ABSTRACT

Title of Document: DREAM DEREGULATED: THE POLITICS OF U.S. HOUSING FINANCE, 1968-1985.

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Beginning in the late 1970s, policymakers enacted a series of legislative and regulatory changes that, by 1985, combined to dismantle the New Deal-era system of housing finance. These policy changes fundamentally restructured the way that Americans accessed credit for homeownership from primarily borrowing via long-term, fixed-rate mortgages from local, federally insured S&Ls that collected deposits at a regulated cost, to increasingly borrowing through adjustable-rate mortgages issued by unregulated brokers who then sold those mortgages to investors in a secondary market, typically through an intermediary such as Fannie Mae or Freddie Mac.

"Dream Deregulated" argues that this transformation of housing finance undermined the progressive intent of the open housing and community reinvestment initiatives of the 1960s and 1970s by making housing credit less stable for all borrowers, relative to the New Deal system, and by largely disconnecting housing

finance from the institutional structure that the civil rights initiatives were designed to regulate. It further argues that policymakers pursued broad deregulation of housing finance only after their pursuit of a narrower agenda of deregulation, that of deposit interest rate ceilings, opened the door to a series of arguments for further deregulation, particularly of S&L assets, including authorization of adjustable rate mortgages. The populist politics of the deregulation of deposit rate ceilings, taken up by and on behalf of "small savers," provided a discursive wedge for advocates of broader deregulation, taken up by and on behalf of the interests of the largest financial institutions and a neoliberal political agenda.

"Dream Deregulated" investigates the policymaking process as a case study in what Paul Pierson calls "politics in time." This study bridges scholarship on fair housing and community reinvestment with that on the deregulation of housing finance, and contributes to a deeper understanding of the politics of opportunity in the United States during the latter third of the twentieth century. It historicizes the politics of financial deregulation, and, with its focus on the populist politics of deregulation, helps to explain the "construction of consent" to a neoliberal regime. Finally, "Dream Deregulated" demonstrates how a contradictory complex of housing policies contributed to the recent financial crisis.

DREAM DEREGULATED: THE POLITICS OF U.S. HOUSING FINANCE, 1968-1985

By

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Introduction

What Happens to a Dream Deregulated?

In fall 2005, Gillian N. Miller, an African American divorcée and mother of three began looking for a home to purchase in Boston.[1] She sought a good neighborhood for her children, and, ideally, a backyard in which they could run and play. Working with a real estate agent, she looked at several properties, passing on a few that she liked but could not afford. Discouraged, she was ready to put her search on hold for the winter. But in January 2006, Miller met a broker from a company called Summit Mortgage. The broker assured her that she qualified for 100% financing, and soon she had a loan and a new house for her family. For this Barbadian immigrant, a home, along with an education, a career, and family, was the American Dream–and, for the moment at least, she had it all.

In the context of American history, that a single woman or an African American, let alone a single African American woman, could secure a home mortgage was a truly remarkable development, possible only because of a hard-fought civil rights battle for equal access to credit for housing, culminating in the 1968 Fair Housing Act and 1974 Equal Credit Opportunity Act. Had someone of her demographic profile embarked on the same search fifty years earlier, in 1955, she would have stood no chance of securing a

[1] The details of Gillian Miller's borrowing experience are drawn from, House Subcommittee on the Constitution, Civil Rights, and Civil Liberties of the Committee on the Judiciary, "Testimony of Gillian N. Miller," April 29, 2010. http://judiciary.house.gov/hearings/pdf/Miller100429.pdf (accessed June 21, 2012). See also, Kimberly Blanton, "Borrowers Sue Subprime Lender, Allege Race Bias," *The Boston Globe*, July 13, 2007, http://www.boston.com/business/personalfinance/articles/2007/07/13/borrowers_sue_subprime_lender_allege_race_bias/ (accessed June 21, 2012), and Miller v. Countrywide Bank, N.A., 571 F. Supp. 2d 251 (D. Mass., 2008), *Westlaw* (accessed June 21, 2012).

mortgage loan from the banks or savings and loans (S&Ls) that then dominated residential mortgage lending. If, that is, in the equally unlikely case she could have found a homeowner or builder and a real estate broker who would sell to her. For much of the twentieth century, lenders, sellers, and brokers discriminated against women and racial minorities as a matter of course.

But simply *accessing* credit was not the end of Gillian Miller's story. It mattered a great deal exactly to what she had gained access. What she had gained access to in 2006 was a form of mortgage financing very different from that operating in 1955, or anytime from the 1930s through the 1970s. In those earlier times borrowers typically obtained a low-interest, long-term, fixed-rate, self-amortizing[2] mortgage originated and held by a bank or, most commonly, a local savings and loan association. Mortgage rates were kept relatively low by a host of government policies that subsidized housing credit, protected it from competitive pressures that would increase its cost, and shouldered some of the risks that would otherwise be borne by lenders and borrowers. This system of housing finance, the laws, regulations, and institutions that governed the way borrowers accessed credit for housing, was expansive in the sense that it made homeownership more affordable for more Americans, but it was also exclusive, in that it systematically discriminated against racial minorities and women–people like Gillian Miller.[3]

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[2] That is, with interest and principal paid back in regular amounts over the life of the loan.

[3] To say that "housing finance" discriminated is not to unduly personify a regulatory system or to remove the actual persons from historical acts of discrimination, but to emphasize that discrimination was "built in" and endemic to the very system itself through historical processes. Kenneth T. Jackson, *Crabgrass Frontier: The Suburbanization of the United States* (New York: Oxford University Press, 1985). Jill Quadagno, *The Color of Welfare: How Racism Undermined the War on Poverty* (New York: Oxford University Press, 1994). Melvin L. Oliver and Thomas M. Shapiro, *Black Wealth/White Wealth: A New Perspective on Racial Inequality* (New York: Routledge, 1995). Ira Katznelson, *When Affirmative Action Was White: An Untold History of Racial Inequality in Twentieth-Century America* (New York: W.W. Norton, 2005). Kevin Fox Gotham, *Race, Real Estate, and Uneven Development: The Kansas City*

The system that Miller had access to in 2006 had long since been transformed. Policy changes in the late 1970s and early 1980s fundamentally restructured the way that Americans obtained credit for homeownership and how that credit was created. The long-term, fixed-rate mortgages of the 1930s-1970s had been joined by adjustable-rate mortgages, shifting interest-rate risk from creditors to borrowers. And the local, federally-insured banks and S&Ls that collected deposits at a regulated cost had been supplanted by unregulated brokers who originated and then immediately sold mortgages to investors in a secondary market, typically pooled with other mortgages by an intermediary such as Fannie Mae or Freddie Mac.

Borrowing in 2006, Miller was signing not one but two mortgages, both with variable rates (one of them with a two-year fixed introductory period that then converted to an adjustable rate). Though she did not know it at the time, the mortgages she received were "subprime," with interest rates and fees higher than those issued to purportedly better qualified "prime" borrowers.[4] Miller, who had bought a house once before with her ex-husband, was confused when the broker presented her with two mortgages instead of one, and was unfamiliar with adjustable-rate loans. She signed the paperwork nonetheless, despite feeling rushed through a closing that had been expedited to suit the needs of the seller. Adding to her confusion, Miller's broker informed her that her mortgages would be sold to a company based on the other side of the country, called Countrywide Home Loans, Inc., while the official mortgagee listed in her paperwork was

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Experience, 1900-2000 (Albany: State University of New York, 2002). David M.P. Freund, *Colored Property: State Policy and White Racial Politics in Suburban America* (Chicago: Chicago University Press, 2007).

[4] The disclosed APRs for the two mortgages were 11.52% and 11.317%. Even those prime borrowers arguably paid higher rates than they would have if housing finance had still enjoyed the protected status it had from the 1930s through the 1970s.

neither Summit nor Countrywide, but rather the Delaware company with a Flint, Michigan P.O. Box, Mortgage Electronic Registration Systems, Inc.[5] Miller walked away "owning" a home, what she considered part of "having the American Dream," but only after paying almost $10,000 in broker fees and facing high and uncertain interest rates for years to come.

The contrast between Gillian Miller's experience obtaining a loan in 2006 and a typical borrower's experience in the 1950s highlights three major revolutions in housing finance over the course of the twentieth century. First, a wide array of federal interventions initiated just before and during the New Deal created a new institutional and regulatory system to provide abundant and affordable credit for housing, dramatically expanding homeownership for white male heads of household while systematically excluding women (as borrowers) and racial minorities. Second, in the 1960s and 1970s, civil rights and community reinvestment activists forced federal lawmakers and regulators to open up access to the New Deal-era system to previously excluded borrowers, and obliged banks and savings and loans to lend in previously excluded (redlined) neighborhoods. And third, in the late 1970s and early 1980s, policymakers reconfigured the institutional and regulatory structure of housing finance again, deregulating certain components of the New Deal System and restructuring others to perform new roles. The new system promised to make credit widely available, but also more costly and risky than under the New Deal-era regime.

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[5] "Mortgage," Suffolk County Registry of Deeds, Book 38951, Page 276 (January 31, 2006), http://www.masslandrecords.com (accessed July 4, 2012). For more on Mortgage Electronic Registration Systems Inc., and its role as a "Nominee of the lender," not an owner, servicer, or mortgagee in any real sense, see Christopher L. Peterson, "Foreclosure, Subprime Mortgage Lending, and the Mortgage Electronic Registration System," *University of Cincinnati Law Review* 78, no. 4 (2010). Available at SSRN: http://ssrn.com/abstract=1469749 (accessed July 4, 2012).

Three Revolutions in Housing Finance

There was something of a golden era of American homeownership in the decades immediately following WWII.[6] Buoyed by a booming post-war economy, many Americans enjoyed unprecedented prosperity, which increasingly included homeownership. While only 44% of households owned their own home in 1940, the percentage reached 55% in 1950, and 63% by 1970.[7] Poor and working class households gained an increasing share of the nation's economic growth as wages rose.[8] Yet even with increased wages most Americans needed to borrow money to purchase a house. They needed credit. While many factors such as supply, income, and down payment requirements influenced the availability, affordability, and achievability of homeownership, financing was the key lever for increasing the rate of ownership.[9] A regulatory and institutional apparatus to provide that financing, forged through public and

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[6] Gary Dymski, "Financial Globalization and Housing Policy."

[7] U.S. Census Bureau, "Historical Census of Housing Tables," *Census of Housing*. http://www.census.gov/hhes/www/housing/census/historic/owner.html.

[8] Judith Stein, *Pivotal Decade: How the United States Traded Factories for Finance in the Seventies* (New Haven: Yale University Press, 2010), 1. Stein notes, "the income of the lowest fifth increased 116 percent, while the top fifth grew 85 percent; the middle also gained more than the top."

[9] See Dwight M. Jaffee, Kenneth T. Rosen, Benjamin M. Friedman, and Lawrence R. Klein. "Mortgage Credit Availability and Residential Construction." *Brookings Papers on Economic Activity* 1979, no. 2 (1979): 333-386. Jaffe, et al., found the conventional wisdom was that credit availability was the primary determinant of cyclicality in housing starts and that "this explanation of the short-run housing cycle in terms of mortgage availability (and to a lesser extent, mortgage cost) has had a major influence on public policy toward housing markets." Ibid., 335-6. In other words, policymakers identified the availability of mortgage credit as the best way to affect access to homeownership. Why they did this is not clear, it may simply have been more feasible to affect the flow of credit than increase wages or the supply of housing. For much of the twentieth century, Jaffe, et al., note, the availability of credit was closely related to the flow of deposits to banks and thrifts. Not surprisingly, this became less true as residential mortgage credit was increasingly raised through secondary markets. The relative importance of housing finance in making homeownership achievable also changed over time. It became more important, for example, during the expansion of homeownership in the 1990s despite income stagnation.

private collaboration in the response to the Great Depression, hit full stride after the war, remapping the nation's residential landscape and dramatically democratizing access to homeownership in the process.[10] The creation of this complex of federal policies, which I will call the New Deal system of housing finance, was the first of the three revolutions in housing finance. It restructured the way that Americans accessed credit for homeownership, most significantly by standardizing the long-term, fixed-rate, fully-amortized mortgage.[11] This innovation reduced previously prohibitive down payments from as much as 50% to 20% or lower, and increased the maturity of mortgages, the time a borrower had to repay a loan, from three to five years to ten to twenty, and, eventually, thirty years. A host of federal agencies, including the Federal Home Loan Bank System, the Home Owners Loan Corporation, and the Federal Housing Administration (FHA), provided lenders with infusions of capital and insured lenders against default risk. Federal deposit insurance and interest rate ceilings, limits on the amount of interest that banks could pay on deposits, allowed lenders to raise funds at low cost which they could then lend at low but still profitable rates. In sum, the New Deal system of housing finance made credit for housing abundant and affordable and, in important ways, limited risk for both borrowers and lenders.[12]

Yet this era was not equally golden for all Americans. The dramatic *expansion* of homeownership paradoxically thrived on *exclusion*. Although, in time, the New Deal system of housing finance opened up access to homeownership to previously excluded

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[10] See Freund, especially chapter 3.

[11] Jackson, 196.

[12] That risk, of course, was shouldered by the federal government as a guarantor of mortgages and deposits and secondary market purchaser.

ethnic groups (helping to confirm their "white" identity in the process), it required exclusion of "inharmonious" racial minorities.[13] Federal appraisal and underwriting policies codified and nationalized longstanding practices and assumptions that held that the presence of certain racial and ethnic groups, particularly African Americans, reduced the value of properties in a neighborhood.[14] Consequently, both private lenders and the federal programs that subsidized them refused to extend credit to racial minorities or to any borrowers in racially heterogeneous neighborhoods. FHA policies directly excluded minorities from the residential mortgages the agency insured, and indirectly from mortgage finance in general, by spreading, sanctioning, and normalizing exclusionary practices throughout the "conventional" or non-federally insured market.[15] Once the FHA had made the long-term, low-interest, self-amortizing mortgage into a viable form of home finance, the conventional market quickly followed suit, if for no other reason than to compete with the FHA-insured market. Along with its terms, the conventional market adopted the FHA's underwriting and appraisal standards, privileging single-family suburban homes for white, male borrowers. This conventional market, though not federally insured, nonetheless benefited from federal policies, including the interest rate ceilings and deposit insurance that allowed banks and savings and loans to attract low cost funds that could be turned into home mortgages, and infusions of capital from a

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[13] "Inharmonious" or "incompatible" racial groups were among the "adverse influences" identified in the FHA *Underwriting Manual*. Federal Housing Administration, *Underwriting Manual: Underwriting and Valuation Procedure Under Title II of the National Housing Act* (Washington, DC: GPO, 1938), sec. 932-940.

[14] Jackson, 198.

[15] Gregory D. Squires, "Community Reinvestment: An Emerging Social Movement," in *From Redlining to Reinvestment: Community Response to Urban Disinvestment* edited by Squires (Philadelphia: Temple University Press, 1992), 6.

system of regional Federal Home Loan banks. Even through the portion of the housing market not directly insured by the FHA, then, the agency's discriminatory policies, with a federal stamp of approval, disseminated racial inequality throughout the national housing market.[16]

Civil rights activists had long challenged the inequitable aspects of the New Deal system, with a handful of minor victories through the 1960s. Then in 1968, Congress passed the Fair Housing Act, banning discrimination on the basis of race, color, religion, or national origin in the rental or sale of housing through a real estate broker, including lending and terms. Activists pressured the four federal financial regulators[17] to issue and enforce fair housing regulations for the depository institutions (banks and savings and loans) that financed the overwhelming majority of residential mortgages. As activists waged this battle into the late 1970s, a parallel (and complementary) movement emerged to combat the practice of redlining, by which lenders refused to make loans in certain neighborhoods (often disproportionately affecting racial minorities). By 1978, the fair housing and community reinvestment movements had affected significant policy changes. The majority of mortgage lenders fell under the jurisdiction of fair housing regulations, were required to disclose lending data (including race of borrowers and location of mortgaged properties), and, under the Community Reinvestment Act of 1977, were obliged to lend money in the neighborhoods in which they collected deposits. This

[16] For a detailed discussion of the relationship between the FHA-insured and conventional markets see Freund, 190-196.

[17] The Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board, the Comptroller of the Currency, and the Federal Reserve Board.

second revolution in housing finance promised the expansive qualities of the New Deal system to those who had previously been excluded from it.

Yet civil rights and community reinvestment activists' success in finally beginning to open access to the New Deal system coincided with a third revolution in housing finance, this one, like the first, a major restructuring of institutions, instruments, and regulations. As the New Deal system began to buckle under the strain of macroeconomic developments including inflation and increasingly volatile interest rates coupled with competitive pressures from financial and technological innovations, regulators and lawmakers scrambled to aid lenders, borrowers, and savers, but struggled to balance their often competing interests.[18]

At several critical junctures, policymakers privileged the interests of consumer-saver/investors over those of consumer-borrowers, culminating in the deregulation of interest rate ceilings (allowing depository institutions to pay higher rates to savers). This class of Americans, who already owned their own homes and had amassed significant savings, became investors seeking market returns on those savings. The number of such saver/investors grew considerably over the middle of the twentieth century–in no small part due to the wealth created by the New Deal system of housing finance. As the material interests of this highly influential constituency changed, so did their relationship to the New Deal system, and indeed the process by which that system was constituted and sustained by policymakers. Once beneficiaries of the low-interest mortgages made possible by interest-rate ceilings, in the context of high inflation, these homeowner-saver/investors turned against the ceilings because they held down the yield they earned

[18] Meyerson.

on their savings. They demanded access to federally-insured market-rate savings accounts and/or removed savings from depository institutions to seek market rates from investment alternatives that did not channel money into housing. Proponents of further financial deregulation then leveraged concessions on interest rate ceilings to press for deregulation of bank and thrift asset powers, allowing depository institutions to issue adjustable-rate mortgages and divert money from residential mortgages into alternative investments.

Out of the contentious debates, negotiations, policies considered, and paths taken and not taken during the late 1970s and early 1980s emerged, by 1985, a newly configured system of housing finance. The traditional leaders in mortgage origination, the savings and loans, and their protected source of low-cost funds had been marginalized, their origination function taken over by mortgage brokers, and their capital raising function taken by secondary market investors (led by the quasi-public/quasi-private Fannie Mae and Freddie Mac), and various forms of variable-rate mortgages competed alongside the standard fixed-rate mortgage. Collectively, the policy changes more fully integrated both residential mortgage financing and household savings into broader capital markets, in which housing would compete with other investment options such as corporate debt. The federal government would remain integral to propping up the mortgage market, though less and less through deposit and mortgage insurance and more and more as a purchaser-of-last-resort and guarantor in the secondary market through its implicit backing of the rapidly expanding Fannie Mae and Freddie Mac.

Housing Policy in Time

Each of the three transformations described above has generated a broad scholarly literature of its own.[19] This dissertation reconsiders their relationship, with particular attention to the timing and sequence of policy developments, to demonstrate two main arguments.[20] First, the restructuring of housing finance in the late 1970s and early 1980s resulted primarily from policymakers' attempts to reconcile the New Deal system to the changing interests of middle-class[21] homeowner-saver/investors[22] in the face of inflation.

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[19] Each of these literatures is extensive. See the bibliography for a fuller list. On the New Deal system, see Jackson, Freund, and Ann Meyerson, "The Changing Structure of Housing Finance in the United States," *International Journal of Urban and Regional Research* 10, no. 4 (1986): 465-497. On fair housing and community reinvestment, see Christopher Bonastia, *Knocking on the Door: The Federal Government's Attempt to Desegregate the Suburbs* (Princeton: Princeton University Press), and Dan Immergluck, *Credit to the Community: Community Reinvestment and Fair Housing in the United States* (Armonk, NY: M.E. Sharpe, 2004). And on the 1970s and 1980s restructuring, see Anthony Downs, *The Revolution in Real Estate Finance* (Washington, DC: Brookings Institution, 1985), and Gary Dymski, "Financial Globalization and Housing Policy: From 'Golden Age' Housing to 'Global Age' Insecurity," in Paul Davidson and Jan Kregel, eds. *Full Employment and Price Stability in a Global Economy* (Cheltenham, UK: Edward Elger, 1999): 139-165.

[20] On the utility of studying policy development "in time," see Paul Pierson, *Politics in Time: History, Institutions, and Social Analysis* (Princeton: Princeton University Press, 2004).

[21] As Meg Jacobs writes, "the question of membership in one vast amorphous middle class is hard to define and therefore subject to constant debate." Here I use middle class as a broad category, to include both of Jacobs' "routes to middle class formation," the expansion of white collar corporate and government jobs between 1880 and 1930, and the expansion under the New Deal social contract of which housing policies were a piece. By the 1970s both "middle classes" would have been among the homeowning majority, well enough situated by income and wealth to be saver/investors, even if some percentage were net debtors because of their mortgages (which during that period would eventually be more than offset by rising home prices). As Jeffrey Hornstein argues, middle-class consciousness was an ongoing historical construction, which, for the whole of the period studied here, was deeply tied to, among other things, (suburban) homeownership. He writes that by the 1940s, "'homeowner,' became a virtual metonym for 'middle class.' To be middle class meant, at least, to own – or aspire to own – a home of one's own." The conclusion that middle-class saver/investors drove policy change is similar to that of Gary Dymski who argues that "the class interests of primarily white, husband-wife household units" was the "straw that stirred the drink of systemic change" in housing finance, but, unlike Dymski, I arrive at this conclusion through investigation of policy regarding interest rate ceilings rather than housing prices. Jacobs, "Inflation: 'The Permanent Dilemma' of the American Middle Classes," in Oliver Zunz, Leonard Schoppa, and Nobuhiro Hiwatari, eds., *Social Contracts Under Stress: The Middle Classes of America, Europe, and Japan at the Turn of the Century*, (New York: Russell Sage Foundation, 2002): 130-156, 131. Jeffrey M. Hornstein, *A Nation of Realtors ®: A Cultural History of the Twentieth-Century American Middle Class* (Durham: Duke University Press, 2005), 10, quote from 202.

