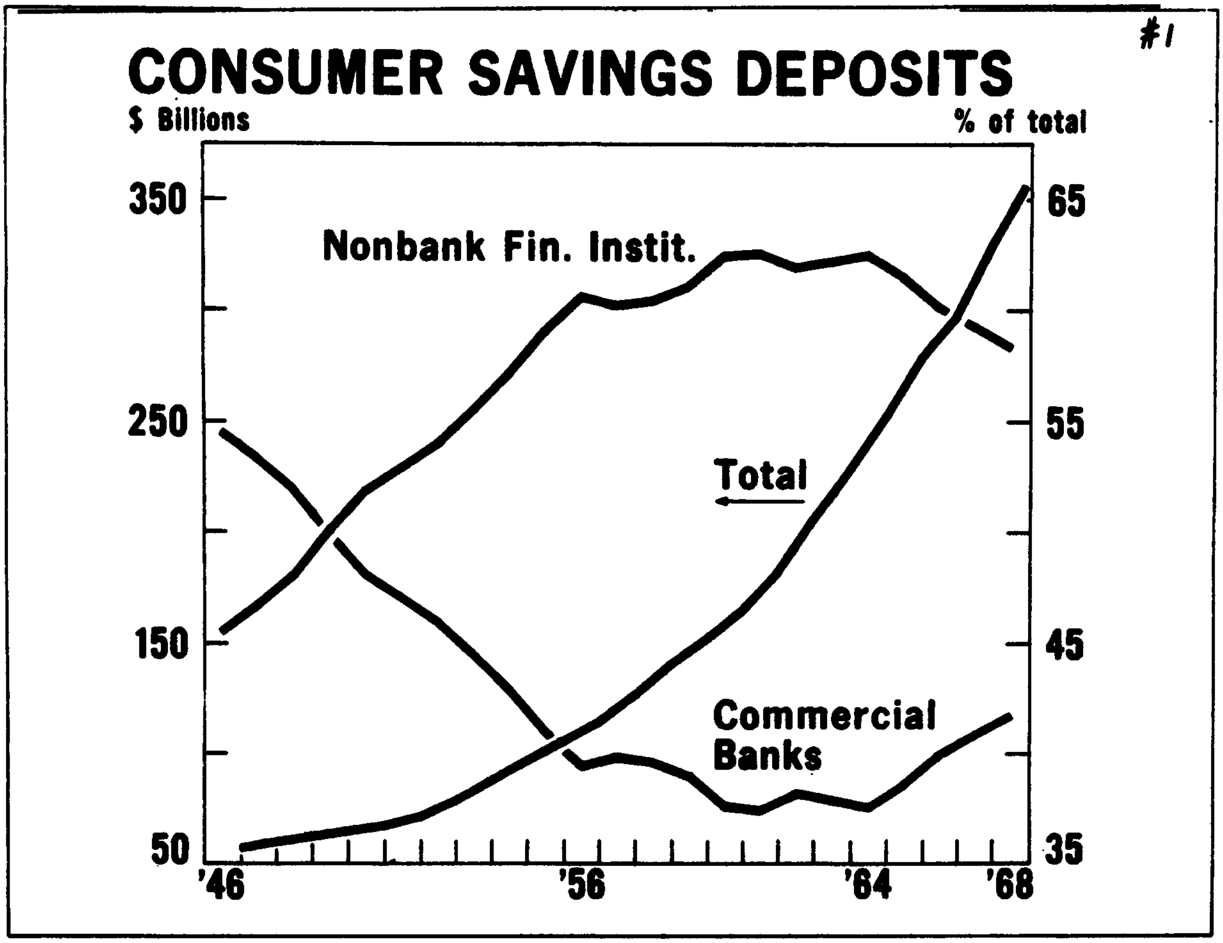
It is clear that coordinated rate ceilings alone are not sufficient to insure an adequate supply of funds to the residential mortgage market. During periods of restrictive monetary policy, funds to nonbank depositary institutions are reduced by a multitude of factors. A coordinated ceiling rate structure applicable to commercial banks as well as thrift institutions may temporarily mitigate inter-institutional competition and, thereby, stem potential drains of funds from one type of institution to another. But sheltering of this kind extended over too long a period of time has perverse effects because it constrains the ability of the institutions to compete, particularly with market securities. During both 1966 and 1968, funds diverted to market securities were substantial. Furthermore, factors not affected by ceilings, such as loan repayments, are vitally important in determining both investment activity and rate-paying capacity.

