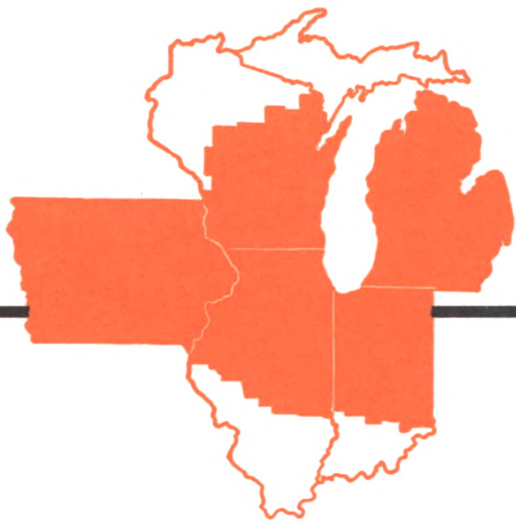
A review by the Federal Reserve Bank of Chicago

Business Conditions



1967 November

Contents

Trends in banking and finance

Corporate issues of long-term securities will break all records in 1967—and by a wide margin. More securities were issued in the first three quarters than in all 1966. Based on October projections for the fourth quarter, sales of long-term securities for new capital will run more than 22 billion dollars — a fourth more than last year's record. Data available for the first half indicate that net additions to corporate funds of nonfinancial corporations were equal to about two-thirds of total capital issues—roughly the same proportion as in 1966 and much more than in 1965.

Partly as a result of these very heavy demands for long-term funds, interest rates on new bond issues have risen to the highest levels in this century. But despite the high costs of such financing, there is little indication of any significant slackening in the pace of new issues.

What is behind this drive for business to raise long-term money? Undoubtedly, it stems largely from the cumulative effects of the 1964-66 boom in capital expenditures and the concurrent shrinkage of corporate liquidity. But there are indications that it also reflects both a concern about the future availability of funds and a widespread judgment that lower interest rates will not be seen anytime soon.

Bond sales and business spending

Business expenditures not covered by current income must, of course, be financed either through liquidation of assets or through increases in liabilities. Corporate funds are needed primarily for fixed investment in plant and equipment. In the long run, the sale of long-term debt tends to be associated with the growth of such investment over and above the amounts that can be financed from retained earnings or funds set aside to replace worn out or obsolete facilities. But both short-run variations in the assets and liabilities of businesses and changes in the relative attractiveness of alternative outside sources of financing at different times result in security

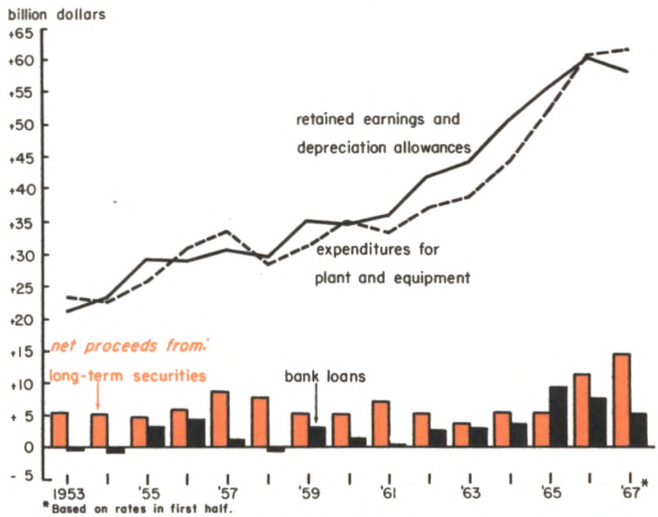
BUSINESS CONDITIONS is published monthly by the Federal Reserve Bank of Chicago. Dorothy M. Nichols was primarily responsible for the article "Trends in banking and finance" and George W. Cloos for "A new banking system?"

Subscriptions to **Business Conditions** are available to the public without charge. For information concerning bulk mailings, address inquiries to the Federal Reserve Bank of Chicago, Box 834, Chicago, Illinois 60690.

issues being concentrated in certain years—years that do not necessarily coincide with major increases in fixed investments.

Expenditures for plant and equipment are expected to be only 2 percent more in 1967 than in 1966. Moreover, the buildup in business inventories slowed sharply in the first half. Clearly, other factors have accounted for corporate decisions this year to increase borrowings by issuing record amounts of long-term debt.

Capital issues of nonfinancial corporations reach record high as capital expenditures level off



SOURCE: Flow of Funds, Board of Governors of the Federal Reserve System.

Perhaps most important has been the intentions of corporations to restore liquidity positions that declined during the 1964-66 surge in spending for new plant and equipment. The ratios of cash and Government securities to short-term liabilities of nonfinancial business corporations dropped sharply in 1964-66—from 37 percent to 26 percent. Cash assets rose much less than short-term liabilities and portfolios of U. S. Government securities declined.

While spending on plant and equipment increased an average of 19 percent a year in 1964-66, the average growth in retained earnings and depreciation allowances of nonfinancial corporations was less than 13 percent. Moreover, a smaller-than-usual proportion of external financing was in long-term form. Meanwhile, needs for short-term funds also rose. Nonfinancial corporate inventories at the end of 1966 were 26 billion dollars above the level at the end of 1963, and accounts receivable were up 34 billion.

