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Will the Funds Be There?

The housing industry is heavily dependent on credit — after all, most people don't have enough spot cash to buy big-ticket items such as houses — and so the industry gets into trouble whenever its suppliers of credit have fewer funds to lend. This happens whenever households stop channelling their savings into mortgage-lending institutions — the so-called financial intermediaries. And this dread process of disintermediation occurs whenever households find they can earn higher interest rates in the money market than at banks and thrift institutions — that is, whenever rates on Treasury bills and other money-market instruments rise substantially above the Congressionally-imposed rate ceilings on various types of time and savings deposits.

The thrift institutions were badly burned during the 1974 crunch, when soaring market rates induced a 15-percent decline (to $57 billion) in the flow of consumer savings into banks and thrift institutions. But these savings flows practically doubled over the next two years, to $109 billion in 1976, as household liquidity improved and as money-market rates fell below thrift-institution offering rates. Yet in late 1977 and early 1978, after the thrifts had boosted their loan commitments to a record $39 billion to finance a record home-building boom, they found the telltale signs of disintermediation facing them again. This raises the questions of what savings alternatives are available to household savers, what interest-rate levels will trigger withdrawals of savings from thrift institutions, and what the thrifts can do in this situation to finance their booming mortgage business.

Alternatives

In periods of rising interest rates, household savers have frequently been able to get a higher return from Treasury bills and notes than from savings deposits. But the Treasury generally sets a minimum purchase amount — for example, at least $1,000 for the seven-year notes issued last month, and a $10,000 minimum for the weekly sales of short-term bills. These minimums (at least for T-bills) effectively limit the ability of small savers to improve on what they could earn from savings deposits.

But the market has provided other alternatives in recent years — in particular, money-market funds and bond funds of various descriptions. The 1974 period of higher interest rates set most such funds into motion and legal changes since that time have improved their viability. Money-market funds — those investing in securities of under one-year maturity — increased from practically zero to about $3.6 billion outstanding by the end of 1975. They later decreased in importance as money-market rates declined, but in the meantime, households began to channel more savings into taxable and tax-exempt bond funds. Many of these funds not only pay interest but also offer free checking privileges — something which the average saver usually can't obtain at an institution.

Money-market and bond funds have certain restrictions of their own, such as minimum initial investments of $1,000 and up. But many of them are no-load funds — purchasable without a sales commission — and many of them offer the free checking privilege

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and are also more convenient than thrift-institution passbook accounts. Because of these features, and because of their ability to offer open-market rates during periods of high interest rates, they represent a strong alternative to traditional forms of savings accounts.

Trigger points

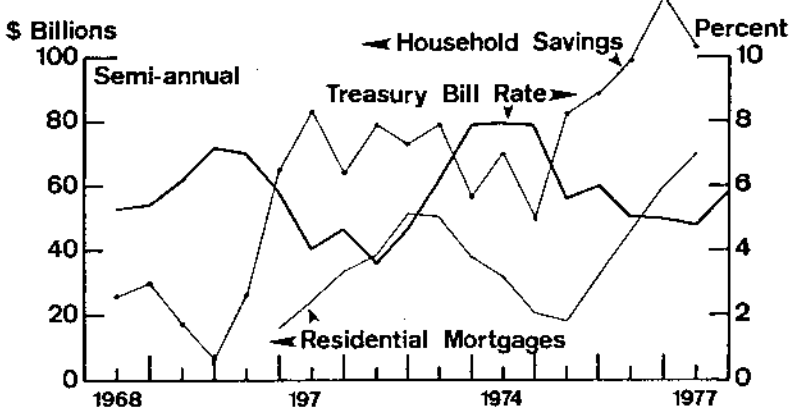
Despite the recent signs of reduced savings inflows, recent history suggests that substantial disintermediation won't occur until the T-bill rate rises at least 150 to 200 basis points above the 5¼ percent rate ceiling on savings-and loan passbook accounts. (One hundred basis points equal one percentage point.) T-bill rates recently have averaged about 6.45 percent, still somewhat below the suggested trigger point.