In the longer view the recent 1968 experience is perhaps more reassuring than disquieting--the super interest-sensitive money seems to be gone: it probably never belonged. We have seen a surprising element of stability in preferences for intermediary claims, I believe, due mainly to their liquidity and convenience features. Current experience suggests that a study of the needs and preferences of savers can be used effectively to tailor claims and instruments in such a way that whole strata of liabilities can be segmented into strong institutional allegiances where the pull of interest rate differentials is muted.

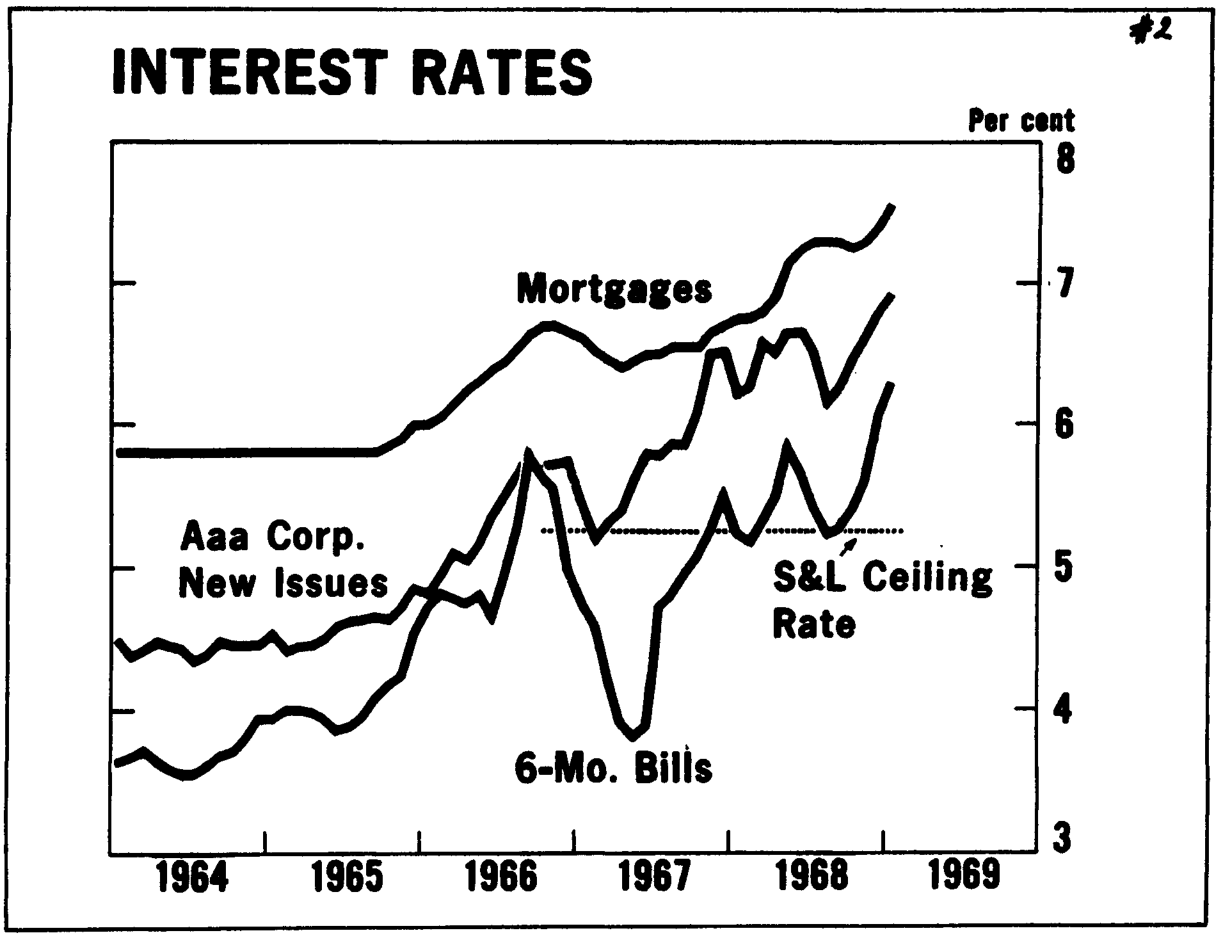
Finally, recent experience adds to the evidence pointing up the advantages to institutions that have access to a greater variety of the Nation's credit markets. They are less disadvantaged as the economy's resources shift to accommodate upsurges of demand from either consumers, business or government.

