FRBSF Weekly Letter

August 2, 1985

Thrift Deregulation and the Mortgage Market

Over the past several years, savings and loan associations have diversified their asset portfolios by increasing the share of nonmortgage investments. This greater diversification is not surprising given that deregulation and other forces have blurred the boundaries marking financial institutions' traditional turf. However, it has raised concerns that the more aggressive pursuit of nonmortgage activities by savings institutions will reduce the flow of funds available to finance housing. This *Letter* examines the reasons for the increased portfolio diversification and its implications for mortgage credit.

Asset diversification

Historically, regulations have limited the options for savings and loans to invest directly in nonmortgage assets. The regulatory restrictions were strongly reinforced by the tax code. By holding 60 percent of its assets in residential mortgages and certain other qualifying assets, a savings and loan is able to defer taxes on a portion of its income. To protect the maximum proportion of income possible (40 percent), a thrift must hold at least 82 percent of its assets in the qualifying assets.

With these regulatory restrictions and tax incentives, savings and loans entered the 1980s holding over 85 percent of their assets in mortgage loans and mortgage-backed securities. Over the past several years, however, the asset mix has changed dramatically. Mortgages and mortgage-backed securities combined fell from 85½ percent of assets at FSLIC-insured savings institutions at the end of 1979 to a little over 73 percent in December 1984.

Changes in the regulations governing the investment powers of savings and loans provide a natural starting point for explaining this marked portfolio shift. In 1980, the Depository Institutions Deregulation and Monetary Control Act (MCA) expanded asset powers for federally chartered savings and loans. Among other things, the Act provided more latitude for thrifts to extend consumer loans and to invest in commercial paper and other corporate securities.

As important as these regulatory changes may have been, they were not sufficient to cause the dramatic decline seen in the ratio of mortgage holdings to assets at thrift institutions. In fact, long before MCA, state-chartered savings and loans in a number of states had fairly broad authority to engage in nonmortgage lending. Yet most of these institutions chose not to exercise their asset powers mainly because of the tax advantages associated with residential mortgage lending.

In recent years, the poor performance of earnings among thrifts has diluted the appeal of these tax incentives. In the latter part of 1981 and during the first part of 1982, over three-quarters of all federally insured savings and loans reported negative net income. With the subsequent decline in interest rates, the earnings situation at savings and loans began to improve. In 1983 and 1984, the savings and loan industry as a whole posted positive net earnings following two years of losses. Nevertheless, by mid-1984 one-fourth of all federally insured savings institutions still were reporting losses.

The relaxed regulatory constraints on asset diversification, combined with the blunting of tax incentives, seem sufficient to explain the change we saw in the asset composition of savings and loans. However, further analysis suggests that these factors were not as important as a first glance would indicate.

First, as shown in Chart 1, nonmortgage loans account for only a small portion of the rise in the ratio of nonmortgage assets to total assets in recent years. Second, special factors account for the changes in "other assets," shown in Chart 1. For example, included in "other assets" is "goodwill and other intangible assets." The value of this asset category was boosted considerably through the purchase accounting procedures used in savings and loan mergers. The rise in the ratio of "other assets" to total assets also reflected savings and loans' investments in their service corporation subsidiaries, a power they already held before MCA.

Increased liquidity

The growth in "cash and securities" over the past several years also points to factors other than the relaxation of asset "restrictions" in influencing the asset mix at thrifts. The bulk of cash and securities are federal government or federally sponsored agency securities, bank CDs and federal funds, which savings and loans were empowered to hold before MCA. The increase in their holdings could reflect factors affecting small-denomination (core) deposits at thrift institutions. A possible connection is that savings and loans accumulated "cash and securities" in the face of deposit interest rate deregulation which stimulated strong core deposit flows relative to the demand for mortgages at these thrift institutions.

However, the simultaneous buildup of managed liabilities at savings and loans following deposit rate deregulation conflicts with the notion that these institutions were reacting to an increase in the supply of core deposits relative to the demand for mortgages. From 1979 to 1984, managed liabilities at savings and loans (large-denomination CDs, Federal Home Loan Bank advances, RPs, mortgage-backed bonds, and other borrowings) rose from about 14½ percent of total liabilities and net worth to 26 percent. This greater reliance on managed liabilities suggests that the increase in liquid assets at savings and loans probably reflected a higher demand for liquidity by thrifts, rather than only strong flows of core deposits.