[22] The term saver/investor is necessary to describe the ambiguous and/or changing financial behavior of middle-class Americans. Increasing numbers of savers began to seek higher returns on savings through investment alternatives. Both by demanding higher returns on federally insured deposits and through new

Second, this restructuring significantly undermined the fair housing and community reinvestment policies of the 1960s and 1970s by largely removing housing finance from the financial institutions and regulators that those polices had targeted, and by making housing finance more costly and risky for all borrowers.

The deregulation of housing finance in the late 1970s and early 1980s turned on the interests and influence (direct and indirect) of middle-class homeowner-saver/investors. Alternative explanations of deregulation–the ascendance of deregulation as a policy solution or idea, the election of conservatives (especially Ronald Reagan) to national offices, the influence of powerful financial institutions, the failure of the New Deal regulatory regime to function under conditions of inflation and interest rate volatility, widespread insolvency of savings and loans–illuminate important contributing factors but fail to sufficiently explain when and how deregulatory policies were enacted in regulation and law.

Placing the restructuring of housing finance of the 1970s and early 1980s in the context of the *success* of the New Deal system in expanding homeownership in the postwar decades, as well as its apparent failure to provide a steady flow of credit to housing during the high inflation and volatile interest rates of the 1970s, highlights the political and economic role of homeowner saver-investors in driving policy change.[23] Of late-twentieth century politics Kim Phillips-Fein has written, "postwar federal government support for highways and mass homeownership helped create communities

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investment accounts that blurred the line between savings and investment, this group placed pressure on the New Deal system and on policymakers to change it.

[23] Many scholars understand the restructuring of housing finance in the 1970s and 1980s as a reaction against the perceived failures of the New Deal system of regulations, but tend to treat the system as static, not as a system that changed the political and economic environment in which it operated.

that would ultimately prove deeply hostile to New Deal liberalism."[24] Consistent with this general appraisal, I argue more specifically that federal support for mass homeownership created a constituency, homeowner-saver/investors, who proved deeply hostile to a particular New Deal policy, interest rate ceilings. That the ceilings themselves had contributed to the expansion of homeownership mattered little to those who had already benefited from them as borrowers and had come to see them only as punitive in their new role as inflation-battling savers. Whether by removing their deposits from savings and loans and banks in search of higher interest rates from alternative investment instruments, especially newly created money market mutual funds, or by demanding that depository institutions themselves pay higher rates, increasing numbers of Americans opted out of the New Deal system of housing finance in the 1970s. This forced policymakers to respond in order to both keep credit flowing to housing and keep depository institutions viable. Here, I emphasize, policymakers had a choice. They could have protected the New Deal system of housing finance by *extending* regulations to cover alternative investment instruments, or they could have removed interest rate ceilings for depository institutions (as they eventually did), allowing savers to earn higher returns wherever they might be found, and capital to flow to whatever institutions could compete to get it, without special regard for channeling capital to housing.

First in 1976, and again in 1980-81, policymakers gave serious consideration to extending regulations to reduce the yields of money market mutual funds, and thereby protect lenders' source of low-cost deposit funds. In both cases, concern for saver-investors' ability to earn higher returns ultimately trumped concern for borrowers and

[24] Kim Phillips-Fein, "Conservatism: A State of the Field," *The Journal of American History* 98, no. 3 (Dec., 2011): 723-743, 731.

financial institutions, as policymakers opted not to extend regulations. Confirming the influence of homeowner-saver/investors in these policy decisions, policymakers chose not to extend regulations to money market funds despite the support of Fed Chairman Paul Volcker, Bank Board Chairman Richard Pratt, the Consumer Federation of America, the National Associations of Realtors, Home Builders, and Mutual Savings Banks, the AFL-CIO, and an unlikely partnership between the American Bankers Association and the U.S. League of Savings Associations. Likewise, lawmakers chose to eliminate interest rate ceilings altogether, allowing savers to earn higher returns on federally insured deposits, despite the insistence of bankers and savings and loan officials that borrowers would have to pay higher rates on loans. Notably, policymakers also made this choice over the objections of representatives of organized labor, and the S&L, banking, and construction industries, all traditionally powerful interest groups.

Framed as a populist measure to end discrimination against "small savers," even lawmakers who remained deeply suspicious of other aspects of deregulation such as the authorization of adjustable rate mortgages, rallied around the push to end interest rate ceilings. By the late 1970s, a majority of lawmakers came to embrace a narrow deregulation agenda, the removal of interest rate ceilings, on behalf of consumer-savers, which then opened the door to further deregulation, the deregulation of thrift asset (lending and investment) powers. Once policymakers committed to the elimination of interest rate ceilings, proponents of broader deregulation leveraged concessions on rate ceilings for wider asset powers, arguing that if depository institutions had to pay market rates to savers, they would have to be freed to charge higher rates to borrowers and seek higher returns on non-housing investments. In the late 1970s and early 1980s,

liberalization of interest rate ceilings gradually became linked to authorization of flexible-rate mortgages, culminating in authorization of adjustable-rate mortgages with minimal consumer safeguards in 1981. And in 1982, Congress passed the Garn–St. Germain Act, including authorization of non-housing investment powers, in order to ensure that regulators could continue to phase out interest rate ceilings.

As S&Ls pursued the new investment options granted by Garn–St. Germain, they largely abandoned their role as the traditional leaders in housing finance. Policymakers turned to secondary markets to replace the thrifts as the primary source of capital for housing with two critical consequences. First, the turn to secondary markets integrated housing finance into broader capital markets, meaning that residential mortgages would compete with other investment alternatives for capital. Instead of supporting the modest return to savers capped by Regulation Q, mortgages would have to support competitive returns on investment as well as profits for several additional layers of intermediaries. Second, the turn to secondary markets facilitated the rise of mortgage companies and brokers in taking over the thrifts' leading role in mortgage origination.

This transformation in housing finance, rooted in the push for market returns for consumer-saver/investors, significantly undermined the fair housing and community reinvestment policies of the 1960s and 1970s. The fair housing and community reinvestment movements emerged in opposition to the inequities of the New Deal system of housing finance and the racially segregated residential landscape it promoted. As fair housing and community reinvestment activists worked to open access to housing finance through the 1960s and 1970s, they very sensibly targeted the institutions that dominated mortgage lending at the time. But even as they achieved new laws and regulations

governing traditional lenders, policymakers began to implement a series of deregulatory policies that drastically reduced the role of those lenders in housing finance. Beginning in 1978, the year that the FDIC finally adopted fair housing regulations, the year after Congress passed the Community Reinvestment Act, and the year that interest rate ceiling deregulation began, the share of mortgages originated by the depository institutions subject to fair housing and community reinvestment regulations steadily eroded, as the share of originations by comparatively less regulated mortgage brokers increased. The deregulation of thrift asset powers and the turn to secondary markets accelerated the emergence of mortgage brokers as the leaders in mortgage origination. The shift in mortgage origination away from the heavily regulated depository institutions had two critical impacts. First, it left the fair housing and community reinvestment apparatuses ill-equipped to monitor mortgage markets, creating a regulatory blind-spot in which discrimination could flourish. Into the 1990s and 2000s, credit discrimination continued for some borrowers as exclusion, but also, for other borrowers, through inclusion at discriminatorily high rates and fees, including a burgeoning subprime market.[25] Second, the restructuring of housing finance made credit widely available, but on more costly and risky terms for *all* borrowers compared to the New Deal system.[26] The restructuring itself

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[25] See, for example, William Apgar and Allegra Calder, "The Dual Mortgage Market: The Persistence of Discrimination in Mortgage Lending," in Xavier de Souza Briggs ed. *The Geography of Opportunity: Race and Housing Choice in Metropolitan America* (Washington, DC: Brookings Institution Press, 2005): 101-123. Apgar and Calder note that housing discrimination has changed in nature, but persists in new forms. Kathleen C. Engel and Patricia A. McCoy, "From Credit Denial to Predatory Lending: The Challenge of Sustaining Minority Homeownership," in James H. Carr and Nandine K. Kutty eds. *Segregation: The Rising Costs for America* (New York: Routledge, 2008): 81-124.

[26] Meyerson. Manuel B. Aalbers, "The Financialization of Home and the Mortgage Market Crisis," *Competition and Change* 12, no. 2 (June 2008): 148-166. Gary Dymski and Dorene Isenberg, eds. *Seeking Shelter on the Pacific Rim: Financial Globalization, Social Change, and the Housing Market*. Armonk, NY: M.E. Sharpe, 2002. William C. Apgar and H. James Brown, *The State of the Nation's Housing, 1988* (Cambridge: Joint Center for Housing Studies of Harvard University, 1988), 1. Frank S. Levy and Richard C. Michel, *The Economic Future of American Families: Income and Wealth Trends* (Washington, DC:

was ostensibly color-blind or race neutral, but viewed *in time*, that is, following decades of systematic discrimination, the negative effects of that deregulation were especially pernicious for the previously excluded groups. Though the costlier terms created generational inequities among all borrowers (a significant unfairness in its own right) wealth and other less-tangible opportunities that had accrued to families who had access to homeownership in the post-war decades mitigated those inequities in ways that reinforced and perpetuated the racial disparities of the post-war era.[27]

"Or Does it Explode?"

By the mid-1980s federal housing finance policy held in tension contradictory policy goals: a stated commitment to equal access to homeownership and the "American Dream" for all and an imperative that the profitability of housing finance be competitive with and integrated into all other capital markets. In the short-term, the rising costs of credit for housing joined with stagflation, and particularly flat wages, stalled the then decades long expansion of homeownership, which plateaued at 64%, for the duration of the 1980s.[28] Over the long term, into the 1990s and 2000s, the contradiction in goals created a market for new and often risky credit instruments in order to restart an expansion of homeownership rates and new-home construction in the face of an affordability gap. The transformation also facilitated the commoditization of what conventional wisdom deemed to be the additional risk that lenders took on in order to

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Urban Institute press, 1991), 87. Alex F. Schwartz, *Housing Policy in the United States: An Introduction* (New York: Routledge, 2006), 23.

[27] Oliver and Shapiro, 23, 27-8, 54.

[28] Kenneth A. Snowden. "Housing Units, by Occupancy and Ownership: 1890-1997." *Historical Statistics of the Unites States Millennial Edition Online*. Eds. Susan Carter et al. (Cambridge University Press, 2006).

meet the requirements of fair housing and community reinvestment legislation into a premium paid by borrowers in the form of higher rates and fees.

The restructured system of housing finance made Gillian Miller believe that she could and should achieve the “American dream” of homeownership. It gave a mortgage broker the incentive and opportunity to soak Miller with fees, sign her up for exorbitant adjustable interest rates, and sell her mortgages without taking on any risk. It made Countrywide eager to buy Miller’s mortgages and confident that it too could sell its stake in Miller’s debt to equally eager investors in a secondary market. Miller had access to homeownership, but under very shaky and costly terms. When Miller lost her job she struggled to keep up with her monthly payments. She took on temp jobs to maintain an income. It might have been enough to pay a more affordable mortgage, but not the two subprime loans she received from Summit Mortgage. Miller ultimately lost her home, and with it “her piece of the American dream.” The dream had been deregulated, making it simultaneously more attainable and less sustainable, a volatile combination borne of the fundamental structural changes to housing finance in the late 1970s and early 1980s.

Out of the raw material of loans like Miller’s, ultimately resting on the ability of borrowers to repay and/or the value of the homes that collateralized them, bankers, investors, insurers, brokers, et al., had erected layer upon layer of complex financial instruments spread deep and wide throughout the global economy. For years this system created enormous profits, but when borrowers struggled to repay escalating rates and investors began to question the value of the various instruments, loans, and homes on which they were premised, the system came crashing down in a global financial crisis.

Overview of the Dissertation

The dissertation is organized in a roughly chronological order, beginning with New Deal interventions in housing finance and ending with the emergence of the secondary markets as the primary source of capital for housing in the mid-1980s. Chapter One describes the institutions, laws, and regulations that made up the New Deal system of housing finance, then discusses its legacies and operation through the immediate post-war decades that shaped later policy development. It argues that interest rate ceilings were an important component of housing finance, helping to keep interest rates low and lending profitable, and which became central to how policymakers, bankers and, especially, savings and loan officials understood how housing finance worked (as incomplete an understanding as it may have been).[29] This overview of the New Deal system and what it wrought, an institutional and regulatory structure (including interest rate ceilings), racial inequality, and a homeowning majority, provides essential context for subsequent housing finance policymaking.

Chapter Two documents the efforts of civil rights and community reinvestment activists to secure, in law and regulation, effective enforcement mechanisms to open equal access to housing and housing finance, and to oblige depository institutions to lend in the neighborhoods in which they collected deposits. Decades of protest and legal challenges finally resulted in significant legislation and regulations, including the 1968 Fair Housing Act, 1974 Equal Credit Opportunity Act, 1975 Home Mortgage Disclosure Act, 1977 Community Reinvestment Act, and fair housing and community reinvestment

[29] Most bankers and S&L officials insisted on the vital importance of interest rate ceilings for housing finance into the 1980s. The two major histories of New Deal housing policy, Kenneth Jackson's *Crabgrass Frontier*, and David Freund's *Colored Property*, make little mention of interest rate ceilings.

regulations issued by the FDIC and Federal Home Loan Bank Board. Significantly, activists targeted traditional depository institutions and their regulators, even as parallel debates and policy changes began to erode the role of those institutions in housing finance. Except in the case of authorization of adjustable-rate mortgages, issues of fair housing and community reinvestment rarely surfaced in debates over the restructuring of housing finance, despite their important implications for shaping opportunity and access to homeownership.

The dissertation then turns to the politics surrounding the restructuring of housing finance in the late 1970s and early 1980s. Chapter Three focuses on the deregulation of interest rate ceilings. A small group of deregulation proponents challenged the ceilings beginning in the 1960s, but support for the ceilings among most bankers and savings and loan officials, representatives of organized labor, builders, and real estate brokers, as well as majorities in Congress made them remarkably resilient. A majority coalition in Congress did not form around removal of the ceilings until 1979, after their elimination had been successfully cast as an end to discrimination against "small savers" desperately fighting inflation. Even then, legislation to initiate a gradual phase-out of the ceilings did not pass until supporters hitched the initiative to authorization of popular bank accounts subject to expire at a court-designated deadline. Policymakers pursued this narrow deregulation of interest rate ceilings against the wishes of the majority of financial institutions, and despite claims that borrowing costs would rise, in order to appease the interests of (largely) homeowning savers. Proponents of ceiling removal argued that savers could earn market rates on their deposits, and depository institutions could better

compete against investment alternatives such as money market mutual funds, which were draining banks and savings and loans of their deposit base.

Chapter Four explores policy alternatives to the deregulation of interest rate ceilings. Policymakers might have instead extended regulations to money market mutual funds, reducing disintermediation and protecting the New Deal system of housing finance. Focusing on the policymakers' consideration of this alternative course serves to highlight why they ultimately chose to deregulate: concern for middle-class consumer-saver/investors. In 1976, the FDIC and Federal Reserve considered regulations that would have severely limited the growth of money market mutual funds, thereby protecting the intent of interest rate ceilings and forestalling the competitive pressures that drained money from depository institutions in the late 1970s and early 1980s. Though small in number at the time, money fund investors lobbied lawmakers who in turn asked the agencies not to regulate the money funds. In the early 1980s, as money funds grew rapidly and depository institutions suffered, a long list of regulators and interest groups called for federal regulation to contain the growth of money market mutual funds. But again, bowing to the interests of middle class investors, the federal agencies backed off and decided not to regulate the money funds.

Chapters Five and Six, then focus on how bankers, savings and loan officials, and proponents of broad financial deregulation leveraged concessions on interest rate ceilings and the earnings problems that their removal induced to pursue further deregulation of bank and thrift asset powers. Chapter Five documents how interest rate ceiling deregulation became linked to authorization of adjustable rate mortgages and documents a shift from congressional opposition to congressional acquiescence to the instruments,

despite concern for borrowers, in order to ensure the end of interest rate ceilings and higher returns to savers. Chapter Six then examines the role of the Depository Institutions Deregulation Committee, the body charged with phasing-out interest rate ceilings, in asset deregulation, culminating in the 1982 Garn–St. Germain Act. The DIDC struggled to enact its mandate to achieve market rates for savers while still maintaining the viability of the savings and loan industry, ultimately refusing to proceed with rate deregulation until Congress loosened asset powers, allowing thrifts to invest in consumer loans, commercial real estate, and other alternatives to residential mortgages. These policy changes went a long way to restructuring housing finance, removing and/or willfully refusing to maintain the protected source of low cost funds for depository institutions, and removing much of the obligation of savings and loans to invest in residential mortgages. The final major piece of the restructuring, policymakers' turn to secondary markets as the primary source of capital for housing, is the subject of Chapter Seven. This piece further facilitated the replacement of thrifts by mortgage brokers in mortgage origination, opened housing finance to capital investors, and maintained a heavy federal stake, via the quasi-public status of Fannie Mae and Freddie Mac, in supporting the nation's mortgage markets.

Historiographical Contributions

This study bridges the literature on fair housing and community reinvestment with that on the transformation (deregulation) of housing finance in the late 1970s and early 1980s. By investigating the two in relation to one another, the dissertation offers insight into the causes of continuing racial disparities in wealth (largely rooted in unequal access

to homeownership) despite a civil rights revolution. Though, as I argue, the deregulation of housing finance had a critical impact on fair housing and community reinvestment policies, both policymakers and scholars have tended to treat the two sets of policies separately. Most histories of the Fair Housing Act, for example, have focused on the enforcement efforts of the Departments of Housing and Urban Development and Justice, largely neglecting the federal financial regulators. I follow the lead of the civil rights activists themselves in arguing that the latter were just as important.[30] An exception to the general trend of separating the two issues, Dan Immergluck, in both *Credit to the Community* and *Foreclosed,* argues that changes to housing finance do have implications for fair lending practices.[31] I join Immergluck in emphasizing this relationship, but with greater attention to the deregulation of the late 1970s and 1980s (rather than the 1990s) and its causes.

Though typically not considering the implications for fair housing and community reinvestment, several scholars have examined the changes in housing finance in the late 1970s and 1980s.[32] Explanations of the changes have focused on the intellectual origins

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[30] See Bonastia, Charles M. Lamb, *Housing Segregation in Suburban America since 1960: Presidential and Judicial Politics* (New York: Cambridge University Press, 2005), and Mara S. Sidney, *Unfair Housing: How National Policy Shapes Community Action* (Lawrence: University of Kansas Press, 2003).

[31] Dan Immergluck, *Credit to the Community: Community Reinvestment and Fair Housing in the United States* (Armonk, NY: M.E. Sharpe, 2004). Immergluck, *Foreclosed: High-Risk Lending, Deregulation, and the Undermining of America's Mortgage Market* (Ithaca: Cornell University Press, 2009). Matthew Lee discusses the CRA in relation to deregulation in the late 1990s in Lee, "Community Reinvestment in a Globalizing World: To Hold Banks Accountable from The Bronx to Buenos Aires, Beijing and Basel," in *Organizing Access to Capital: Advocacy and the Democratization of Financial Institutions* edited by Gregory D. Squires (Philadelphia: Temple University Press, 2003): 135-153.

[32] See, for example, Anthony Downs, *The Revolution in Real Estate Finance* (Washington, DC: Brookings Institution, 1985). With the exception of changes in fiscal and monetary policy after 1979, the "causes" examined by Downs, including changing expectations of inflation, the loss of housing's protected position in credit markets, deregulation, and technological changes, describe the transformation better than they explain it.

and ascendance of deregulatory and free market ideas, implying a building momentum culminating in the application of those ideas to housing finance,[33] the power and influence of large financial institutions,[34] or the triumph of one set of financial institutions over another.[35] Deregulatory ideas and the contending financial interest groups were indeed important in informing the shape of deregulatory policies, but I argue that it was the influence of middle-class saver/investors that created political openings and/or tipped the balance of competing agendas to allow those policies to be implemented. The various financial interest groups were often at odds with one another, and lawmakers routinely went against the wishes of even the most powerful among them.

This interpretation speaks also to the wider literatures on deregulation, the rise of conservatism, and the rise of neoliberalism. The deregulation of housing finance was a part of what Martha Derthick and Paul Quirk call the emergence of "deregulation as a policy fashion," a short period in the late 1970s and early 1980s during which significant deregulation was achieved in a range of industries including telecommunications, energy, and trucking.[36] Richard Vietor writes that across these industries, "sudden economy-wide performance problems undermined political faith in the prevailing systems of economic management," opening space for deregulatory reform.[37] But that space proved quite

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[33] Dorene Isenberg, "U.S. Housing Policy Transformation: The Challenge of the Market," in Gary Dymski and Dorene Isenberg, eds. *Seeking Shelter on the Pacific Rim: Financial Globalization, Social Change, and the Housing Market* (Armonk, NY: M.E. Sharpe, 2002): 42-62.

