The Viability of Thrift Intermediaries as Financial Institutions*

Introduction

Mutual Savings Banks (MSB's) and Savings and Loan Associations (SLA's) — the thrift intermediaries — have been losing their share of the savings market. Commercial banks increased their relative earnings, paid out higher returns on time and savings deposits, and won a larger share of the over-the-counter savings market. Since the late 1950's, time and savings accounts in commercial banks have grown steadily relative to the increase in MSB deposits and SLA shares.

As interest rates started spiraling upward in 1965, the thrift intermediaries found themselves increasingly "locked in" with long-term mortgages: the *average* return on the mortgage portfolio fell below the current *marginal* return; the mortgage portfolio was falling in market value relative to their fixed claim dollar liabilities; and disintermediation — the withdrawal of funds seeking higher market returns — created additional liquidity and solvency problems.

In this paper we shall first analyze the problems and the policy issues that have emerged in the past decade. We then consider the *Report of the President's Commission on Financial Structure and Regulation* (the *Hunt Commission Report*) and the specific proposals it offers to enable thrift intermediaries to compete effectively and achieve viability as financial institutions.[1]

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* Financial support from the National Science Foundation and from Wayne State University is gratefully acknowledged.

1 The *Report of the President's Commission on Financial Structure and Regulation* (Washington, 1971), the *Hunt Commission Report*, is the most recent assessment offering a series of recommendations for improving the competitive posture of the thrift intermediaries. Somewhat earlier, Professor Irwin Friend directed a comprehensive four volume *Study of the Savings and Loan Industry* (Washington, 1970) for the Federal Home Loan Bank Board. Leo Grebler in a volume on *The Future of Thrift Institutions.* (Illinois, 1969)

The thrift intermediary problems that have surfaced in recent years are reviewed in section I, and highlight some of the issues taken up in this paper. The relative decline of the thrift intermediaries in the decade ending in 1965 is analyzed in section II; the conditions generating disintermediation, which reached crisis-like proportions bordering on a national emergency in 1966, are analyzed in section III. The question of *statutory specialization* and of *protected specialization* is considered in section IV. The *Hunt Commission Report* and earlier proposals for improving the competitive posture of the thrift intermediaries by broadening their powers and permitting them to diversify are taken up in sections V and VI. The effects of these proposals on the institutions and on the housing and mortgage markets are summarized in section VII; our conclusions are presented in section VIII.

I. An Overview of Problems Facing Thrift Intermediaries

In the past two decades, thrift intermediaries have been confronting intensified commercial bank competition, and, on several occasions since the mid-1960's, massive withdrawals of funds seeking higher returns on competitive short term instruments. The thrift intermediaries are concerned about "one-stop" banking, third party money transfers, "full-service" and customer convenience, and whether they can maintain their share in the rapidly growing financial services industry. The postwar experience, summarized in this section, suggests that we need to reconsider the role of specialized intermediaries in the efficient allocation of capital.

A. *The Intensified Commercial Bank Competition for Savings Deposits*

The MSB and SLA share of the savings market declined as the commercial banks initiated their serious competition for savings deposits, a drive which began gradually in the late 1950's and accelerated in the 1960's. The commercial bank share of the savings flows in the three depository intermediaries rose dramatically from

focuses on the issue of diversification and specialization. Going back to the early 1960's, there is the *Report of the Committee on Financial Institutions to the President of the United States* (Washington, 1963), *The Heller Report*, and the *Commission on Money and Credit* report, *Money and Credit* (Prentice-Hall, 1961).

less than 25 percent in the decade ending in 1957, to approximately 50 percent in the latter half of the 1960's. The September 1966 introduction of interest rate controls slowed the commercial bank drive, but the thrift institutions' share of the market has eroded in the past decade.[2]

The composition of commercial bank deposits changed markedly as a result of this successful competition for savings. Savings deposits as a ratio to demand deposits increased from .4 to .6 during the 1950's, from .6 to 1.3 in the 1960's, and the ratio is presently averaging close to about 1.4, more than three times as large as the .4 ratio that prevailed in the 1950's.[3]

B. *Postwar Yield Curves and the Nonbank Thrift Intermediaries*

Thrift intermediaries benefited from the large spread between short and long rates that prevailed from the beginning of the postwar period up until the middle fifties. The upward sloping yield-to-maturity curve favored intermediation income, and long term mortgage yields were high enough, and rising at a sufficient pace, relative to short term rates. The thrift intermediaries were able to raise their dividends and keep them attractive relative to the return on commercial bank savings deposits and other short term instruments.[4]

2 See G. K. Kardauche, *The Competition for Savings* (New York, 1969), and G. Benston, "Savings Banks and the Public Interest", *Journal of Money, Credit and Banking* (February 1972).

3 The rapid growth in time deposits may reflect a longer-term shift from an M_1 money stock concept (currency plus demand deposits) to an M_2 concept (M_1 plus commercial bank time deposits) that predates the postwar rise in interest rates. Thus, while the public has been viewing its money stock holdings in terms of the broader M_2 concept, the manifestation of this modification in preferences was most evident in the postwar period, when rising interest rates and higher returns on savings brought about a sharp increase in time deposits relative to demand deposits.

The rapid rise in time deposits relative to demand deposits may therefore be rationalized as a change in monetary habits — as an evolutionary adjustment in preferences from M_1 to a broader monetary aggregate such as M_2. On the other hand, commercial bank time deposit growth also came at the expense of thrift intermediary claims, and may represent a more fundamental and revolutionary change in preferences and in the public's desired portfolio of all liquid assets, including monetary assets, intermediary claims and other non-monetary claims. This latter possibility may portend a potentially greater problem for the thrift intermediaries. See M. Friedman and A. Schwartz, *Monetary Statistics of the United States* (New York, 1970).

4 For a review and analysis of interest rate movements in the postwar period, see S. Homer and R.I. Johannesen, *The Price of Money, 1946 to 1969* (Rutgers Univ., 1969); D. I. Fand, "High Interest Rates and Inflation in the United States: Cause or Effect?", this

The post World War II yield curve changes significantly affected the investment income of the three depository intermediaries. From the end of World War II till 1970 the SLA return on assets increased by approximately 50 percent; the MSB return, by close to 100 percent; and the commercial bank return, by almost 200 percent.

The commercial banks' success in lifting their earnings enabled them to increase their share of the savings market. At first this was primarily a catching up with the intermediary returns. But the commercial bank return caught up with the SLA rate in the middle 1960's and surpassed it towards the end of the 1960's. The advantage of a shorter term portfolio emerged most dramatically when short term rates exceeded the mortgage return in the late 1960's.

C. *Inflationary Expectations and Disintermediation*

While the interest rate escalation since 1965 brought about substantial withdrawals for all depository institutions, it was especially severe for the thrift intermediaries. As interest rates started climbing in 1965, the mortgage portfolio return fell below current rates on new investments, while the dividend rate on intermediary claims had to rise in order to remain competitive and to avoid withdrawals. A severe earnings squeeze therefore inevitably developed. Regulation "Q" ceilings were used to thwart commercial bank competition but did not stop disintermediation — massive withdrawal of funds from all depository institutions to open market instruments.

Nonbank intermediaries specializing in long term assets and issuing short term liabilities have been grappling with especially severe earnings, liquidity, and solvency problems since the mid-1960's. Indeed, the very intensity of these problems since the post-1965 inflation accounts for the proposals to shorten the maturity of their assets so that earnings may adjust more quickly to changing market rates, and to manage their liabilities in ways that would lessen deposit withdrawals when interest rates rise.[5]

Review (March 1972); H. Kaufman and R. I. Johannesen, *The 1972 Annual Review of the Bond Market* (Salomon Bros., 1973); and A. M. Wojnilower, *An Old Story in a New Setting* (First Boston, 1973).

[5] For examples of these recommendations, see I. Friend, "Summary and Recommendations" and "Changes in the Asset and Liability Structure of the Savings and Loan Industry", in *Study of the Savings and Loan Industry, op. cit.*; L. Grebler, *The Future of Thrift Institutions, op. cit.*; and the *Hunt Commission Report*.