The volatility in interest rates through most of the 1979-1984 period may have provoked the thrifts' heightened demand for liquidity. In addition, a byproduct of deregulation has been a shortening in the overall maturity of core deposits. As a result, savings and loans could have been attempting to increase holdings of short-term assets such as those in "cash and securities."

Implications for the mortgage market

The proposition that a link exists between the asset mix of savings and loans and the allocation of credit to housing is a variant of the one that ties the volume of total mortgage credit to deposit growth at thrifts. In the latter proposition, the proportion of credit flows allocated to mortgages is assumed to vary directly with the share of funds channeled through thrifts. If this were true, it follows that if thrifts reduce their propensity to invest in mortgage-related assets, then, all else remaining equal, a smaller fraction of credit flows would go to mortgages, and mortgage rates would rise relative to other market rates.

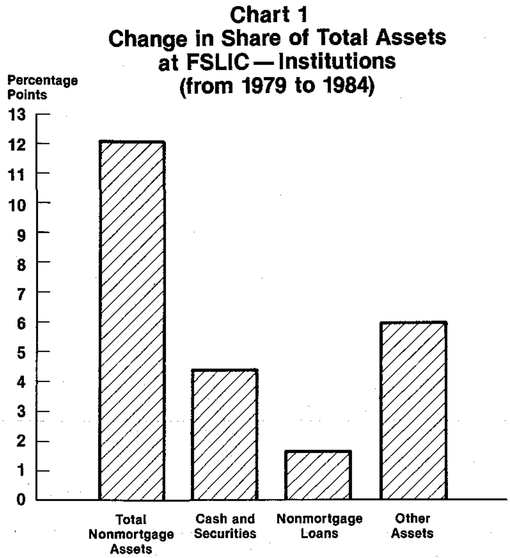
For deposit flows at thrifts and their mix of assets to change the allocation of credit to the mortgage market requires that developments specific to those institutions not be offset by other lenders. In other words, it requires that mortgage borrowers at thrift institutions be cut off from turning to other existing mortgage lenders or from turning to other sources of funds in financial markets. Some degree of such separation might be expected in the short run if institutional arrangements for channeling funds in the credit market are costly to adjust and the market disruptions are viewed only as temporary. However, it seems reasonable to expect that a permanent change in the propensity of thrifts to extend mortgage loans would induce adjustments by other lenders.

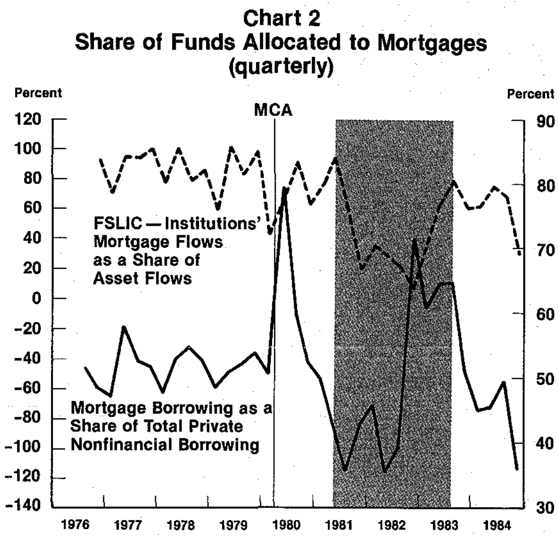
There exists an additional flaw in the argument that a lower proportion of thrift assets allocated to mortgages translates into a reduced supply of mortgage credit. A reduction in the ratio of mortgages to assets at thrift institutions does not necessarily imply a decline in their mortgage lending. The volume of mortgage loans held by savings and loans can increase as the ratio of mortgages to assets declines if total assets grow at a faster rate.

This last point is particularly important in light of the impact that deposit deregulation had in causing reintermediation — that is, return flows of small-denomination deposits to savings and loans. In addition, the level of intermediation carried out by savings and loans has been boosted by their increased reliance on managed liabilities. The effect of these two phenomena was quite evident in 1984, a year in which assets of federally insured savings institutions expanded by almost 20 percent and mortgage holdings also rose by about 15½ percent. Thus, since the changing mix of assets was accompanied by rapid growth in assets, the nonmortgage activities of savings and loans complimented, rather than substituted for, their mortgage lending.