All in all, these past five years have been rich and varied in experience, however painful. Out of this "agony and ecstasy" much should be gained to strengthen intermediary institutions and to enlarge the services they can profitably provide to their customers.

#1

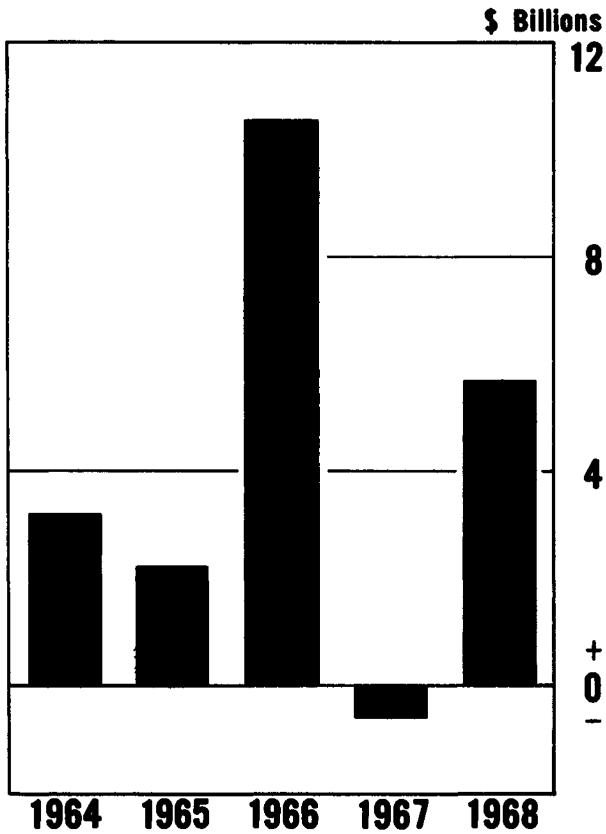

CONSUMER SAVINGS DEPOSITS
$ Billions
% of total
350
250
150
50
65
55
45
35
Nonbank Fin. Instit.
Total
Commercial
Banks
'46
'56
'64
'68

#2


INTEREST RATES
Per cent
8
7
6
5
4
3
Mortgages
Aaa Corp.
New Issues
S&L Ceiling
Rate
6-Mo. Bills
1964
1965
1966
1967
1968
1969