[34] Richard L. Florida, "The Political Economy of Financial Deregulation and Reorganization of Housing Finance in the United States," *International Journal of Urban and Regional Research* 10, no. 2 (June 1986): 207-231.

[35] Ann Meyerson, "The Changing Structure of Housing Finance in the United States," *International Journal of Urban and Regional Research* 10, no. 4 (1986): 465-497.

[36] Martha Derthick and Paul J. Quirk, *The Politics of Deregulation* (Washington, DC: The Brookings Institution, 1985), 53.

[37] Richard H.K. Vietor, *Contrived Competition: Regulation and Deregulation in America* (Cambridge: Harvard University Press, 1994), 2.

narrow. The institutions and regulations of the old systems proved very resilient, even in the face of severe "performance problems."

The basic argument for deregulation held that it would increase competition that would then result in better prices and services for consumers. With its consumer-centric justification, as Daniel Rodgers puts it, "Deregulation was a radical project before it became a conservative one."[38] Indeed, the impetus behind interest rate ceiling deregulation was an application of this idea. Policymakers such as Senator Proxmire thought that without Regulation Q, banks and thrifts would compete to give savers higher returns. But this logic did not translate so neatly to banking and housing finance, a regulatory regime in which consumer interests were uniquely divided and in many ways at odds, particularly the interests of consumer-savers and consumer-borrowers. Increased returns to savers, according to bankers, thrift officials, and regulators alike, would result in higher costs to borrowers. The consumer-centric rationale for deregulation simply did not apply to banking in the same way as it did to other industries. Furthermore, in the case of housing finance, explanations of deregulation have to account for two distinct stages of deregulation, the first of bank and thrift liabilities (the amount of interest they paid on deposits), and the second of thrift asset powers. I argue that the proponents of asset deregulation, in concrete and discernable ways, leveraged concessions on interest rate ceilings to secure broader powers. Lawmakers' ultimate backing of both deregulation of interest rate ceilings and authorization of adjustable-rate mortgages and broadened thrift asset powers reflected less a wholehearted embrace of deregulation as a concept, philosophy, or ideology than an arduous negotiation of competing interests in which no

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[38] Daniel T. Rodgers, *Age of Fracture* (Cambridge: Harvard University Press, 2011), 8.

party, neither consumer advocates nor financial institutions, got everything they wanted.[39]

Vietor argues that "regulatory reform in the banking sector was little more than the political acknowledgement of de facto competition [from nonbank financial instruments]."[40] But this account, typical of the literature, implies that regulators had no recourse to limit such competition.[41] As discussed above, however, regulators could have extended regulation to money market mutual funds and other instruments that drew money from depository institutions, and they gave that option serious consideration. Taking the debates over the possible regulation of MMMFs seriously serves to highlight why policymakers ultimately chose to deregulate–to ensure market rates to savers.

This dissertation joins a growing number of studies that emphasize developments in the 1970s as marking a critical shift or break in twentieth-century American history,[42] but also roots such changes in the internal contradictions of postwar liberalism.[43] The deregulation of S&L asset powers (often attributed to the conservative and/or free market

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[39] Richard L. Florida, "The Political Economy of Financial Deregulation and the Reorganization of Housing Finance in the United States," *International Journal of Urban & Regional Research* 10, no. 2 (1986): 207-231. Dorene Isenburg, "The Political Economy of Financial Reform: The Origins of the US Deregulation of 1980 and 1982," in *Capitalism, Socialism, and Radical Political Economy: Essays in Honor of Howard J. Sherman* edited by Robert Pollin (Northampton, MA: Edward Elgar Press, 2001). Martha Derthick and Paul J. Quirk, *The Politics of Deregulation* (Washington, DC: Brookings Institution, 1985).

[40] Vietor, 266.

[41] Meyerson is one of the few exceptions that does not regard the deregulation of housing finance as an inevitable response to inflation, rising interest rates, and the consequent thrift earnings crunch.

[42] See Stein, Rodgers, Bruce Schulman, *The Seventies: The Great Shift in American Culture, Society, and Politics* (Cambridge: De Capo Press, 2002), and Schulman and Julian Zelizer, eds. *Rightward Bound: Making America Conservative in the 1970s* (Cambridge: Harvard University Press, 2008).

[43] See Thomas Sugrue, *The Origins of the Urban Crisis: Race and Inequality in Postwar Detroit* (Princeton: Princeton University Press, 1996), Robert O. Self, *American Babylon: Race and the Struggle for Postwar Oakland* (Princeton: Princeton University Press, 2003), Matthew Lassiter, *The Silent Majority: Suburban Politics in the Sunbelt South* (Princeton: Princeton University Press, 2006), and Freund.

leanings of the Reagan administration), grew directly out of the bargain struck by (mostly Democratic) policymakers in the late 1970s to reconcile the changing interests of homeowner-savers to the New Deal regulatory system in the context of inflation and financial innovation. Indeed, as Rodgers writes, "too sharp a sense of break at Reagan's 1980 election simplifies and distorts."[44]

And yet this study cautions against moving too far in the opposite direction, which risks missing what was different about the approach to deregulation by the Reagan administration. The case of adjustable-rate mortgage authorization is illustrative. On one hand, the bargain to allow flexible-rate mortgage instruments in exchange for the end of interest rate ceilings had been struck before Reagan and a Republican Senate majority came to power. On the other hand, if one looks at the consumer safeguards that accompanied flexible-rate mortgage proposals and authorizations from the early 1970s into the early 1980s, the arrival of the Reagan administration corresponds with an abrupt loosening of regulatory consumer protections. Similarly, the Reagan administration's unquestioning assumption that secondary markets would reduce the cost of housing finance broke from the Carter administration, which remained more skeptical. In both cases, the Reagan regime exhibited a fuller faith in the free market to deliver desired outcomes without need of even minimal regulatory protections.

The deregulation of housing finance was a significant piece of a broader shift in political economy that has been described as the rise of neoliberalism. On several defining characteristics of neoliberalism, including deregulation to reduce barriers to the free flow of capital, liberalization of capital investment, and privatization of state assets,

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[44] Rodgers, 3.

the newly restructured system of housing finance largely conformed.[45] The deregulation of interest rate ceilings and thrift investment powers in particular functioned to integrate both household savings and residential mortgage credit into national and global capital markets. Only in privatization, where changes to the charter of Fannie Mae and the creation of Freddie Mac privatized profit but implicit federal backing continued to federalize (and socialize) risk, did the transformation in housing finance fall short of fulfilling the central aspects of neoliberalism. Critics have pointed out that neoliberalism has also included an assault on the welfare state and labor unions as impediments to efficient, free markets. Such policies shift risk to individuals, a characteristic shared by the new system of housing finance, especially in its authorization of adjustable-rate mortgages.[46] Finally, critics argue that neoliberal policies have disproportionately benefited the wealthy.

This literature has accurately captured how the post-deregulation system of housing finance functions and whose interests it best serves, but this study contributes a better understanding of the political developments that enabled the transformation of housing finance and how those developments related to structural change.[47] It will add to the intellectual history of neoliberal ideas the historical contexts of the fair housing and community reinvestment movements, and the success (as well as the failure) of the New Deal system of housing finance. In the process, it offers a richer answer to the question

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[45] Kean Birch and Vlad Mykhnenko, *The Rise and Fall of Neoliberalism: The Collapse of an Economic Order?* (London: Zed Books, 2010), 5.

[46] Jacob Hacker, *The Great Risk Shift: The Assault on American Jobs, Families, Health Care, and Retirement and How You Can Fight Back* (Oxford: Oxford University Press, 2006).

[47] Krippner and Stein are among the few studies that attempt to historicize the development and implementation of neoliberal policies.

posed by David Harvey, "how was neoliberalization accomplished, and by whom?"[48] And it helps to explain the "construction of consent" to a neoliberal regime.[49]

In the case of housing finance, the political processes that resulted in neoliberal policies, which indeed have had dubious benefits for most Americans (especially racial minorities), turned on the interests not of the financial elite, but of middle-class homeowner-saver/investors. Martin Gilens and Larry Bartels in separate studies beginning with data from the early 1980s and late 1980s, respectively, find little relationship between the policy preferences of low- and middle-income Americans and the voting records of elected officials, what Jacob Hacker and Paul Pierson term "unrepresentative democracy." In contrast, I argue that in the mid to late 1970s, policymakers were very much responding to middle-class Americans' preferences regarding market rates on savings. It could be that this was one of the last times that middle-income voters held such sway, but at least in the pursuit of interest rate ceiling deregulation and the decision not to regulate money market mutual funds, policymakers had not yet turned their backs on the middling majority. The wealthiest Americans, those who Bartels and Gilens find were the only ones able to influence policy, had little stake in the decisions regarding rate ceilings or money funds as they already had access to market rates.[50]

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[48] Harvey, 39.

[49] Ibid.

[50] Martin Gilens, *Affluence and Influence: Economic Inequality and Political Power in America* (Princeton: Princeton University Press, 2012). Larry M. Bartels, *Unequal Democracy: The Political Economy of the New Gilded Age* (Princeton: Princeton University Press, 2008). Jacob S. Hacker and Paul Pierson, *Winner-Take-All Politics: How Washington Made the Rich Richer–And Turned Its Back on the Middle Class* (New York: Simon & Schuster, 2010).

Finally, there is a rapidly growing literature and continuing commentary on the causes of the current economic crisis (also variously known as the subprime-, housing-bubble-, foreclosure-, debt-, leverage-, or financial crisis, among other names).[51] Much of the discussion has centered on the role of the federal government in regulating financial institutions. On one side of this debate, left-leaning pundits and commentators have pointed to deregulation as a major cause, citing in particular, the Gramm-Leach-Bliley Act of 1999, which ended the Glass–Steagall separation of commercial and investment banking, and the Commodity Futures Modernization Act of 2000, which reduced oversight of the development of financial derivatives. Others have looked back to the DIDMCA of 1980, or to the Garn–St. Germain Act of 1982, as Paul Krugman did in his *New York Times* column of May 31, 2009, titled "Reagan Did It."[52] On the other side of the debate, conservative commentators have pointed to the incomplete deregulation or privatization of Fannie Mae and Freddie Mac, or to the requirements of the Community Reinvestment Act of 1977, as the primary causes of the crisis due their promotion of high-risk lending.[53] While the deregulatory legislation of 1990s and 2000s is undoubtedly critical to understanding the recent crisis, I argue that the earlier period of deregulation, which made secondary markets the primary source of capital for housing and authorized

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[51] For a few examples, see Edward Gramlich, *Subprime Mortgages: America's Latest Boom and Bust* (Washington, DC: Urban Institute Press, 2007), Bethany McLean and Joseph Nocera, *All the Devils Are Here: The Hidden History of the Financial Crisis* (New York: Penguin, 2010), and Robert Shiller, *The Subprime Solution: How Today's Global Financial Crises Happened, and What to Do about It* (Princeton: Princeton University Press, 2008).

[52] Paul Krugman, "Reagan Did It," *The New York Times,* May 31, 2009, http://www.nytimes.com/2009/06/01/opinion/01krugman.html.

[53] See, for example, Peter J. Wallison, "Regulating Paul Krugman," *The Enterprise Blog, American Enterprise Institute*, June 1, 2009, http://blog.american.com/?p=1391.

a variety of mortgage instruments, constituted a fundamental shift in housing finance that underlies the crisis.[54]

[54] Patricia McCoy and Elizabeth Renuart root the emergence of the subprime market in the preemption of usury ceilings by the DIDMCA and the deregulation of mortgage instruments in the Garn-St. Germain Act. Patricia A. McCoy and Elizabeth Renuart, "The Legal Infrastructure of Subprime and Nontraditional Home Mortgages," in Nicolas P. Retsinas, Eric S. Belsky, eds., *Borrowing to Live: Consumer and Mortgage Credit Revisited*, Joint Center for Housing Studies, Harvard University, James A. Johnson Metro Series, Brookings Institution Press, November 2008. Available at SSRN: http://ssrn.com/abstract=1471306 or http://dx.doi.org/10.2139/ssrn.1471306.

Chapter 1

The Mixed Legacies of the New Deal System of Housing Finance, 1932-1968

Federal policymaking regarding housing finance between 1968 and 1985 cannot be understood apart from the context of three and a half prior decades of the operation of the New Deal system of housing finance. It is necessary, therefore, to describe the basic features of the New Deal system and the ways that it shaped both residential patterns and the politics of opportunity in post-war America. Much of this story has become familiar to students of twentieth-century American history, but this account highlights two underemphasized aspects of the workings and consequences of New Deal-era housing policies. First, in addition to the now well-known host of New Deal housing agencies and policies such as the Home Owners' Loan Corporation, the Federal Housing Administration (FHA), and the FHA and Veterans Administration mortgage insurance programs, this account emphasizes the role of interest rate ceilings, known as Regulation Q, in creating and allocating affordable mortgage credit.[1] The ceilings, which limited the amount of interest that commercial banks could pay to savers, gave savings and loans a competitive advantage in attracting deposits. In the immediate post-war decades, S&Ls greatly increased their share of the nation's household savings, which they then turned almost exclusively into residential mortgage financing. Interest rate ceilings also

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[1] Neither Kenneth Jackson in his seminal suburban history, *Crabgrass Frontier*, nor David Freund in his sweeping treatment of New Deal housing policies, for example, include discussion of interest rate ceilings. Freund does briefly discuss the federal deposit insurance programs. Kenneth T. Jackson, *Crabgrass Frontier: The Suburbanization of the United States* (New York: Oxford University Press, 1985), 195. David M.P. Freund, *Colored Property: State Policy and White Racial Politics in Suburban America* (Chicago: Chicago University Press, 2007).

functioned to keep lenders' cost of funds low, enabling lenders to issue mortgages at rates that were both profitable for themselves and affordable for borrowers.

The emphasis here on Regulation Q and its legacies is a piece of a second, broader, point of reinterpretation of New Deal housing policies. As it succeeded in expanding homeownership to white households, the New Deal system, including Regulation Q, contributed to a transformation of the material interests of a growing middle class, altering the very political and economic contexts in which the system operated. Four legacies of the New Deal system, an inherited institutional and regulatory structure; a homeowning majority; a racially segregated residential landscape; and a culture of "colorblind individual meritocracy," which largely erased the pervasive federal role in promoting homeownership and racial exclusion, cast a long shadow over subsequent policy development.[2] Crucially, as the New Deal system expanded homeownership to white households in the post-war decades, it changed the material and political relationship of those households to the existing regulatory regime. Specifically, achieving homeownership made households less likely to support interest rate ceilings. While the ceilings helped lenders to profitably lend at affordable rates, they did so by limiting the amount of interest that savers could earn on deposits. Once a homeowner had secured a low-interest, fixed-rate mortgage, he (and then it was generally a *he*) had gained everything he could from interest rate ceilings as a borrower, and now only stood to "lose" interest income as a saver. As the majority of American households came to own their homes, and especially as inflation increased during the 1970s, the political

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[2] On a culture of meritocracy, see Matthew D. Lassiter, *The Silent Majority: Suburban Politics in the Sunbelt South* (Princeton: Princeton University Press, 2006). On government officials' active erasure of the federal role in post war America, see Freund.

pressure to end interest rate ceilings, and thereby help savers earn higher rates of return, eclipsed the political pressure to continue the ceilings to help would-be homeowners.

The New Deal System of Housing Finance–Institutions and Regulations

A wide complex of laws, regulations, and institutions, some predating the New Deal and others new, coalesced in the 1930s to resuscitate and fundamentally restructure the nation's mortgage markets. The product of a public-private collaboration of federal policymakers, industry representatives, and land-use experts, this restructuring innovated new mechanisms to create and allocate credit for housing.[3] Emergency legislative and regulatory responses to the Great Depression, including the Federal Home Loan Bank Act of 1932, the Banking and Home Owners' Loan Acts of 1933, and the National Housing Act of 1934, combined with existing policies such as the mortgage interest deduction to change both how residential mortgage credit was created and how borrowers accessed it, in ways that made that credit more abundant and affordable. The newly reconfigured system of housing finance, which I will call the New Deal system, governed the way that American home buyers accessed mortgage credit from the 1930s through the 1970s.

Created in 1932, the first of the new institutions that would shape housing finance over the decades that followed was a network of Federal Home Loan Banks (FHLBs) to provide supplemental capital to lending institutions.[4] When lenders lacked sufficient

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[3] Freund, chapter 3.

[4] David Mason notes that by 1941, S&Ls representing 90% of total assets had become members of the FHLB System though a numerical majority had not joined until 1960. `Mason, *From Buildings and Loans to Bailouts, 1831-1995* (New York: Cambridge University Press, 2004), 108.

funds to meet local demand for mortgages or deposit withdrawals, they could turn to their regional FHLB for an advance, an infusion of capital, against the collateral of mortgages they held. After an initial capitalization of up to $125 million from the U.S. Treasury, the Federal Home Loan Banks raised funds by selling stocks to members and issuing its own debt offerings (bonds) to the public.[5] The FHLB System was governed by a board (the Federal Home Loan Bank Board, or FHLBB) which became the principal federal regulator of the thrift industry (savings and loans and mutual savings banks).[6] The thrift and real estate industries heartily endorsed the bank system. Morton Bodfish, an official of the thrift industry's chief lobbying organization, the United States Savings and Loan League, wrote the legislation creating the FHLBs and ensured that they and the FHLBB would provide an institutional home for an on-going public-private partnership in housing finance.[7] On its own, the FHLB system did little to stimulate new borrowing as it addressed the supply of credit but, without significantly altering mortgage terms, not demand for credit. Later, when subsequent interventions did liberalize mortgage terms and invigorate demand, the FHLBs ensured that lenders could meet that demand even if they lacked sufficient capital on hand.

The revolution in mortgage terms needed to induce greater demand came through a second institutional intervention–this one under the Roosevelt Administration. The Home Owners' Loan Corporation (HOLC) was established in 1933 as an emergency response to the alarming rate of foreclosures since the onset of the Depression, a number

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[5] Federal Home Loan Bank Act, 72d Cong. Chapter 522.

[6] Freund notes that under this arrangement, allowing thrifts to profit from increased lending backed by federal authority and Treasury funds, "the lines between the 'public' and 'private' home finance markets first began to blur." Freund, 109.

[7] Freund, 108-9.

that reached nearly a quarter million homes in 1932.[8] Congress initially capitalized the HOLC with $200,000,000 from the U.S. Treasury, and authorized the agency to raise an additional $2 billion by issuing 18-year bonds at 4% interest.[9] Between 1933 and 1935, the HOLC refinanced roughly one million home loans, sparing both borrowers and lenders the costs and hardships of foreclosure.[10] Important as this intervention was in its own right, the HOLC's enduring significance derived from its development of the long-term, low-rate mortgage instrument, and its systematic appraisal of neighborhoods including valuation based on racial composition.[11] These two innovations outlived the institution itself to become essential components of the New Deal system of housing finance.

The HOLC's experimentation with the long-term, low-interest, fully-amortized mortgage provided government backing to instruments that had been tried, on less liberal terms, by private lenders with minimal success. Federal capitalization, however, allowed the HOLC to refinance at terms manageable even for Depression-afflicted homeowners. Such positive experience with the liberal mortgage instrument set important precedents for subsequent federal policymaking. Longer maturities and lower interest rates promised to lead to expanded demand in ways that the exclusively supply-oriented FHLBs could

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[8] Kenneth A. Snowden, "Mortgage Foreclosures and Delinquencies, 1926 – 1979," *Historical Statistics of the Unites States Millennial Edition Online*, edited by Susan Carter et al. (Cambridge University Press, 2006).

[9] "Home Loan Bonds Find Increasing Favor Among Mortgage Holders, Fahey Says," *The Pittsburgh Press*, January 5, 1934. *Google News Archive Search* (accessed June 20, 2012).

[10] Jackson, 195.

[11] Freund, 113.

not. The key to unlocking this potential would lie in developing a sustainable program to make such instruments profitable for traditional lenders.[12]

Rivaling the development of new mortgage instruments in long-term impact, the HOLC instituted a set of appraisal practices that required racial exclusion. The agency most famously recorded its appraisal of neighborhoods in what were called Residential Security Maps, classifying areas hierarchically (in descending order) A, B, C, and D. The highly rated A neighborhoods tended to be low-density, racially-homogenous (white), and of newer or at least well-maintained housing stock. Reflecting the prevailing assumption of leading land-use experts and planners, neighborhoods with any presence of racial minorities received the lowest classification, designating those areas as high risk, and making many properties ineligible for HOLC refinancing. The maps systematized racial prejudice in lending, as local lending institutions embraced and employed the A, B, C, D classifications. "Even more significantly," historian Kenneth Jackson writes, "HOLC appraisal methods, and probably the [residential security] maps themselves, were adopted by the Federal Housing Administration."[13] At a critical moment, the HOLC fused longstanding prejudicial lending and real estate practices with the transforming system of housing finance.[14]

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[12] Ibid., 111-113.

