JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

6. Real Estate Finance/Mortgage Banking/Mortgage Guaranty Insurance

g. "Capital Flows to the Mortgage Market" and "Recent Changes in Capital Flows to the Mortgage Market", no date

Index

CAPITAL FLOWS TO THE MORTGAGE MARKET

I. The financial intermediaries which originate or invest in mortgages by their very nature as an intermediary operate in a market for capital inflow (that is, they must compete for the liquid savings of firms and households) and in a market for placement of their capital in earning assets.

A. The access to each market for any type of intermediary is restricted by law and regulation.

B. Competition in each market occurs not only from intermediaries of the same type, but also from other types of financial enterprise. They compete with each other locally and on an inter-regional basis so capital may flow between lenders, regions, or security types.

C. In general savers regard their savings as highly liquid, easily withdrawn, and yet bearing interest at a stated annual rate.

D. There are four functionally distinct sub-systems of activity for each of the interemediary institutions and each has a different set of actors making discretionary decisions:

1. The market structure system.

2. The transactions system.

3. The liquidity system.

4. The safety system.

E. Each of these systems operates within certain constraints of public policy which includes:

1. Protect the assets of the general public.

2. Advance fiscal and monetary policy of economic planning.

3. Promote efficient service to the public.

4. Advance special social goals or needs as distinct from economic efficiency--to intervene to make markets perform differently than financial resource allocation would require.

5. To avoid the subversion of regulation to monopoly profiteering.

II. The market structure system has households and firms as suppliers of the commodity money and as demanders of the same commodity as mortgage money.

A. The capital inflow from savers has various degrees of discretionary or compulsive behavior implicit in it--ranked something like this:

1. Discretionary new cash savings. (New deposits)

2. Discretionary demand deposits. (Existing old deposits)

3. Discretionary time deposits. (CD's, savings plans)

4. Discretionary contract obligations. (Premiums, fund shares)

5. Forced savings to repay old debt. (Principal amortization)

6. Forced saving to anticipate ~~to anticipate~~ new debt. (Escrows, prepaid expenses)
7. Forced payment of income taxes. (Percentage of tax allocated to mortgage money)

B. Each of these elements in the savings pattern is a variable which at times is capricious and more often than not out of phase with the market for investment of these resources.

1. New cash savings as a per cent of income were declining until 1966 when the public attitudes changed toward the conservative. Several studies of attitudes indicated that the public saw "getting ahead" as accumulating reserves instead of material things. Consider the drop in consumer finance.

2. Demand deposits could be further classified as to mobility or inertia relative to the distribution of business money versus household money.

3. Discretionary time deposits became a major area of competition with the introduction of bank CD's, insurance premium payroll check-offs, and mutual fund monthly payment plans.

4. Contract obligations can be modified--particularly life insurance premiums which may be paid, borrowed, or modified by shifting to a different contract type. In 1966 large-scale policy loans meant unexpected cash flow reverses for life insurance companies.

5. Debt repayment runs ahead of schedule when there is more money than good loans available and slightly behind schedule when money is in short supply.

6. Forced saving anticipating escrow payments is perhaps the most constant as insurance, tax, or sinking fund dates are generally fixed.

7. Income taxes are a type of forced saving and to the degree that these taxes are channeled directly into mortgage loans, the function is one of forced saving. Such use of taxes for the supply side of funds is directly responsive to the demand side for funds.

C. Competition for saving money in each of these areas is regulated by the power to license the creation or expansion of intermediaries, the rate at which they may pay interest or dividends, and the rules of competition via branches, advertising, new account dividends, reserve strength, or management performance.

1. Banks are subject to national or state regulation, FDIC standards, FRB standards, and the social system within their own fraternity as to good behavior and sanctions against the maverick.

2. Savings and loans have state or national charters, FSLIC standards, home loan bank standards, and a private system called the U.S. Savings and Loan League.

3. Insurance companies are regulated as to sales practices, advertising, marketing areas, commissions, and price and here too there are social organizations.

4. Investment companies may be regulated by state or SEC regulations, pension funds are facing new state regulation, credit unions have state regulation as well as their own self-regulating devices.

D. Within these limits the market system operates. Indeed, when the limits themselves are out of balance, the strain can severely damage the institution.

1. In the liquidity crisis of August-September 1967 we saw when banks were allowed to pay 5.5% on CD's while savings and loans could pay 4.5% dividends, savings began to swing toward banks. At the same time unexpected government bond sales drove the bond rate above the CD rate. In August there was a fear that CD holders would cash in and switch to bonds at a time when bank reserves were not adequate to cover it.