D. *Movement in "Q" Ceilings in the Past Two Decades*

The Banking Act of 1933 authorized the Federal Reserve Board to establish maximum rates on commercial bank time and savings deposits. The Federal Reserve Board initially imposed a 3 percent Regulation "Q" ceiling rate on commercial bank time and savings deposits in November 1933 to limit competition for funds, which was then viewed as being detrimental to their solvency. The ceiling rates were lowered to 2.5 percent in 1935 and 1936.

"Q" ceilings on savings deposits were raised in 1957 from 2.5 percent to 3 percent — the first increase in over twenty years. They were raised again in 1962 to impose a maximum of 4 percent on both savings and time deposits with maturities of twelve months or more. In November of 1964, the "Q" ceilings on time deposits were raised, for the first time, above the ceiling on savings deposits. Subsequent changes in the 1960's generated "Q" ceiling rates ranging from 4.5 percent on savings deposits up to 7.5 percent on large certificates of deposit, *CD's*, with maturities of one year or more.

The "Q" ceiling increases since 1957 have significantly changed the savings market from the early postwar years when the commercial bank rate on savings deposits was regulated, while the MSB's and the SLA's were not subject to any rate control. The successive increases in the "Q" ceilings, the increasing number of banks offering the maximum rates, and the higher rates permitted on CD's substantially narrowed the 100-150 basis points rate differential favoring thrift intermediary claims in the early postwar period.[6]

The "Q" ceiling increases initiated in 1957 were designed to permit commercial bank competition for savings deposits. Since 1966, the spread between the "Q" ceiling rates and market rates has been kept down at times to influence bank credit and to stop withdrawals from the nonbank intermediaries.[7]

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[6] Commercial banks used the CD as the major instrument to appeal to yield sensitive savers by selectively moving up rates on time deposits relative to the return on thrift intermediary claims. When rate control was extended to all three depository intermediaries in the fall of 1966, the thrift institutions' rate advantage was kept at relatively narrow margins, and the average differential in recent years has been fairly small.

[7] For an analysis of Regulation "Q", see L. S. Ritter, *Regulation Q: Issues and Alternatives* (Chicago, 1965); G. R. Morrison and R. T. Selden, *Time Deposit Growth and the Employment of Bank Funds* (Chicago, 1965); A. H. Cox, Jr., *Regulation of Interest*

E. *The Decline of Passbook Saving*

Intermediary claims and other fixed claim assets may have lost considerable appeal to many savers who have a wider range of options in choosing a savings outlet. The more affluent households may prefer equity investments to participate in economic growth and to minimize the adverse effects of price inflation on their savings; and the proportion of such households will presumably increase with the growth in income. While the passbook savings account served as the backbone of the thrift industry for over a century, it may no longer attract a sufficient share of savings. The thrift intermediaries have therefore proposed to offer the public a more attractive menu, which would include some equity type assets and a more complete line of financial services in order to maintain their relative market position.

F. *Financial Intermediation and Allocative Efficiency*

Finally, and perhaps the most important problem confronting the specialized intermediaries is their role in the efficient allocation of capital. Financial intermediation through depository institutions is unquestionably superior to an alternative which requires surplus units to transact directly with deficit units. Efficient intermediation requires that financial resources be allocated in various uses so as to maximize their returns, and that the resources are supplied at the lowest cost. We do not know whether intermediaries allocate capital efficiently under our present system; we do not have satisfactory evidence of either operating or allocative efficiency; and we do not know whether they can compete successfully in the rapidly growing financial services industry.[8]

Rates and Bank Deposits (Ann Arbor, 1966); C. B. LUTTRELL, "Interest Rate Controls — Perspective, Purpose and Problems", *Review*, Federal Reserve Bank of St. Louis (September 1968); C. E. REUBLING, "The Administration of Regulation Q", *Review*, Federal Reserve Bank of St. Louis (February 1970); and P. A. SAMUELSON, "An Analytical Evaluation of Interest Rate Ceilings for Savings and Loan Associations and Competitive Institutions", in *Study of the Savings and Loan Industry, op. cit.* See the *Hunt Commission Report*, "The Regulation of Interest Rate Ceilings on Deposits", pp. 23-31.

8 See D. I. FAND, "Financial Regulation and the Allocative Efficiency of our Capital Markets", *National Banking Review* (September 1965); D. P. JACOBS, "Specialization in Financial Institutions", *Conference on Savings and Residential Financing*, 1966 Proceedings; and S. M. GOLDFELD, "Savings and Loan Associations and the Market for Savings: Aspect for Allocative Efficiency", in *Study of the Savings and Loan Industry, op. cit.*

Experience in the past decade has focused attention on the following questions:

1. *One-Stop Banking and Additional Financial Services for Customer Convenience.* Thrift institutions believe that one-stop banking may enhance their ability to attract savings, and they would accordingly like to offer additional financial services for customer convenience. Individuals are in the market for consumer loans before they buy a home and apply for mortgage loans, and their subsequent savings choices often depend on the financial services they obtained at an earlier date. As a logical extension of their present focus on household savings and home financing, MSB's and SLA's should evolve into more broadly oriented consumer-household- or family-centered financial institutions.[9]

2. *Third Party Transfers and the Checkless Society.* Some thrift institutions would like to be able to provide checking accounts (demand deposits), and credit cards to participate more directly in money transfers and thereby avoid the present cumbersome arrangements for transferring funds to third parties. They have an understandable interest in the technology of electronic money transfers, which would permit them to engage in money transfers without issuing checking accounts. Non-check automated payment transfer systems may be instituted in the near future, posing both a challenge and an opportunity for the thrift intermediaries.[10]

II. The Successful Commercial Bank Competition for Savings: Narrowing Spreads, and Tight Money-Tight Credit

From their 1946 low of 2.2 percent, corporate Aaa long rates climbed steadily reaching almost 10 percent in 1970, a dramatic rise attesting to the remarkable postwar recovery of the U.S. economy from the depressed 1930's. Until the mid-1960's, the postwar interest rate rise was still in the normal range and was presumably reflect-

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9 For some discussion of the role of "full service" banking, see L. GREBLER, *op. cit.*; I. FRIEND, *op. cit.*; G. ENSLEY, "The Need for Modernizing our Financial Structure" (March 1972); and I. SCOTT, "The Future of the Payments System and Checking Account for Mutual Savings Banks" (May 1972).

10 The impact of electronic money transfers on the SLA's is taken up in D. P. JACOBS and E. M. LERNER, *The Impact of Electronic Money Transfers on the Savings and Loan Business* (Chicago, 1972), and Governor G. W. MITCHELL, "Recent Developments in Money Transfers" (February 1973).

ing the commitment to full employment enacted in 1946, the Keynesian macroeconomics (and the "new inflation") of the 1950's, and the elimination of the gap between potential and actual output in the first half of the 1960's. It was not until the latter half of the 1960's that accelerating inflation and inflationary expectations brought about an extraordinary escalation of interest rates. The postwar rise in interest rates was associated with a decline in the spread between short and long rates, with the consequence that the specialized thrift intermediaries were less able to compete effectively for savings deposits.

Monetary actions to stabilize the economy affect the spread between short and long term interest rates. Thus, when the authorities restrict monetary growth, all money market rates rise but short term rates rise relatively most, and when they accelerate monetary growth, short term rates drop more sharply than long term rates. *Easy* money and *easy* credit conditions in the recession and *tight* money and *tight* credit conditions in the boom change short term rates on market instruments not only relative to long term rates but also relative to the rates offered on savings by the depository institutions.

Savings inflows to the depository intermediaries are sensitive to changes between short term market rates and the rates offered on savings. Commercial banks with earnings that keep abreast of market rates were therefore relatively successful in the battle for savings, as we shall show in this section.

A. *Factors Shaping the Competition for Savings*

In this section we shall briefly summarize several features of the postwar period: the declining spread between short and long term rates, the relative earnings of the three depository institutions, the effective interest rate (or dividend) paid on savings, and the declining differential in favor of intermediary claims. The analysis below suggests that the successful commercial bank drive for savings and the associated decline of the thrift intermediaries was primarily due to these postwar developments.