[13] Jackson, 203. Amy Hillier argues that the maps were not distributed widely to lenders and that lending practices after the adoption of the maps simply continued previous practices, indicating that the impact of the maps themselves has been overstated by Jackson and subsequent scholars. Regardless of the particular impact of the maps, the HOLC joined racial exclusion to the new and evolving, federally-underwritten, market for mortgage credit, setting important precedent as the same network of public and private actors would design subsequent policies. Amy E. Hillier, "Redlining and the Home Owners' Loan Corporation," *Journal of Urban History* 29, no. 4 (May 2003): 394-420. On the "public-private alliance that drafted federal housing policy and administrated its programs," see Freund, 100-102.

[14] Freund, 115-118.

Established by the National Housing Act of 1934, the Federal Housing Administration (FHA) built on HOLC precedent, not only using racially exclusive appraisal practices, but also adopting the long-term, amortized mortgage instrument. Rather than refinancing mortgages on the verge of foreclosure as had the HOLC, the FHA insured lenders against default on new mortgages (and home improvement loans). The FHA's merging of racial exclusion and new mortgage instruments reduced payments and increased maturities for mortgages in A and B neighborhoods, but largely excluded the C and D neighborhoods that included most urban neighborhoods and neighborhoods with racial minorities. Because the federal government assumed the risk of default, lenders could offer lower interest rates (Jackson claims two to three percentage points). The FHA insurance program, augmented in 1944 by a comparable Veterans Administration (VA) program under the auspices of the GI Bill, insured 11 million homes by 1972. The FHA and VA insurance programs privileged single-family suburban homes of new construction, ensuring that new homeowners would most likely live in newly built and exclusively white suburbs.[15] Even as the share of mortgages insured by the FHA declined, as they did into the 1960s and 1970s, the revolution FHA insurance had fostered continued to shape the politics of homeownership and opportunity throughout the postwar era. By establishing the long-term, low-interest, amortized mortgage as the standard instrument for both FHA-insured loans and the conventional (not federally insured) loans which had to compete with them, the FHA program's influence extended far beyond the mortgages it actually insured. Indeed the entirety of the nation's mortgage

[15] Jackson, 205-7.

markets (both federally-insured and conventional) had been revolutionized by federal policies.

In an additional effort to stimulate housing and related industries, the 1934 Housing Act provided for a secondary market for mortgages, envisioning private investors who would purchase mortgages from lenders, who could then turn the proceeds back into more loans. As a private secondary market failed to materialize, Congress moved in 1938 to establish the Federal National Mortgage Association (FNMA or Fannie Mae). FNMA purchased FHA and, later, VA-insured loans, assuring lenders of the liquidity of such loans, and thus encouraging more lending. Even if FNMA did not purchase a particular loan, the fact that they likely would if needed made issuing the loan less risky for the lender. Though exceedingly modest compared to what FNMA and other secondary market activity would become by the close of the twentieth century, the agency played an important role in facilitating the standardization of mortgage instruments and in supplementing the amount of capital available for mortgage finance.[16] The FNMA proved to be a particularly important part of the institutional legacy of the New Deal system as policymakers turned to it and similar institutions (the Federal Home Loan Mortgage Corporation and the Government National Mortgage Association) to take the lead in making the secondary markets the primary source of capital for housing in the 1980s.

Further subsidizing borrowers, the federal income tax, since its inception in 1913, had allowed taxpayers to deduct interest on all forms of consumer debt from their taxable income. Though not originally intended as a housing policy, this exemption proved to be

[16] Freund, 192.

a major federal support for homeownership, especially after WWII, as the proportions of both homeowners and taxpayers increased.[17] The benefit to borrowers was considerable. In 1962, for example, the mortgage interest deduction saved homeowners $2.9 billion.[18] This subsidy, as old as the income tax itself, gave special status to homeownership throughout the twentieth century. Rarely was the deduction questioned in discussions of housing policy, despite deregulation of many other aspects of housing finance.[19]

While the Federal Home Loan Banks and the Federal National Mortgage Association supplied traditional lenders with additional capital, FHA insurance protected lenders against default risk, allowing lenders to make more credit available to more borrowers, and the mortgage interest deduction made borrowing more affordable, regulations governing depository institutions further increased the amount and affordability of credit for residential mortgages. Created through the Banking Act of 1933, the Federal Deposit Insurance Corporation (FDIC) guaranteed the safety of

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[17] Christopher Howard, *The Hidden Welfare State: Tax Expenditures and Social Policy in the United States* (Princeton: Princeton University Press, 1997), 49-54. Cohen writes that "the proportion of federal tax returns claiming interest deductions rose from 2.8 percent in 1950 to 30.6 percent by 1960 and to 39.3 percent in 1970. Lizabeth Cohen, *A Consumers' Republic: The Politics of Mass Consumption in Postwar America* (New York: Knopf, 2003), 146. See also, James R. Follain, David C. Ling, and Gary A. McGill, "The Preferential Income Tax Treatment of Owner-Occupied Housing: Who Really Benefits?" *Housing Policy Debate* 4, no. 1 (1993): 1-24.

[18] Freund, 194-5. Howard notes that it is difficult to estimate the benefit of the mortgage interest deduction in its early years, as records did not separate that deduction from other consumer debt. Howard, 95.

[19] The deduction had plenty of critics, especially among economists and some policymakers who wanted to eliminate loopholes in the tax code, most notably Stanley Surrey, Assistant Secretary for Tax Policy under Kennedy and Johnson. Some limitations were made in the 1980s, including a $1 million cap on the amount of mortgage debt eligible for the deduction in 1987. See Howard for a full discussion of reform efforts. These critiques and reforms took place within consideration of the tax code and budget, not housing per se. An exceptional case was the suggestion of former HUD official Howard Ball, to Sen. Richard Lugar who was directing hearings on an emergency mortgage interest reduction bill in 1982, that a ceiling be placed on the amount of the tax deduction, and the resulting revenue be invested directly into home construction. See Howard Ball, to Richard Lugar, April 29, 1982, in *Emergency Mortgage Interest Reduction Payments Act of 1982: Hearing before the Subcommittee on Housing and Urban Affairs of the Committee on Banking, Housing, and Urban Affairs, United States Senate, Ninety-seventh Congress, First Session, March 23, 1982.* (Washington, DC: GPO, 1982), 137-138.

deposits placed in commercial banks. A year later, the National Housing Act created a comparable program for savings and loans through the Federal Savings and Loan Insurance Corporation (FSLIC). As with FHA mortgage insurance, the federal government took on risk, making savers more willing to deposit their money and thus enabling depository institutions to attract more capital than they could have in the absence of the guarantee.

A less well known provision of the Banking Act established interest rate ceilings, later known as Regulation Q, a limit on the amount of interest that banks could pay to depositors. Like the interest deduction, policymakers did not initially envision the interest rate ceilings as a housing policy. Rather, policymakers intended the ceilings to limit competition between institutions, preventing the bidding up of interest rates that would, in turn, lead banks into risky investments to cover their increasing cost of funds. In practice, the result of the ceilings was a protected source of low-cost funds for banks and thrifts, and the benefit for residential mortgages quickly became apparent. With ceilings limiting and increasing the predictability of their cost of funds, banks and thrifts were able to loan credit to borrowers at profitable, but still relatively low, and fixed rates. While the reality was much more complex, this became understood by lenders and policymakers as the "3-6-3 rule: pay 3 per cent on deposits, lend money at 6 per cent and be on the golf course by 3 o'clock."[20]

Until 1966, the interest rate ceilings did not apply to savings and loan associations, but only to commercial banks. The exemption gave S&Ls a competitive edge, as they could offer a slightly higher rate than that offered by banks to attract savers'

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[20] Niall Ferguson, *The Ascent of Money: A Financial History of the World* (New York: Penguin Press, 2008), 251.

dollars. Limitations on the products that S&Ls could offer offset this advantage somewhat. For example, a depositor could have a savings account at an S&L, but not a checking account. Despite these restrictions, this government intervention, an artificial ceiling on the interest rates offered by banks, allowed savings and loans to grow dramatically. The policy had the effect of channeling household savings into the depository institutions that were statutorily obligated to devote the overwhelming majority (80%) of their capital into residential mortgages. Interest rate ceilings, therefore, functioned to allocate credit towards housing. In just the decade and a half following World War II, the share of household savings deposited in the nation's savings and loans increased from 8.7% to 28.7% (from $9.8 billion to $62.2 billion), virtually all of it backed by federal deposit insurance.[21] These billions of dollars, supplemented by FHLB advances and FNMA purchases financed the greater part of the dramatic postwar expansion of homeownership.

The HOLC and FHA have received greater attention from historians than have interest rate ceilings. Yet, the interest rate ceilings were important for a number of reasons. First, they helped depository institutions attract low-cost capital, which they could then lend at low, but profitable rates. Accounts emphasizing the innovations of the HOLC and FHA tend to take the lenders for granted, but the rate ceilings, along with deposit insurance, helped lenders to thrive. As the dramatic increase in deposits raised by the S&Ls in the postwar decades indicates, the interest rate ceilings played a critical role in establishing the S&L industry as the nation's primary housing lenders. Though FHLB advances augmented this capital base, allowing lenders to extend more credit than they

[21] Leon T. Kendall, *The Savings and Loan Business* (Englewood Cliffs, NJ: Prentice-Hall, Inc., 1962), 39. U.S. Savings bonds lost about 20% of their market share over this period.

could if just relying on their own deposit-capital, that deposit-capital was no less important a piece of the creation of mortgage credit. Second, while FHLB advances and secondary market purchases allowed lenders to extend credit beyond the capacity of their own pooled deposits, S&L officials routinely cited interest rate ceilings as the reason that they could lend at low rates. These officials understood their profitability and ability to lend at low rates as a function of the spread between their cost of funds (which were kept in check by interest rate ceilings) and the rate on the mortgages they issued. Even if this was not strictly true, S&L officials' widespread assumption that it was, made interest rate ceilings central to lending decisions, including mortgage rates. Third, as subsequent chapters will demonstrate, the restructuring of housing finance in the 1970s and 1980s began with a populist deregulatory agenda calling for the end of interest rate ceilings. This narrow push for deregulation was subsequently leveraged into a much broader restructuring of housing finance (and financial services more generally).

These essential components of the New Deal system of housing finance, a system of regional Federal Home Loan Banks to provide capital to lenders, the Federal National Mortgage Association to assure the liquidity of FHA and VA-insured loans, the long-term, low- and fixed- rate, amortized mortgage instrument, deposit insurance, interest rate ceilings, specialized housing lenders (the savings and loans), and the mortgage interest deduction remained in place into the 1970s, bestowing an institutional and regulatory inheritance to federal policymakers in the 1960s, 1970s, and 1980s. The New Deal system established an array of entrenched and powerful interest groups, as the public-private partnerships forged during the New Deal flourished. The bank and thrift lobbies, including the American Bankers Association, the U.S. League of Savings and Loan

Associations, the National Savings and Loan League, the National Association of Home Builders, and the National Association of Real Estate Brokers, members of which had played an integral role in drafting the legislation that created the New Deal system, continued to weigh in on any policy initiatives concerning housing finance, each seeking to protect the regulations that benefited their constituents.[22] In the postwar decades, the thrift industry became the dominant residential mortgage lender, affording a special claim to stewardship over the politically popular "American dream" of homeownership. The fixed-rate mortgage reached a similar, almost sacrosanct status, as an essential piece of making the dream achievable. Even the New Deal-era policies that would engender the greatest criticism in the 1970s, namely interest rate ceilings, exhibited considerable inertia; none would be easily overturned.[23]

A Nation of Homeowners, and the Politics of Saving

As long as interest rates remained relatively stable, as they did until 1966, the New Deal system functioned smoothly. New Deal-era housing policies, in fact, proved remarkably successful, both in expanding homeownership for white households, and in promoting racial segregation. In the wake of Depression-era foreclosures, the nation's homeownership rate had dropped to 44% in 1940, and as late as 1945, housing starts numbered only 325,000. But by the late 1970s, 65% of households owned their homes, or at least held a mortgage, and housing starts between 1946 and 1980 averaged over 1.5

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[22] Freund, 105.

[23] Paul Pierson writes, "institutions… do not adapt swiftly and effortlessly. They are subject to change, but… in many circumstances they will exhibit very substantial inertia." Pierson, *Politics in Time: History, Institutions, and Social Analysis* (Princeton: Princeton University Press, 2004), 156-7.

million per year.[24] The impact of the success of the New Deal system on residential patterns, the vitality of construction, home finance, and related industries, and on wealth and opportunity cannot be overstated. Surprisingly, this substantial change in the material status of millions of American households, the achievement of homeownership, is overlooked in most accounts of the changes in housing finance in the later third of the twentieth century.[25] The shift to majority homeownership, I argue, fundamentally altered the political context, the alignment of interests, surrounding housing finance policy. This proved to be especially true of interest rate ceilings. In the immediate postwar decades, *potential* homeowners, then in the majority, welcomed a "6%" mortgage rate (of the 3-6-3 rule), which brought homeownership within reach. For most of the postwar period, borrowers largely remained unaware of the ceilings and the relationship between the "3%" they received on their savings deposits and a "6%" mortgage rate, and most depositors were perfectly satisfied with the 3% return. But by the late 1970s and early 1980s, as inflation rose, and the majority of households *already owned their home* (or at least had already locked in that 6% mortgage), homeowners became much more concerned with the rates they could earn on their savings than with continuing a system that promoted low-interest mortgages. Once general interest rates rose above the interest

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[24] Kenneth A. Snowden, "Housing Units Started and Authorized by Permit, by Metropolitan Location, Region, and Number of Units in Structure: 1945-1999," *Historical Statistics of the Unites States Millennial Edition Online*, edited by Susan Carter et al. (Cambridge University Press, 2006).

[25] The importance of majority homeownership in shaping housing finance policy parallels a similar dynamic in the politics of health insurance reform. Jacob Hacker writes, "the most compelling explanation for the messy failure of the [Clinton] Health Security plan – the one overshadowing and underlying all others – is also the one most likely to be taken for granted. Most Americans, between 80 and 85 percent, have health insurance…. Private health insurance reaches more than two-thirds of nonelderly Americans… and this means, in turn, that proposals for government sponsored health insurance face singular hurdles – not just the opposition of a huge and resourceful private medical industry, but also the fears of insured Americans about the effect of policy changes on their existing coverage." Jacob S. Hacker, *The Divided Welfare State: The Battle Over Public and Private Social Benefits in the United States* (Cambridge: Cambridge University Press, 2002), 179-180.

rate ceilings on deposits, savers began to become aware of the ceilings (often with the aid of a newspaper columnist), and those savers, by then a majority of them homeowners, increasingly found the ceilings to be an impediment to their prosperity. A system that was once understood (by policymakers, if not savers and borrowers) to allow borrowers access to low-interest loans was recast as a system in which savers unfairly subsidized borrowers.

The shift to majority homeownership was accompanied by a parallel development in which increasing numbers of Americans, most of them middle-class homeowners, began to invest their savings outside of the traditional depository institutions that dominated mortgage lending, and in all likelihood had provided their own mortgages. Historian Edwin Perkins, writing on the widely successful efforts of Merrill Lynch to broaden participation in the stock market, observes that "beginning in the 1950s millions of middle-class households became regular investors in common stocks…."[26] Perkins writes that Merrill Lynch's revolution in middle-class investment pulled in households that had previously kept their savings in "bank savings accounts, U.S. savings bonds, and whole-life insurance policies."[27] Journalist Joe Nocera calls this "astonishing transformation of the financial habits of the middle class," a "money revolution."[28] A 1950 Merrill Lynch survey revealed that one-quarter of the firm's accounts were held by investors with incomes under $5,000, and that twice as many customers under the age of

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[26] Edwin J. Perkins, *Wall Street to Main Street: Charles Merrill and Middle-Class Investors* (Cambridge: Cambridge University Press, 1999), 238.

[27] Ibid., 238.

[28] Joseph Nocera, *A Piece of the Action: How the Middle Class Joined the Money Class* (New York: Simon & Schuster, 1994), 10.

36 had opened accounts than those over 65.[29] This shift of savings out of depository institutions, called disintermediation, reduced the capacity of the New Deal system to channel household savings into the mortgage market, making the supplemental stimulants, FHLB advances and FNMA purchases all the more important.[30] Yet the scale of disintermediation in the 1950s and early 1960s paled in comparison to the intermittent bouts following a credit crunch in 1966, and the lengthy period of rising inflation in the 1970s. The latter was severely exacerbated by the ready alternative investment instrument provided through the advent of the money market mutual fund, which regulators ultimately decided not to curtail, despite the threat they posed to housing finance.

It was these middle-class homeowning saver/investors' diversion of savings dollars from depository institutions, either by removing savings to seek higher returns elsewhere or, later, by demanding that interest rate ceilings be raised or removed, that ultimately made the New Deal system both politically and economically unsustainable. By all accounts, by the late 1970s, the New Deal system struggled to supply a steady flow of abundant and affordable credit for housing. Explanations of this development typically focus on the failure of the New Deal system to function in periods of rising interest rates.

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[29] Perkins, 207.

[30] Indeed Congress authorized increased support through Treasury funding of $1.75 billion to FHLB and FSLIC in 1950, and a new $1 billion revolving fund for FNMA in 1958. See Freund, 193. While these actions were based on a recognition that mortgage credit through traditional lenders had tightened, policymakers did not emphasize disintermediation as a cause. Regarding the 1958 authorization, for example, they attributed the tightening of credit to "Federal Reserve Board actions to control inflation, substantial increases in dollar amounts expended for industrial plant construction, expansion, and modernization, and the initiation of such new programs as that presently used to finance shipbuilding through the issuance of Government-guaranteed high-interest-bearing securities." Only the last of these implied that savings dollars might be shifting from traditional lenders to higher-yielding securities. The increased investment in plant construction indirectly hints at capital shifting into stocks, but, by and large, policymakers did not appear to consider the increasing participation of middle-class savers in common stocks as a source of tightening credit conditions. See Senate Committee on Banking and Currency, *Increased FNMA Authorization*, 85th Cong., 1st sess., S. Rep. 94, 3.

Indeed, inflation caused interest rates to rise above the interest rate ceilings that limited the returns paid to depositors on their savings, leading savers to seek higher returns outside of depository institutions. And innovation, the introduction of new investment instruments offering rates above the ceilings, especially the money market mutual fund, provided attractive outlets to those very savers. As savers diverted their deposits from banks and S&Ls to invest in money market mutual funds, the traditional depository institutions could not sustain profitable lending. But explanations of the failure of the New Deal system of housing finance in the 1970s tend to overlook the role of the New Deal system itself in contributing to the dynamics that led to its dysfunction. It was the *success* of the New Deal system in contributing to the creation of a majority class of homeowner investors who, by the 1970s, no longer needed or wanted a regulatory system designed to provide low-interest mortgages, at least not at the cost of limited returns on savings (even homeowners might want to refinance at low-rates under some circumstances).[31] In sum, inflation and innovation were integral to the changing politics of housing finance, but only in the context of a growing number of homeowner-investors whose economic and political interests worked against the preservation of the New Deal system.

Racial Segregation

As New Deal policy revolutionized housing finance, creating a nation of homeowners, it built the imperative of racially homogenous neighborhoods into the DNA of the new market. Most important in this process was the FHA. Adopting the same

[31] Lower rates for refinancing were not to be had in the late 1970s.

racially exclusive appraisal principles employed by the HOLC, the FHA endorsed racial restrictive covenants, contractual agreements prohibiting the sale of a property to designated races, and the underlying principle that neighborhood stability and property values required racial homogeneity. FHA appraisal forms required designation of neighborhoods' racial composition and even an assessment of the possibility of "infiltration" of a neighborhood by racial minorities. Any presence of a racial minority, or the possibility thereof, could result in a neighborhood receiving a C or D rating and being excluded by the insurance program. These principles were codified in the early editions of the FHA's *Underwriting Manual*, standardizing and popularizing them for public and private sector alike.[32] Consequently, historian David Freund writes, "the government began to actively promote, indeed to help pay for, the systematic segregation of residential neighborhoods and to deny certain federally subsidized housing opportunities to minorities."[33] From 1950 to 1970, as FHA and VA policies facilitated a massive shift of white residents into growing suburbs, black residents moved in increasing numbers to urban centers, reaching a third of the population in cities such as Chicago, Detroit, and Cleveland, and more than half in Gary, Newark, and Washington, DC.[34]

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[32] Freund, 130. Federal Housing Administration, *Underwriting Manual: Underwriting and Valuation Procedure Under Title II of the National Housing Act* (Washington, DC: GPO, 1938), sec. 932-940.

[33] Freund, 132.

[34] Douglas S. Massey and Nancy A. Denton, *American Apartheid: Segregation and the Making of the Underclass* (Cambridge: Harvard University Press, 1993), 45.

The homeownership rate among African Americans also increased in the postwar decades, up 15% from 1940 to 1960, when the rate reached 39%.[35] These gains occurred despite exclusion of African Americans from directly benefiting from federal programs, including FHA/VA insurance. Changes in mortgage instruments as well as the movement of whites to suburbs opened up some measure of opportunity for African Americans to achieve homeownership, albeit on decidedly unequal terms. Despite such dramatic upheaval in residential patterns, including rising black homeownership, sociologists Douglas Massey and Nancy Denton note the persistence of segregation and increasing "spatial isolation" (likelihood of living in a majority black neighborhood) of black residents in postwar America.[36] In sum, the revolution in residential patterns fostered by the New Deal system ensured continuing racial segregation and created new racial inequality.