2. Disaster was averted in the short run by inertia on the part of the CD holders, relaxation of restrictive bank reserve policies, a reduction on maximum CD rates payable to small accounts, an increase on S and L rates payable as dividends, and some adjustment of federal fiscal policy.

3. Nevertheless banks stopped making loans to generate liquidity for the expected runoff of CD's; interest rates rose so that life insurance reserves became the cheapest money available and there was a runoff of life insurance cash flows at a time when bonds offered the best buy in years.

4. Life insurance companies had expected positive cash flows and had made loan committments accordingly. Since there was barely enough cash for these committments as well as bond purchasing, life insurance companies went to the banks for money and stopped making mortgage loans.

5. The savings and loans expected that a cash out of CD's in the fall would be followed by a cash out of passbooks in December, the usual date for dividends to accrue. They too stopped making loans in order to accumulate liquid reserves from portfolio runoffs and in a few cases to offset large withdrawals.

6. When savings lag loan committments and bonds are favored over mortgages, and disintermediation threatens, the result is a money crunch or liquidity squeeze. As each intermediary anticipates how discretionary savers may behave, the lending pattern changes even though savings continue to grow.

III. The transaction system is motivated ~~both~~ by desire for profit, safety, and stability.

A. For example, savings and loans compete with dividend price, convenience, folksy localism, and advertising. When savings rise relative to loan opportunities, the advertising budget would fall. If the average efficiency of promotion remained the same, net savings inflow would fall.

B. To cut the dividend rate may or may not affect the market. Small account holders are sluggish and insensitive to small rate changes. (A $1000 account cut from 4.85% to 4.75% would mean an interest loss of $1 per year.) Interest rate sensitivity is true only of larger accounts. Physical convenience and local image may insulate some lenders from market leaders. Many small banks still pay 1.5% on savings and local savings and loans may pay 3%.

C. On the loan transaction side there is a briar patch of restrictions within which lenders must compete. Regulations are concerned with both standards of individual loans and balance of the total portfolio for risk and yield.

D. For all intermediaries except the savings and loans the mortgage portfolio in terms of risk and yield must compare favorably with all other investment opportunities,so there are three levels of discretion:

1. How much to invest in mortgages.

2. What kind of mortgages to invest in.

3. Which individual mortgages to make.

E. As we will see, the portfolio mix tends to prefer the less risky, less discretionary loan unless the government offers incentives which override the normal transaction mechanism such as FHA and VA insurance of loans ~~and escape valves~~ for the financial risk and escape valves for the money risk in FNMA and HLB loans.

F. Transaction policy on the part of the lender must match transaction preferences on the part of the borrower and there are transaction patterns for this group too.

IV. As the attitude of savers and loan officers can change more quickly than the responsibilities of borrowers, radical changes in the pattern of any one of the three means a loss of equilibrium and a threat to liquidity.

A. The liquidity system of banks with their controlled power to create money via the FRB tends to operate more automatically than any other.

B. The liquidity system of savings and loans depends on the limited resources of the home loan bank and FNMA.

C. The insurance industry depends primarily for liquidity on stability of premium income and normal runoff and turnover of investments.

D. The liquidity problem is concerned only with the ability to meet a rapid shift in the need for cash to meet withdrawals or loan commit-tments. This does not include the problem of loss to assets due to default, devaluation, or deficit operations.

V. The safety system has four basic lines of defense, assuming that there is some provision for liquidity.

A. The state of the economy and of the housing market in particular for savings and loan is very important. The risk exposure facing real es-tate lenders is essentially the potential fluctuation in employment, income, and price level as it affects ability and willingness to save voluntarily or through payment of loans.

B. Given some state of the economy, safety is a function of the diversi-fication and average loan ratio of a mortgage portfolio.

C. The next line of defense is the surplus reserve position of the inter-mediary relative to its saver liabilities to savers, and there are various tax incentives to encourage accumulation of reserves from pre-tax net income.

D. The fourth level of safety involves regulatory agencies with guarantee funds such as (FDIC and FSLIC) and the monitoring of operations by audit-ing agencies. Both safety devices can prescribe constraints on com-petition for savings or market areas for loans, as well as the maxi-mum distribution of assets diverted to mortgage loans.

The growth pattern of metropolitan centers have characteristics which come from a mix of public and private decisions. The rules of the economic game of economic growth quickly distort urban growth to reflect political disequilibrium within the metropolitan area. The luxury of democratic politics and social-cost, social-benefit questions of public decision making appear to be incompatible with private decisions measured in terms of money.