#3

HOUSEHOLD PURCHASES
OF MARKET SECURITIES



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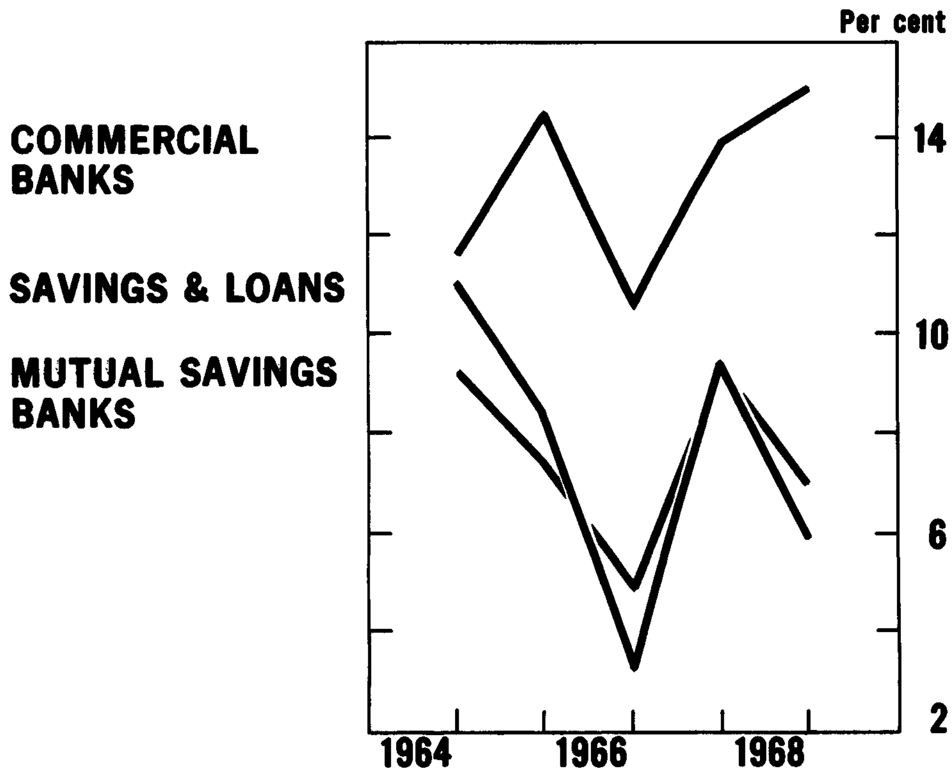