1. *The Secular Decline in the Spread Since World War II.* The "yield curve" relating the interest return on securities to their maturities may slope upwards, with yields rising as maturity

increases, or it may be relatively flat, or slope downwards, with yields declining as maturity increases. Whether one uses U.S. government or corporate securities to calculate a yield curve and to measure the term structure of interest rates, the pattern is likely to be fairly similar.

The decline in both the government and corporate spreads, using annual data since World War II, is very similar. In the late 1940's, the spread on governments never went below 120 basis points and averaged close to 200 basis points in many years. In the early 1950's the spread ranged from a 1952 low of 91 basis points to a 1954 high of 160 basis points. In the latter part of the 1950's, the spread began to narrow, ranging from 20 basis points in 1957 to 160 basis points in 1958. The spread narrowed steadily in the 1960's (except for the two years, 1961 and 1962) and turned negative for the first time in the postwar period. Since 1965 the spread varied from a *positive* 91 basis points in 1970 to a *negative* 56 basis points in 1969.

The pattern for the corporate spread is very similar. In the late 1940's, the spread averaged approximately 140-150 basis points. In the early 1950's, the spread averaged close to about 80-90 basis points, but declined to a low of 5 and 8 basis points in 1956 and 1957 respectively. The spreads were almost uniformly low in the early 1960's except for 1961 and 1962. Since 1965 the spread was negative in two years, and has varied from a positive 41 basis points spread to a negative 80 basis points spread.

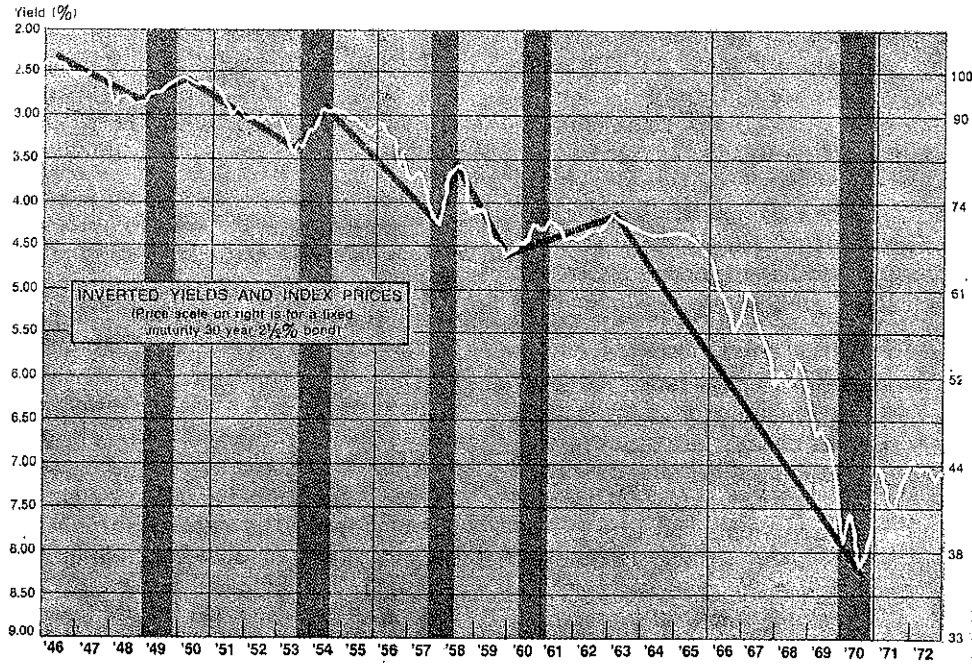
The secular updrift in interest rates and the rise in short term rates relative to the long term rate shown in charts 1 and 2 apparently did slow down the relative income growth of the specialized intermediaries; and commercial banks with shorter term maturities were able to raise their earnings proportionately more than the specialized intermediaries, as summarized in the next section.

2. *The Return on Assets for the Three Depository Institutions, 1946-1969.*[11] We shall compare the rate of return (investment

[11] We present our regression results for the period 1946-1969. We have not utilized the data for 1970-1972 because of the distorting effects of the 1969-1970 recession and because of several other changes that have been introduced since the 1968 Housing Act. The forces operating in the postwar period can be better seen by focussing on the period up to 1969.

CHART 1

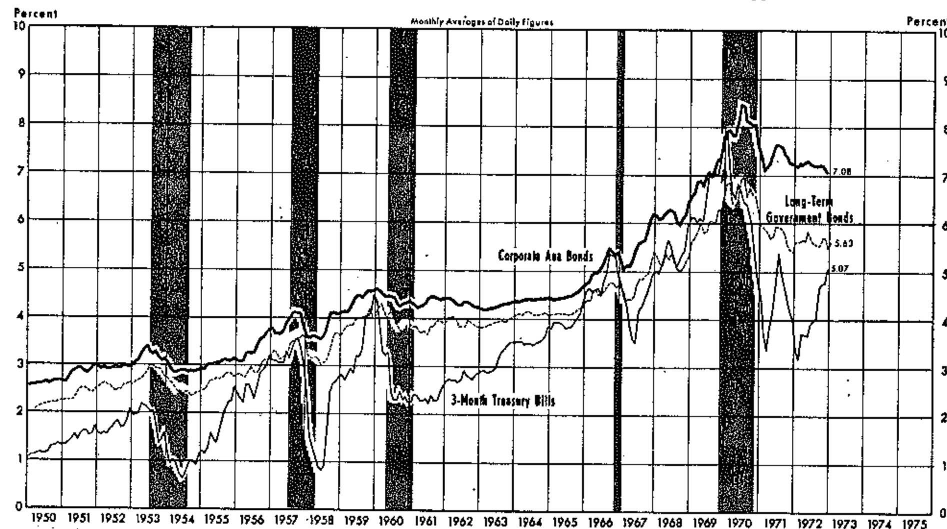
PRIME LONG CORPORATE BONDS SINCE 1946



H. KAUFMAN and R. I. JOHANNESEN, *1972 Annual Review of the Bond Market.*

CHART 2

SHORT AND LONG TERM INTEREST RATES SINCE 1950



The shaded areas shown in 1953-54, 1957-58, 1960-61 and 1969-70 represent periods of business recessions as defined by the National Bureau of Economic Research. The shaded area in 1966-67 represents an "unofficial mini-recession".
Latest data plotted: December.
Review, Federal Reserve Bank of St. Louis (January 1973).

income) on assets for the three depository institutions to analyze the impact of the post World War II interest rate and yield curve changes on their relative earnings. For every 100 basis points rise in the long term (corporate Aaa) rate, the commercial bank asset return increased by 102 basis points, the MSB return increased by 71 basis points, and the SLA return increased by 51 basis points. Similarly, comparing the return on assets with the commercial paper rate, we find that the commercial bank return exceeded the MSB return and was almost twice as large as the SLA return. For the entire period 1946-1969, the return (investment income) on SLA assets increased (in basis points) only about half as much as the increase on commercial bank assets. See tables 1 and 2.

3. *The Rate Paid on Savings Deposits, 1946-1969.* The competition for savings deposits was affected by the relative income changes for the three depository institutions. This is evident when we compare how the rates paid on savings responded to increases in the corporate Aaa rate. For every 100 basis points rise in the long term rate, the commercial bank payout rate increased by approximately 109 basis points, the MSB rate, by approximately 86 basis points, and the SLA rate, by approximately 66 basis points. A similar pattern emerges when we compare the response of the dividend rate to increases in the commercial paper rate. The interest elasticity of the SLA dividend (payout) rate, for the postwar period, was less than that of the MSB elasticity, and considerably below the commercial bank elasticity. In absolute terms, the increase in the SLA payout rate was approximately 60 percent of the increase in the commercial bank payout rate. See tables 1 and 2.

4. *The Declining Rate Differential in Favor of Intermediary Claims.* Commercial bank investment income since 1946 increased approximately 30 percent more than the MSB income and about 100 percent more than the SLA income. Not surprisingly, the increase in the commercial bank payout rate on savings since 1946 exceeds the MSB increase by approximately 20 percent, and the SLA increase by about 40 percent.