A. It is useful to distinguish between policy decisions of values and objectives and execution decisions which involve community outlays of ~~xahx~~ cash and long-term ~~xah~~ cash flow.

B. Many community decisons do involve industrial systems analysis such as purchase or lease, sanitary fill locations, etc. or citing of municipal facilities

Recent Changes in Capital Flows to the Mortgage Market

I. As suggested earlier, savers regard their deposits, regardless of technicalities, as highly liquid, easily withdrawn, and yet bearing interest at a rate comparable to long term interest rates.

   A. For the private intermediary we identify four functionally distinct subsystems of activity:

      1. A savings market system
      2. A mortgage loan transaction system
      3. A liquidity system
      4. A safety system

   B. At the federal level we discussed a variety of institutions which were tied to the private intermediaries with varied objectives:

      1. To protect the assets of the general public
      2. To insulate mortgage finance from fiscal policy
      3. To advance special social goals at the expense of economic efficiency through intervention in some financial markets
      4. To avoid subverting of charters through relulation to become monopoly profiteering

   C. While both the public and private system depend on large part on mechanics, ultimately they operate most effectively because of subtly phychological controls on discretionary or compulsive behavior. In the past several years the psychology, the taboos, and behavioral morays on which it has depended have been severely weakened by subtle changes in the monetary policies of the federal reserve and related regulatory groups.

   D. Households and firms as suppliers of the commodities "money" have various degrees of discretionary or compulsive behavior opportunities with the degree of discretion and volatility ranked something like this:

      1. Discretionary new cash savings. (new deposits)
      2. Discretionary demand deposits. (existing old deposits)
      3. Discretionary time deposits. (CD's, savings plans)
      4. Discretionary contract obligations. (premiums, fund shares)
      5. Forced savings to repay old debt. (principal amortization)
      6. Forced saving to anticipate new debt. (escrows, prepaid expenses)
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   E. Each of these elements in the savings pattern is a variable which at times is capricious and more often than not out of phase with the market for investment of these resources.

      1. New cash savings as a percent of income were declining until 1966 when the public attitudes changed toward the conservative. Several studies of attitudes indicated that the public saw "Getting ahead" as accumulating reserves instead of material things. Consider the drop in consumer finance.

2. Demand deposits could be further classified as to mobility or inertia relative to the distribution of business money versus household money.

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7. Income taxes are a type of forced saving and to the degree that these taxes are channeled directly into mortgage loans, the function is one of forced saving. Such use of taxes for the supply side of funds is directly responsive to the demand side for funds.

F. Competition for saving money in each of these areas is regulated by the power to license the creation or expansion of intermediaries, the rate at which they may pay interest or dividends, and the rules of competition via branches, advertising, new account dividends, reserve strength, or management performance.

II. There is a quiet revolution in the regulation of intermediaries which is having its impact on the discretionary behavior of savers now, and in the immediate future.

A. The monetarist school of economics has captured the Fed and influential members of congress and their basic proposal might be briefly summarized as follows:

1. Competitive markets, free of government regulation, are economically efficient and such efficiency is almost always benign and desirable.
2. Economic instability is primarily the product of governmental rather than private discretion.
3. A steady rate of growth in the money supply is necessary and adequate support for economic stability.

B. Three objectives of this philosophy which are having increasing impact are:

1. The chief target of monetary policy is the stabilization of monetary aggregate.
2. The removal of interest rates and controls if money supply equilibrium is to be achieved

3. Conversion of our specialized financial institution into widely diversified institutions resembling commercial banks since these specialized lenders (i.e., savings & loans, mutual banks) would not be able to survive a system of freely fluctuating interest rates.

C. It is axiomatic that interest rates, at least for large firms, should be allowed to rise high enough to control total credit flows simply on the basis of sheer interest expense, i.e., rely on the discretionary behavior of borrowers to understand their marginal cost of money.

1. This runs the risk that we may be gravely underestimating the interest burden people are willing to carry to buy now and pay later.
2. Consumer and businesses have always been willing to tolerate loan sharks, consumer credit rate, and the collection losses of irrational borrowing. Why the taboo for thousands of years on interest rates?
3. Most borrowers have not been deterred by higher rates which they always tend to regard as temporary, efffectively reduced by income taxes or offset by inflation.
4. Even businesses have preferred to borrow in the short term because they have an instinctive evasion of long term high rates. Rolling over short term debt gives them a floating rate contract Recently Citicorp formalized that with a floating bond rate.
5. A floating rate menas that timing of borrowing is no longer important in maintaining competitive costs.
6. Businesses which fail to go along with the bullish bias of these arrangements jeopardize their future. The bear who cuts reeearch, advertising, or expansion plans loses more on the down side than the bull.

