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FRBSF Weekly Letter

New Source of Mortgage Funds?

Many financial-market analysts believe that availability of mortgage credit will be one of the crucial factors determining the severity of the current cyclical downturn. They look to money-market certificates and secondary-market sales of mortgages — the two dominant sources of new funds in the current housing cycle — when determining whether thrift institutions will have enough funds for their mortgage-lending activities in the period ahead. But they may be overlooking another, less publicized, potential source of funds. In California, where strong housing demands have required massive extensions of mortgage credit, savings-and-loan associations are turning increasingly to time deposits of state-and-local governments to finance their mortgage lending.

These public funds still account for only a small portion of the *total* funds held by California S&L's — but in 1978 they contributed 13 percent of the *net inflow* of savings capital, including 46 percent of the net increase in time certificates of $100,00 and over. The recent California experience provides a case study of the feasibility of this type of money-market, non-consumer deposit as a source of thrift-institution mortgage funds-and in addition, as a flexible tool for liability management. The California case also illustrates some of the statutory and institutional barriers that must be surmounted before public deposits permanently become a viable source of mortgage funds.

Statutory hurdles

Savings-and-loan associations in California, as well as thrift institutions in many other states, have long faced such barriers to the use of state and local deposits. California S&L's weren't permitted to accept deposits of this type until the voters passed a constitutional amendment to that effect in June 1976. This amendment reflected voters' concern over the severity of the 1973-74 housing decline, when the dwindling flow of funds to S&L's made mortgage credit virtually unavailable.

Nonetheless, a year and a half after passage of this constitutional amendment, S&L's still held only $300 million in state and local deposits — a very small share of their total $67 billion in savings capital (regular savings deposits and time certificates). The basic problem was a California statute requiring each depository institution to pledge securities as collateral for such deposits. (Pledged securities must have a market value of at least 110 percent of the total uninsured amount of such deposits.) Since S&L's hold only a small percent of their asset portfolios in securities, this pledging requirement made these deposits relatively unattractive. Moreover, S&L's by regulation had to exclude pledged securities when computing their liquidity ratios for supervisory purposes.

To ease this situation, the California legislature in late 1977 passed a bill to expand the definition of eligible collateral for state (but not local) deposits — specifically, by including promissory notes secured by first mortgages or first trust deeds on residential real property located in California. Thereafter, state deposits became a viable source of S&L funds, even though the statute required mortgage collateral to be at least 50 percent in excess of the amount deposited, compared with the 10-percent excess requirement for securities. Large associations, at least, have had no problem meeting these mortgage-pledging requirements, although they have incurred extra costs in selecting mortgages that meet the State's eligibility requirements and in physically placing collateral in custody.

By the end of 1978, S&L's held 85 percent of the State's time deposits, compared with only 4 percent of the total when the change in

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pledging requirements first became effective. Thus, in only a year's span, a major portion of the State's time-deposit funds (excluding negotiable CD's, which are considered securities) was channeled from banks to S&L's.

Favorable factors

A number of favorable institutional factors meanwhile enhanced California S&L's use of public funds for mortgage credit. One such factor was the existence of California's Pooled Money Investment Account, which operates as a sophisticated cash-management fund for surplus funds of the State and some local government units. By combining these funds, the Account can provide a relatively stable flow of funds for investment in time certificates, even though the flow from individual participating units may be highly volatile. Through its pooling capabilities, the Account also can offer funds in a wide range of maturities and denominations. The Account's average maturity on deposits placed with S&L's tends to be longer than on those placed with banks — out to 2½ years and occasionally longer. In addition, a portion of these deposits may be renewed at maturity.

California's S&L industry, which is dominated by large multi-branch institutions, characteristically has exhibited relatively sophisticated liability-management techniques. These associations acquire funds from the California Pooled Account through negotiated bids, so that the amounts, maturities and rates on such funds are mutually determined. In addition, several large associations issue negotiable CD's, either directly or through dealers, with the Pooled Account being a heavy purchaser. And now that larger local-government units are authorized to invest in negotiable CD's (without pledging requirements), the amount of public funds invested in such instruments may increase significantly.

Still, local-government deposits make up only about one-third of the total public funds on deposit at California S&L's. Local funds are less attractive than state funds, as they must be collateralized by securities — mortgages still not being authorized as eligible collateral for such funds. In addition, these deposits tend to have shorter maturities than state deposits — generally under one year.