The increasing commercial bank share of the savings market was already beginning to impinge on the intermediaries in the late 1950's. But it was not until the historically relatively low commercial bank rate on savings approached the dividends paid by the thrift intermediaries — in the latter half of the 1960's — that it reached a

TABLE 1

REGRESSION RESULTS: FOR THE RELATION BETWEEN THE RETURN (INVESTMENT INCOME) ON ASSETS EARNED BY THE DEPOSITORY INTERMEDIARIES AND THE LONG-TERM RATE; FOR THE EFFECTIVE INTEREST AND DIVIDEND RATE PAID BY DEPOSITORY INTERMEDIARIES AND THE LONG-TERM RATE, 1946-1969

Dependent Variables	Constant Term	Regression Coefficient	R^2
Rate of Return on Assets at:			
Commercial Banks	.054	1.022	.937
Mutual Savings Banks	1.317	.708	.913
Savings and Loan Associations	3.164	.508	.881
Effective Interest and Dividend Rates on Savings Deposits Paid by:			
Commercial Banks	−1.940	1.089	.926
Mutual Savings Banks	−.271	.862	.893
Savings and Loan Associations	.859	.657	.892

TABLE 2

RELATION OF THE RATE OF RETURN ON ASSETS AND THE EFFECTIVE INTEREST AND DIVIDEND RATE PAID BY DEPOSITORY INTERMEDIARIES TO THE LONG-TERM RATE, 1946-1969

	Commercial Banks	Mutual Savings Banks	Savings & Loan Associations
A rise in the long rate of 100 basis points is associated with an increase (in basis points) in the:			
Rate of return on assets	102	71	51
Effective interest and dividend rate	109	86	66
A rise in the long rate from 2.5% to 7.0% is associated with an increase (in basis points) in the:			
Rate of return on assets	460	318	229
Effective interest and dividend rate	490	388	296
The required rise in the long rate needed for a 100 basis point increase in the:			
Rate of return on assets	97.8	141.2	196.8
Interest and dividend held	91.8	116.0	152.2

crisis stage. From an early postwar 200 basis points, the rate differential in favor of thrift intermediary claims declined until it was quite small after 1965; and the commercial bank share in over-the-counter savings exceeded 50 percent for the first time in the postwar period.

B. *Tight Money and the Relative Decline of Thrift Intermediaries*

The postwar interest rate and yield curve changes, outlined above, reflect secular forces, short-term cyclical movements, and medium to longer term persistent changes in inflationary expectations, with distinctive effects that need to be examined.

The cyclical episodes of *tight money* and *tight credit* in the decade prior to the mid-1960's posed very difficult problems for the thrift intermediaries, but they did not threaten their very existence and viability: the periods of monetary restraint were typically relatively short; the interest rate spreads, while declining, were rarely negative; the dividend rates on intermediary claims were still quite high relative to the regulated commercial bank rates; and the potent CD instrument had not yet been developed.[12]

Inflationary expectations in the middle 1960's sharply accelerated the relative decline in the nonbank intermediary share of the savings market. Indeed, the specialized intermediaries, with long term mortgage assets and short term liabilities, are clearly extremely vulnerable to the disintermediation that we experienced in the U.S. following the post-1965 interest rate escalation. The (medium or possibly longer-term) inflationary expectations that emerged in the mid-1960's, coupled with the secular updrift of interest rates starting in 1946, have brought about very substantial changes in credit market conditions that may take a long time to reverse.

But while the cyclical changes from *easy money* to *tight money* and their yield curve effects may continue to disadvantage thrift intermediaries in the future, they do not appear to threaten the very survival of these institutions. In contrast, disintermediation,

12 Profitable outlets for "high cost" money induced the commercial banks to develop the certificates of deposit (CD's) beginning in 1961, first as an instrument to draw on business funds in large denominations, and later expanding its scope to include consumer CD's — the smaller CD's tailored for individual savers. Consumer type CD's represented approximately 70 percent of all CD's issued in 1970.

the massive withdrawal of funds that is associated with *easy money*, inflationary expectations, and *tight credit*, and which reached such crisis proportions in 1966, does threaten the very survival of the thrift intermediaries.

III. Disintermediation: Easy Money-Tight Credit, and Inflationary Expectations

Commercial banks have relatively short term portfolios. They can therefore earn and pay higher rates to keep their deposits and avoid withdrawals when interest rates rise. Life insurance companies with assets and liabilities that are both long term do not experience a withdrawal or cashing-in of insurance funds in periods of rising interest rates, except for the increase of policy loans. Commercial banks and life insurance companies have relatively balanced term structures. In contrast, thrift intermediary portfolios, with mortgage loans as their principal asset and passbook savings as their main source of funds are unbalanced, offering no protection against deposit withdrawals in periods of escalating interest rates.

The unbalanced MSB and SLA term structures led to difficulties that were dramatically illustrated in the mid-1960's. Passbook savings are similar to demand deposits (in fact, if not in law), and the dividend rate must stay in line with market rates to retain existing accounts and to attract new funds. But the bulk of thrift intermediary income comes from long term mortgages, fixed at rates that are below the currently rising market levels; and several years may elapse before the average portfolio return approximates the higher market yield on new investments.

In the decade prior to 1965, the thrift intermediary share in savings declined slowly as the differential between intermediary claims and savings deposits in commercial banks narrowed. In contrast, the disintermediation crises since 1966 had both a more immediate and dramatic impact in curtailing the net inflows of funds to all depository institutions; and while initially associated with a massive movement of funds from all financial institutions into open market instruments, its impact on the thrift intermediaries was relatively most severe.

The 1966 and 1969 disintermediation crises followed the extraordinary interest rate escalation starting in 1965 and confronted

the thrift intermediaries with serious earnings, solvency, and liquidity problems. A rise in interest rates flattens the yield curve, curtailing intermediation income, and also depreciates all dollar denominated liquid assets. Individuals withdraw funds from the depository institutions either to obtain the higher market yields, or to minimize their capital losses by moving out of fixed claim assets denominated in nominal units whose real value also falls in inflation. In addition to the loss of deposits, thrift intermediary income on their long term mortgages lags behind the rise in market rates, and the market value of these long term assets falls relative to their deposit liabilities. Thrift intermediary earnings, liquidity, and solvency were all adversely affected by the interest rate escalation.

Climbing interest rates induce savers to shift funds from thrift institutions to the commercial banks, whose shorter term portfolio income does keep up with market rates and who can attract the yield-sensitive saver by paying higher rates on CD's (e.g. the 1966 experience). But as the interest rate rise continues, savers shift from depository institutions to market instruments in order to obtain higher yields (e.g. the 1969 experience).

It is therefore doubtful whether thrift intermediaries can survive as viable depository institutions in their present form if we do not succeed in controlling inflationary expectations and if we face another decade of rising, and high, interest rates. Purchasing power clauses, variable rate mortgages, bond financed mortgage banks, and other far-reaching institutional changes may be necessary, if we have to face future bouts with accelerating inflation, inflationary expectations, and escalating interest rates.[13]

Regulation "Q" ceilings and the 1966 act controlling interest rates on all depository institutions were the initial response to the movement of funds from intermediaries to commercial banks; but as the interest rate escalation and the massive withdrawal of funds continued, it led to a variety of measures that we associate with *protected specialization*.

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[13] See Governor A. F. Brimmer, "Interest Rate Discrimination, Savings Flows, and New Priorities in Home Financing (June 1972), and Chairman A. F. Burns *Statement* before the Subcommittee on Priorities and Economy in Government of the *Joint Economic Committee* (December 1972).

IV. Statutory (Regulatory) Specialization, and Protected Specialization

The economic advantage of specialization is most readily rationalized when it develops naturally and in response to market forces, and has been recognized since Adam Smith's *The Wealth of Nations*. But one may question whether specialization that does not arise in a natural manner also bestows benefits on the public. In this section we consider whether specialization that is imposed on an institution by the statutes or by regulation is beneficial to society.

A. *Statutory Specialization: Pro and Con*

Statutory specialization committing the thrift institutions to mortgage lending developed at a time when passbook accounts were the only significant source of funds, when the institutions were investing mainly in local mortgage markets, when management was often relatively unsophisticated, when deposit insurance was not available, and when safety for the public's savings was necessarily the main concern.