A second factor has been the smaller amount of funds supplied from internal sources. Profits and retained earnings declined in the first half of 1967, and neither is expected to show a significant rebound during the rest of the year. Drains due to lower earnings will probably not be offset by the growth of funds set aside through depreciation allowances.

Reduced reliance on bank loans is consistent with corporate efforts to improve liquidity. The net increase in the amount of funds nonfinancial corporations acquired through bank loans reached a peak of nearly 10 billion dollars in 1965 and exceeded the amount raised in the capital market. The net increase in borrowings from banks slowed in 1966, especially after midyear, when credit restraint reduced the availability of bank credit. The increase has been still smaller this year as demand softened and paydowns were made out of the proceeds of bond issues.

The shifting relation between bank loans and securities sales is not new. Similar shifts were made in 1957-58 and 1960-61. In both periods, bank loans rose sharply before cyclical peaks while security issues reached their highs somewhat later. Considerations of both cost and liquidity are involved in this pattern. Liquidity is normally high at the beginning of an expansion, and so is the availability of bank credit. Also, because short-term rates typically fall faster than long-term rates in the previous downturn, short-term credit is relatively less expensive at the beginning of a rise in economic activity.

Even when pressure on capacity begins to develop later in an expansion, bank term loans often provide a convenient, flexible way of financing new investment in plant and equipment. Corporate treasurers do not like to issue long-term obligations at the high interest costs that usually develop toward the peak of a boom. Shorter termed money, if it can be obtained, may also be expensive, but expectations are that it can be funded at more favorable rates later in a period of slackening demand.

Nevertheless, restraint imposed on the growth of bank credit to curb aggregate expenditures may cause businesses that cannot obtain loans to turn to the capital market while the expansion is still in progress. And subsequently, as business activity slows, declining capital market rates encourage further shifts into long-term debt, again restoring liquidity.

This year's record volume of capital issues has exceeded what might have been expected on the basis of past cyclical patterns. The terms of financing in the capital market no longer appear favorable. Bond rates dropped early in the year, but they have moved up sharply since spring. By mid-October, the interest cost on new issues of high-grade corporate securities was well over 6 percent. Meanwhile, as loan demand lagged below what commercial banks were prepared to accommodate, the prime loan rate at banks remained at 5.5 percent.

High rates have, of course, discouraged or postponed some issues that would otherwise have been offered. But the continued issuance of a record volume of bonds in the face of rising interest rates, coupled with modest takedowns under bank loan commitments, can be attributed to two major factors—liquidity needs of corporations and expectations of the future availability of credit.

Business corporations have still not achieved a comfortable level of liquidity. Despite the huge amount of long-term funds corporations had already raised, their liquidity ratios continued to shrink during the first half of the year as their cash and holdings of U. S. Government securities declined. To a great extent, this was the result of accelerated tax payments that absorbed a considerable portion of the cash proceeds from securities sold during the period.

If business activity accelerates as expected in the months ahead, increases in the rate of inventory buildup and moderately higher capital expenditures will probably require greater cash outlays. Some of the current capital market financing is to provide funds for these needs and perhaps also for undefined contingencies.

The willingness to pay current bond market rates for funds in anticipation of future needs reflects concern that bank credit may again become scarce. Under these conditions, interest rates would probably rise to even higher levels. Such expectations have been nourished by the currently stimulative rise in Government spending and the associated deficit with its implications for Treasury borrowing and total demand for credit. There is nothing on the horizon to suggest a change in this outlook.

Commercial paper boom dampened?

The sale of short-term notes in the commercial paper market has become more important in the last two years in meeting the financing needs of large, well-established companies. From the end of 1965 through mid-1967, the amount of commercial and finance company paper outstanding rose from 9 billion dollars to 17 billion. Notes placed directly with investors by major finance companies account for more than two-thirds of the total, but notes placed through dealers, including most of the paper issued by nonfinancial business, have risen faster—to more than two and a half times the notes outstanding at the end of 1965.

The increased use of short-term notes, a large part of which are sold to other businesses, reflects essentially the same forces that have stimulated long-term security issues—the need for funds and interest rate differentials. Companies raised funds by any means available during the credit squeeze of 1966. Moreover, tailoring the maturities of these notes to coincide with expected cash needs had considerable appeal to investors, since they, too, were interested in maximizing liquidity.

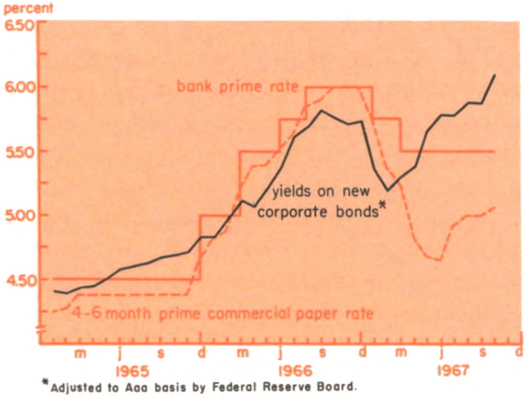
The average yield on four to six-month paper offered through dealers remained close to the prime loan rate through most of 1965 and 1966. While the issuer paid a differential over the yield to the investor, the net cost was probably less than the effective rate on bank loans. In any case, the popularity of commercial paper in 1966 was probably less attributable to the interest rate than to the availability of funds.