The intensity of disintermediation can be measured roughly by the percentage of noncompetitive tender offers at Treasury bill and note auctions — that is, the percentage of offers to buy such securities at the average auction price. However, the public was not very responsive to an October offering of three-year notes at an effective yield of 7.24 percent, and not much more so to last month's offering of seven-year notes at an 8-percent rate. Noncompetitive bids actually amounted to 38 percent of accepted bids for the latter issue — the highest proportion in the last several years — but most market watchers expected somewhat greater public interest.

These financing results suggest that the trigger point for disintermediation hasn't yet been reached, although the rise in market rates has contributed to a reduced flow of savings to thrift institutions. These institutions have improved their ability to compete for the saver's dollar by restructuring their offerings within the framework of rate ceilings. S&L rates range from 5¼ percent on passbook accounts to 7¾ percent on six-year certificates — the latter providing an effective rate of more than 8 percent on a daily compounded-basis — and they have persuaded consumers to shift an increasing portion of their savings into the longer-term certificates in recent years. Between 1971 and 1977, fixed-maturity certificates rose from 48 percent to 62 percent of total S&L deposits. Thrift institutions have locked in these savings not only because of their attractively high rates, but also because of the interest penalty attached to early withdrawal.

Finding funds

Nonetheless, the higher level of market rates suggests a continuation of the recent slowdown in savings inflows, which could force many mortgage-lending institutions to reduce their recent record level of loan commitments. Still, many institutions have achieved more flexibility in meeting mortgage demand because of their success in developing alternative sources of funds. In addition to the usual heavy inflow of mortgage repayments, they have obtained (since 1975) substantial amounts from sales of mortgage-backed bonds. Again, they have recently expanded their sales of mortgages to the Federal National Mortgage Association and to the Federal Home Loan Mortgage Corporation, which in turn have sold



them to the secondary-mortgage market through "pass through" certificates. And S&L's have relied heavily on advances from their Home Loan Banks; these advances rose nearly $4.5 billion in the second half of 1977, reversing the $6.1-billion decline in that source of funds over the preceding two and a half years.

Some of these sources of funds may be less accessible to mortgage-lending institutions in 1978 than they were last year. With investors in the secondary market demanding higher yields, thrift institutions are already being forced to discount their mortgages or sell only those bearing the highest interest rates. The Home Loan Bank System has already reduced its investment portfolio in order to meet the heavy demand for advances from member S&L's, and has recently entered the market with an unexpectedly large $2.6-billion debt offering to replenish its own funds. This agency offering adds to the market pressures created by the projected heavy level of Treasury financing this year.

Direct Treasury borrowings from the public, along with the borrowings of Federal agencies, could approach $100 billion in fiscal 1978 and $110 billion in fiscal 1979, compared with an already high $80-billion annual average for the three preceding fiscal years. To meet these heavy financing requirements, the Federal government and its agencies will be offering a wide range of securities in the market. A substantial portion of those offerings may have to be purchased by household savers – either directly, or indirectly through money-market funds – and they can be attracted only by interest rates higher than those they can earn at thrift institutions. Thus, disintermediation could be a direct consequence of large Federal deficits.

Mortgage demand

Yet even if funds are hard to come by, demand for mortgage credit is likely to remain quite high in 1978. Housing activity reached record or near-record levels in the final quarter of 1977, as buyers purchased 4.8 million new and existing homes, and builders started 1.6 million single-family homes (both at annual rates). And demand still remains relatively strong, despite January's severe (but weather-related) slump in starts.

The nation's difficulty in reducing inflation has encouraged individuals to bid more aggressively for mortgage funds than they used to do, because home ownership – in addition to its tax advantages – now represents a more satisfactory hedge against inflation than investments in such financial assets as stocks, bonds, and savings deposits. In Henry Kaufman's words, "The cost of financing consequently is not the deterrent it once was in the financing decision. Home buyers, imbued with the notion of inflation as an inflation hedge, will probably not retreat as quickly as demanders of funds as they did in past economic expansions when credit demands from other sectors increased sharply." Although the prime mortgage rate has already risen to 9½ percent in many parts of the country, the combination of heavy demand and a restricted supply of funds could mean even greater pressure on rates as the year goes on.

Jack Beebe and Ruth Wilson

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