Some evidence

If the change in the asset mix at savings and loans had an impact on the amount of funds channeled to mortgages, this impact should be reflected in the behavior of mortgage interest rates. In that case, the smaller the share of savings and loan assets allocated to mortgages, the higher mortgage





rates should be relative to other market rates. However, an empirical investigation of the relationship between savings and loan asset composition and mortgage interest rates did not turn up any systematic association. For the period from mid-1978 through 1984, the fraction of net asset acquisitions by savings and loans allocated to mortgages had no significant effect on the interest rate for fixed-rate mortgages.

These results are consistent with the evidence on the relation between the proportion of savings and loan assets devoted to mortgages and the overall allocation of funds to mortgages by all lenders shown in Chart 2. The dashed line in the chart represents the quarterly change in mortgages at FSLIC-insured institutions as a percent of the change in their total assets, while the solid line shows net extensions of mortgages by all lenders, including households, as a share of borrowing by individuals and private nonfinancial firms in the United States.

The shaded region in the chart sets off the period in which the shift to nonmortgage assets at savings and loans was most pronounced. During that period, the ratios of mortgages to private domestic nonfinancial borrowing varied but, on balance, tended to rise, not fall. Rather than savings and loan portfolio changes, the movements of the ratio of total mortgage lending to private borrowing in the early 1980s appear to reflect changes in interest rates (largely through their effects on the ability and willingness of borrowers to purchase homes). The peak in the ratio of mortgages to private borrowing due to distortions during the 1980 credit control period aside, the ratio of mortgages to private borrowing fell in late 1980 and early 1981 as market interest rates rose. The ratio remained low relative to the late 1970s until the second half of 1982 when market rates began falling sharply.

As net mortgage flows at FSLIC-insured institutions (measured as a share of the change in assets) stabilized between mid-1983 and the third quarter of 1984, the ratio of total mortgages to the volume of aggregate private borrowing fell. On balance, it does not appear that there has been a consistent positive (or negative) relation between changes in the relative allocation of funds to mortgages by savings institutions and the share of aggregate borrowing accounted for by mortgages.

Conclusion

New asset powers for savings and loans have contributed to a greater diversification of their assets, although these were not the only stimuli. Poor earnings, the use of purchase accounting in thrift mergers, and changes affecting thrift liabilities also have influenced the composition of savings and loan assets.

This aggressive pursuit of nonmortgage investment by savings and loans has raised some concerns that fewer funds overall would be available for mortgage lending. Contrary to this concern, greater asset diversification at savings and loans has not been detrimental to the mortgage market.

Fred Furlong and Kimya Moghadam

Editorial comments may be addressed to the editor (Gregory Tong) or to the author.... Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

Research Department
Federal Reserve
Bank of
San Francisco

Alaska Arizona California Hawaii Idaho
Nevada Oregon Utah Washington

PRESORTED
FIRST CLASS MAIL
U.S. POSTAGE PAID
PERMIT NO. 752
San Francisco, Calif.

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 7/17/85	Change from 7/10/85	Change from 7/18/84 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	192,509	− 224	10,977	6.0
Loans and Leases[1] [6]	174,160	363	11,578	7.1
Commercial and Industrial	51,647	245	1,712	3.4
Real estate	63,622	116	2,935	4.8
Loans to Individuals	34,811	87	6,139	21.4
Leases	5,389	− 43	370	7.3
U.S. Treasury and Agency Securities[2]	11,522	− 602	− 439	− 3.6
Other Securities[2]	6,828	15	− 160	− 2.2
Total Deposits	197,628	− 352	9,504	5.0
Demand Deposits	47,044	− 252	2,878	6.5
Demand Deposits Adjusted[3]	31,653	− 178	3,222	11.3
Other Transaction Balances[4]	13,818	− 149	1,558	12.7
Total Non-Transaction Balances[6]	136,765	48	5,066	3.8
Money Market Deposit Accounts—Total	44,836	137	6,737	17.6
Time Deposits in Amounts of $100,000 or more	37,646	− 65	− 2,648	− 6.5
Other Liabilities for Borrowed Money[5]	23,773	955	2,704	12.8

Two Week Averages of Daily Figures	Period ended 7/15/85	Period ended 7/1/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (−)	55	21
Borrowings	106	91
Net free reserves (+)/Net borrowed(−)	− 51	− 69

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change