But after the turn of the year, rates on commercial paper declined relative to rates on bank loans. This was undoubtedly an important factor in maintaining the strong growth of such paper outstanding. By midyear, rates on these notes were almost a full percentage point below the prime loan rate, although still well above the yield on Treasury bills of similar maturity.

With the climb in market interest rates since June, much of this advantage has disappeared. The average yield on four to six-month notes sold through dealers rose to 5 percent in early August, but bill rates moved up even faster and the investment yield on six-month bills exceeded 5.25 percent by mid-October. Meanwhile, the volume of commercial paper outstanding has leveled off, at least for now.

In contrast to the very sharp growth in the previous year and a half, this leveling off presumably reflects some reduction in the demand for short-term funds by issuers of such paper, since rates have recently failed to keep pace with rates on other short-term yields. The acquisition of long-term funds through the sale of bonds has probably

Yields on new corporate bond issues rise faster than rates on bank loans and commercial paper



*Adjusted to Aaa basis by Federal Reserve Board.

been important in reducing the need for financing through short-term notes.

Altogether, this has been a year in which business corporations made substantial adjustments in their financial positions. Funds acquired through issues of long-term bonds appear to have reduced their reliance on bank loans and the commercial paper market, at least temporarily. These adjustments have restored a great amount of borrowing potential—an important element in the ability of corporations to finance future expansion.

Homebuilding upsurge continues

Residential construction has rebounded vigorously from its 1966 slump. New dwelling units were started at an annual rate of 1.4 million in the third quarter—up more than 50 percent from the abnormally low level of late last year and not far below the sizable, but not record, total for 1965.

Prospects are good that residential building will increase further in the current quarter and the upswing will continue into 1968 as well. Building permits issued for new units in metropolitan areas of the Midwest have been at high levels, and recent reports on construction contracts indicate a substantial backlog of work building up, especially for apartment buildings.

Homebuilding depends heavily on the flow of funds into mortgage credit. For this reason, doubts have been raised concerning the longevity of the extent of the recovery in housing. When overall demands for credit are large and interest rates rise, competing uses for financial resources tend to siphon funds from channels supporting homebuilding. This was the case in 1966.

Most forecasts of total economic activity for 1968 show relatively full employment of men and resources and a rise in the general price level of 3 percent or more. Homebuilding has typically declined in similar periods in the postwar era.

Is residential construction once again vulnerable to the inroads of competing uses for funds?

Credit and homebuilding

Nationally, housing starts declined 21 percent from 1965 to 1966. The drop in the Midwest was somewhat less than for the nation. It was more severe on the West Coast. This year, total starts are expected to be up about 12 percent. While a forecast at this time is particularly difficult to make, it may be noted that a further 10 to 15-percent increase would come in 1968 if starts were to remain at their relatively advanced September rate. To a great extent, the recent drop and subsequent revival in housing activity reflects changes in the availability of mortgage funds.

Mortgage debt outstanding, residential and other, now exceeds 350 billion dollars—far more than the gross debt of the Federal Government. It rose 26 billion dollars a year in 1963-65—more than five times the net volume of long-term capital raised by corporations through sales of securities. Last year, the net increase in mortgage debt was reduced to 21 billion dollars, while net funds raised by corporate sales of securities rose 5 billion dollars to 11 billion.

The slower growth in mortgage debt and the faster rise in corporate debt in 1966 were not unrelated. Companies have great flexibility in adjusting rates paid on loans and securities, while mortgage rates tend to be sticky for a number of reasons—including lending practices, the nature of channels through which funds flow and usury laws.

Loans on one to four-family nonfarm homes account for about two-thirds of all mortgage debt outstanding. The reduced volume of funds flowing to this sector in 1966 accounted for almost nine-tenths of the slowdown in the rise in mortgages.

Savings and loan associations, mutual savings banks, commercial banks, life insurance companies, trust funds and individuals all reduced their net investments in one to four-family mortgages in 1966. This was partly because of increased business needs for funds and the attractive rates available on Treasury issues. The effect on the mortgage market was twofold. Some institutional funds were diverted to nonmortgage investments. And many investors, individual and corporate, chose to purchase securities and money market instruments directly rather than place their funds with financial intermediaries that might have invested the funds in mortgages. This trend toward direct investment is termed "disintermediation."

The reduction in savings inflows at S&Ls (savings and loan associations) and MSBs (mutual savings banks) was particularly sharp in 1966. These institutions hold almost 60 percent of all one to four-family mortgages outstanding and place most of their newly acquired funds in such obligations. The net increase in mortgages at these institutions was only half as great in 1966 as in 1965.