The case for *statutory specialization* may have been clearer when government first began to regulate the thrift institutions. It was plausible for legislators and regulators to assume that when financial intermediaries specialize in one class of assets, it would simplify management tasks, enhance the institution's safety, and provide financial services to the public at lower cost.

Whatever merit *statutory* or *regulatory specialization* may have had at this earlier period, it does not carry over to the present day thrift intermediaries, especially the larger institutions: the competition for savings deposits is intense and management can no longer rely on saver loyalty; and decisions concerning liquidity and mortgage lending and dealings with regulatory agencies require a professional expertise. And even if *statutory specialization* had potential benefits, it could still be questioned. The non-specialized lenders — commercial banks and life insurance companies — always have the option of realizing similar benefits by having mortgage portfolios as large as those of the specialized thrift institutions.

While the available evidence may not permit a decisive test on the long run social benefits of *statutory specialization*, it suggests

that small institutions may operate more efficiently and more profitably when they are specialized. But we cannot determine the asset size at which economies due to specialization level off. Accordingly, the choice between more diversified activities and perpetuation of the current range of operations must be made on other grounds.

One could argue that *statutory specialization* restricts portfolio flexibility and it is not likely to satisfy the criteria of allocative efficiency. On the other hand, restrictions on institutional portfolios need not necessarily lead to credit misallocation if the public is sufficiently yield sensitive and will transfer funds to those intermediaries that pay the highest return. Thus, if the public's choice of a savings outlet is interest elastic, it could correct any potential misallocation of credit resulting from institutional portfolio inflexibility. But, in order for this corrective to operate it is necessary that the interest rate, or dividend, paid by the intermediaries, always reflects the market rate of return that they are currently earning. And it is doubtful that this condition is satisfied.

B. *Protected Specialization*

Following the post-1965 accelerating inflation *statutory specialization* has given way to *protected specialization.* As market rates on competitive short term instruments started climbing above the rates offered on savings deposits, all depository intermediaries were facing massive withdrawals in 1966. The serious disintermediation problems gave rise to the system of *protected specialization* — of Regulation "Q" deposit ceilings and interest rate controls on depository institutions and housing subsidies. And the thrift intermediaries have become more dependent on federal agencies.

The difficulties of continuing with the system of "*statutory cum protected specialization*" may be briefly summarized:

"*Statutory specialization*" is not likely to satisfy the criteria of allocative efficiency in the capital markets and in the use of resources.

"*Protected specialization*" conflicts with our traditional support of free, competitive, markets and places the initiative for innovative responses to changing financial needs on to the public authorities.

Federal advances for housing subsidies would expose thrift institutions to new risks and rigidities, and dependence on subsidies

necessarily requires abrupt changes in operations whenever priorities change.

Thrift institutions cannot continue to count on Regulation "Q" type interest rate ceilings for protection.

Low ceiling rates, mandated for all depository institutions, would nevertheless lead to huge withdrawals as savers are drawn to the higher yields on market instruments.

Regulation "Q" will thus become ever less effective in future periods of rising interest rates, as the typical thrift intermediary depositor will learn to seek out higher yielding, smaller denomination, money market instruments issued by both private business and the U.S. Treasury.

The thrift intermediaries will have to acquiesce to a phase-out of Regulation "Q", whether through economic obsolescence or through legislation. These considerations therefore suggest that we need to formulate the institutional and regulatory changes that would enable the thrift intermediaries to compete effectively and remain viable institutions.[14]

V. Broadened Powers to Achieve Competitive Viability in the Financial Services Industry

The Hunt Commission report follows previous studies in favoring proposals that would permit the thrift institutions to offer a variety of financial services designed to enable them to compete more effectively and thereby, hopefully, to insure their viability in the rapidly growing financial services industry. By providing middle income groups and the non-affluent public with some of their necessary financial needs, the thrift intermediaries may increase their attractiveness as family institutions for all age groups. These broadened powers are thus viewed as the vehicle which the thrift intermediaries will utilize to maintain their market share and retard the flow of savings to non-mortgage uses.

14 The Hunt Commission recommends that the rate regulation on time and savings accounts of $ 100,000 or more be removed immediately, that the Federal Reserve Board be given power on a standby basis to stipulate rate maximums on accounts of less than $ 100,000, that the Board have discretionary power to reduce the $ 100,000 cutoff amount for the standby power, and that the Board's standby power to establish rate ceilings be abolished at the end of a 10-year period. The *Hunt Commission Report* thus recommends a gradual phasing out of interest rate ceilings on deposits. See pp. 23-27.

The kinds of new financial services that may improve the competitive posture of the thrift intermediaries include trust department services, service corporations, no-load mutual funds, and equity participations to facilitate their growth potential. They are briefly reviewed in this section.

A. "*Full-Service*" *and* "*One-Stop*" *Banking*

Customer convenience may influence households in deciding where to keep their savings, and may be a factor in the competition between thrift institutions and commercial banks. Thrift institutions often pay rates between ½ and 1 percent above the commercial bank rate on savings, and the "full-service" and "one-stop" banking is said to be a significant reason for the differential.[15]

B. *Third Party Transfers and Checking Accounts*

Limited checking account facilities for savings depositors may improve customer convenience, since MSB's and SLA's do permit their depositors at the present time to use lawful but cumbersome substitute arrangements — such as withdrawal through the institution's check made out to third persons. Authority to handle checking accounts would replace these unsatisfactory substitutes for third party payments. The thrift intermediaries would be required to maintain cash reserves against checking deposits. The Hunt Commission report proposes that thrift institutions be permitted to offer third party payment services, including checking accounts and credit cards but limited to households and non-business entities.[16]

Since we are approaching the automated payment transfer system, or the "checkless" society, some critics have suggested that the thrift institutions skip the check stage and proceed directly to an automated payment system. The *giro* system in Germany and other countries is believed to have contributed to the popularity

15 The Commission recommends that: "savings and loan associations and mutual savings banks be permitted to offer a wider variety of time and savings deposits and certificates of deposit, varying with respect to interest rate, withdrawal power, and maturity", and... "engage in a variety of financial fiduciary or insurance services for individuals and non-business entities of the type, but not more extensive than those approved for bank holding companies by the Board of Governors of the Federal Reserve System under the Bank Holding Company Act".

16 The Commission recommends that: "under specified conditions, savings and loan associations and mutual savings banks be permitted to provide third party payment services, including checking accounts and credit cards, to individuals and non-business entities only".

of savings banks in the household sector; and the electronic money transfer mechanism extends and simplifies the giro system, using more advanced technology. The thrift institutions, according to this view, may be better off concentrating on the development of electronic money transfers in order to participate in a more comprehensive scheme for automated transfers.

Provision of electronic money transfer services would offer customer convenience in the form of a relatively new product instead of competing with commercial banks for checking services. The "bill paying" approach, already adopted by a few MSB's, would permit the thrift institutions to pay their depositors' utility, tax, mortgage, rent and other recurring bills. Salary transfer programs or "payroll deduction" plans are another variant offered by savings banks in some European countries.

C. *Mutual Fund Service, Trust Departments, and Service Corporations*

Shares in a low-cost no-load mutual fund may serve as another vehicle to increase customer convenience, and the feasibility problems could be eased substantially if the thrift intermediaries cooperated in setting up such an enterprise. The mutual fund has been among the most rapidly growing outlets for savings. A growing segment of the public seeks equity investments to participate in the growth of the economy and to protect their assets against price inflation. The common stock investments of mutual funds offer capital appreciation, long term growth opportunities that are precluded in the traditional savings account. The number of people owning common stocks directly has tripled since 1951, suggesting perhaps an increasing demand for long term capital appreciation and a preference for professional management.[17]

D. *Other Financial Services*

Another proposal is for the thrift institutions to offer trust services as a desirable supplement to their investment revenues.

17 The Commission recommends that: "savings and loan associations and mutual savings banks, and subsidiaries of savings and loan associations and mutual savings banks and holding company affiliates of savings and loan associations be permitted to manage and sell mutual funds, including commingled agency accounts, subject to regulation by the Securities and Exchange Commission".