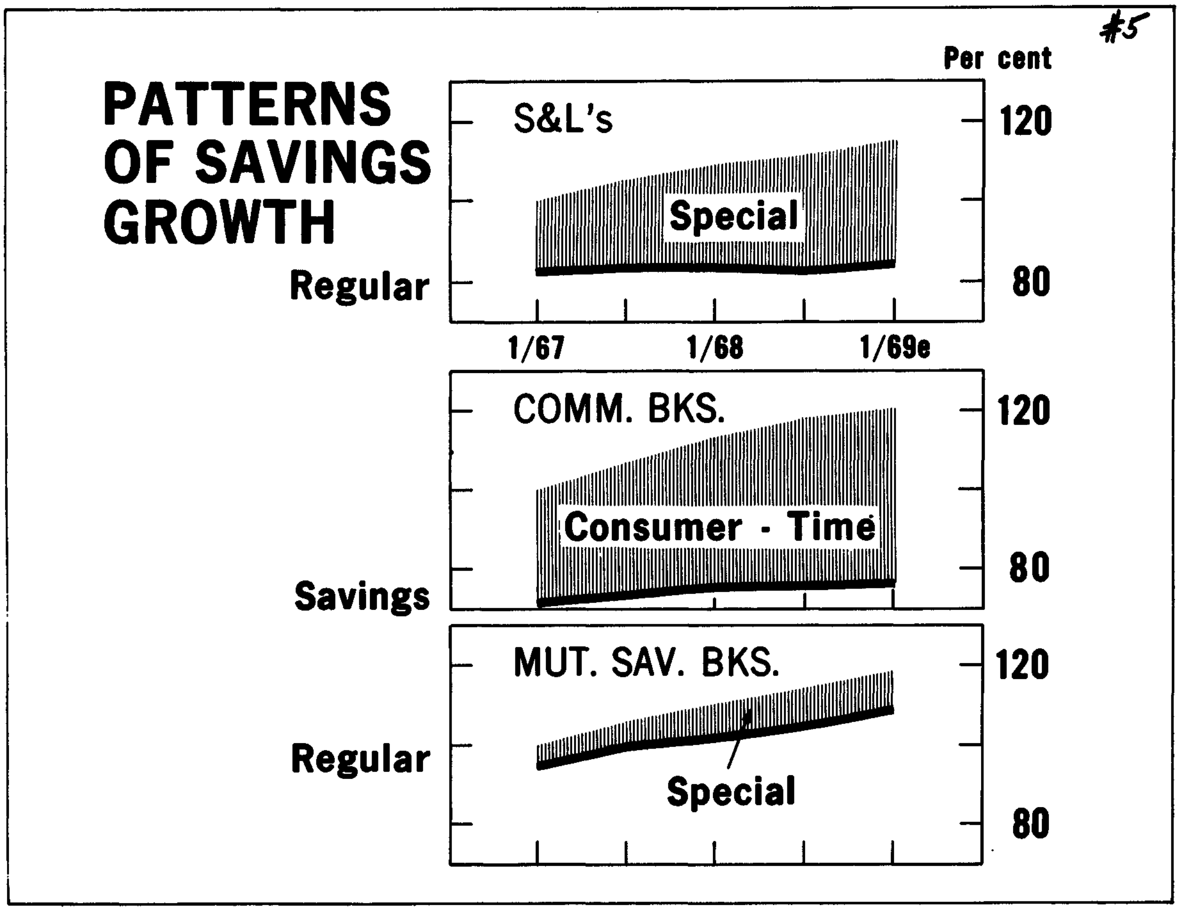
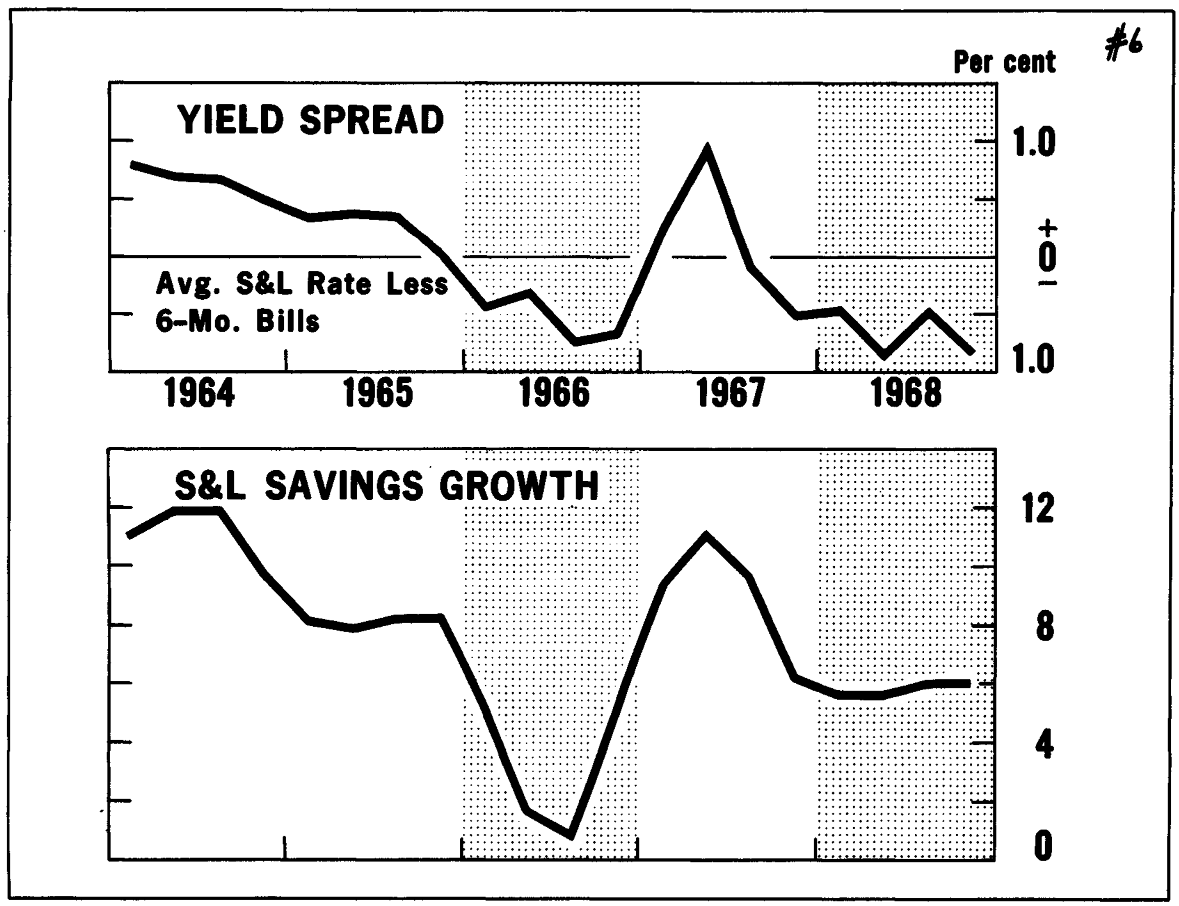
RATE OF GROWTH IN SAVINGS