Because of the high level of loan commitments made earlier, the rate of housing starts was well maintained in the first quarter of 1966, although by then financial institutions had already begun to cut back on new commitments to builders. Until late in the year, the net inflow of new savings to financial institutions, especially S&Ls, was sharply curtailed. The volume of funds made available by repayments of existing mortgages was also reduced far below the rates of earlier years as prepayments associated with transactions in existing properties were curtailed. As a result, many S&Ls virtually ceased to make new commitments. To honor commitments already made, they reduced liquid asset reserves and made extensive use of borrowings from Home Loan Banks.

Savings inflows rise

The process of disintermediation was reversed in the final weeks of 1966 as the general level of interest rates, especially short-term rates, receded from the highs of August and September. Commercial banks began to rebuild the volume of their time certificates of deposit. Life insurance companies reported that the demand for policy loans had abated. And S&Ls and MSBs noted much improved inflows of savings.

December saw net inflows of savings to S&Ls at 1.7 billion dollars—a record amount. Most months since, including September, also brought inflows at all-time highs. In the first nine months of 1967, savings capital at S&Ls rose 7.7 billion dollars—an annual growth rate of more than 9 percent—compared with a gain of only 1.3 billion in the first nine months of 1966, which was less than the dividends credited to these accounts. Deposits at MSBs rose 4.1 billion dollars in the first nine months of 1967—more than twice as much as a year earlier.

Financial institutions moved cautiously to increase mortgage lending in early 1967 at a time of year when such activity tends to be seasonally low in any case. This was partly because the supply of new houses was relatively small and partly because the revival in homebuilding was delayed by the need for developers to acquire and prepare land and for contractors to reactivate or strengthen their organizations. But financial institutions also wanted to improve liquidity positions that had eroded in 1966.

Loans of the Home Loan Banks to S&Ls had been as high as 7.3 billion dollars in July 1966. By September 1967, they had been reduced to 4.1 billion. Cash and Governments held by S&Ls rose from 9.7 billion to 11.6 billion dollars between July 1966 and September 1967. After a slow start in early 1967, mortgage loans of S&Ls began to rise and by September were up 5.2 billion dollars from the start of the year, compared with 3.8 billion for the same period in 1966. Because net additions by S&Ls slackened appreciably as the year 1966 advanced, the year-to-year margin of gain will rise during the remainder of 1967.

Mutual savings banks did not have the problem of rebuilding liquidity in early 1967 to the same extent as S&Ls. As a result, most of the increase in MSB deposits has been available for investments. Attracted by high yields on corporate securities, MSBs increased their holdings in this form by 2.4 billion dollars in the first nine months of 1967. This was equal to the increase in their mortgage portfolios.

Life insurance companies and commercial banks have invested less in mortgages thus far in 1967 than in the same period last year, when their activity was relatively great. Clearly, the continued strength of homebuilding depends on a sustained rate of savings inflows to financial institutions, especially to the S&Ls.

Labor shortages

During expansions of residential construction, not only credit but also manpower determines the number of new units. Despite the sharp decline in homebuilding in 1966 and the relatively low level of activity in early 1967, there was little evidence of increased unemployment among construction workers in most sections of the country. Total employment in construction even averaged somewhat higher in 1966 than in 1965. Apparently, building trade workers not required in residential construction readily found work in nonresidential construction, which was unusually strong throughout most of the year, or in industrial and maintenance jobs.

Widespread shortages of most building trade workers—including electricians, steam fitters, plumbers, carpenters, iron workers and bricklayers—have been reported in recent months. According to *Engineering News Record,* Chicago, Detroit, Milwaukee and Indianapolis are among the ten major United States centers with inadequate numbers of construction workers.

The supply of skilled workers has been critically short in the building trades throughout most of the postwar period. Apprenticeship programs have not turned out enough young journeymen. Many older workers, meanwhile, have retired earlier than in past years or reduced their workweeks by finding part-time jobs. Shortages of construction workers have helped account for rapid increases in the wages of principal building trades—amounting to 7 percent or more—well in excess of the increases accruing to most workers in other lines.

How vulnerable is homebuilding?

Because of the decline in residential construction, additions to the stock of housing in 1966 and 1967 fell below basic demand by as many as half a million units. This, with rising incomes, increased family formations and the desire of existing families to improve their living quarters, has increased demand for new dwelling units.

Evidence of a developing housing shortage is found in increases in the prices of homes and in rising costs of construction labor and materials—up 6 percent in 12 months. Evidence is also found in rising rents and lower renter and owner vacancy rates—rates that are at their lowest levels in a series dating back to 1960. Vacancies are especially low in the Northeast and Midwest.

Taken with the 1.5 million yearly starts needed simply to keep abreast of net family formations and the removal of old units, these factors suggest that basic demand for housing will tend to sustain homebuilding for years to come. As increasing numbers of postwar children reach marriageable age and as incomes advance, housing starts appear likely to reach a rate as great as 2 million a year by the early 1970s.

Strong demands for funds on the part of business and Federal, state and local governments are expected to exert further upward pressures on interest rates. Fortunately, there are reasons to believe that the impact of competing needs on housing will not be as great in 1968 as in 1966, particularly if some form of surtax is eventually enacted by Congress.