Qualified intermediaries would be authorized, under this plan, to establish separate trust departments and to perform trust administration operations including investment services for their clientele. The thrift institutions would concentrate on typically middle-class customers and offer them low-cost trust services. It is not clear whether the settlement of estates and other trust activities can be operated for relatively small accounts without loss; and the thrift institutions can hardly expect to capture a significant volume of the large, and presumably profitable, accounts from the commercial banks. And it is questionable whether the indirect benefits to the intermediaries would warrant trust departments as "loss leaders," as this does raise equity questions for the mutual institutions.[18]

The service corporation offers still other possibilities for additional service income. SLA-owned service corporations do engage, at the present time, in data processing, credit information, appraisal and construction inspection services, title abstracts, real estate loan brokerage and warehousing, market surveys and other research. They are also used to arrange mortgage loans on large projects on behalf of the SLA's owning the corporations. The services could be broadened to include real estate brokerage, property insurance, escrow, and could also be offered to other institutions and business firms.

E. *Mobile Homes, Non-Residential Property, Variable Annuities, Equities, and Equity Participations*

The case for including mobile homes and other types of property in the mortgage loan portfolio is that it would add to the growth potential of the thrift institutions. Mobile homes have grown rapidly in the 1960's and illustrate a relatively new activity

18 The Commission recommends that: "savings and loan associations and mutual savings banks be granted a widened range of loan and investment powers, including authority to:

> make direct investment in real estate and participate directly with other organizations in the ownership of real estate, including participation through stock ownership... participate directly in real estate through loan agreements to receive rental and other non-interest income, whether or not the institution holds an equity interest in the same property

and ... engage in a variety of financial fiduciary or insurance services for individuals and non-business entities of the type, but not more extensive than those approved for bank holding companies by the Board of Governors of the Federal Reserve System under the Bank Holding Company Act".

that could accelerate the income growth of the intermediaries. The number of units delivered annually to builders has been growing rapidly from 100,000 units in the early 1960's to almost 400,000 units in 1969. Mobile homes now represent over 25 percent of single-family housing starts, compared to less than 10 percent in the early 1960's. Technically the debt instruments are not of the mortgage type, but this kind of loan is likely to continue to grow, and lending on mobile homes is closely allied with real estate lending.[19]

The financing of large-scale residential and non-residential property may also offer unusual growth potentials, and similarly with new town development and the rebuilding of city core areas if they gather momentum under the aid provisions of the Housing and Urban Development Act of 1968. The proportion of SLA assets that may be invested in multi-family residential and non-residential mortgages and in land and other real estate held for investment is limited by regulation and tax legislation. While these limitations are not restrictive under present conditions, a case can be made for revision to encourage change.

Broader powers to acquire equity investments is another factor that may accelerate thrift intermediary growth. MSB's are already allowed in most states to hold equity securities, but they are generally not permitted to purchase land or other real estate for investment, except for large-scale housing; and SLA's have limited authority to acquire land and improved real estate but not common stock. There are some questions about the federal insurance of accounts backed by equity instruments.

Variable annuity plans are worthy of consideration where the MSB's have authority to sell life insurance. Annuity-type savings plans for retirement may be split to provide for fixed payouts plus variable annuities backed by a separate portfolio of equity instruments managed by a central institution — essentially the program pioneered in the early 1950's by T.I.A.A. and C.R.E.F. — the Teachers Insurance and Annuity Association and the College Retirement Equity Fund.

19 The Commission recommends that: "savings and loan associations and mutual savings banks be granted a widened range of loan and investment powers, including authority to make loans on mobile homes, without restriction on sizes and types, to invest in equity securities..., and that federally chartered mutual savings banks located in states where Savings Bank Life Insurance is now authorized be permitted to offer this service".

Some life insurance companies are currently shifting toward an equity interest by requiring equity participation or a share in rentals for income property on which they are making mortgage loans. A growing tendency of corporate bond issues to offer convertibility into common stock or to include warrants may reflect investors' preference for an opportunity to share in the expected increase in corporate earnings. While equity participation in conjunction with mortgage loans on income property is now generally prohibited, they could remove some imbalance between the position of owner and that of mortgage lender that develops in a period of rising prices.[20]

VI. Broadened Powers to Improve Income and Cash Flow and to Manage Liabilities

The Hunt Commission report follows previous studies in proposing that the thrift intermediaries need to shorten their assets and lengthen their liabilities to improve income and cash flow and survive as financial institutions. The broadened powers are usually constrained to be congruent with the tradition of the thrift intermediaries.

The rationale for broadened powers and diversification derives from the notion that MSB's and SLA's should provide the modern financing needs of households — their principal clientele. Spokesmen for these institutions suggest:

> For well over a decade now, the savings bank industry has sought to broaden the structure of its assets and liabilities in order to serve better the financial needs of America's families and individuals over their entire economic life cycle. It has not sought, and it does not now seek, the homogenization of the financial world. Savings banks have sought, and continue to seek, only those broadened powers which are consistent with their mission and a half century of consumer financial service. They seek, indeed, the preservation of this distinctiveness as personal and family financial centers.[21]

20 We incline towards the view that the Hunt Commission proposals would benefit the intermediaries. As suggested in section VII below we would caution that the initial implementation of these proposals should focus on the notion of complementarity and concentrate on new services that are demanded or supplied jointly with those currently being offered.

21 G. W. Ensley, *The Commercial and Financial Chronicle*, April 1972.

Greater freedom to shorten their portfolio via consumer lending and to lengthen the term structure of their liabilities may benefit the thrift intermediaries. The effects of such broadened powers on the thrift intermediaries are examined in this chapter. In section A we consider the impact of consumer lending on the institutions' income and cash flow, and in section B we consider the impact of flexible liability management. While our analysis focuses on the beneficial effects for the institutions, we do recognize that the public interest aspects of diversification must be carefully considered before any firm conclusions can be drawn.

A. *Additional Consumer Lending to Improve Income and Cash Flow*

A specialized thrift intermediary may periodically have its income fall below cash requirements, and diversification may enable it to improve both income and cash flow. Additional powers to extend shorter term consumer loans could improve income and cash flow and thereby minimize the risk of being unable to meet withdrawals.

Several studies suggest that there is a net yield spread between consumer loans and mortgages of approximately 1 percent before taxes and losses and that consumer lending could still remain attractive relative to mortgage lending, even if additional consumer lending by the thrift institutions would tend to reduce this spread. The effect on income and cash flow will depend on the resources channeled into consumer loans relative to mortgage loans, as we shall illustrate below.[22]

1. *The Effect on the Rate of Return.* Consumer lending will lift thrift intermediary income, but the extent to which earnings increase — expressed as an increase in the rate of return on assets — depends on the yield spread and on the proportion of consumer loans held in the portfolio. As shown in the table, the installment-mortgage spread, the spread between installment loans and mortgage loans (assumed to vary from 50 to 200 basis points), and the size of the consumer loan portfolio (illustrated for 5 and 10 percent respectively) together determine the increase in the rate of return on assets for a mortgage specializing thrift intermediary.

22 The Commission recommends that: "savings and loan associations and mutual savings banks be granted a widened range of loan and investment powers, including authority to: make secured and unsecured consumer loans in amounts not to aggregate in excess of 10 percent of total assets".

Table 3

THE RELATIONSHIP BETWEEN THE INSTALLMENT-MORTGAGE SPREAD, THE PERCENTAGE OF ASSETS IN CONSUMER LOANS, AND THE INCREASE IN THE RATE OF RETURN ON ASSETS

Percentage of assets in consumer loans	The installment-mortgage spread (basis points)				
	50	75	100	150	200
5	2.5	3.75	5.0	7.5	10.0
10	5.0	7.5	10.0	15.0	20.0

Fand: *Savings Intermediaries and Consumer Credit Markets.*

The installment-mortgage spread appears to have varied in the past from 70 basis points when interest rates were relatively low to 150 basis points at the higher interest rate levels. Assuming that this range of the spread continues in the future, an institution investing 10 percent of its assets in consumer loans could raise its average return on assets by as much as 15 basis points. Thrift institutions are currently earning approximately 6 percent, and the addition of a consumer loan portfolio could raise these earnings by 15 basis points. This 2½ percent increase in the rate of return is not spectacular, but it does evidence a marginal improvement in earnings.

