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Business & Financial Letter

Housing Specialists

Households are now spending more out of income, and thus are beginning to slow down their flow of funds into the nation's thrift institutions. Yet savings flows are still immense in relation to past historical patterns. No one expects a repetition of the 1976 experience, when net savings at savings-and-loan associations rose 18 percent above the 1975 record to a new peak of $46 billion, but most observers believe that heavy inflows of funds will continue to support a strong upturn in housing activity. Indeed, there is no question about the immediate future, since commitments for future mortgage lending were 38 percent higher in February than a year earlier.

Maintaining predominance

The S&L's remain the nation's housing specialists, with $323 billion in mortgage debt outstanding at year-end 1976—up 14 percent for the year. The thrifts hope to maintain their strong position, with the help of Congress' expected extension of interest-rate ceiling on savings deposits—a move which would allow them to retain the one-quarter percent differential over commercial-bank rates. Although Congress last year shelved financial-reform proposals that would have permitted S&L's to expand outside the mortgage-lending field, the thrifts continue to argue for expanded lending powers while testing new ways of stabilizing flows of funds into housing.

The very substantial (albeit reduced) savings flows reflect the fact that S&L rates still represent the best game in town for household and other savers. For more than a year, rates on Treasury bills and other short-term money-market instruments have remained almost consistently below the 5¼-percent S&L passbook rate. Rate spreads between longer-term governments and S&L certificates also have favored the latter.

Given the recent signs of tightening in market rates, S&L's may be under less pressure than they were in late 1976 to reduce their cost of funds. At that time, the large supply of funds—along with increased commercial-bank activity in mortgage markets—put downward pressure on mortgage rates. In the face of a heavy savings inflow, the thrifts tried to maintain a viable spread between the rates they were charging for mortgages and the rates they were paying for savings, primarily by marginal measures rather than by basic rate reductions. Many S&L's eliminated their longest-dated certificates and raised minimum deposits on intermediate-maturity certificates. A few even reduced rates on passbook accounts, but soon scrambled back to higher ground when the market failed to follow them.

Protection through VRM's

Whatever their feeling about the direction of rates in the short term,

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thrift industry leaders have shown increased interest in protecting themselves against the long-term threat of inflation through new types of mortgage contracts. The most common of these is the variable interest-rate mortgage—the VIR or VRM—under which the rate charged varies over the life of the instrument (within prescribed limits) in line with some index of the mortgagor's cost of funds. The instrument is designed to reduce the likelihood of disintermediation—that is, to assure continued availability of lendable funds—during periods of high interest rates. Because the VRM shifts some of the interest-rate risk formerly borne solely by the mortgagor to the mortgagee, some regulatory agencies are hesitant to permit them. For example, Federally chartered S&L's are not yet able to offer them to their customers.

In California, however, eighteen state-chartered S&L's, along with two major commercial banks, have been offering VRM's for more than a year. Roughly two-thirds of the total lending by S&L's offering VRM's has been in this type of mortgage, with the two banks reporting somewhat lower figures. Terms vary among offering institutions, but most permit refinancing with no prepayment penalty in the event of an upward adjustment in the variable mortgage rate.

California institutions tie their variable rate to the weighted cost of funds paid by California members of the Federal Home Loan Bank System. Available semi-annually with a lag, this index has fluctuated narrowly over the past two years, never dropping the ten basis points which (under state law) would call for a mortgage rate reduction. (Over the second half of 1976, the California indexed rate rose from 6.382 percent to 6.394 percent.) In contrast, one Massachusetts institution reduced its mortgage rate by 25 basis points (one-quarter percentage point) last October when the index used in that state permitted such a reduction.

Protection through GNMA

Federal support will remain a major feature of the 1977 mortgage market, following 1976's 15.5-percent increase (to $117 billion) in mortgages underwritten or insured by Federal programs. Direct subsidy programs for housing are due to double this year under the new administration's budget, but the biggest assist should come indirectly from secondary-market support programs, such as the pass-through bonds developed by the Government National Mortgage Association (GNMA). Under this system, a mortgage issuer assembles a pool of VA and FHA loans bearing the same interest rate and similar maturity and converts them into a GNMA security, thus freeing up funds to be reinvested in new mortgages.

In late 1976, about 500 firms were active in the GNMA market—predominantly mortgage-banking companies which specialize in the

origination of VA and FHA mortgages. During the year, outstanding issues of pass-through bonds jumped from $18 billion to almost $31 billion. Because of their government sponsorship and efficient packaging, they could be marketed at a rate 50 basis points below the rate on the underlying mortgages—and in consequence have become popular with managers of pension funds and trust funds, as well as private individuals able to afford the $25,000 price per security. In fact, the general success of pass-through bonds has led some lenders to try to extend this technique to pools of conventional mortgages.

Altogether, thrift institutions appear to be in rather good shape to finance the 1.8 million units (or more) which the housing industry plans to build this year. Of course, there could be trouble later on if savings flows slow down in response to rising market interest rates. But any development of that type would also tend to speed the thrift industry's adoption of new mortgage instruments geared to offset the impact of inflation on S&L balance sheets.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/23/77	Change from 3/16/77	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	93,996	– 835	+ 6,537	+ 7.47
Loans (gross, adjusted)—total	71,723	– 529	+ 6,738	+ 10.37
Security loans	1,428	– 268	+ 528	+ 58.67
Commercial and industrial	23,509	+ 63	+ 783	+ 3.45
Real estate	22,182	+ 47	+ 2,559	+ 13.04
Consumer instalment	12,434	+ 30	+ 1,619	+ 14.97
U.S. Treasury securities	9,361	+ 94	– 371	– 3.81
Other securities	12,912	– 400	+ 170	+ 1.33
Deposits (less cash items)—total*	93,199	– 646	+ 5,782	+ 6.61
Demand deposits (adjusted)	26,037	– 745	+ 1,952	+ 8.10
U.S. Government deposits	224	– 768	– 19	– 7.82
Time deposits—total*	65,129	+ 660	+ 3,277	+ 5.30
States and political subdivisions	5,344	– 41	– 827	– 13.40
Savings deposits	31,658	+ 132	+ 6,350	+ 25.09
Other time deposits‡	26,027	+ 522	– 1,874	– 6.72
Large negotiable CD's	9,458	+ 529	– 3,237	– 25.50

Weekly Averages of Daily Figures	Week ended 3/23/77	Week ended 3/16/77	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	+ 48	+ 25	+ 73
Borrowings	50	1	2
Net free(+)/Net borrowed (–)	– 2	+ 24	+ 71
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (–)	+ 117	+ 79	+ 1,287
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (–)	+ 147	+ 461	+ 25

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

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