Savings inflows to financial institutions continue at high rates. As a result, many S&Ls, MSBs and other lenders are actively seeking new mortgage investments. Because rates on short-term money market instruments have not regained their 1966 highs, there has been no reassertion of the trend toward disintermediation. Although mortgage interest rates have risen since spring, the supply of mortgage funds has been sufficient for these rates to remain appreciably below the levels of a year ago. Moreover, there appears to be little tendency for lenders to stiffen terms other than rates for qualified borrowers. A large supply of mortgage funds seems likely for well into next year.

Part of the impact of tight money conditions on homebuilding in 1966 reflected the shock effects, on lenders and borrowers alike, of the highest mortgage rates since the early 1920s. The public has now become familiar with mortgage rates ranging upward from 6 percent, and there is less reluctance to pay such rates. In addition, regulatory changes (especially with regard to rate ceilings), some improvement in operating techniques and improved liquidity will help managers of financial institutions stabilize mortgage lending programs in the face of changed market conditions. These developments, coupled with strong demand for housing, will help the homebuilding industry compete for funds.

Whatever changes have occurred since 1966, it should not be supposed that homebuilding activity will be insulated from competition if overall credit demands are large and short-term rates again reach parity with long-term rates. Enactment of the proposed income tax surcharge, together with programs to reduce or retard the growth of Government spending, would moderate the extreme pressures on loanable funds that could threaten the achievement of a high level of housing starts throughout 1968.

A new banking system?

Legislation introduced in Congress in late September would provide charters for a new type of financial institution—Federal savings associations. Under the proposed bill, the Home Loan Bank Board would issue charters both to new associations and to converted savings and loan associations (S&Ls) or mutual savings banks (MSBs), giving them broad lending, investing and borrowing powers.

The new Federal Savings Association bill (H.R. 13118) has strong support from groups representing both S&Ls and MSBs. In vigorous opposition are groups representing the commercial banks. According to an American Bankers Association spokesman, the "prospect of a unified thrift industry going to Congress for legislation to establish what appears to be a new banking system . . . may turn out to be the greatest legislative challenge commercial banking has faced since the 1930s."

The legislation being considered represents an amalgamation of the principal features of two bills introduced last June. One (H.R. 10745) would have established a new system of Federal mutual savings banks and allowed S&Ls and MSBs meeting certain requirements to convert to that form of organization. This bill had the support of the Administration, some S&Ls and various other private groups, and almost all MSBs represented by the National Association of Mutual Savings Banks.

Another (H.R. 11139) would have allowed existing S&Ls and MSBs to become Federal savings associations with much broader powers than S&Ls now have. This bill, written by the United States Savings and Loan League, was supported by nearly all S&Ls.

Hearings on these bills were held in July before the Subcommittee on Bank Supervision and Insurance of the House Committee on Banking and Currency. The bills had many features in common. The principal objections of the S&L industry to the Federal savings bank bill centered on the standards to be applied to applicants for charters and the extent of the regulatory powers to be entrusted to the Home Loan Bank Board. The new compromise bill includes features of the earlier bills that are most attractive to both S&Ls and MSBs.

While S&Ls are well represented throughout the country, MSBs are found in only 18 states and are relatively unimportant in many of them. Indiana and Wisconsin, for example, the only states in the Seventh Federal Reserve District that charter MSBs, have only seven of them, ranging from 6 to 25 million dollars in deposits. They are heavily concentrated in the Northeast with banks in New York, Massachusetts and Connecticut holding more than four-fifths of all MSB deposits.

For the last ten years, MSBs have pressed for Federal charters to be made available in all states, believing that a dual system would promote a more favorable regulatory climate than a system based entirely on state charters. Meanwhile, S&Ls have sought expansion of their lending and investing powers, now limited largely to real estate loans and Governments, to include consumer loans and corporate securities.

The proposed legislation would accomplish the principal objectives of both groups. The new Federal savings association bill would presumably encourage a fusion of MSBs and S&Ls into a "new banking system."

The compromise bill

Under the compromise bill, new Federal savings associations could be formed by at least five applicants able to provide an initial reserve of at least $100,000. The association would have to serve a "useful" purpose, have a "reasonable" expectation of success and foster competition without causing "undue injury" to existing deposit-type institutions.

A state chartered S&L or MSB could convert to a Federal charter, provided it met the requirements for a new organization, the conversion did not contravene state law and the Home Loan Bank Board found the applicant's financial condition and management satisfactory. The board would be directed to issue a charter to any Federal S&L with two-thirds of its directors favoring conversion, if no disciplinary action was pending against it. After ten years, the board could issue charters converting any remaining Federal S&L to the new organization, abolishing the present type of Federal S&L charter.

The new associations would have to include the words *Federal*, *savings* and *association* in their names, except that an association using *bank, institution* or *society* in its name before conversion could continue to use the term. After January 1, 1973, the word *bank* could be used in the name of any federally chartered association.

Federal savings associations could establish branches, subject to approval of the Home Loan Bank Board. In considering applications for branches, the board would apply criteria similar to those used in granting charters. These would include determining whether the branch or office of an affiliated institution could have been established under state law if the association had been a state chartered commercial bank or any type of thrift institution.