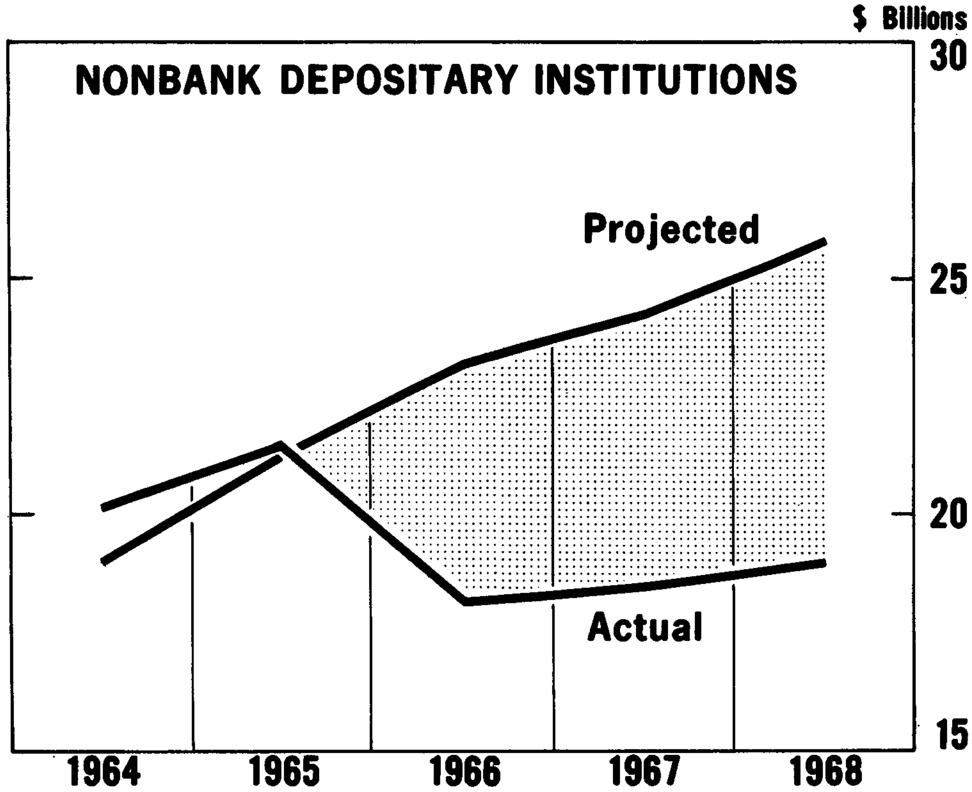



#5
PATTERNS OF SAVINGS GROWTH
Per cent
S&L's
Special
Regular
120
80
1/67
1/68
1/69e
COMM. BKS.
Consumer - Time
Savings
120
80
MUT. SAV. BKS.
Regular
Special
120
80


#6
Per cent
YIELD SPREAD
Avg. S&L Rate Less
6-Mo. Bills
1.0
+
0
−
1.0
1964
1965
1966
1967
1968
S&L SAVINGS GROWTH
12
8
4
0