The import of this legacy of racial segregation and inequality for federal housing finance policies from the late 1960s to the mid 1980s are twofold. First, a counter mobilization emerged to redress the inequalities of the New Deal system and open that system up to all borrowers. Critics had protested the discriminatory aspects of federal policies from their inception and by the late 1960s and 1970s these protests coalesced into fair housing and community reinvestment movements influential enough to achieve federal legislative victories. The 1968 Fair Housing Act, 1974 Equal Credit Opportunity Act, 1975 Home Mortgage Disclosure Act, and 1977 Community Reinvestment Act all represented significant, if ultimately inadequate, challenges to the machinery of

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[35] Andrew Wiese, *Places of Their Own: African American Suburbanization in the Twentieth Century* (Chicago: University of Chicago Press, 2004), 123.

[36] Massey and Denton, 46.

inequality at the center of the New Deal system. Yet despite these legislative interventions, and their promise to open up equal access to housing finance, segregation and racial inequality have proven stubbornly persistent. Racial discrimination in housing has changed form since the postwar decades, generally shifting to inequitable terms and costs rather than blocked access, but these new forms of discrimination are rooted in the New Deal system.[37] Concern over racial equality and nondiscrimination at times came to the fore of debate over housing finance. In addition to the policies listed above, Congress, in 1975 emphatically rejected Federal Home Loan Bank Board regulators' proposal to authorize adjustable-rate mortgages, largely due to objections raised by civil rights activists. And for some policymakers, enduring racial inequality in housing remained a nagging problem in search of a policy solution. Yet, most discussion of housing finance policy after 1977 oddly separated issues of discrimination and inequality from those concerning the institutional structure.

The second critical piece of the legacy of racial segregation is that the inequalities wrought by the New Deal system of housing finance were, to some degree, self-perpetuating.[38] The exclusion of generations of African American families from the benefits of federal largesse disadvantaged subsequent generations compared to white counterparts who inherited the wealth created through homeownership. Sociologist John Henretta finds that intergenerational transfers of material wealth and socialization are

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[37] James H. Carr and Nandine Kutty, "The New Imperative for Equality," in Carr and Kutty eds. *Segregation: The Rising Costs for America* (New York: Routledge, 2008): 1-37, 10.

[38] Carr and Kutty, for example, attribute "America's wealth disparities along race and ethnic lines, as well as the disproportionate concentrated poverty among minority households," to "decades of public policies intended to economically marginalize minority households." Carr and Kutty, 2.

both important factors in the attainment of homeownership for younger generations.[39] The decline in homeownership rates for young minority families in the 1980s bears this out. While rising housing costs and stagnating incomes created generational gaps for all Americans in the 1980s, Dowell Myers and Jennifer Wolch find, “Hispanic and black homeownership rates became further differentiated from those of whites.”[40] The “mounting problems of affordability” in the 1980s also hit racial minorities, “just over 12 percent of white owners faced excessive payment burdens in 1980 and in 1990, whereas 23 percent of blacks, 17 percent of Asians, and 17 percent of Hispanics faced payment burdens.”[41] The legacy of inequality was also directly linked to the legacy of segregation. Due to the widespread belief in the positive correlation of racially homogenous neighborhoods and housing prices, segregation actually created wealth for white homeowners. That wealth then contributed to the intergenerational transfers that perpetuated inequality.

Erasure of Federal Role in Housing Finance

While the New Deal system of housing finance both fueled the expansion of homeownership and promoted racial residential segregation, the prevailing understanding of the federal government’s role in postwar metropolitan development held that it had

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[39] John C. Henretta, “Parental Status and Childs’ Home Ownership,” *American Sociological Review* 49, no. 1 (February 1984): 131-140.

[40] Dowell Myers and Jennifer R. Wolch, “The Polarization of Housing Status,” in Reynolds Farley ed. *State of the Union: America in the 1990s, Volume One: Economic Trends* (New York: Russell Sage Foundation, 1995): 269-334, 296.

[41] Myers and Wolch, 270, 288. It is not clear whether Myers and Wolch define payment burden by the traditional 25 percent of income standard, or by the standard widely adopted in the early 1980s at 30 to 35 percent of income for housing. In either case, the racial discrepancies are evident.

done neither.[42] Suburban whites came to understand their economic success (homeownership in particular) as the result of hard work and astute market participation and not of federal intervention, while they increasingly identified supposedly "urban" problems of poverty, blight, and physical deterioration and their costs, taxes to support public services, welfare, and public housing, with black city residents. This narrative dovetailed with the contention of policymakers, realtors, and land-use experts that healthy property values depended on racial residential segregation. Tempered by the invalidation of scientific racism, and maintaining that government had not interfered, this account of post-war suburban expansion "naturalized" the notion of *market*-driven inequality and segregation by race and class. This understanding absolved both the government and individuals from responsibility for segregation and inequality, placing the onus on individuals to improve their socioeconomic status through judicious market participation and hard work.

That the prevailing understanding of postwar metropolitan development largely erased the role of the federal government was hardly accidental. Freund writes that "most public officials and business leaders insisted, and apparently believed, that Depression-era housing programs did not interfere with or alter the existing market for residence. They insisted that the stunning growth of suburbs and homeownership rates and the corollary segregation of neighborhoods and capital owed little if anything to state interference."[43] Both policymakers and private interests, including the National Association of Real Estate Brokers, urban planning experts, and developers,

[42] Freund, Chapters 3-4.

[43] Freund, 101.

characterized federal intervention into housing markets as a jump-start to a latent market rather than as a subsidy or an intrusion into the market. This dubious interpretation enabled private interests, policymakers, and homeowners to obscure the government's involvement in suburban growth, and racial and class residential segregation.

The long-term implications of this free market, non-interventionist interpretation of metropolitan development were many, deeply shaping postwar politics, especially, as Freund, Matthew Lassiter, and others have shown, in promoting racial inequality and obstructing efforts to ameliorate that inequality. The erasure of the federal role in creating wealth through homeownership exclusively for white households has very specific import for debates over fair housing and community reinvestment policies in the 1960s. As Chapter Two will explore in greater detail, the FDIC, as a regulator of member banks, delayed the adoption of fair housing regulations for a decade, claiming that the agency had nothing to do with housing finance. Only in the context of the decades-long mischaracterization of federal intervention could the FDIC deny a role in housing finance. After all, federal deposit insurance enabled depository institutions to raise capital for, among other things, residential mortgage lending. Similarly, the prevailing understanding of New Deal housing policies as unleashing market forces rather than creating credit and directing it to suburban mortgages enabled community reinvestment opponents to disparage reinvestment proposals by the label they meant pejoratively, "credit allocation." Community reinvestment proponents' efforts to point out (rightly) that federal policy had allocated credit (to suburban whites) since the 1930s failed to resonate widely among lawmakers. Instead community reinvestment proponents had to moderate their proposals to claim that they would not result in credit allocation. Finally,

homeowners' beliefs that they did not benefit from federal intervention, particularly from interest rate ceilings, facilitated their opposition to the ceilings as savers. While thrift officials routinely credited rate ceilings for fostering homeownership, most borrowers remained unaware of the ceilings and the role they played in keeping their interest rates low. For most bank and thrift customers interest rate ceilings became visible only when inflation rose far above the ceilings, and even then, typically only when a newspaper columnist pointed out the savings "lost" due to the ceilings. The erasure of the federal role in housing finance during the postwar decades, then, figured both in the efforts to redress discrimination and in the politics of financial deregulation.

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The implications of these four legacies of the New Deal system, the institutional and regulatory structure, majority homeownership, racial segregation and inequality, and the erasure of the federal role in housing finance, underscore the main theoretical premise of this study: that the politics of housing finance must be viewed in time in order to understand how and why housing finance was fundamentally restructured in the late 1970s and early 1980s. The New Deal system facilitated significant changes in wealth and residence which then altered the political and economic contexts in which the system operated. The emergence of middle-class homeowning saver/investors, in particular, drove the politics of financial deregulation via that group's abandonment and opposition to interest rate ceilings, despite the role of the ceilings in helping many of them to become homeowners themselves.

As subsequent chapters will show, the increasing diversion of savings from traditional depository institutions strained the New Deal system. Opposition to interest rate ceilings then constrained policy options to maintain and/or reform the system in the 1970s. After policymakers eventually moved to deregulate the interest rate ceilings, on behalf of middle-class investors and "small savers," representatives of financial institutions and free market economists leveraged concessions on interest rate ceilings to achieve broader deregulation. This broader deregulation, in turn, consequently undermined the fair housing and community reinvestment movements designed to ameliorate the New Deal system's legacy of racial inequality and segregation.

Chapter 2

Redressing Discrimination, 1968-1977

The New Deal system of housing finance, forged through public-private collaboration of federal policymakers and industry insiders, revolutionized the institutions, financial instruments, and markets that created and allocated residential mortgage credit in the United States. In the decades immediately following World War II, the newly restructured credit markets generated massive sums of wealth for financial institutions and households, not to mention the construction, real estate, and related industries. The legacies of this first revolution in housing finance–an entrenched institutional and regulatory structure, a (white) homeowning majority,[1] racial discrimination and segregation, and an erasure of the federal role in housing finance–engendered and shaped a second, a series of laws and regulations aimed at opening up equal access to the opportunity, credit, and wealth created by the New Deal system for women and racial minorities.

This second, civil rights revolution in housing finance policy responded to both the expansive and exclusionary aspects of the New Deal system. The inequities and exclusivity of the New Deal system elicited protest and calls for reform, coalescing into open housing and community reinvestment movements. These movements wished to deploy the expansive qualities of federal policies, the capacity to make homeownership more attainable, to the benefit of previously excluded women and racial minorities. Accordingly, and sensibly, the open housing and community reinvestment movements

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[1] It is significant that a numerical majority of American households became homeowners and that the overwhelming majority of those households were white, male-headed households.

sought reform legislation and regulation targeting the institutions at the center of the New Deal system, the savings and loans and commercial banks that, at that time, made the vast majority of residential mortgage loans. In addition to efforts to end discrimination by sellers and real estate brokers, activists aimed to enlist the federal financial regulators to ensure that lenders provided access and equitable terms to borrowers irrespective of sex, race, or location of property.

The signature achievements of the civil rights revolution in housing finance were the Fair Housing Act of 1968, the Equal Credit Opportunity Act of 1974, the Home Mortgage Disclosure Act of 1975 (HMDA), the Community Reinvestment Act of 1977 (CRA), and just as importantly, the federal regulations to enforce these acts. Effective January 1, 1970, the Fair Housing Act banned discrimination on the basis of race, color, religion, or national origin in the rental or sale of housing through a real estate broker, including lending and terms. The Equal Credit Opportunity Act added sex to the list of categories that could not be considered in lending. Finally, the HMDA required public record keeping and disclosure of lending data that the CRA sought to utilize in holding depository institutions accountable to meet the credit needs of the communities in which they were chartered. In sum, these policies aimed at deploying the institutions and financial institutions that had successfully made homeownership accessible to millions of white Americans for the benefit of previously excluded borrowers.

The legacies of the New Deal system also shaped the opposition to the fair housing and community reinvestment movements. The white homeowning majority had become deeply invested in the imperatives of the New Deal system, especially racial exclusion, and opposed open housing reforms that would, many argued, impinge their

rights as property owners. Because of prevailing assessment practices, racial residential segregation had created wealth for white homeowners, that is, a property was worth more precisely because it was in a racially homogenous, white neighborhood. The effective erasure of the federal role in housing finance too created obstacles to fair housing and community reinvestment efforts. Insisting that they played no direct role in housing finance, for example, the federal financial regulators stalled for years the implementation of fair housing regulations, well after the passage of the Fair Housing Act in 1968. Likewise, policymakers' characterization of housing finance in the postwar decades as the product of market forces allowed for a baseless claim that affirmative community reinvestment credit allocation policies constituted something wholly different (and antithetical to American values), with the consequence of severely circumscribing the design and impact of the Community Reinvestment Act.

Yet despite this opposition, by the late 1970s, activists had succeeded in bringing the overwhelming majority of mortgage lending depository institutions under the jurisdiction of nondiscrimination and fair housing regulations. Over the decade, these regulations were expanded to include prohibitions of discrimination on the basis of sex, new disclosure and recordkeeping requirements, and mandates for community reinvestment. This civil rights revolution in housing finance policy promised to open up equal access for all to the opportunity, credit, and wealth that had been created by the New Deal system only for white, male-headed households. Yet racial inequality in homeownership, racial segregation, and discrimination (though to some extent shifting gradually from outright exclusion to inclusion on inequitable terms) persisted long after

the passage of the Fair Housing, Equal Credit Opportunity, and Community Reinvestment Acts.[2]

The reasons for the failure of the civil rights revolution in housing finance to translate into equal opportunity for racial minorities are many. This chapter does not attempt to address them all, but rather to draw attention to a few that have been underdeveloped in the scholarly literature, especially those related to the timing and sequence of policy development. First, as introduced above, the legacies of the New Deal system influenced the design of fair housing and community reinvestment policies in ways that limited their impact. The erasure of the federal role in postwar housing finance helped key federal regulators such as the FDIC to delay implementation of fair housing regulations a full decade after the Fair Housing Act was passed. Similarly, by denying that past policies had allocated credit to white, male-headed households in exclusively white suburban neighborhoods, opponents were able to cast the affirmative action proposals preferred by community reinvestment activists as undesirable credit allocation schemes, resulting in watered-down versions of the Home Mortgage Disclosure and Community Reinvestment Acts.[3] Second, the sequence of fair housing legislation preceding community reinvestment legislation largely removed explicit reference of race from the debates over community reinvestment. Policymakers treated redlining as a separate issue from the racial discrimination already outlawed by the Fair Housing Act, despite the disproportionate (though not exclusive) impact of redlining on racial

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[2] Douglas S. Massey and Nancy A. Denton, *American Apartheid: Segregation and the Making of the Underclass* (Cambridge: Harvard University Press, 1993).

[3] As will be explained below, the Community Reinvestment Act, in particular, as passed, fell far short of the affirmative action policy favored by key community activists.

minorities. The exclusion of race from the debate over redlining made it all the more difficult for policymakers to see redlining as a problem analogous to racial discrimination in employment or college admissions and thus suitable for a similar affirmative action remedy.[4] Third, the fair housing and community reinvestment movements achieved legislation while the New Deal system remained intact, and designed regulation and enforcement mechanisms accordingly. But even as these policies were being implemented, a combination of market pressures, deregulatory policies, and regulatory inaction began to dismantle the New Deal system itself. Most significantly, these changes fostered a shift in mortgage origination away from the traditional lenders (savings and loans and commercial banks), which were targeted by fair housing and community reinvestment regulations under the supervision of the federal financial regulators. Increasingly, mortgage origination would be taken over by comparatively unregulated mortgage companies and brokers. While the regulatory actions and inactions that precipitated this change will be addressed in greater detail in subsequent chapters, this chapter documents how activists and cooperative policymakers painstakingly built a legislative and regulatory apparatus through the federal financial regulators to enforce nondiscrimination in lending and foster community reinvestment by traditional housing lenders. This chapter also places the civil rights revolution in housing finance in time, in the context of both the legacies of the New Deal system, and the beginning of the dissolution of that system. Even as nondiscrimination and community reinvestment policies were made, policymakers were engaging in a debate over the proper role, both

[4] On the difficulty of translating affirmative action policies to areas other than racial discrimination or a close analogue, see John Skrenty, *The Minority Rights Revolution* (Cambridge: Harvard University Press, 2002), especially chapter nine.

present and future, of traditional depository institutions in the financial marketplace. Two competing visions emerged, one that conceptualized depository institutions, the deposits they collected, and the loans they made as locally-oriented and obligated, and one that considered depository institutions as intermediaries of free flowing capital in national or global markets obligated only to the laws of supply and demand. The activists of the fair housing and community reinvestment movements, by and large, held to the former vision, and invested in policies that conformed to that model. But after the passage of the CRA, it was the latter vision that increasingly shaped policy, with, as subsequent chapters will show, disastrous consequences for fair housing and community reinvestment policies.

The Fair Housing Act of 1968

Federal legislation banning discrimination in housing lagged behind analogous laws concerning discrimination in public accommodations and voting. The landmark 1964 Civil Rights Act, for example, had glaringly omitted the vast majority of housing from its purview.[5] While it prohibited discrimination in some "federally assisted" housing, the act exempted the federal assistance most responsible for the post-war

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[5] Civil rights activists had long challenged the discriminatory aspects of the New Deal system, with a handful of minor victories through the mid-1960s . President John Kennedy's Executive Order 11063 prohibited discrimination in the sale or rental of housing owned or operated by the government, supported by loans or grants of the federal government, or provided by loans insured or guaranteed by the federal government. The order also created a Presidential Committee on Equal Opportunity in Housing. John F. Kennedy, "Executive Order 11063," November 20, 1962 http://www.presidency.ucsb.edu/ws/index.php?pid= 59002 (accessed March 16, 2011). See also David M. P. Freund, "'Democracy's Unfinished Business': Federal Policy and the Search for Fair Housing, 1961-1968," http://www.prrac.org/pdf/freund.pdf (accessed September 14, 2011).

expansion of homeownership, the FHA and VA insurance programs.[6] Even as advances were made in banning discrimination in the "public sphere," intervening in what many considered the more private realm of housing remained politically untenable. Public opposition, based on a range of objections, was widespread. Some directly objected to the prospect of "compelled [racial] amalgamation,"[7] or even the implication of a fair housing law that "all humans" were equal.[8] More commonly, white homeowners expressed their opposition in terms of their own rights as property owners.[9] Of the fair housing bill proposed in 1966, for example, Dr. H. O. Yorke of Florida wrote, "it is legally and morally wrong to deprive any citizen of his God given right and privilege to choose his associates, in private life…. This dictatorial mandate would invade the privacy of every individual who owns or operates any property."[10] President Johnson and liberals in Congress kept fair housing on the agenda,[11] but given white homeowners' deep

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[6] Bonastia, 75. Title VI prohibited discrimination in housing built through federal financial assistance, including by loan or contract, but explicitly did not consider federal insurance or guarantees (such as federal deposit insurance or the FHA/VA mortgage insurance programs) as federal financial assistance for the purposes of the prohibition. P.L. 88-352, Title VI.

[7] A pamphlet distributed by "The Independent American," a conservative newspaper, decried the bill as an attempt to achieve "compelled [racial] amalgamation." The Independent American, "If You Own Property, Is Your Home Really Yours: How the Liberals plan to deprive you of 'freedom of choice' regarding the sale or rental of your property," 1966, folder "B34-1," Box B34, Gerald R. Ford Papers, Gerald R. Ford Library, Ann Arbor, MI.

[8] Emery Friedman of Texas charged that the bill was "Communistic" as it "proposes to put all humans on an equal basis," and "gives the negro the right to invade a white community." Friedman to Ford, 1966, folder "B34-2," Box B34, Gerald R. Ford Papers, Gerald R. Ford Library, Ann Arbor, MI.

[9] Freund, "'Democracy's Unfinished Business,'" 384.

[10] Yorke to Ford, July 30, 1966, folder "B34-1," Box B34, Gerald R. Ford Papers, Gerald R. Ford Library, Ann Arbor, MI.

[11] Johnson highlighted fair housing in both his 1967 and 1968 "State of the Union" addresses, challenging, in 1967, "we should continue to seek equality and justice for each citizen…. We should find a solution to fair housing, so that every American, regardless of color, has a decent home of his choice." Lyndon Baines Johnson, "Annual Message to the Congress on the State of the Union," January 17, 1968. *Public Papers of the Presidents of the United States: Lyndon B. Johnson, 1967*, 1 entry 3 (Washington, DC: Government Printing Office, 1968): 2-14. http://www.lbjlib.utexas.edu/johnson/archives.hom/speeches.hom/670110.asp

investment in residential segregation, most supporters remained pessimistic about the chances of actually passing legislation. Even when proponents managed to pass a bill in the House, in 1966, it fizzled in the Senate under filibuster.[12]

Given these continuing struggles, it is remarkable that the Fair Housing Act passed when it did in 1968. It is worth briefly recounting just how narrowly the bill journeyed through Congress to underscore both the continuing opposition it faced and the compromises necessary to navigate the legislative process. At several potential veto-points, the fair housing title of the 1968 Civil Rights Act appeared doomed to the same fate as the unsuccessful attempts at open housing legislation in 1964 and 1966. Strategic maneuvering, discipline, compromise, and external circumstances (namely the release of the Kerner Commission Report and the assassination of Martin Luther King Jr.) combined to move the bill to passage.

The substance of the Fair Housing Act originated in the Senate as part of a strategy to disaggregate the Johnson administration's civil rights initiatives in order to improve the chances of passage of the separate measures.[13] This approach held the advantage of sending the housing provision, isolated from other civil rights measures, to the Committee on Housing and Urban Affairs, which Jean Dubofsky points out, "includ[ed] more liberals than the normal birthplace of civil rights legislation, the

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(accessed March 9, 2011). Lyndon Baines Johnson, "Annual Message to the Congress on the State of the Union," January 17, 1968. *Public Papers of the Presidents of the United States: Lyndon B. Johnson, 1968-69*, 1 entry 14 (Washington, DC: Government Printing Office, 1970): 25-33.