Savings accounts at the new associations would be called *deposits*, which represents abandonment of the *share account* terminology S&Ls now use. Savings deposits could be accepted from all types of depositors, except foreign governments and businesses organized for profit. With approval of the Home Loan Bank Board, withdrawal requests on savings deposits could be placed on rotation under an "equitable plan." Time deposits other than passbook savings could be accepted from all types of depositors, including businesses, but not from foreign governments. Payments made to holders of both savings and time deposits would be called *interest,* not *dividends.*

Federal savings associations could obtain funds by borrowing, through the issue of notes, bonds, debentures or other obligations, subject to regulation by the Home Loan Bank. They could not sell capital stock.

Associations would have to keep 60 percent of their nonliquid assets in residential mortgages and related real estate loans. Conventional loans on single-family residences (including condominiums) would be limited to $50,000 and 90 percent of market value, including furnishings and equipment. Such loans could be made on property within an association's primary lending area—a radius of 100 miles.

There would be no restrictions on investments in Governments and Government agency issues, state obligations, bankers' acceptances and stock of Home Loan Banks. Subject to certain limitations, security holdings could include municipals, Canadian government securities and corporate bonds and stocks. Equity investments would be limited to 50 percent of an association's reserves and undivided profits.

Loans could also be made for repairs and improvements of real property, for educational purposes and to purchase unimproved property and mobile homes. Associations could also make loans secured by deposits or life insurance policies. Unsecured loans could be made to individuals up to $5,000.

Associations could act as loan servicing contractors, exercise certain trustee powers and serve as agents for the purchase and sale of investment company securities.

Liquidity reserves in cash, bank deposits and Government and Government agency securities would be required. The amount of reserves—from 4 to 10 percent of deposits and borrowings—would be determined by the Home Loan Bank Board. Additional liquidity requirements might be imposed in special cases.

The bill would change the name of the Federal Savings and Loan Insurance Corporation (administered by the Home Loan Bank Board) to the Federal Savings Insurance Corporation (FSIC), which would insure all Federal savings associations and qualified state chartered associations.

Mutual savings banks

Deposits at MSBs in New York, Massachusetts and Connecticut are larger than savings accounts at commercial banks and S&Ls combined. The size of accounts is limited in these leading states, but the limits have been raised over the years and are now $25,000 for single-name accounts in New York, exclusive of accumulated interest, and $30,000 in Massachusetts and Connecticut.

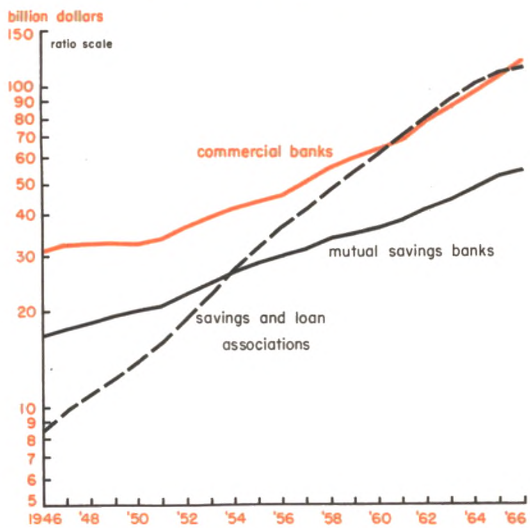
Some new MSBs have been organized in recent years, but mergers have reduced the number slightly since World War II. There were 506 MSBs in the United States at the end of 1966. Although many are small, the average size of these institutions far exceeds the average for commercial banks or S&Ls.

The largest MSB, the Bowery Savings Bank of New York, has deposits of 2.5 billion dollars. Only three commercial banks in the Midwest are larger and no S&L in the area is more than a fourth as large. At the end of 1966, seven MSBs had more than 1 billion dollars in deposits and 26 had 500 million.

These banks have broad powers regarding the types of investments they may choose, but regarding individual investments, the powers are closely restricted by laws and regulations that vary state to state. Purchases of corporate bonds, for example, are limited in most states to "legal lists" of eligible issues determined by criteria relating to the size of issues and the debt, surplus and earnings of issuing companies.

Savings banks have reduced their holdings of Governments every year since 1947—these securities accounting for less than 8 percent of total assets at the end of 1966.

Competition of principal media for savings has intensified



SOURCE: **Flow of Funds,** financial assets of households, Board of Governors of the Federal Reserve System.

Mortgage loans, on the other hand, have increased every year since 1946 and recently accounted for 77 percent of all MSB assets.

After obtaining authority in the early Fifties to buy FHA and VA mortgages originated in other states, MSBs acquired a substantial volume of out-of-state mortgages. In September 1966, such holdings totaled 18.4 billion dollars—40 percent of all mortgage portfolios.

The ability of MSBs to acquire corporate securities and other nonmortgage assets gives them an investment flexibility S&Ls do not have. Corporate bonds, which had accounted for more than 20 percent of MSB assets in the Twenties, have constituted about 10 percent since World War II. These totals include some Government agency issues and some corporate stocks.