D. Now suppose we are talking about banks who manufacture credit. How does one exhort banks to exercise discretion in curtailing credit expansion since they are now in a competitive marketing structure not only in individual communities but between regions?

1. It could be argued that for any business overexpansion leads to retribution.
2. However, with respect to banks the worst transgressors are not likely to reap the severest punishment since everyone understands concern for the safety for the whole structure virtually compells authority to step in if improtant banks were threatened.

E. FRB has assigned an expanding role to commercial banks which suggests that they shouldn't worry at all. Several times in recent months the chairman of the Federal Reserve Board has promised "no credit crunch" which as a practical matter guaaantees the banks unlimited access to central bank support.

1. Indeed the federal bank let it be known that the bank could dalvage the mortgage trust by providing credit where no credit was deserved by banking standards and now o/3 of the capital of our 100 largest banks is exposed in supporting REIT where asset values are significantly less than liabilities.

2 2. The first time Central Bank has deliberately abandoned use of uncertainty and fear of loss as a means of influencing discretionary savings and lending to influence institutions for which it is responsible.
3. Unlimited access to funds and floating rate means almost unlimited expansion.
4. Acceptance of non-traditional loans and competitive inroads on other financial institutions.
5. Pressure on specialized lenders part of strategy growing from Hunt reports and legislation such as Financial Institutions Reorganization Act (failed in Congress in Dec., 1974).

F. Debate surrounding survival of specailized lenders (i.e. S & L's) argues they cannot survive without commercial bank access to diversified loans and FRB funds.

1. Diversification might reduce mortgage lending
2. Those in favor argue unlimited access to funds would favor continued mortgage lending
3. Floating mortgage rates would remove the money risk as well
4. Home mortgage rate tied to FRB discount rate would create political resistance to FRB
5. Floating savings and bank bonds already here along with floating interest rates on construction and development loans. Eventually the lending institutions will broker for a loading charge government insured floating rate deposits into government or privately insured floating rate mortgages. The loading would contain servicing and profit.

G. In short, banks could announce the price of their products as a fixed markup on some other publicly known interest rate.

H. Curbing inflation used to involve a credit squeeze on and through commercial banks.

1. Dual prime rate diluted Regulation Q
2. Controlled rates on home mortgages and small savings appease Congress
3. Banks free to raise interest rates on major deposits and major loans
4. Home mortgage subsidies protected FRB against consequences of pursuint stabilization through interest rate adjustments of monetary aggregates

III. When everyone understands responses of Federal Reserve policy to reported monetary aggregates, then uncertainty is removed for borrowers and savers.

A. Money supply a reliable thermometer of general economic and financial help. FRB now tries to stabilize the thermometer rather than the patient.

B. A dose of short term interest rates, up or down

C. Wall Street analysts can now anticipate increase or decrease in money supply in the following quarter given knowledge about disequilibium currently.

D. Frequent inversion of interest rates and other signs indicate old comfortable spectrum of yields from short term to long term has disappeared as a fundamental perception of the world. Thus interest rate boundaries no longer curb speculators.

E. Once money game becomes a loading charge on a floating rate then the subtle taboos and anxieties that control discretion and inertia of borrower and saver break down. Coupled with instant electronic news transmission, we have a drastic change in the culture of our money markets and stability of capital flows to real estate.

F. Capacity to generate savings is reduced by cost of energy and inflation national problems require capital intensive solutions and homogenizing credit institutions will eliminate subsidy of home mortgage interest rates by artificial interest rates paid to savers.

G. All these factors suggest high interest rates for mortgages which in turn drastically hurts consumer ability to purchase a home without reducing other discretionary expenditures.

1. Since the Federal Reserve fears the political clout of middle class America, a way must be found to subsidize home purchase.
2. We have already seen GNMA, FNMA, and HLB subsidy scheme.
3. Another way to reduce cost is to reduce real estate taxes by means of block grants, federalizing of welfare control, and rent supplemtnt programs. All of these require deficit spending or forced savings through the income tax and therefore some reduction in discretionary savings.
4. These dynamics suggest further restructuring of the institutional subsystems which we have been studying in the residential field and gradual concentration of real estate ownership among our long term fixed costs financial institutions - the life insurance companies and the pension fund.