GROSS MORTGAGE REPAYMENTS

#7



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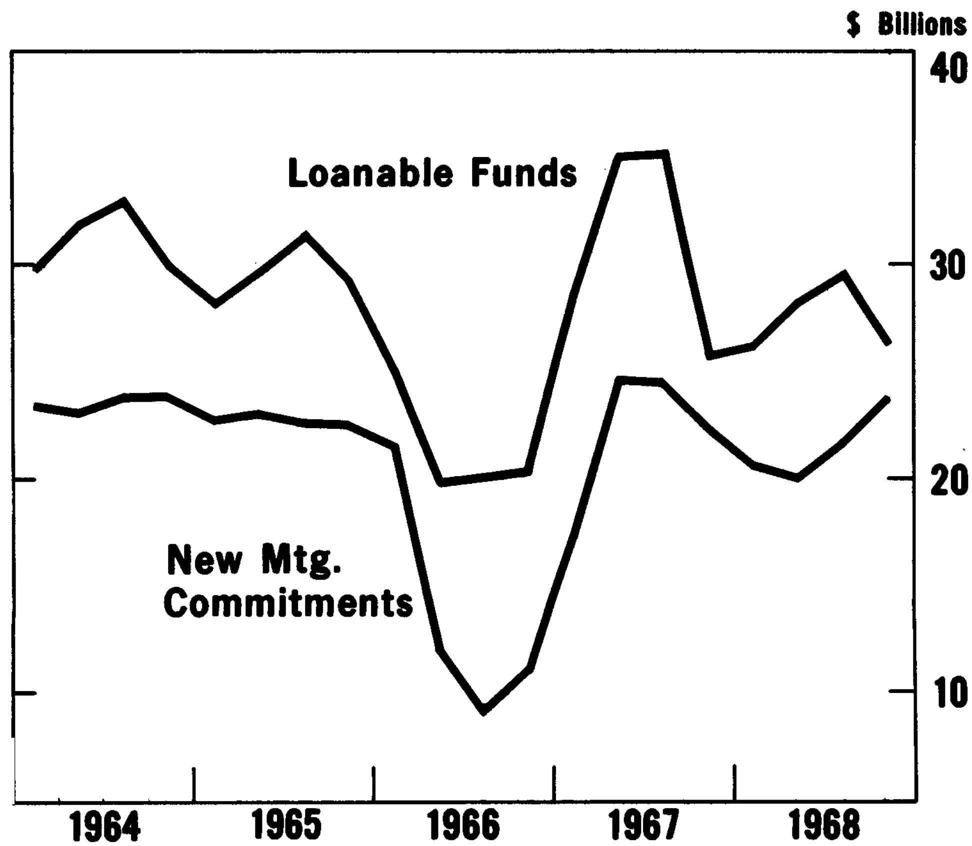
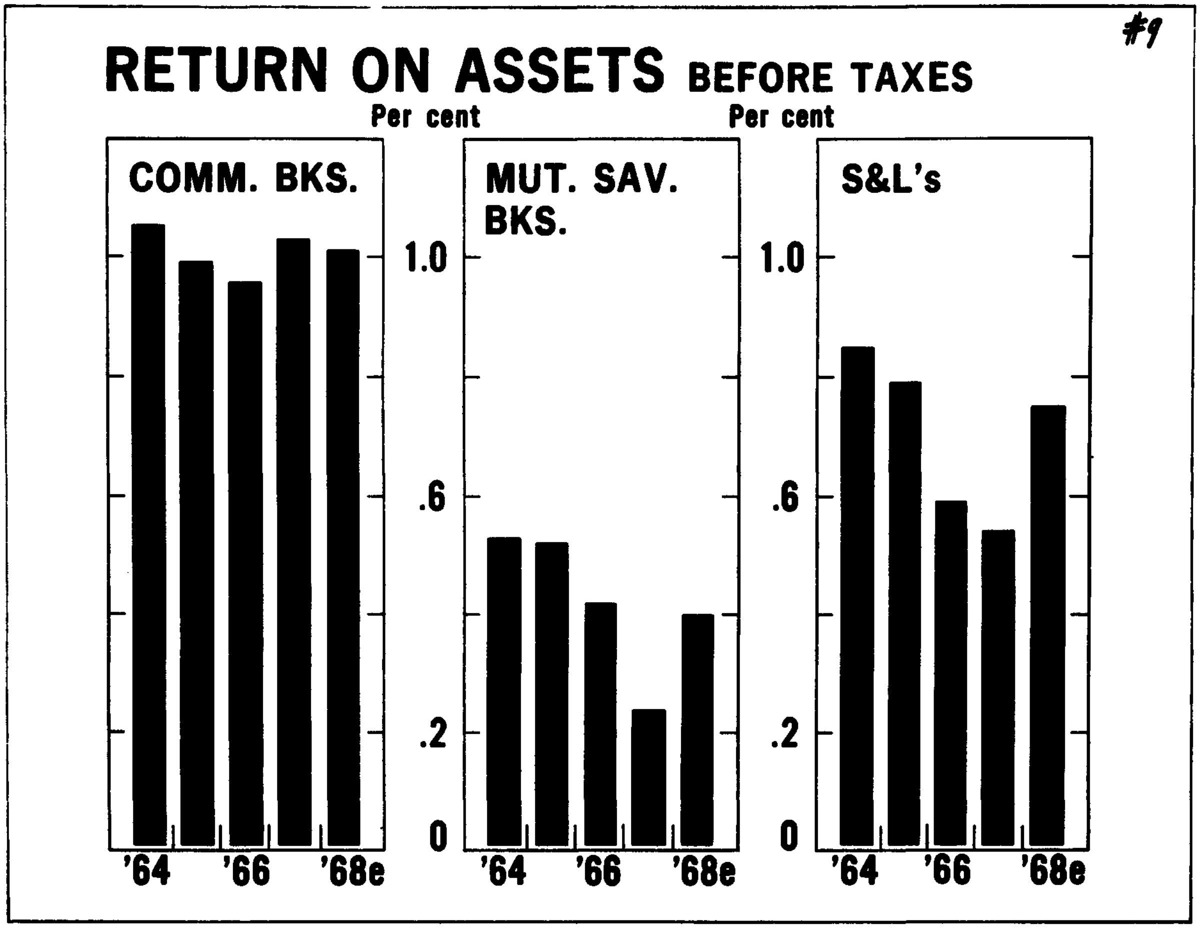
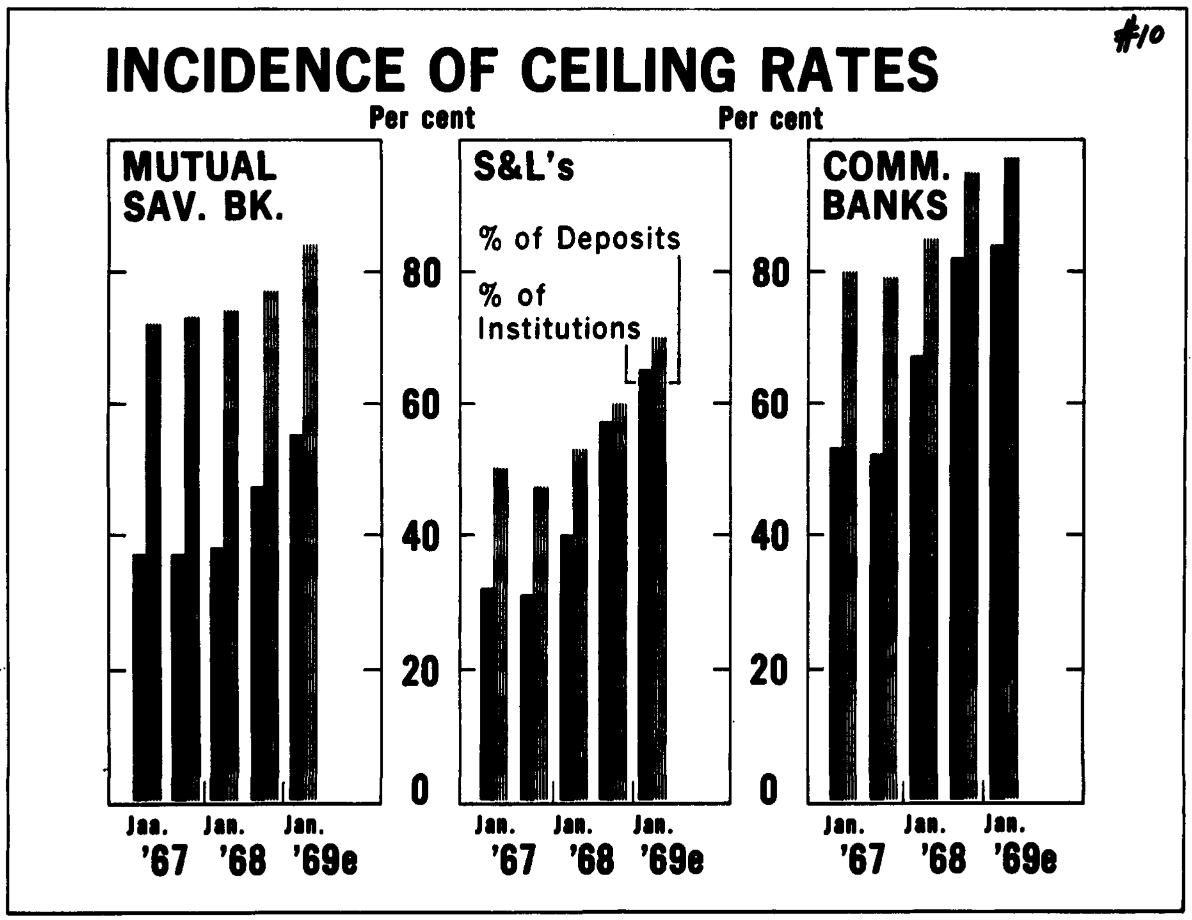



#9
RETURN ON ASSETS BEFORE TAXES
Per cent
Per cent
COMM. BKS.
MUT. SAV. BKS.
S&L's
1.0
.6
.2
0
1.0
.6
.2
0
'64
'66
'68e
'64
'66
'68e
'64
'66
'68e


#10
INCIDENCE OF CEILING RATES
Per cent
Per cent
MUTUAL SAV. BK.
S&L's
% of Deposits
% of Institutions
COMM. BANKS
80
60
40
20
0
80
60
40
20
0
Jan. '67
Jan. '68
Jan. '69e
Jan. '67
Jan. '68
Jan. '69e
Jan. '67
Jan. '68
Jan. '69e