Source of funds

Public deposits have certain advantages over consumer deposits. Thrift institutions normally acquire such funds at their own option, on a bid or negotiated basis. In contrast, to control consumer-deposit flows, they must make a decision to offer (or discontinue offering) a certificate of a given maturity or rate, and must make this same offer to all consumer depositors. Because public deposits are acquired at the S&L's own option, they can be used deliberately to stabilize the association's entire "pool" of funds. For example, the maturities of these deposits may be timed to synchronize with funds obtained through sales of mortgage assets. In particular, very short-term maturities can be used to offset seasonal outflows of consumer savings associated with tax-payment dates.

Of course, thrift institutions might find public funds becoming too costly at some point in the interest-rate cycle, given the narrowing

spread between the mortgage rates that they can charge and their average cost of funds. But this consideration applies to other market-rate sources of funds, including consumer money-market certificates, and is not uniquely characteristic of public funds. In California, mortgage rates have not been constrained by statute, since the usury laws are not applicable to rates on real-estate loans made by S&L's. In addition, California S&L's have been able to maintain a favorable spread because of the high percentage of their portfolios held in variable-rate mortgages. These factors have helped S&L's to bid competitively for public funds against banks and other market instruments, even in the current period of rapidly rising interest rates.

California as a guide?

Beginning in 1977, California S&L's have been expanding their outstanding mortgages at a record rate of $10 to $12 billion a year. This massive expansion has coincided with the increased S&L access to public funds, and may account in part for the rapid acceleration in the use of such funds. For a while, in the second half of 1978, S&L's relied more heavily on the newly authorized money-market certificates, with rates tied to Treasury-bill rates. But following the March 1979 regulatory change affecting money-market certificates, the S&L's have lost part of this market to banks and to the rapidly expanding money-market funds. Meanwhile, "pass through" sales of mortgages to the secondary market have become a less attractive source of funds, because with the sharp rise in mortgage rates, older lower-rate mortgages have had to be sold at a substantial discount.

These recent developments have again enhanced the relative attractiveness of public deposits, as can be seen from the July report of the California State Pooled Investment Account. These July data show that S&L's held 93 percent of the Account's funds invested in time deposits. In addition, the share of public funds invested in S&L-issued negotiable CD's apparently also increased.

California's recent experience in the use of public time deposits as a source of mortgage funds may well serve as a guide to other areas of the country. However, some of the institutional factors that have aided California associations, such as the prevalence of large branch institutions, may not be present to the same degree in other states. But the move toward more sophisticated cash management has become widespread, both by governmental units and thrifts, and has helped stimulate greater use of public deposits as a source of housing funds.

California has demonstrated that access to public deposits — by providing a non-consumer, money-market source of funds — gives thrift institutions greater flexibility in liability management. Expanded use of public funds can serve to "smooth out" the flow of mortgage funds, not only over short time periods such as tax dates, but more importantly, during those cyclical periods when the inflow of consumer savings is insufficient to meet the demand for housing credit. But this potential role of public deposits as a significant aid to housing finance may be crucially tested in California in coming months.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/19/79	Change from 9/12/79	Change from year ago @ Dollar	Percent
Loans (gross, adjusted) and investments*	133,866	1,051	+ 19,004	16.55
Loans (gross, adjusted) — total#	110,793	1,012	+ 18,723	20.34
Commercial and industrial	31,876	285	+ 4,678	17.20
Real estate	40,491	238	+ 8,344	25.96
Loans to individuals	22,576	45	NA	NA
Securities loans	2,268	122	NA	NA
U.S. Treasury securities*	7,599	− 109	− 1,585	− 17.26
Other securities*	15,474	148	+ 1,866	13.71
Demand deposits — total#	44,418	− 1,905	+ 2,789	6.70
Demand deposits — adjusted	30,337	− 651	+ 543	1.82
Savings deposits — total	30,243	− 209	− 249	− 0.82
Time deposits — total#	54,167	679	+ 6,344	13.27
Individuals, part. & corp.	45,841	771	+ 8,020	21.21
(Large negotiable CD's)	20,338	444	+ 902	4.64

Weekly Averages of Daily Figures	Week ended 9/19/79	Week ended 9/12/79	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	− 67	− 9	− 27
Borrowings	226	60	54
Net free reserves (+)/Net borrowed(−)	− 159	− 69	− 81
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (−)]	+ 562	+ 1,449	+ 117
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (−)]	− 234	− 154	+ 281

* Excludes trading account securities.
\# Includes items not shown separately.
@ Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.

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