Competition for savings

Mutual savings banks maintained their position relative to other deposit-type institutions in the early postwar years. At the end of 1950, they had the same proportion—30 percent—of personal time and savings accounts in MSBs, commercial banks, S&Ls and credit unions as in 1945. But the ratio began a decline in 1951 that continued through 1966. At year-end, MSBs had 18 percent.

Savings deposits of MSBs nearly tripled during 1950-66, but time and savings accounts at commercial banks almost quadrupled and share accounts at S&Ls were increased eightfold.

Part of the reason for MSBs' slower growth has been the relatively slower growth of personal income in the principal MSB states. But other factors have also been at work. Savings banks have grown less than their competitors in most of the states where they are chartered.

Until recent years, MSBs paid savers at rates appreciably lower than rates paid by S&Ls—which doubtless favored growth of S&Ls. Increases in rates paid by MSBs in 1966 were partly responsible for savings at these banks rising proportionately more than share accounts at S&Ls. Savings at MSBs increased 4.9 percent compared with 3.3 percent at S&Ls. This was the first time since World War II that savings increased faster at MSBs than at S&Ls.

The average rate MSBs paid on deposits at the end of 1966 was 4.74 percent—close to the average dividend paid by S&Ls and well above the 4 percent commercial banks have been allowed to pay on passbook savings but below the 5-percent ceiling on commercial bank savings certificates.

Spokesmen for MSBs maintain that their industry has been handicapped by greater restrictions on branching than apply to their competitors, especially in New York, and by limited authority to make personal loans, which are forbidden altogether in New York and several other states. Both restrictions on MSBs would be changed by the proposed Federal legislation.

Growing similarities

Most financial institutions have broadened both their investment programs and their services to the public in the postwar period. This trend has resulted partly from legislative changes easing restrictions and partly from management decisions to use existing authority more competitively. Particularly with regard to services offered their customers, commercial banks, MSBs and S&Ls have become more similar. The proposed legislation would narrow the differences further.

Commercial banks in recent years have emphasized "one-stop, full-service" banking. Large banks that concentrated on services to businesses, well-to-do individuals and correspondent banks ten years ago now commonly offer mortgage credit, instalment loans, special checking accounts and personal time certificates, along with passbook savings accounts.

Investments of S&Ls are still confined largely to mortgages and Government securities, but their mortgage lending powers have been broadened, and they now have authority to finance nursing homes and land improvements, and to make educational loans. Very much wanted by many S&Ls is the power to finance consumer purchases of mobile homes, furniture and household durables.

Although MSBs have much broader investment powers than S&Ls, more than 77 percent of MSB assets were in the form of mortgages at the end of 1966, compared with 85 percent for S&Ls. In some states, MSBs can make limited personal loans.

Provision of checking services is usually considered a unique function of commercial banks. Nevertheless, many MSBs and some S&Ls offer arrangements that let customers pay bills through money orders, registered checks or other means. Both types of institutions often provide safe deposit box facilities.

Neither MSBs nor S&Ls are seeking authority to enter the short-term business loan field in competition with commercial banks and finance companies. Nor do they propose to provide full-fledged checking account services, which might lead to charges that they are functioning as commercial banks and prepare the way for their regulation as such.

That most MSBs are controlled by self-perpetuating boards of trustees instead of directors elected by shareholders does not usually make any real difference in practice. Shareholders in S&Ls usually sign perpetual proxies in favor of existing boards when they open accounts, and proxy fights to obtain managerial control are difficult and rare.

The growing similarity between MSBs and S&Ls provides the basis for the proposed conversion legislation. Some S&Ls in Washington and Connecticut recently converted to MSBs. On the other hand, some MSBs in Ohio have recently converted to commercial bank charters.

Deposits and share accounts

Savings held in commercial banks and MSBs are *deposits*, and a debtor-creditor relationship exists between the bank and its depositors. Savings at S&Ls are called *share accounts*, and in theory at least, the shareholders own and control the institutions.

Under ordinary conditions, bank deposits must be paid in full, either on demand or at the expiration of a prescribed period. A bank must maintain enough cash or very liquid assets to satisfy such demands. Otherwise, the bank is judged in default and must close its doors, awaiting liquidation, reorganization or consolidation with a sound bank. On the other hand, an S&L can pay a proportion of withdrawal requests in rotation, depending on its liquidity position, and continue to operate unless investigation by supervisory authorities shows that the association is insolvent, as well as illiquid, with outstanding liabilities in excess of its assets.

Legally, deposits and share accounts are very different, but under normal conditions, the difference is obscured. Withdrawal requests from holders of savings accounts at commercial banks, MSBs and S&Ls are almost invariably paid on demand. Any bank or association that invoked the right to defer payments would risk loss of public confidence, mass applications for withdrawals and a sharply reduced inflow of new funds.

Few holders of S&L accounts think of themselves as shareholders, and share accounts are commonly referred to as deposits.

Returns to S&L savers are *dividends*, but in common parlance they are often called *interest*. For Federal income tax purposes, S&L payouts are treated as interest, not as dividends on stock.