[12] Christopher Bonastia, *Knocking on the Door: The Federal Government's Attempt to Desegregate the Suburbs* (Princeton: Princeton University Press), 85.

[13] Senator Mondale introduced S. 1358 on March 22, 1967,with co-sponsors Brewster, Brooke, Case, Clark, Dodd, Fong, Gruening, Hartke, Hart, Inouye, Javits, Kennedy (MA), Kennedy (NY), Long (MO), McCarthy, Pastore, Randolph, Scott, Tydings, Williams (NJ), and Young (OH). *Congressional Record,* 90th Cong., 1st sess., 1967, 113: 7544-5. *Lexis Congressional* (accessed March 9, 2011).

Judiciary Committee."[14] The fair housing bill proposed prohibition of refusal to sell or rent, or to discriminate in terms of sale or rental based on race, color, religion, or national origin. It took aim at real estate brokers, sellers, and lenders, recognizing that discrimination occurred at every step of the process of finding and purchasing a home. The bill empowered the Secretary of Housing and Urban Development to administer the law, but also called on "all executive departments and agencies" to act "in a manner affirmatively to further the purposes" of the fair housing act.[15]

The 1967 and 1968 debates and hearings echoed the themes of prior debate over fair housing, rehashing the objections that a fair housing law would reward the actions of urban rioters, create unrealistic expectations, and bring unwanted federal intervention into local affairs.[16] However, as Mara Sidney shows, key differences in the rhetoric of fair housing advocates in the 1968 debate both helped enable the bill's passage and constrained its impact. In 1968, she argues, fair housing advocates employed a strategy that leveraged urban riots to emphasize the need for open housing but at the same time evoked imagery of middle-class blacks, contrasted to rioters, as the likely beneficiaries, in order to assuage moderates. This rhetoric, she contends, "promised and delivered a modest fair housing law to help middle class blacks."[17] Supporters framed the fair housing provisions with free market rhetoric, Sidney continues, to assert that while the

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[14] Jean Eberhart Dubofsky, "Fair Housing: A Legislative History and a Perspective." *Washburn Law* 8 (1969): 149-166, 149.

[15] *S. 1358: Fair Housing Act of 1967*, 90th Cong., 1st sess., 1967, in Senate Subcommittee on Housing and Urban Affairs, of the Committee on Banking and Currency, *Fair Housing Act of 1967: Hearings before the Subcommittee on Housing and Urban Affairs of the Committee on Banking and Currency,* 90th Cong., 1st sess., August 21, 22, and 23, 1967 (Washington, DC: Government Printing Office, 1967): 439-459, 446.

[16] Bonastia, 82.

[17] Mara S. Sidney, "Images of Race, Class, and Markets: Rethinking the Origin of U.S. Fair Housing Policy," *Journal of Policy History* 13, no. 2 (2001): 181- 214, 183.

law would promote equal opportunity, economic realities would preclude any radical changes in the racial residential landscape.[18]

Senator Walter Mondale (D-MN), the bill's chief sponsor, pioneered this rhetorical balancing act. He underscored the modest achievement of equal opportunity, "for those still condemned by poverty to remain in the ghetto, there will be at least the knowledge that it is poverty–and not their fellow citizens or their Government–that forces them to live in the slums."[19] Yet he also assured moderates, "dispersal and racial balance is not the goal and motivation of this legislation. If this were our goal, we would have to concede ahead of time that it is doomed to failure. It will simply not achieve dispersal and racial balance. The laws of economics will determine that."[20]

Significantly, this rhetoric reinforced the prevailing naturalization of racial segregation, alleging that residential segregation resulted from the operations of a free, and, following enactment of the 1968 Civil Rights Act, purportedly fair, market. The ostensibly racially neutral laws of economics, however, were anything but. Decades of public and private practices had so firmly infused the "laws" of housing economics with race that the association could not easily be undone. Language like Mondale's effectively sanctioned continuing discrimination that remained submerged under, or could be explained away by, supposedly race-neutral economic considerations.

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[18] Ibid., 193, 197-8.

[19] Walter Mondale, *Congressional Record,* 90th Cong., 1st sess., 1967, 113: 22842. *Lexis Congressional* (accessed March 9, 2011).

[20] Ibid., 22841. Mondale, "there has been no mass influx of families into neighborhoods which their financial resources would not enable them to enter if they were not white. The normal workings of economics has prevented that." Ibid., 7544-5.

Dovetailing with fair housing proponents' ostensibly race-neutral economic language, opponents employed similar, purportedly neutral individual rights and constitutional arguments to advance their case. Invoking aphorisms such as "a man's home is his castle," Senate opponents thundered against the bill's infringement on the constitutional property rights of people of all races. On some occasions, however, what may have been an implicit assertion of *white* homeowners' rights became explicitly so. In a 1967 hearing, Senator Sam Ervin (D-NC) argued with a witness, "don't you think that white people also have a right to live where they want to live and select the schools for their children also? … this bill undertakes to destroy it."[21] Ervin, employing what would become an increasingly popular rhetorical attack on civil rights legislation, turned the logic of the legislation completely on its head saying, "the truth about the bill is that it gives to men of one race the freedom to deny men of other races their freedom."[22] A group of New York real estate agents similarly objected to the fair housing amendment, claiming that it violated the freedom of the seller to choose a buyer, and that the provision threatened the income of agents and thus constituted "reverse discrimination."[23] But fair housing proponents persistently countered the notion that the bill was unconstitutional. Attorney General Ramsey Clark argued that the bill's constitutionality rested in both the commerce clause as "the housing business is substantially interstate in

[21] Senate Subcommittee on Constitutional Rights, *Civil Rights Act of 1967: Hearings before the Subcommittee on Constitutional Rights of the Committee on the Judiciary*, August 1, 8, 9, and 14; September 19, 20, 21, 26, and 27, 1967 (Washington, DC: Government Printing Office, 1968), 234-5.

[22] Sam Ervin, *Congressional Record,* 90th Cong., 2d sess., 1968, 114: 5643. http://web.nexis-lexis.com/congcomp/ (accessed March 18, 2011).

[23] M.C. O'Brien, Jr., President Brooklyn Board of Realtors, to Emanuel Celler, March 14, 1968; H.R. 2512 To 2516; Judiciary Committee; Legislative Files, Public Bills; 90th Congress; Records of the U.S. House of Representatives, RG 233; National Archives Building, Washington, DC.

character," and the Fourteenth Amendment, as "discriminatory housing patterns are a direct outgrowth of past illegal Government action and that those patterns impede State and local government in their ability to provide equal protection of the law."[24]

In February 1968, floor managers linked the "Fair Housing Act of 1967" to a bill to protect civil rights workers, which had previously been passed by the House.[25] Southern Democratic Senators had already engaged in a filibuster of the latter bill, but, as Joseph Rauh, counsel to the Leadership Conference on Civil Rights, put it, "'as long as the Southerners want a filibuster, we might as well give them something to filibuster about. We can beat a filibuster for two things as easily as one, perhaps easier.'"[26] Proponents of the bill failed on two cloture votes (which would have ended the filibuster) as Senate liberals prevailed upon Illinois Senator Everett Dirksen, who had opposed the bill and its predecessors, to negotiate the details of a compromise measure.[27] Dirksen agreed to support cloture, but not until he had offered a compromise amendment that slightly reduced the powers of enforcement of the HUD Secretary (though increasing those of the Attorney General), and, affirming (white) property rights, removed single-family dwellings sold *without* a real estate agent from the bill's coverage (Mondale estimated this additional exemption to represent approximately 7 million housing units).[28]

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[24] Senate Subcommittee on Constitutional Rights, *Civil Rights Act of 1967*, 80.

[25] Walter Mondale, *Congressional Record,* 90th Cong., 2d sess., 1968, 114: 2270-72. *Lexis Congressional* (accessed March 16, 2011).

[26] As cited in Bonastia, 86.

[27] The Senators were Mondale, Hart, Hruska, Baker (TN), Brooke, and Javits. The staffers were Clyde Flynn and Bernard Waters. *Congressional Record,* 90th Cong., 2d sess., 1968, 114: 4574-5. *Lexis Congressional* (accessed March 10, 2011).

[28] Dubofsky, 156-7. Walter Mondale, *Congressional Record,* 90th Cong., 2d sess., 1968, 114: 4569. *Lexis Congressional* (accessed March 10, 2011). The Mondale Amendment was tabled to allow for the Dirksen Amendment on February 28, 1968.

A third cloture vote fell short despite the Dirksen compromise amendment, but on the same day, March 1, 1968, the National Advisory Commission on Civil Disobedience, commonly known as the Kerner Commission, issued findings that proponents hoped would garner additional support for the bill. The Kerner Report included the recommendation "that the federal government enact a comprehensive and enforceable open housing law to cover the sale or rental of all housing, including single-family homes."[29] Boosted by the report, three days later, a fourth cloture vote ended debate on the civil rights bill with the Dirksen version of the fair housing title intact.[30] On March 11, the bill passed the Senate by count of 71 to 20.[31]

While the Kerner Commission report precipitated the bill's passage in the Senate, the bill stalled in the House until the April 4 assassination of Dr. Martin Luther King Jr. and subsequent urban rioting gave it new life. The morning of the assassination, the House Committee on Rules began hearings on the Civil Rights Act of 1968. Opponents of the bill such as Bob Sikes, a Florida Democrat, found Title VIII, the fair housing title, "particularly objectionable."[32] James Henry Quillen (R-TN) protested that favorable action on the bill would send a dangerous message to rioters.[33] The riots that broke out in the wake of the King murder elicited yet more pointed vehemence from opponents such

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[29] Dubofsky, 158.

[30] Ibid. The cloture vote tallied 65 to 32. *Congressional Record,* 90th Cong., 2d sess., 1968, 114: 4960. *Lexis Congressional* (accessed March 18, 2011).

[31] Dubofsky, 159.

[32] Bob Sikes, in House Committee on Rules, *To Prescribe Penalties for Certain Acts of Violence or Intimidation*, 90th Cong. 2nd sess., April 4, 5, 8, and 9, 1968 (Washington, DC: Government Printing Office, 1968), 23.

[33] Quillen said, "what I dislike is that this minority group can burn down parts of big cities, can murder and rape, and get by with it and then can threaten the Congress and the Congress capitulates." Ibid., 22.

as Quillen and Representative Joe Waggonner (D-LA).[34] Supporters of the bill likewise looked to the recurrence of riots to press their case. No one put the matter more starkly than Representative Tip O'Neill: "I think the American people will hold the Congress as a whole responsible for this legislation. I would hate to think what would possibly happen in the major cities of this country if this Congress does not act this week."[35]

Emphasizing the role of the King assassination, Representative Colmer (D-MS–chairman of the Committee on Rules) lamented, "on Thursday evening [April 4] when I went home, in my humble judgment as well as that of many others, we had the votes to send the bill to conference. But now the situation is changed."[36] As it was, the bill narrowly made back to the floor, rather than to a Conference Committee where key provisions could have been altered or jettisoned, by an 8 to 7 vote by the Committee on Rules.[37] In that sense, the bill narrowly passed through the legislative process. Yet, when the bill came to a vote in each house, it passed by relatively large margins: 71 to 20 in the Senate and a tighter 250 to 172 in the House.[38] In the Senate, opposition came primarily

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[34] On April 8, Waggonner mused, "is there a fear that the militant Black Power groups will continue to burn our cities down if Congress does not pay this blackmail? …Yes." Joe Waggonner Jr., in ibid., 68.

[35] Ibid., 64. At least some of the "American people" certainly would have held Congress accountable. A Mrs. Paul Prewitt wrote that she was "still very much shaken by the tragic events of last night, we urge you to act NOW on passing a decent fair Housing Bill." Prewitt, to Emanuel Celler, April 5, 1968; H.R. 2512 To 2516; Judiciary Committee; Legislative Files, Public Bills; 90th Congress; Records of the U.S. House of Representatives, RG 233; National Archives Building, Washington, DC. Likewise, John Fegan was "shocked into writing," by King's death, pleading for action on the fair housing provisions and concluding, "now more than ever before the black people of our country need to be reassured that the mainstream of America is open to them in every way." John Fegan, to Emanuel Celler, April 5, 1968; H.R. 2512 To 2516; Judiciary Committee; Legislative Files, Public Bills; 90th Congress; Records of the U.S. House of Representatives, RG 233; National Archives Building, Washington, DC.

[36] Colmer, *Congressional Record,* 90th Cong., 2d sess., 1968, 114: 9620.

[37] Ibid.

[38] The House count indicates a vote on a resolution (HR 1100) to agree to the Senate amendments to HR 2516.

from southern Democrats (only three Republicans voted against the bill[39]), while in the House, southern Democrats and Republicans joined Republicans from elsewhere in the country (especially California, Indiana, Illinois, Ohio and Pennsylvania) against the legislation.[40]

The 250 yeas in the House and the 70 affirmative votes in the Senate indicated widespread, though far from universal, accord that discrimination in housing violated some fundamental American principle. Like these lawmakers, over the next decade regulators, bankers, and S&L officials would learn to signal their assent to the objective of fair housing–even if they went on to protest various means of achieving that goal. The lesson was twofold, however, as these actors also learned the potency of an accusation of discrimination, and soon "small savers," as well as commercial bank, Savings and Loan, and mutual fund executives would make claims that they too were victims of unfair discrimination.

President Johnson signed the Civil Rights Act of 1968 into law on April 11, 1968.[41] The Fair Housing Act (Title VIII) prohibited discrimination in the sale or rental of housing based on race in three stages covering first government-supported housing (including mortgages insured by the FHA and VA), then multi-unit housing, and finally,

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[39] They were Paul Fannin (AZ), Strom Thurmond (SC), and John Williams (DE). Two Iowa Senators, Republicans Hickenlooper and Miller also indicated that they would have voted against the bill. *Congressional Record,* 90th Cong., 2d sess., 1968, 114: 5992. *Lexis Congressional* (accessed March 18, 2011).

[40] The Democrats from outside the South who voted against the bill were James Delaney (NY), Kenneth Gray (IL), Roman Pucinski (IL), and Johnny Walker (NM).

[41] Lyndon B. Johnson, "Civil Rights Act," *Weekly Compilation of Presidential Documents* 4, no. 15 (April 15, 1968): 673-4. *HeinOnline* (accessed September 6, 2011).

effective January 1, 1970, single-family dwellings sold through a real estate broker.[42] The act banned discrimination on the basis of race, color, religion, or national origin, but it did not, as did the 1964 Civil Rights Act, prohibit discrimination on the basis of sex. The act targeted discrimination on the part of real estate agents or brokers and, in Section 805, discrimination by lenders.[43]

Even as the bill was passed, some lawmakers expressed their doubt that the law would have significant consequences. New York Representative Joseph Resnick's pessimism stemmed both from the experience of his home state, which had boasted an open housing law for seven years with what he considered disappointing results, and from that of the South, where the 1964 and 1965 Civil Rights Acts still fell short of their aims. "It was easy enough for us," said Resnick, "when the enemy was a Southern sheriff …. It is much more difficult when the enemy is not so clear–when we pass laws, yet conditions remain unchanged."[44] Resnick maintained that money and enforcement would have to follow for the legislation to be meaningful; "too many of us think that the bill we

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[42] Raymond Celada, Congressional Research Service, "The Civil Rights Act of 1968: Background and Title-by-Title Analysis," (Washington, DC: GPO, 1968), 160-1.

[43] Section 804 targeted real estate brokers and prohibited, "(a) to refuse to sell or rent in response to a good faith offer, or negotiate for the sale or rental or in the provision of services or facilities in connection therewith because of race, color, religion or national origin; (b) to discriminate in the terms, conditions, or privileges of sale or rental or in the provision of services or facilities in connection therewith because of race, color, religion or national origin; (c) to make, print, or publish, or cause to be made, printed or published, any notice, statement or advertisement with respect to the sale or rental of a dwelling that indicates any preference, limitation or discrimination based on race, color, religion or national origin; (d) to represent to any person because of race color, religion or national origin, that a dwelling is not available for inspection, sale or rental when in fact it is available; (e) to induce or attempt to induce for the purposes of making a profit, any person to sell or rent any dwelling by representations regarding the present or prospective entry into the neighborhood of a person or persons of a particular race, color, religion or national origin." Subsequent sections, 805 and 806, prohibit discrimination by lenders. Ibid., 47-49. Religious organizations remained authorized to sell or rent only to members of the religion provided that the religion itself was open to all, as were private clubs for whom housing or lodging was "incident[al] to its primary purpose or purposes." PL 90-284. Sec. 807.

[44] *Congressional Record,* 90th Cong., 2d sess., 1968, 114: 9843.

passed today is a great victory…. But I say that it will be worth nothing but a hoax unless there is vigorous enforcement–block by block, town by town, county by county."[45]

The 1968 Civil Rights Act placed the onus of enforcing the Fair Housing title almost entirely on victims of discrimination. Petitioners could file a complaint with HUD up to 180 days after the alleged incident, at which point HUD officials would decide whether or not to try to resolve the complaint by "informal methods of conference, conciliation, and persuasion."[46] If HUD decided not to attempt to resolve the complaint, or if no resolution had been reached after 30 days, the complainant could then take civil action. The act affirmed that in such cases, "burden of proof shall be on the complainant."[47] The act also authorized the U.S. Attorney General to initiate civil action on "reasonable cause to believe that any person or group of persons is engaged in a pattern or practice of resistance to the full enjoyment of any of the rights."[48]

In a weekend strategy session immediately following the Civil Rights Act's passage, HUD officials met with civil rights advocates to discuss the enforcement of the Fair Housing Act. The group focused on the need to emphasize action and results over study and information. George Culberson of Congressional Research Services argued that HUD did not need to conduct any studies since "discrimination is [known to be] almost universal," and suggested that HUD "get at [the] villain–[the] real estate boards–[the] real

[45] Ibid.

[46] PL 90-284, Sec. 810.

[47] See PL 90-284, Sec. 810(e).

[48] PL 90-284, Sec. 813.

estate industry–top to bottom."[49] Clarence Mitchell, of the NAACP, urged that attention be on "getting people into housing–focus on results."[50] To turn his staff to this task, HUD Secretary Robert C. Weaver directed in an agency memo, "The Fair Housing title requires us not only to administer these provisions, but to administer all our housing and urban development programs so as to affirmatively further the purposes of the law," and added, "it is particularly important that everyone in the Department recognize our firm policy against segregation of the races."[51] Striking a tone more conciliatory towards fair housing opponents, Weaver explained, "the goal is not a random mixing of peoples or the blotting out of social and cultural identities, but rather to allow every man the same opportunity to fulfill his potential."[52]

Weaver's plans for vigorous enforcement of the Fair Housing Act suffered a major blow when a Conference Committee set the appropriation for administering HUD's Fair Housing programs at $2 million. HUD had originally sought $11 million, and while the Senate had agreed to $7 million, the House countered with $1 million.[53] The shortfall meant a drastic reduction in the number of staff that could be devoted to fair

[49] "Summary of Saturday Meeting on Title VIII," April 13, 1968; Civil Rights Act of 1968; Secretary Weaver's Subject Files, 1960-69; Records of the Department of Housing and Urban Development, 1942-87; General Records of the Department of Housing and Urban Development; RG 207; NACP.

[50] Ibid.

[51] Robert Weaver, "Clarification of Law and Department Policy Re. Integration, to "All Principal Staff," October 15, 1968; Civil Rights Act of 1968; Secretary Weaver's Subject Files, 1960-69; Records of the Department of Housing and Urban Development, 1942-87; General Records of the Department of Housing and Urban Development; RG 207; NACP.

[52] Ibid.

[53] Thomas M. Kerr, Chairman, Housing Committee, Urban League of Pittsburgh, letter to the editor, *Pittsburgh Post-Gazette*, January 10, 1969, *Google News Archive Search* (accessed September 7, 2011). *Congressional Record*, 90th Cong., 2nd sess., 1968, 114: 30741. *Lexis Congressional* (accessed September 7, 2011).

housing duties. Boris Shishkin, Secretary of the AFL-CIO Housing Committee, wrote to Secretary Weaver expressing his regret that the appropriations for HUD would reduce the effectiveness of Fair Housing enforcement, but also indicated his preparedness to educate the AFL-CIO membership of the law's provisions and how to lodge a complaint.[54] Due to the lack of adequate funding, HUD would have to rely on organizations like the AFL-CIO, Urban League, NAACP, and local organizations to facilitate individual complaints. While such assistance would be critical for educating victims of discrimination of the complaint process, it would only exacerbate the challenge to the severely underfunded and understaffed HUD office of resolving and processing alleged violations.

In the first decade after the law took full effect in 1970, HUD logged over 26,000 complaints. By 1973, the understaffed agency carried a backlog of over 1,800 cases. By 1979, the year-to-year carryover had been reduced to 500 cases, a number that, while a dramatic improvement, fell far short of the results-oriented approach mapped out at the first weekend strategy session. The majority of complaints dealt with rental properties, but "refusal to sell" complaints averaged over 200 per year, and "discrimination in financing" over 100 per year. Revealingly, the number of complaints categorized under "discrimination in terms and conditions" rose throughout the decade, averaging over 800 per year, indicating that while, in some cases, access may have been expanded to minorities, it frequently came at a higher price.