2. *The Effect on Cash Flow.* Consumer loans and mortgages are typically amortized on a monthly basis, and these monthly repayments are an important part of the internally generated liquidity. We estimate that the cash flow for installment loans is approximately 70 percent of outstandings, compared with a 15 percent ratio for the mortgage cash flow. A small portfolio of consumer loans can have a substantial cash flow effect for a thrift institution with a constant stock of assets, as shown in the table. Thus, a 10 percent consumer loan portfolio will raise the cash flow ratio by 40 percent, from 15 to 21 percent, for a mortgage specializing thrift intermediary.

Table 4

RELATIONSHIP BETWEEN PERCENTAGE OF ASSETS IN CONSUMER LOANS, GROWTH RATE OF ASSETS, AND THE INCREASE IN CASH FLOW

Percentage of assets in consumer loans	Rate of growth of assets (percent)			
	0	5	10	15
0	15	20	25	30
5	18	23	28	33
10	21	26	31	36

Fand: *Savings Intermediaries and Consumer Credit Markets.*

Cash flow for a growing institution includes not only the amortized monthly payments, but also the inflow of savings deposits. Our table illustrates the cash flow increase for institutions with (1) asset growth rates from 0 to 15 percent, and (2) consumer loan portfolios of 0, 5, and 10 percent. While a 10 percent consumer loan portfolio will raise the cash flow ratio by 40 percent for an institution with a constant stock of assets, the cash flow increase for an institution growing at a 15 percent annual rate is only 20 percent.

This table also illustrates how a consumer loan portfolio may temper the cash flow effect of a reduction in net savings. For example, for an institution with no consumer loans, a reduction in the savings inflow from a 10 percent rate to zero lowers the cash flow from 25 to 15 percent — a 40 percent decline; but the same reduction in savings would lower the cash flow from 31 to 21 percent — a 30 percent decline for an institution with a 10 percent consumer loan portfolio.

A given reduction in the savings inflow will cause less of a liquidity shrinkage for thrift intermediaries with consumer loan portfolios. A portfolio of installment loans may therefore serve as an internal source of quick cash and as a secondary reserve; a rise in the cash flow ratio increases the thrift institutions' flexibility to cope with a liquidity crisis — whether due to withdrawals (disintermediation) or to a decline in the inflow of savings.

B. *Liability Management to Attract Yield Sensitive Investor-Depositors and to Lengthen the Maturity of the Portfolio* [23]

While the increased competition for savings that manifested itself in the late 1950's and in the 1960's may be viewed as a non-recurrent phenomenon, the commercial banks are nevertheless likely to remain far more potent competitors than they were in the early postwar years. The market share of the thrift institutions may therefore continue to decline unless both MSB's and SLA's develop new techniques to attract sophisticated investor-depositors. An increasing number of depositors are sensitive to interest rates, responsive to yield differentials, and attuned to a greater variety of investment outlets that have become increasingly important. This trend can safely be projected into the future.

During the 1950's and much of the 1960's, the passbook account was still — as it had been for almost a century — the major savings instrument. Regulatory changes in the early 1970's permitted the thrift intermediaries to vary the maximum interest rate, the maturity, the minimum balance, to pay either more or less than the posted passbook account rate, and to issue a 90-day notice account with no required minimum balance, at a higher rate. The institutions may also issue certificate accounts in fixed amounts, with fixed maturities, and at a higher rate than is paid on passbook saving.

As shown in table 5, thrift institutions may now offer regular, variable rate, split rate, daily interest, and 90-day notice *passbook* accounts; fixed-balance accounts and 48-96 month monthly-payment *bonus* accounts; variable rate, fixed rate and fixed term, the deferred income, the $100,000 *certificate* accounts, and the 6 percent special housing *certificate*. These special accounts pay higher rates for longer term holdings, up to 7½ percent for a 10-year $100,000 certificate, and are designed to meet the preferences of a differentiated saving public. Some have also suggested the inclusion of retirement savings plans offering annuities.

Flexible liability management seeks to diversify the instruments offered to the public by issuing a larger proportion of minimum-

[23] The Commission recommends that: "savings and loan associations and mutual savings banks be permitted to offer a wider variety of time and savings deposits and certificates of deposit, varying with respect to interest rate, withdrawal power, and maturity; savings and loan associations and mutual savings banks be permitted to issue subordinated debt instruments of all maturities".

TABLE 5

CHARACTERISTICS OF REGULAR AND SPECIAL SAVINGS ACCOUNTS

Passbook accounts	Maximum earnings rate	Term	Minimum balance
Regular	5%	None	None
Variable rate	5% (Combined base rate plus extra) Has appeal for associations paying a regular passbook rate below maximum.	At least 12 months	$ 1,000
Split rate	May pay more than association's regular passbook rate on specified amounts provided that rate does not exceed 5%. Has appeal for associations paying a regular passbook rate below maximum.	None	Specific dollar balances, established by association board, earn different rates within the account
Daily interest	5% (Normally offered at lower rate).	None	None
Notice account 90-Day Notice	5.25%	At least 90 days	None
Bonus accounts			
Fixed balance accounts	Total rate not exceeding 5.75%, depending on term. The bonus not exceeding 3/4 of 1%.	3-36 months	$ 1,000
48-96 Month Monthly payment	Bonus above passbook rate not more than 1%, total interest not exceeding 6%.	48-96 months	Saver makes monthly payments of agreed upon sum
Certificate accounts			
Variable rate	5.25%	3-6 months	None
Fixed rate - Fixed term	5.25%	6 months to 1 year	$ 1,000
	5.75%	1 year or more	$ 1,000
	6%	2-10 years	$ 5,000
Deferred income	5.25%	3-6 months	None
	5.25%	6 months to 1 year	$ 1,000
	5.75%	1 year or more	$ 1,000
	6%	2-10 years	$ 5,000
$ 100,000 Certificate	6.25%	60-89 days	$ 100,000
	6.75%	90-179 days	
	7%	180 days - less than 1 year	
	7.50%	1-10 years	
6% special housing certificate	6%	2-5 years	$ 10,000

amount and fixed-rate special accounts, and fixed-maturity certificates of deposit at differential interest rates. Longer term, fixed-maturity deposits at attractive rates are designed to attract the yield sensitive and sophisticated savers and, at the same time, to lengthen the maturity of MSB and SLA liabilities. Savings banks in many European countries have traditionally held highly differentiated accounts, and interest rate differentials between "regular" passbook savings accounts and "special" accounts tend to be larger than they are in this country.

Capital notes and debentures may also perform this dual function of attracting funds not otherwise available to the institutions and of lengthening the maturity structure of their liabilities. One possible offset is that medium term or long term obligations and fixed-maturity certificates do expose savings institutions to the risk of an interest rate decline. Clearly, the risk of declining interest rates must be weighed against the risk of rising interest rates. But given our present unbalanced thrift intermediary portfolios, it would appear that the risk of rising rates needs to be covered first.

Flexible liability management could be very helpful for a thrift institution facing a sharp run up of market interest rates. Thus, to the extent that it has longer term liabilities, less funds are subject to withdrawal in response to rising interest rates. And, to the extent that the special accounts enable it to attract funds even in periods of rising interest rates, the probability that withdrawals will exceed inflows — the probability of a net withdrawal — is diminished.[24]

VII. The Hunt Commission Proposals: Some Effects

A. *The Question of Complementarity*

While there has been a growing consensus that the thrift intermediaries will benefit from the additional powers to offer this wide array of financial services, we must nevertheless concede that our empirical knowledge is somewhat scanty. Do commercial banks offer a variety of financial services because there is a joint demand for these services, or because they are supplied jointly? And does a "full-line" of services characterize a competitive and allocationally

24 See section VII below.

efficient financial services industry? Or is it possible that commercial banks started offering many of these services because rate competition was traditionally somewhat limited in some banking markets?

The prohibition of interest payments on demand deposits and the interest ceilings on savings and time deposits limit the direct competition for deposits, with the result that "a large part of the traditional price bargaining in banking has shifted to a bartering of services." We cannot therefore infer a natural complementarity among financial services because a "full-line" of these services is currently being offered by many commercial banks.