All financial institutions try to maintain a margin of liquidity by balancing new loan and investment commitments with expected net cash inflows. To allow for contingencies and take advantage of unexpected investment opportunities, they maintain a liquid reserve in the form of cash and securities, primarily Governments. At the start of 1967, cash and Governments held by MSBs equaled 9.4 percent of their assets. The ratio was 8.3 percent for S&Ls and much higher, 29 percent, for commercial banks.

Both MSBs and S&Ls are urged by supervisory authorities to maintain adequate reserves of liquid assets, and S&Ls belonging to the Home Loan Bank System are subject to a statutory liquidity requirement. But neither type of institution is required to keep a specific proportion of assets or liabilities in the form of nonearning reserve accounts in the way commercial banks maintain reserve balances with Federal Reserve Banks and correspondent banks.

Financial institutions can gain temporary liquidity by borrowing. Commercial banks can borrow from Federal Reserve Banks or correspondent banks, or sell time certificates, notes or debentures. Borrowing by S&Ls is mainly in loans from commercial banks and Home Loan Banks and MSBs use certain specialized organizations serving the industry.

Almost all S&Ls are members of the Home Loan Bank System, and they have used the lending facilities of Home Loan Banks freely at times, especially when demand for mortgage loans was strong and during the liquidity squeeze of 1966.

Mutual savings banks have been eligible for membership in the Home Loan Banks since they were established in 1932. At the end of 1966, 9 percent of all MSBs, with 16 percent of total assets, were members of the Home Loan Bank System. They have also been eligible for membership in the Federal Reserve System since the Banking Act of 1933, but few have joined and none have been members since 1962.

Pros and cons

Legislation to provide Federal charters for MSBs has been supported in recent years by the Commission on Money and Credit (1961), the President's Committee on Financial Institutions (1963), the Council of Economic Advisers, the Treasury, the Home Loan Bank Board and the President himself (1966 and 1967).

Spokesmen for the Board of Governors of the Federal Reserve System have stated that the Board "has no objection in principle" to the proposed legislation, but they raised questions in 1966 and 1967 about branching powers, deposit insurance, regulation of interest payments, mergers, reserve requirements, taxation and the possible impact of the legislation on housing construction.

The Treasury's endorsements of the proposed legislation have also been qualified. A Treasury statement sent to the subcommittee in July 1967 stressed the necessity for "care and prudence characteristic of the best traditions of mutual savings banking" and emphasized that "these high standards, combined with adequate supervisory safeguards, be clearly expressed in the authorizing legislation."

Proponents of Federal MSB legislation have argued that a nationwide system would improve banking facilities in some areas, encourage savings by offering a wider choice of financial institutions, result in a larger and more even flow of mortgage funds over the business cycle—and between regions—and strengthen savings institutions by providing additional flexibility in making investments.

Opponents of Federal charters, led by the ABA, have argued that MSBs and S&Ls do not pay their fair share of Federal income taxes (a view supported by the Treasury in the case of MSBs), that the proposed legislation might divert funds from mortgage markets, that need for the legislation has not been established, and that "quasi-banks" should not be given broader branching powers than those available to commercial banks.

Regardless of the merits of the case for Federal charters for MSBs, it is clear that the compromise bill differs substantially from the bill introduced with Administration support last June. One of the most significant new features is the almost automatic conversion privileges offered to Federal S&Ls. Many of these institutions have had little, if any, experience with the important new functions they would be empowered to perform.

The bill would give S&Ls some of the advantages of MSBs, and vice versa. It would also give them powers they do not now have.

Savings and loan associations could begin buying corporate, municipal and Canadian securities, and making loans on mobile homes and secured and unsecured consumer loans. They could call their share accounts *deposits,* their dividends *interest* and, starting in 1973, themselves *banks.*

Mutual savings banks could choose state or Federal charters, accept time deposits from corporations, be freed of limitations on the size of individual accounts, make consumer loans (which are barred in some major MSB states), establish branches more readily and pay depositors on rotation.

The new charters would not authorize savings associations to accept demand deposits or make short-term business loans. Those operations would continue in the province of commercial banks. The restriction that 60 percent of an association's nonliquid assets had to be in residential mortgages and related real estate loans would not—now at least—require modification of the portfolios of most existing S&Ls or MSBs.

The public issues

As Congress considers the bill to provide charters for Federal savings associations, the paramount interest is the impact of such legislation on the economy as a whole. First, what effect would the establishment of a unified MSB-S&L system with broadened powers have on the volume of savings and the division of saving among competing uses? Second, despite the precautionary language of the bill, would Federal chartering of new institutions create conditions of overbanking in some areas and result in weakening of financial institutions?

Along with the controversial tax issue, a difficult obstacle facing proposed legislation is the prospect that S&Ls converting to the new charters might—temporarily at least—divert a proportion of their available funds from mortgages to other investments, reducing the volume of funds available to finance residential construction. The Government has taken many steps since the early Thirties to encourage homebuilding and homeownership. The Home Loan Bank System, Federal charters for S&Ls, and FSLIC, Federal mortgage insurance and guarantees, and continued liberalization of these programs through legislative and regulatory changes have all aided residential construction. Any measure that appears likely to reduce the availability of mortgage funds—even temporarily—would need to be supported for other considerations of overriding importance.