On one level, these statistics show that the fair housing act was working. Victims of discrimination could, and did, appeal to a federal agency that would attempt to resolve

[54] Boris Shiskin, to Weaver, October 18, 1968; AFL-CIO 1968; Secretary Weaver's Subject Files, 1960-69; Records of the Department of Housing and Urban Development, 1942-87; General Records of the Department of Housing and Urban Development; RG 207; NACP.

their complaint voluntarily, or, if that failed, would refer cases to the Department of Justice. But the complaints, which surely represented only a small percentage of actual cases of discrimination in housing, also document the continuation of discrimination, showing that the fair housing act had not translated into open housing for all. Nor, given the backlog of cases, is it apparent that those who availed themselves of the system had their situations resolved before they had to make alternative housing plans for themselves.

Most scholarly assessments of the efficacy of the Fair Housing Title have understandably been focused on these HUD and Department of Justice enforcement mechanisms.[55] To the extent that the act explicitly delegated enforcement powers, it granted responsibility to those two cabinet level departments. However, Title VIII also made it illegal for lenders to discriminate and stated that "all executive departments and agencies shall administer their programs and activities relating to housing and urban development in a manner affirmatively to further the purposes of this title and shall cooperate with the Secretary to further such purposes."[56] This led some activists to see potential for more effective enforcement to come through the federal regulators of those lenders, the Federal Reserve, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board, and Office of the Comptroller of the Currency. Effective supervision of

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[55] Bonastia argues that the Nixon-era held promise for fair housing and desegregation, as HUD Secretary George Romney took seriously the Fair Housing Act's mandate to affirmatively enforce the act. He argues that HUD proved to be a weak institutional home for enforcement, and that ultimately scandals within the agency, and Nixon's suspension of spending in housing programs in 1973 closed this moment of opportunity. See also, Charles M. Lamb, *Housing Segregation in Suburban America since 1960: Presidential and Judicial Politics* (New York: Cambridge University Press, 2005).

[56] P.L. 90-284, Sec. 808(d).

lending practices could curb abuses before they occurred, rather than waiting for legal action after the fact.

Bill Taylor, first as the Staff Director of the U.S. Commission on Civil Rights and then from the Center for National Policy Review, and others doggedly pursued this avenue for nearly a decade after passage of the Fair Housing Act.[57] In July 1968, senior HUD official Jay Janis wrote to Secretary Weaver conveying Taylor's recommendation that HUD take "an affirmative role with regard to FDIC and Federal Reserve Board Banks [and FHLBB] in connection with fair housing."[58] Taylor had first suggested in Senate testimony on the Fair Housing Title that the agencies make federal chartering and insurance for banks and thrifts conditional on compliance with the act.[59] HUD Undersecretary Robert C. Wood indicated the Department's receptivity to Taylor's proposal to seek Fair Housing Act enforcement help through the financial regulators, replying to Taylor, "the passage of Title VIII and the specific language of section 808(d) call for serious reconsideration of any decision that may have been made at the time of promulgation of Executive Order 11063 not to apply it to the activities of FDIC and FSLIC."[60] Wood suggested that "termination or refusal of assistance," to financial institutions, would be "a more effective means of enforcement than the private court

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[57] William L. Taylor, *The Passion of My Times: An Advocate's Fifty-Year Journey in the Civil Rights Movement* (New York: Carroll & Graf Publishers, 2004), 104.

[58] Janis, to Weaver, July 23, 1968; Civil Rights Act of 1968; Secretary Weaver's Subject Files, 1960-69; Records of the Department of Housing and Urban Development, 1942-87; General Records of the Department of Housing and Urban Development; RG 207; NACP.

[59] Senate Subcommittee on Constitutional Rights, *Civil Rights Act of 1967*, 209.

[60] Wood, to William Taylor, July 12, 1968; Civil Rights Act of 1968; Secretary Weaver's Subject Files, 1960-69; Records of the Department of Housing and Urban Development, 1942-87; General Records of the Department of Housing and Urban Development; RG 207; NACP.

action provided for under sections 810 and 812 of Title VIII."[61] For his part, Secretary Weaver had long held the view that federally-insured institutions should fall within the reach of fair housing regulations.[62]

Getting the financial regulators to accept Taylor, Wood, and Weaver's interpretation of their responsibilities would be an uphill battle, however, as officials in those agencies had long subscribed to the myth that they had no *direct* role in supposedly "private" housing markets, and thus no authority or obligation to intervene in them.[63] Indeed, early signs from the Fed were not promising, as Fed Chairman William Martin Jr. replied to Weaver, "the Federal Reserve Act, under which this System operates, did not include provision for this type of supervision nor have we had any experience with problems of this nature."[64] FDIC Chairman K.A. Randall responded similarly that "this Corporation's direct statutory responsibilities would almost never involve operations under the fair housing title."[65] And FHLBB Chairman John Horne simply referred Weaver to the Bank Board's 1961 Resolution condemning racial discrimination by financial institutions, and indicated that compliance would be sought through the regular FHLBB supervisory processes. Horne relayed the FHLBB's intention to use persuasion as a first tool, but that "cease-and-desist procedures, restrictions on bank advances, or

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[61] Ibid.

[62] Freund, "'Democracy's Unfinished Business,'" 38.

[63] Ibid., 24, 38.

[64] William Martin, Jr., to Weaver, July 17, 1968; Civil Rights Act of 1968; Secretary Weaver's Subject Files, 1960-69; Records of the Department of Housing and Urban Development, 1942-87; General Records of the Department of Housing and Urban Development; RG 207; NACP.

[65] K.A. Randall, to Weaver, June 5, 1968; Civil Rights Act of 1968; Secretary Weaver's Subject Files, 1960-69; Records of the Department of Housing and Urban Development, 1942-87; General Records of the Department of Housing and Urban Development; RG 207; NACP.

loss of membership in the system" could be employed if persuasion failed.[66] Horne's response carried the most promise, but even it fell short of issuing Fair Housing regulations, thus leaving considerable discretion to individual examiners.

Despite the regulators' cool initial response in 1969, HUD officials recommended an affirmative action program for the four regulatory agencies including fair housing regulations, data collection by lenders including information on race, training of examiners for civil rights compliance, a process for referral of violations to HUD and the Justice Department, requirement of a fair lending poster, and "development and use of sanctions against discriminating lenders."[67] When the agencies failed to respond, a group of civil rights organizations, including the U.S. Commission on Civil Rights, the Urban League, and others, formally petitioned the agencies "for the issuance of a regulation implementing section 805 of title VIII." The petitioners requested regulations requiring record keeping on all loan applications including data on the "race, color, or minority group identification" of the applicant, reasons for denying an application, and data on the property including "racial and economic characteristics" of the area, a log of oral inquiries, requirement that institutions advertise that they are equal housing lenders, and lobby notice of the same. In response, the four agencies issued a policy statement requiring notice of nondiscrimination compliance in advertising, and the posting of a fair lending poster in an institution's lobby, but only took the other recommendations under

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[66] John E. Horne, to Weaver, June 28, 1968; Civil Rights Act of 1968; Secretary Weaver's Subject Files, 1960-69; Records of the Department of Housing and Urban Development, 1942-87; General Records of the Department of Housing and Urban Development; RG 207; NACP.

[67] Senate Committee on Banking, Housing, and Urban Affairs, *Report on Fair Lending Enforcement by the Four Federal Regulatory Agencies,* 94th Congress 2d sess., S. rpt. 94-930 (Washington, DC: GPO, 1976), 5. *Proquest Congressional* (accessed August 30, 2011).

consideration.[68] The Federal Reserve, at least, indicated that it had also adopted the use of a civil rights questionnaire in its examination process and a fair housing component to its examiner training program.[69]

While the federal agencies stalled, evidence of discrimination by lenders continued to mount. A HUD survey of lenders in 1972 revealed almost 1,000 institutions that admitted to considering racial composition of neighborhoods, and 90 that admitted to considering race of applicant, in lending decisions.[70] Yet by April 1972, only the FHLBB had issued further fair housing regulations, including adoption of statements prohibiting discrimination in lending and applications (though with no explicit enforcement mechanism). The Bank Board retracted proposed regulations that would have required collection of racial data.[71] The FDIC also proposed rules that included new record keeping requirements, and held public hearings that covered, among other things, the possibility of a prohibition against discrimination on the basis of sex and a potential

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[68] Federal Home Loan Bank Board, "Nondiscriminatory Requirements in Real Estate Lending," Department of the Treasury, "Real Estate Loan Activities," Federal Deposit Insurance Corporation, "Real Estate Loan Activities," and Federal Reserve System, "Civil Rights Act Nondiscrimination Requirements in Real Estate Loan Activities," in *Federal Register* 36, no.250 (December 29, 1971): 25151-2, 25167-9, *HeinOnline* (accessed September 7, 2011).

[69] Federal Reserve System, "Civil Rights Act Nondiscrimination Requirements in Real Estate Loan Activities," *Federal Register* 36, no.250 (December 29, 1971): 25151-2, 25167-9, *HeinOnline*, (accessed September 7, 2011).

[70] Senate Committee on Banking, Housing, and Urban Affairs, *Report on Fair Lending Enforcement by the Four Federal Regulatory Agencies*, 6.

[71] Federal Home Loan Bank Board, "Proposed Nondiscrimination Requirements," *Federal Register* 37, no. 12 (January 19, 1972): 811-3, *HeinOnline* (accessed September 7, 2011). Federal Home Loan Bank Board, "Part 528–Nondiscrimination Requirements," *Federal Register* 37, no. 82 (April 27, 1972): 8436-8, *HeinOnline*, http://heinonline.org (accessed September 7, 2011).

exemption for banks "in areas of low minority concentration," but after hearings declined to issue any new fair housing regulations.[72]

In 1973, the FHLBB revisited its regulations to clarify that "activities of lenders which may not be intended to be discriminatory might still be so in their effects." The rules sought to delineate what considerations might "achieve a sound business purpose," and those that did not. In the former category fell a borrower's prior credit history (but not solely whether or not a person had previously owned a home), and in the latter, age, sex, or marital status of an applicant, ability to speak English, excluding overtime pay or other supplemental income, and–anticipating the CRA–"age, income level, or racial composition of neighborhood."[73] The statement of policy constituted the fullest articulation of the spirit of the Fair Housing Title to that date, but still failed to incorporate the racial record keeping that many activists believed was necessary to monitor and enforce the law. As MIT professor Lester Thurow testified before Congress in 1976, "if you collect the right data and then analyze it in the right way, detecting discrimination is a perfectly straightforward problem."[74]

Getting the financial agencies to take responsibility for such data collection and analysis remained anything but straightforward. Not until 1974, five years after the passage of the Fair Housing Act, did continued agitation by the petitioning civil rights

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[72] Federal Deposit Insurance Corporation, "Fair Housing Lending Practices," *Federal Register* 37, no. 183 (September 20, 1972): 19385-6, *HeinOnline* (accessed September 7, 2011). Federal Deposit Insurance Corporation, "Fair Housing Lending Practices," *Federal Register* 37, no. 224 (November 18, 1972): 24679-80, *HeinOnline* (accessed September 7, 2011).

[73] Federal Home Loan Bank Board, "Part 531–Statements of Policy," *Federal Register* 38, no. 241 (December 17, 1973): 34653, *HeinOnline* (accessed September 7, 2011).

[74] Senate Committee on Banking, Housing, and Urban Affairs, *Equal Opportunity in Lending: Hearings before the Committee on Banking, Housing, and Urban Affairs, United States Senate, 94th cong., 2d sess.* (Washington, DC: GPO, 1976), 7. *Lexis Congressional* (accessed September 9, 2011).

groups succeed in pressuring the four agencies to begin a six-month pilot program including racial data collection in eighteen metropolitan areas.[75] The pilot program revealed evidence of discriminatory lending, yet the agencies still balked at making such data collection permanent.[76]

The petitioning tactic had yielded exasperatingly little in terms of substantive, enforceable regulations. Indicating the absence of real change, as late as 1974, Richard Platt Jr., FHLBB Director of the Office of Housing and Urban Affairs, requested counsel's opinion on appraisal forms "which seek or include information relating to the 'ethnic composition' of a neighborhood or information relating to whether ethnic composition is changing.'"[77] FHLBB General Counsel Charles Allen responded that such questions were indeed illegal under the Fair Housing Act, and that use of the forms should be discontinued.[78] Yet such uncertainty within FHLBB itself suggested the limited effectiveness of the law in the absence of clear regulations.

While the fight to secure regulations to enforce the Fair Housing Act continued, activists sought to expand legal authority to prohibit discrimination on the basis of sex.

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[75] Federal Home Loan Bank Board, "Part 528–Nondiscrimination in Lending," *Federal Register* 39, no. 65 (April 3, 1974): 12110, *HeinOnline* (accessed September 7, 2011). Department of the Treasury, "Real Estate Loan Activities," *Federal Register* 39, no. 67 (April 5, 1974): 1233, *HeinOnline* (accessed September 7, 2011). Federal Deposit Insurance Corporation, "Inter-Agency Fair Housing Data Evaluation Project," *Federal Register* 39, no. 106 (May 31, 1974): 19274, *HeinOnline* (accessed September 7, 2011).

[76] Senate Committee on Banking, Housing, and Urban Affairs, *Report on Fair Lending Enforcement by the Four Federal Regulatory Agencies,* 5-6. See also, Lester Thurow, Senate Committee on Banking, Housing, and Urban Affairs, *Equal Opportunity in Lending*, 3. Thurow testified that none of the agencies had properly evaluated the collected data, despite the availability of similar studies and even software to analyze the data for evidence of discrimination while controlling for "legitimate economic" factors. He found the Comptroller's data to be the most useful, and determined that it showed evidence of discrimination.

[77] Charles E. Allen, General Counsel, to Richard Platt Jr., February 7, 1974; Community Reinvestment Act; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[78] Ibid.

Because the Fair Housing Act had omitted sex discrimination from its purview, this was first a legislative battle, which culminated in passage of the 1974 Equal Credit Opportunity Act. Senators Bill Brock (R-TN) and William Proxmire (D-WI) offered the title as an amendment to the Depository Institutions Amendments of 1974, after a prior Senate effort at an Equal Credit Act (S. 2101) had languished for a year with no action in the House.[79] During conference negotiations on the Depository Institutions bill, the committee adopted the Senate provisions for Equal Credit Opportunity. The Conference Report passed in the House, with some controversy over the Equal Credit Opportunity title. The bill, which included, among other things, extension of Regulation Q interest rate ceilings and an increase in federal deposit insurance, passed with 355 yeas, 1 nay, 6 present, and 72 not voting.[80] The Senate agreed to the Conference Report without a roll call vote.[81]

As Title V of The Depository Institutions Amendments Act of 1974, the Equal Credit Opportunity Act prohibited lending discrimination on the basis of sex or marital status. Title V directed the Federal Reserve Board to design the regulations that would then be enforced by the Fed, FDIC, OCC, and FHLBB accordingly.[82] The Fed issued Equal Credit Opportunity rules, known as Regulation B, in October 1975. Among other things, the regulations prohibited discounting of income based on sex or marital status or

[79] *Congressional Record,* 93d Cong., 2d sess., 1974, 120: 19213.

[80] Ibid., 34770.

[81] Ibid., 34886.

[82] P.L. 93-495.

considering the likelihood of an applicant bearing children.[83] FHLBB regulations also explicitly prohibited income discounting for women (done traditionally due to possible loss of income during and after pregnancy).[84]

The petitioning avenue had borne little fruit for open housing advocates, and while the Equal Credit Opportunity Act demonstrated the possibility of new legislation, regulation of the private sector remained essential to giving legislation teeth. The courts provided an additional option to activists seeking greater leverage over the regulatory agencies. In April, 1976, the National Urban League, the National Committee Against Discrimination in Housing, the NAACP, the National Association of Real Estate Brokers, the Metropolitan Washington Planning and Housing Association, the League of Women Voters, and other civil rights organizations filed suit against the Federal Reserve, FDIC, FHLBB, and the Office of the Comptroller of the Currency. The suit claimed that those agencies had failed to enforce fair housing legislation in accordance with Section 805.[85]

The lawsuit by itself may or may not have achieved the desired results, but Taylor and the Center for National Policy Review added pressure on the agencies by requesting oversight from the Senate Committee on Banking, Housing, and Urban Affairs. Taylor

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[83] Federal Reserve System, "Part 202–Equal Credit Opportunity," *Federal Register* 40, no. 205 (October 22, 1975):49298-49310.

[84] Robert Schafer and Helen F. Ladd, *Discrimination in Mortgage Lending* (Cambridge, MA: The MIT Press, 1981), 6.

[85] John Herbers, "4 U.S. Agencies Urged to Act Against Bias in Home Financing," *The New York Times*, May 9, 1971. *Proquest* (accessed August 24, 2011). The action was coordinated by the Center for National Policy Review, headed by William Taylor, formerly of the United States Commission on Civil Rights. Richard C. Paddock, "4 Agencies Lax on Home Loan Bias Laws, Suit Says," *Los Angeles Times*, April 27, 1976. *Proquest* (accessed August 24, 2011). For a detailed study of the lawsuit based on archival research and oral histories, see Andrew Nash, "The Origins of Fair Lending Litigation," *The Civil Rights Litigation Clearing House* (University of Michigan, 2004), http://www.clearinghouse.net/chDocs/resources/caseStudy_ AndrewNash_1228406481.pdf (accessed October 15, 2011).

found a sympathetic figure in the committee's Chairman, William Proxmire.[86] In March 1976, the committee convened oversight hearings on the enforcement of the Fair Housing Act by the federal regulatory agencies with jurisdiction over mortgage lenders. Citing section 808(c), the committee report argued that the agencies had an obligation to "affirmatively further the purposes of the Fair Housing Act," and that "clearly, if mortgage lending institutions discriminate, fair housing objectives of the 1968 Act are frustrated."[87]

By 1976, the committee found, only the Federal Home Loan Bank Board had begun to take positive steps in fair housing enforcement. The FHLBB had recently filed an amicus brief in the *Laufman v. Oakley* case stating that "'the Board's … regulations are not only a valid exercise of its authority, but are *a necessary and wholly proper response to the mandate imposed on the Board by Title VIII*'" (emphasis added in Committee Report).[88] But the committee was generally displeased with the position of the other three agencies and the past efforts, or lack thereof, of all four. The report declared that encouraging voluntary compliance was not sufficient, and chastised the Office of the Comptroller of the Currency, which it charged with doing "nothing more than check[ing] to see whether the 'Equal Lender' poster is displayed."[89] In hearings, the FDIC representative argued that the Corporation was "not in housing programs as such, actively engaged in housing programs and in promoting and developing housing, [and

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[86] Taylor, 107.

[87] Senate Committee on Banking, Housing, and Urban Affairs, *Report on Fair Lending Enforcement by the Four Federal Regulatory Agencies,* 1.

[88] Ibid., 1-2.

[89] Ibid., 2.

therefore] some certain provisions of the act are not applicable to us."[90] The committee's report expressed a general sense of dismay that despite the overwhelming prevalence of discrimination, the agencies had not made a single referral to the Justice Department, nor one formal finding of discrimination. The committee recommended that lenders record demographic statistics and designate a fair housing compliance officer, and that the agencies include fair housing education in the training of bank examiners, set aside one full day during the examination process to investigate an institution's fair housing compliance, and to adopt regulations similar to those recently adopted by the FHLBB. Reflecting increasing agitation on the issue, the committee also called on examiners to analyze data to determine if an institution had engaged in redlining–the practice of refusing to lend in particular neighborhoods due to racial composition.[91]

The committee rejected the concerns of witnesses who contended that affirmative steps constituted credit allocation that endangered the financial soundness of depository institutions. "Obviously," the report read, "the 1968 Fair Lending Act does not require depository institutions to make unsound loans….To assert that equitable treatment of minorities might somehow entail greater risk is itself a form of bigotry."[92] In a running dissention during the hearings, Senator Jake Garn (R-UT) repeatedly implied that the types of regulations that Senator Proxmire favored, what Proxmire would have considered merely enforcing the Fair Housing Act, would constitute a relaxation of credit

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[90] Senate Committee on Banking, Housing, and Urban Affairs, *Equal Opportunity in Lending*, 19.

[91] Senate Committee on Banking, Housing, and Urban Affairs, *Report on Fair Lending Enforcement by the Four Federal Regulatory Agencies,* 4.

[92] Ibid., 12-13.

granting standards that would endanger the "rights of depositors."[93] Senators Garn and Helms (R-NC) issued dissenting remarks in the committee report, but its general tone, expressing that of Senator Proxmire, conveyed a strong recommendation that the agencies make a priority of fair housing regulations.