Complementarity cannot be inferred from practices that develop in markets where ordinary price competition is restricted; and we must distinguish between genuine complementarity and pseudo-complementarity that develops as a subtle substitute for price competition. We need additional evidence on this issue and we should proceed somewhat cautiously in the immediate future, if we wish to strengthen the competitive posture of the thrift institutions. The thrift institutions should be permitted to provide new service if it is supplied or demanded jointly with those they are currently offering, or if the additional financial service would help improve its income, cash flow, or growth prospects.

B. *The Effect on the Intermediaries*

We have suggested in the text above that a shortening of the portfolio will improve liquidity, and that a 10 percent investment in consumer loans could raise cash flow by 40 percent. Increased lending powers will enable the institutions to raise the average yield on their portfolios and raise dividends to compete for deposits. Flexible liability management permits a greater variety of deposit liabilities designed to meet the needs of different savers, and may thus allow institutions to obtain a greater and more stable deposit base.

Extended service functions may also help. Savings institutions typically pay more for savings deposits than do commercial banks, and this presumably reflects the notion of "one-stop" banking. The ability of savings institutions to equalize these service advantages, assuming equal treatment of taxes and reserve requirements, may help reduce the spread.

C. *The Effect on Mortgage Lending and the Housing Market*

The changes proposed by the Hunt Commission may help improve the competitive posture of the institutions, and this is clearly one very important consideration. For if the institutions come under increasing pressure, their very existence is in question. On the other hand, we must not only consider the impact of these proposals on the viability of the institutions, but must also assess their likely effect on housing investment and the mortgage market. For if the proposed changes would help the institutions but adversely impact the mortgage market and housing investment, this must be considered explicitly.

One major concern is that the Hunt Commission proposals may divert funds from the mortgage market, to the detriment of housing investment. Yet several other factors associated with the Hunt Commission proposals may offset the diversion effect. The Hunt Commission proposals may lead to an increase in deposits, the portfolio changes need not all come at the expense of mortgages, and the removal of "Q" ceilings may also be helpful to the mortgage market.

The Hunt Commission proposals may indeed have a positive effect on both mortgage and housing markets by improving financial markets. Also, a reduction in mortgage lending does not necessarily imply a reduction in housing, since it may be offset by a decline in the mortgage-housing ratio. Finally, if we want to stimulate housing, it may be better to do it directly through a subsidy scheme, instead of operating indirectly through the mortgage market.[25, 26]

While the short run effects of the Hunt Commission proposals on housing are not clear and may be somewhat adverse, the effects on the institutions and on the mortgage market appear to be beneficial. Accordingly, the Hunt Commission proposals are likely to have a beneficial impact even on the housing market in the long run.

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25 See A. H. MELTZER, "Credit Availability and Economic Decisions: Some Evidence from the Mortgage and Housing Markets", forthcoming.

26 See R. C. FAIR and D. M. JAFFEE, "The Implications of the Proposals of the Hunt Commission for the Mortgage and Housing Markets", forthcoming.

VIII. Conclusion

Thrift intermediaries offer returns on savings that move with short term rates, while their mortgage portfolio income varies with long term rates. Their intermediation income thus depends on the difference between short and long term rates and varies therefore with the slope of the yield curve. A relatively flat yield curve, which reduces the differential between the rates on intermediary claims and the return on the mortgage portfolio, clearly disadvantages the thrift intermediaries.

The upward sloping yield curve in the early postwar years, with long term rates approximately 200 basis points above the short rate, favored the thrift intermediaries; and it may have been taken as a natural state of affairs. It appears now, in retrospect, that this sharply sloped interest rate term structure was probably a residue of the Great Depression and the stagnationist expectations that it generated. In any event, our financial history clearly illustrates cases where yield curves do not slope upwards and where the spread between short and long rates is small or even negative.

The thrift intermediary experience since World War II, including the changing composition of intermediary claims, the decline in passbook saving, the thrift intermediary failures in the competition for savings, and the disintermediation and reintermediation phases in recent years, are summarized in section I. Three policy issues that emerge from this review are taken up in sections II-IV. We first consider whether the successful commercial bank drive for savings deposits, a phenomenon that became increasingly evident in the decade prior to 1965, is likely to continue in the future. Commercial banks, we find, were able to lift earnings, to raise payout rates on savings deposits, to withstand the cyclical episodes of *tight money* and *tight credit*, and were therefore more successful in the competition for savings deposits.

Our analysis in section II also suggests that the cyclical *tight money* and *tight credit* problems do not threaten the existence of the intermediaries. The relative increase of commercial bank savings deposits in the second postwar decade, from the mid-1950's to the mid-1960's, was, in part, an offset to the amazing growth of thrift intermediary claims in the first postwar decade; indeed, the second postwar decade may be viewed as the aftermath of the Great Depression and the stagnationist expectations that were still prevalent in the first postwar decade.

In section III we focus on disintermediation — massive withdrawals from depository institutions in response to accelerating inflation and escalating interest rates. Disintermediation, the manifestation of *easy money* and *tight credit*, is the result of excessive monetary growth and inflationary expectations. It cuts income, lowers liquidity, and reduces the solvency of depository institutions offering claims fixed in nominal units. All such depository institutions, not only the thrift institutions, will be seriously threatened if we do not succeed in controlling the factors that generate inflationary expectations.

In section IV we consider the case for *statutory specialization* which is imposed on a financial institution and which does not emerge naturally in response to market forces. We find that the case for *statutory specialization* is weak both on theoretical and empirical grounds. There is, at least in principle, a basis for changing the specialized character of the thrift institutions.

Our findings in sections II-IV suggest that secular, cyclical and intermediate term factors in our postwar monetary history help explain why the thrift intermediaries have been losing out in the competition for savings which started, seriously, in the latter part of the 1950's. The secular factor is the updrift of interest rates since 1946, which enabled the commercial banks to lift earnings and raise the payout rate on savings. The cyclical factor is the tight money effect whiplashing the yield curve and raising short term rates relative to long term rates; and episodes of *tight money* and *tight credit* did hurt the thrift intermediaries in the latter part of the 1950's. The intermediate term factor is the problem of *easy money* and *tight credit* and inflationary expectations. The disintermediation crisis which first emerged in 1966 was associated with excessive monetary growth, accelerating inflation, and inflationary expectations, and dramatically manifests this *easy money* and *tight credit* problem. Although disintermediation implies an outflow of funds from all depository intermediaries, its impact on the thrift intermediaries was most severe. The cyclical *tight money* and *tight credit* effects following a slowdown in monetary growth may be viewed as a much milder version of the *easy money* and *tight credit* effects following the emergence of inflationary expectations.

The *Hunt Commission Report* offers a comprehensive set of proposals to cope with these problems, incorporating many of the recommendations of the Federal Home Loan Bank Board Study and earlier studies. The thrift intermediaries need additional powers and need to diversify in order for them to compete successfully and achieve viability in the financial services industry. Some of the recommended changes are reviewed in section V.

These proposals would permit the thrift intermediaries to offer "full-service" and "one-stop" banking to include checking accounts, credit cards, trust department services, and other financial services; to lend on mobile homes and non-residential property; and to acquire equities and equity participations. These recommendations are controversial and constitute a set of basic changes in institutional structure. It may be appropriate to experiment with these proposals, and we favor the notion of complementarity for the initial implementation (see section VII).

Our analysis in section VI suggests that there is a case for additional consumer lending to shorten the maturity of assets and to improve the income and cash flow of the thrift intermediaries, and for flexible liability management to attract yield-sensitive investors and to lengthen the maturity of the portfolio.

The case for additional services that have a high degree of complementarity with those already being offered by the thrift intermediaries is outlined in section VII. The notion of joint demand and joint supply may be helpful if one must select among the Hunt Commission proposals those that are most worthy of initial implementation. The additional modifications necessary to improve the thrift intermediary competitive posture could then be determined by continuing iterative experiments. The Hunt Commission proposals should help the institutions, and may also prove helpful to the mortgage market and housing investment in the long run.

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