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Remarks of

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While naturally Secondary Market Conferences such as this focus primarily on the buying and selling side of the mortgage investment business, a more fundamental reason why any secondary market exists is to provide a means of better matching investment funds with credit demands throughout the nation, and of providing liquidity for portfolios of financial instruments. This morning, I would like to give you some of my personal opinions about liquidity in the mortgage market from three different directions. First, liquidity as a concept of ability to meet mortgage commitments. Second, liquidity as a means to sell mortgages for cash to others, presumably at a profit, as a means of leveraging your portfolio yield. And third, liquidity as a steady source of cash funds with which to operate your associations.

Several times in recent years most savings and loan associations have been concerned about their liquid position and their ability to meet their forward mortgage commitments. During these years you learned a very complex word which has taken on somewhat of a dirty connotation. While I'm not sure who originally coined this word, I am inclined to think that my, and your friend, Saul B. Klamman, Deputy Executive Vice President of the National Association of Mutual Savings Banks encouraged its popular use. Of course, I am speaking about "disintermediation." But, do we really understand what this word means?

Does "disintermediation" mean the net withdrawal by savers of funds from deposit accounts at intermediaries to invest directly for whatever reason, including direct investment? Or does "disintermediation" mean the diversion of investment funds from placement in intermediaries for whatever reason because the alternative investment opportunities on a direct basis look better? While you may think that the subtleties between these two concepts are not worthy of discussion, I would like to pursue them for a moment. This second concept, I think, might be better called a "circumfiduciation" to describe how savers circumvent intermediaries, in part to go around them to the market place. This is a term I am sure I first heard from Saul Klamman and, therefore, give him credit and blame for its use.

If you accept this subtle definition of disintermediation as being the net withdrawal of funds from thrift institutions, you soon find from the facts that we have not had significant disintermediation in this country insofar as the saving and loan industry is concerned. We have had only five months since the beginning of 1954 in which the total deposits in the country's savings and loan associations did not rise, after seasonal adjustment, above the balance at the end of the previous month. And, more interesting, in the post World War II era the savings and loan industry has not experienced a single quarter in which the net savings

deposits did not increase. Thus, disintermediation is like another well known convention topic, there is a lot more talk about it than actually has occurred.

On the other hand, if you consider my earlier definition of circumfiduciation, we have had a substantial quantity of it from time to time as the public has become less willing to make deposits in savings and loan associations and, instead, has used its funds for other purposes or other investments. The rates of growth in deposits has swung markedly from low to high rates of increase. This circumfiduciation has taken place not only in periods when interest rates rose and savers were inclined to invest their savings elsewhere for better rates, but also in periods when savers found it more attractive to invest in the stock market or invest in other types of consumer goods.

No matter which of these subtleties or definitions you may be willing to accept, even the milder form of circumfiduciation has produced dramatic changes in the mortgage markets in the last decade. Managers of savings and loan associations, having once tasted actual disintermediation in the middle 1960's, didn't know when circumfiduciation would lead into ultimate disintermediation. Moreover, there have been times when their substantial forward mortgage commitment positions, when measured against their revised projection of cash resources, has encouraged them to run, don't walk, to the nearest exit from the mortgage market. Like a burnt child fears the

fire, these earlier experiences have made even the prospect of disintermediation or circumfiduciation produce market psychologies which are in turn translated into market action such as we saw in the fall of 1975.

As is being discussed in more detail by others here today, we now have many new tools to hedge the risks of changes in cash flow for savings and loan associations. The forward standby commitments of the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association have been one of the chief weapons. Conditional borrowing rights from the Federal Home Loan Banks have stayed some of these fears. More recently, investment bankers' willingness to issue standby commitments for the purchase of GNMA mortgage-backed securities has added to the tool of tricks to fight cash flow change.

As I, an outsider, view the status of your industry today, you are in an unusually liquid position. About 10 percent of your assets are in liquid investments. While your forward mortgage commitment position exceeds \$17 billion, when measured against only internally generated cash flow, you are in an excellent position to meet any prospective changes in deposits, while still being able to maintain your mortgage investment.

While there are many new tools to offset variations in cash flow, one element is still missing and still troublesome for most savings and

loan associations. That is the fact that most builders continue to demand forward long-term commitments at fixed interest rates. It is easy to understand the need on builders' parts for these commitments because of the long lag time between the start of a project and its actual marketing. However, we need to remember that all the interim risk is being borne by the lender or, indirectly, by the savers who provide the funds for the lender. If rates go up, the builder closes on such commitments; if they should go down, the builder usually renegotiates. As long as this condition exists, we need to find better ways to hedge this interest rate risk or find ways to transfer it to others. Obviously, builders and other practitioners of the real estate market cannot assume it. They have neither the financial capacity nor the inclination. If this were not so, you would have not been requested to issue one in the first place.

Therefore, the only solution is to find a way to transfer this risk to others. Thus far this has been largely done by the use of Federal Home Loan Mortgage Corporation and FNMA standby commitments. The recently developed GNMA futures market on the Chicago Board of Trade also has promise for being an effective hedge mechanism. As these hedging devices develop, I hope that some way can be found in which prospective borrowers or builders are able to use these hedge devices more directly and eliminate the practice by which savers and thrift institutions continue paying the cost to cover this risk.

If the need for substantial forward commitments at fixed rates is reduced, then I think it is possible that swings in the rate of new deposits are not so likely to produce dramatic changes in the flow of funds into the mortgage market. The substantial amount of internally generated cash flow which the average association produces will enable it to maintain a more orderly mortgage investment program. Associations will thus be able to use the Federal Home Loan Mortgage Corporation, FNMA, or the advance mechanism more sparingly. Equally important, the Federal Home Loan Mortgage Corporation and FNMA can become true central mortgage banks by providing a more aggressive sales program in order to meet the demands of those associations which have sudden surges of cash without sufficient mortgage flow to properly and profitably invest the cash promptly. The result of these changes, in my opinion, will be a more stable source of funds for the mortgage market, with better operating efficiency on the part of both the building industry and the mortgage investment industry. This should produce better net yields to savers and/or lower costs to home buyers.

The reason most of you are here is because you feel that the best source of liquidity for your mortgage portfolio is the sale of loans in the secondary market. As one who has made a living in it for 25 years, I still believe strongly in a secondary mortgage market and want to make it work.

For that reason, I want to share with you one of my current concerns about its future.

Your savings and loan industry for a long time was proud of the percentage of total home loans which your industry has made each year. While properly it should be a source of pride that you have been able to do this much business, it should begin to be an equal source of concern to you. Listen to some of these figures as dramatic evidence that you are rapidly becoming not only the chief source of home mortgage funds, but in a real sense practically the only private source. In 1960 you held 39 percent of the home mortgage debt outstanding; in June 1975 you had 49 percent. In contrast, the life insurance industry in 1960 held 18 percent and now holds 5 percent. While commercial banks have held rather steady with 14 percent in 1960 and 18 percent in 1975, the nation's pension funds have never gotten up to one percent in any year. And the situation looks like it is getting even worse, or better, however you view it. In the first nine months of 1975, savings and loan associations made or acquired 54 percent of all the long-term home mortgages, with mutual savings banks 7 percent, commercial banks 15 percent, and 21 percent being handled either by Federal credit agencies or GNMA mortgage pools. If you were following this arithmetic, it is obvious that all other sources of mortgage money, including pension funds, life insurance companies, fire insurance companies, individuals, and foreign sources, constituted only 3 percent of the market.

Viewed in this light, I believe my point is obvious. How can a secondary market be a true source of liquidity if the government is the only major place to sell mortgages other than another savings and loan association? They are likely to be subject to the same economic liquidity pressures that you are. We all know that government attitudes can change with changes in public priorities. This even includes that holy of holies, the single family housing market.

What is obviously needed is a way to broaden the market for mortgages to include other pools of private savings as potential purchasers. A realistic view would show that we have a long way to go. Life insurance companies left the single family business years ago and currently show little inclination to return. Pension funds have never really gotten started. While commercial banks are still around and will be around in years to come, it is highly likely that in periods when you need an aggressive secondary market for sale of mortgage assets, commercial banks will have similar demands for cash from the other users of credit, and thus have limited interest in outside investment possibilities.

As you realistically assess the possibilities of broadening the market, we must face up to the fundamental problem. No one dislikes mortgages as an investment. Even today when some types of mortgage investment have come into public discredit, the facts have proved that single family home loans have withstood the pressures of recession as

well or better than most other investments. Furthermore, improved techniques for handling the administrative burden which mortgages impose have been developed so that those impediments to mortgage investment have been largely removed or tremendously reduced.

The problem with broadening the mortgage market is primarily the need for mortgages to produce a competitive yield to other forms of investment. Too long mortgages have been sheltered from price competition and thus are favored investment only from those pools of savings which have no alternatives. If the Congress passes some version of the present financial institutions' restructuring proposals, which includes the liberalization of the types of asset mix in which your industry may invest, I believe the consequences will be an increase in mortgage yields to levels more competitive with those offered by other comparable investments.

Even the prospects of such causes anguish to some of our home-builder friends. They are already having trouble getting buyers to pay today's interest rates for today's home prices and can see their market shrinking further, if rates go higher. I, nonetheless, feel that this is a sound long-term move which will benefit all concerned. Until home mortgage rates become competitive with other investments, the mortgage market will continue to narrow further and further. The flows of funds into the market will become more and more volatile; and the stop/go syndrome

which has plagued the housing industry will continue to be a cause of higher cost in housing.

Now let's turn to the third and ultimate source of liquidity for your mortgage portfolio. That source is a sound economy and a stable price level.

Our experiences of recent years through real estate investment trusts have taught us that there is nothing liquid about a mortgage loan in default. Thus, the quality and liquidity of a mortgage loan portfolio is as much dependent upon the strength of the underlying economic conditions as it is upon the initial ability of the underwriter.

A stable price level benefits liquidity in several ways. It tends to reduce fluctuations in interest rates which in turn will make the cash flow from prepayments more predictable. Stable prices provide the confidence which consumers need to save for their future. They also provide investors with the confidence and assurance necessary to make loans for long terms at fixed yields.

As a Governor of the Federal Reserve System, it is my responsibility to strive for stable prices and a sound economy. Yet, no matter how hard we strive, the Federal Reserve System can't accomplish this goal alone. It can only be achieved if all of the citizens in our country do their best, not only to strive toward that goal, but to believe that it can ultimately be reached.

Back too many years ago, my high school class adopted the usual Latin motto which goes on the front page of yearbooks but is usually forgotten. Our motto was "Ad Astra Per Aspera," which is translated "through effort to the stars." Our country has conquered many challenges in its first 200 years. I am confident that our challenge of economic stability can, and will, be reached in the years ahead.