The twin pressures of the Senate Hearings and the lawsuit finally began to bear fruit in 1977. The FHLBB came to an agreement with the civil rights organizations in March, the FDIC in May, and the Comptroller of the Currency later the same year, while the suit continued against the Federal Reserve until dismissed by the U.S. District Court, District of Columbia. The FDIC agreed to appoint a civil rights specialist to oversee fair housing enforcement, and to collect data on race and sex, if voluntarily given by loan applicants, in order to monitor possible discrimination.[94] The settlements promised progress in fair housing regulation, but results were mixed. Using the settlement agreement with the Comptroller as a case study, Goering and Wienk argue that the plaintiffs achieved only a "hollow victory," due to deficiencies in the OCC's Fair Housing Home Loan Data System.[95] Their assessment cautions against an overstatement of the achievement, yet the civil rights groups considered the cooperation of the financial

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[93] Senate Committee on Banking, Housing, and Urban Affairs, *Equal Opportunity in Lending*, 23.

[94] "FDIC Agrees to Get Loan Applicant Data," *The Washington Post,* May 19, 1977. *Proquest* (accessed August 24, 2011).

[95] John Goering and Ron Wienk, "An Overview," in Goering and Wienk eds. *Mortgage Lending, Racial Discrimination, and Federal Policy* (Washington, DC: The Urban Institute Press, 1996), 403-408. Specifically, they argue that most banks had too few applications to discern patterns and that "anomalies" could be explained away. They note that the OCC abandoned the system after a decade of use, and no findings of noncompliance.

regulators, at long last, to be an essential weapon in the fight for equal access to housing and housing finance.[96]

As important as the cooperation of the financial regulators was the cooperation of the lenders themselves. In October 1977, the FDIC's long awaited proposal of new fair housing regulations elicited a deluge of comment letters from a wide variety of depository institutions. These letters offer a window into the thinking of bankers from across the country, and likely are similar to the reactions of S&L officials to the fair housing regulations issued by the FHLBB.[97] Opponents of the regulations largely did not challenge the goal of anti-discrimination directly; many in fact made special effort to affirm their commitment to equal opportunity. Instead their protest came in one or more of the categories of: objection to additional paperwork and resulting increases in operating costs, insistence that sufficient fair housing regulation existed already, predictions that consumers would resent being asked to identify by race and national origin or even to consider such questions as being, or likely to lead to, discrimination, or that discrimination was simply not an issue for a particular bank's area and population. Collectively, the letters represent a strong repudiation of fair housing regulations as an unwelcome and unnecessary burden on lenders. These respondents did not believe that a social goal of nondiscrimination, whether they agreed with the goal or not, justified the costs associated with record keeping and compliance, as R.A. Lux wrote, "no rational person can oppose the aims of the Fair Housing Act and the Equal Credit Opportunity Act, but the implementation of those acts has been more expensive and time-consuming

[96] Taylor, 108.

[97] Comment Letters directed to the FHLBB, if they exist, were not readily identifiable in FHLBB archives.

than the results may justify."[98] Other responses point to telling assumptions made by some bankers about discrimination, race, sex, and what they considered to be responsible lending.

Of the bankers who protested the new regulations while affirming the goals of nondiscrimination, some, like William J. Rhodes objected solely on the basis of the costs imposed by additional record keeping, while maintaining, "we recognize that sex, color, etc. has no relationship on whether a loan should be granted or denied."[99] For others, however, that relationship blurred. Willis M. Hansen, President of the State Bank of Lawler (Iowa), for example, wrote, "we agree with non-discrimination based on color, sex, etc.," affirming the goals of fair housing regulation, but then continued "it is difficult for us to understand why we should be told to whom we should make loans."[100] Hansen's seamless transition from fair housing to being told to whom he must make loans betrayed a latent association of lending to minorities and unsound or risky business practice. Here Hansen was hardly alone. J.L. Savage, a bank president in Georgia likewise implied that fair housing regulations amounted to a weakening of lending standards.[101] C.W. Mitchell, a loan officer in Texas warned, "this proposed regulation moves one step closer to

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[98] R.A. Lux, Theresa State Bank, Theresa, WI, to Executive Secretary, FDIC, October 20, 1977; Comments Re: Fair Housing; Comment Letters; Office of the Executive Secretary; Records of the Federal Deposit Insurance Corporation; RG 34; NACP (hereafter "Comments Re: Fair Housing").

[99] William J. Rhodes, Western Community Bank, to FDIC, November 29, 1977; ibid. See also, Merle J. Prins, First Michigan Bank and Trust Company, Zeeland, MI, to Executive Secretary, FDIC, November 23, 1977; ibid.

[100] Willis M. Hansen, to Alan Miller, November 15, 1977; ibid.

[101] J.L. Savage, The Bank of Griffin, to Jerry L. Langley, FDIC, October 25, 1977; ibid. Other letters which protest the proposed regulations by raising the specter of unsound lending include R.L. Utsey, Jr., Farmers and Merchants Bank, St. George, SC, to Executive Secretary, FDIC, October 20, 1977; ibid. John J. Govern, Security Savings Bank, to Executive Secretary, FDIC, December 1, 1977; ibid.

required allocation of credit according to governmental edict," implying that fair lending was forced lending.[102]

A few bankers expressed sympathy to the regulators, indicating that they understood "the current political and legal pressures that have forced you to propose these regulations,"[103] implicating the "do-gooders,"[104] "a few radicals,"[105] and identifying "Senator Proxmire et al."[106] as the main culprits. The majority of respondents objected to the additional record keeping requirements. Several suggested that forms already in use such as those used with FNMA and FHLMC would provide all of the information required.[107] Others objected to the idea that the financial regulators should have a role in fair housing enforcement at all, arguing that it was up to "those persons who have been discriminated against [to] report such incidences."[108] As W. Timothy Finn, II of the Deposit Bank of Pleasureville, KY put it, "in the case of a bank robbery, you don't require robbers to take pictures of themselves; you make the bank do it."[109]

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[102] C.W. Mitchell, First State Bank, Rio Vista, TX, to Executive Secretary, October 31, 1977; ibid.

[103] Don L. Taylor, Waukesha State Bank, to Executive Secretary, FDIC, November 3, 1977; ibid.

[104] Willis M. Hansen, to Alan Miller, November 15, 1977; ibid. See also, Gerald S. O'Sullivan, Fox Lake State Bank, Fox Lake, IL, to Executive Secretary, FDIC, October 24, 1977; ibid.

[105] W.B. Gray, Farmers and Merchants Bank, the Bank on the Wabash, to Executive Secretary, FDIC, October 21, 1977; ibid.

[106] Dan B. Todd, Farmers and Merchants Bank, Timberville, VA, to Alan Miller, FDIC, November 10, 1977; ibid.

[107] John S. Fortenbury, Jacksonville Mortgage Company, Jacksonville, AK, to Executive Secretary, FDIC, October 24, 1977; ibid. John P. Howard, Deep River Savings Bank, Deep River, CT, to Executive Secretary, FDIC, October 25, 1977; ibid.

[108] Kenneth Rayborn, First Citizens Bank of Cleveland, Cleveland, TN, to Alan Miller, FDIC, November 2, 1977; ibid.

[109] Finn, to Executive Secretary, FDIC, October 24, 1977; ibid.

Several small, rural banks petitioned for exemption from additional record keeping requirements on the basis that their lending area had few or no minorities. Kent Simpson, President of Farmers-Citizens Bank in Salem, Indiana wrote, "in our rural community we don't even understand the connotation of discrimination in lending."[110] One New Hampshire banker protested that "blacks in our market area come to 7/10th of 1% of the population,"[111] another in West Virginia, "the geography and minority make up of our area is such that data furnished by us … would be useless,"[112] and an Iowa banker, "we have a 100% white population in our town and there are no slum areas."[113] With revealing language, D.F. Baertsch of North Dakota wrote, "if we had any minorities in our area we would be more than happy to fill out a special form so that you could check on us to see that we were not discriminating against Indians, Negroes, or any other minority race."[114] The responses of the rural bankers revealed their association of fair housing problems with large cities, and, exclusively, with racial minorities. In petitioning for exemptions on the basis of an absence of racial minorities, these rural bankers appear completely oblivious to the possibility that record keeping requirements might be

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[110] Kent Simpson, Farmers-Citizens Bank, Salem, IN, to Alan Miller, FDIC, November 11, 1977; John Hardie, New Hampshire Savings Bank for the People, to Alan Miller, FDIC, November 25, 1977; ibid

[111] John Hardie, New Hampshire Savings Bank for the People, to Alan Miller, FDIC, November 25, 1977; ibid.

[112] Cline A. Knotts, Community Bank, Parkersburg, West Virginia, to Executive Secretary, FDIC, November 2, 1977; ibid.

[113] Gary Homan, Ackley State Bank, Ackley, IA, to Executive Secretary, FDIC; ibid. See also, David Pike, Farmers Savings Bank, Grundy Center, IA, to Executive Secretary, FDIC, November 3, 1977; ibid.

[114] D.F. Baertsch, Farmers and Merchants Bank, Beach, ND, to Executive Secretary, FDIC, October 24, 1977; ibid. Some bankers felt that the regulations unfairly "require[ed] all lenders to prepare another form because of alleged abuses by central city banks." John Hardie, New Hampshire Savings Bank for the People, to Alan Miller, FDIC, November 25, 1977; ibid.

necessary to monitor discrimination on the basis of sex. In their minds, it seems, either "fair housing" and/or lending itself did not apply to women.

The more compelling objections included the legitimate concern that gathering demographic information could offend or arouse the suspicion of applicants, and the assurance of many bankers that increased costs would be passed on to consumers. Bank President Doris M. Tarrant reported that in a pilot program using the proposed form, "customer reaction ran from irritation of completing another government form to irritation with the bank for inquiring into areas that it was their understanding were prohibited by equal lending laws."[115] J. Denman Morrison of Washington Mutual Savings Bank wrote, "quite understandably, it is difficult to convince people who have perhaps experienced discrimination in the past, that having written down their race and sex in your loan file, you are not going to use that information in making your final determination."[116] The new questions likely did arouse skepticism from some applicants, but only because they were so new. Had the FDIC adopted such regulations in the immediate wake of passage of the Fair Housing Act, such confusion could have been avoided. Most civil rights activists had long since determined that collection of racial data, though not without its downside, was essential to efforts to monitor and enforce fair housing law.

Second in frequency only to the objection to added paperwork, many bankers charged that additional record keeping would ultimately increase the cost of borrowing. Merle J. Prins warned, "[it is] the consumer who is ultimately the victim of all these

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[115] Tarrant, United Jersey Bank, to Executive Secretary, FDIC, November 16, 1977; ibid.

[116] J. Denman Morrison, Washington Mutual Savings Bank, to Executive Secretary, November 3, 1977; ibid.

regulations."[117] Letter after letter promised that costs would be passed on to borrowers.[118] An Indiana cashier argued, "in the end the consumer you are trying to protect will bear the costs of all this legislation in the form of higher rates and closing fees, as well as in a slower, more complex, more rigid mortgage process."[119] Disingenuous or not, such concern for "the consumer" actually elevated the interests of borrowers, in general, over those borrowers who might become victims of discrimination. Though framed in the most generous terms, it was yet another way to say that the possible social benefits did not justify the costs.

A few of the opponents sought to turn the language of nondiscrimination to their advantage. In a particularly angry letter, C.V. Smith, President of Tennille Banking Company in Georgia fumed, "your people are not satisfied unless they are writing some regulations concerning discrimination. But, the fact of the matter is, they are creating wholesale discrimination against businesses by making it more and more difficult to show a black bottom line."[120] Others charged, "this is discrimination against bankers,"[121] and "I feel sometimes like we're the people who are being discriminated against."[122]

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[117] Merle J. Prins, First Michigan Bank and Trust Company, Zeeland, MI, to Executive Secretary, FDIC, November 23, 1977; ibid.

[118] Perry Stewart, The Miami Deposit Bank, Yellow Springs, OH, to Executive Secretary, November 25, 1977; ibid. George R. Geer, Jr., to Executive Secretary, FDIC, November 10, 1977; Ibid. D.W. Mawer, The Huntington Bank of Toledo, Toledo, OH, to Executive Secretary, FDIC, November 4, 1977; ibid.

[119] Brent Clifton, Grabill Bank, Grabill, IN, to Executive Secretary, FDIC, November 11, 1977; ibid. Similarly, John P. Howard of Deep River Savings Bank in Connecticut mused, "whether or not the consumer is actually benefiting from all of these regulations remains to be seen. One thing for, sure, he is certainly paying for them." John P. Howard, Deep River Savings Bank, Deep River, CT, to Executive Secretary, FDIC, October 25, 1977; ibid.

[120] C.V. Smith, to Executive Secretary, FDIC, n.d.; ibid.

[121] C.E. Hendrix Jr., Horatio State Bank, AK, to Executive Secretary, FDIC, November 3, 1977; ibid.

[122] Estel Wyrick Jr., The Edon State Bank Company, Edon, OH, to Executive Secretary, October 26, 1977; ibid.

The letters indicate a link between fair housing policies and a rising chorus in favor of deregulation.[123] For most bankers, the fair housing, equal credit, disclosure, and community reinvestment policies constituted yet another layer of red tape that imposed additional costs and burdens. Some objected specifically to the social objectives of these particular regulations, and even those who did not do so explicitly, did place the fair housing regulations into a category of unnecessary or unbeneficial regulations, as opposed to the beneficial ones, such as Regulation Q. In reacting to the fair housing regulations, the bankers adopted a rhetoric calling for deregulation generally, "NO MORE PAPERWORK, PLEASE…,"[124] "we are regulated to death,"[125] fair housing regulations are "a sledgehammer being used to kill a mosquito,"[126] and "it would be nice if we had time to do some banking business, rather than just fill out forms."[127] But these bankers would also have been among the vast majority that greatly valued FDIC insurance, not to mention Regulation Q. The deregulatory impetus that grew in response to the fair housing and reinvestment regulations did not amount to universal support for any and all types of deregulation, but rather remained selective and self-interested.

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[123] This finding is consistent with the argument of Harris and Milkis that Regan-era deregulation especially targeted "social regulation." Richard A. Harris and Sidney M. Milkis, *The Politics of Regulatory Change: A Tale of Two Agencies* (New York: Oxford University Press, 1996), 5. Significantly, the bankers remained highly selective in their opposition to "economic" regulations.

[124] Richard Galloway, Community State Bank, Rockwell, IA, to Alan Miller, FDIC, November 17, 1977; Comments Re: Fair Housing.

[125] Alpha M. Hutchinson, The Citizens Bank, Morehead, KY, to Executive Secretary, FDIC, November 14, 1977; ibid.

[126] Robert H. Avery, Bat Harbor Banking and Trust Company, Bar Harbor, ME, to Executive Secretary, FDIC, October 25, 1977; ibid.

[127] Stanley Barber, Wellman Savings Bank, Wellman, IA, to Alan Miller, FDIC, November 14, 1977; ibid. See also, Carleton C. Van Dyke, Farmers State Bank, Marcus IA, to Executive Secretary, FDIC, October 31, 1977; ibid. H.L. King, South Baldwin Bank, Foley, AL, to Executive Secretary, FDIC, October 31, 1977; ibid. Ward T. Alling, Moodus Savings Bank, Moodus, CT, to Executive Secretary, FDIC, October 21, 1977.

Depending on one's perspective, the Equal Credit Opportunity, Home Mortgage Disclosure, and Community Reinvestment Acts either added to the regulatory burden or to the toolbox to fight discrimination in housing. Gregory Squires locates the origins of a social movement for community reinvestment in "the civil rights movement of the 1950s, the antipoverty campaigns of the 1960s, and a range of populist struggles of the 1970s."[128] He argues that the glacial response of the federal financial agencies to the Fair Housing Act led to the Home Mortgage Disclosure Act (HMDA) in 1975 and the Community Reinvestment Act (CRA) by animating activists into continuing agitation.[129] Senator Proxmire, a key figure in the efforts to lean on the financial regulators for fair housing enforcement, collaborated with Gale Cincotta of National People's Action, an umbrella organization that coordinated grassroots community activism, to become the chief proponent of HMDA and CRA in Congress.[130] Cincotta rose to the forefront of the reinvestment movement through her activism in Chicago, which then became a model for efforts in other cities. Beginning in 1969, Cincotta had led the Organization for a Better Austin (OBA) to fight the consequences of redlining in a Chicago neighborhood using tactics such as picketing, opening and immediately closing accounts, and depositing large amounts of pennies. The OBA joined with other community groups to form larger coalitions to span the city. The groups' persistence brought lenders to the negotiating

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[128] Gregory D. Squires, "Community Reinvestment: An Emerging Social Movement," in *From Redlining to Reinvestment: Community Response to Urban Disinvestment* edited by Squires (Philadelphia: Temple University Press, 1992), 2. On the Community Reinvestment Act, see also, Dan Immergluck, *Credit to the Community: Community Reinvestment and Fair Lending Policy in the United States* (Armonk, NY: M.E. Sharpe Press, 2004), and Richard Marisco, *Democratizing Capital: The History, Law, and Reform of the Community Reinvestment Act* (Durham, NC: Carolina Academic Press, 2005).

[129] Squires, 9-10.

[130] Ibid., 10.

table where they promised to renew efforts to lend to previously underserved neighborhoods.[131] In 1974, one of these negotiations, between the Bank of Chicago and the Organization of the NorthEast, culminated in an unprecedented formal, written community reinvestment agreement. The agreement required the bank to prioritize lending in previously redlined neighborhoods and to provide semiannual reports of the geographic distribution of both loans and deposits. This settlement served as a test case for the types of disclosure that could be required of the nation's banks and thrifts.[132] That year, Cincotta and National People's Action began meeting with Senator Proxmire and his staff to work toward federal legislation requiring disclosure of lending patterns, and later, community reinvestment.[133]

Scholarly attention to the problem of redlining bolstered the activists' case. Proxmire requested a Congressional Research Service study of lending in Washington, DC during 1973, which found that DC Savings and Loans made only 10.8% of their total lending within the District.[134] In 1974, a literature review on redlining circulated within the FHLBB with the conclusion that "the bulk of evidence supports the hypothesis that overt discrimination on the basis of race and sex is still practiced widely, in spite of federal mandates to the contrary."[135] The paper contended that while redlining was no

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[131] Jean Pogge, "Reinvestment in Chicago Neighborhoods: A Twenty-Year Struggle," in Squires, *From Redlining to Reinvestment*, 133.

[132] Ibid., 134-5.

[133] Immergluck, *Credit to the Community*, 143.

[134] Committee Staff Study, in Senate Committee on Banking, Housing and Urban Affairs, *Home Mortgage Disclosure Act of 1975: Hearings before the Committee on Banking, Housing, and Urban Affairs, 94th Cong., 1st sess.* (Washington, DC: GPO, 1975), 12.

[135] Kerry D. Vandell, Barbara Silbert Hodas, and Rachel Bratt, under the supervision of Arthur P. Solomon, "Financial Institutions and Neighborhood Decline: A Review of the Literature," November 1974; Home

longer formally practiced in most cases, that disinvestment by area continued, and that ostensibly neutral underwriting practices had a greater negative impact on women and minorities. “The evacuation of conventional capital from a neighborhood,” the report argued, “results in a fall of the area into ‘the underworld of real estate finance,’ characterized by the presence of mortgage brokers, shorter terms, lower ceilings, higher payments, second and third mortgages, low amortization, and such instruments as land installment contracts.”[136]

The preponderance of evidence notwithstanding, the FHLBB took no proactive steps in response to the 1974 report. Not until almost a year later, in September 1975, did FHLBB Acting Chairman Garth Marston write that the issue of redlining “is building to still another crescendo. Our efforts must be focused on what is in the best interests of the public, including the borrower, the saver, and the general. This means that the savings and loans must be making proper efforts to make economically sound home loans available to a broad spectrum of the American people.”[137] The banks and financial regulators had likely hoped that the issue would simply go away. In May 1975, Steven Doehler of the National Association of Realtors wrote to FHLB Board Member Grady Perry that the banking and thrift industries were joining forces against Proxmire’s disclosure bill (S. 1281) and indicated that the bill would not likely be passed,

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Mortgage Disclosure Act of 1975–Redlining; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[136] Ibid.

[137] Garth Marston, to FHLBB Staff; Home Mortgage Disclosure Act of 1975–Redlining; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

"Proxmire's Nader-like bills always have a tough time!"[138] But ongoing pressure from community activists, coupled with Proxmire's political clout, precipitated the introduction of the Home Mortgage Disclosure Act. Proxmire's hearings on the act occasioned debate not only over the issue of urban disinvestment, but also over the proper function of depository institutions as financial intermediaries. At the center of the debate over disclosure and community reinvestment rested competing visions of the role of depository institutions: one emphasizing an ethical obligation to the community of an institution's charter, and another that emphasized the market obligation to direct capital to its most efficient (and profitable) use. Critically, the activists and cooperating policymakers behind HMDA and CRA held to the former, more traditional view, and designed the legislation accordingly. But increasingly, the latter viewpoint was winning out, facilitated by deregulatory policies that made deposit capital more mobile than ever, and thus more difficult to harness for purposes of local reinvestment.

HMDA hearings featured witnesses representing community advocacy groups from Chicago, Milwaukee, Cincinnati, Indianapolis, and Providence. In his opening remarks, Proxmire cited the damning study of redlining in DC, while subsequent witnesses offered evidence of redlining in each of their cities every bit as stark as the data from DC. For example, Cincotta testified that National Security Bank in Chicago invested only $172,000 of its $33 million in savings in the neighborhoods that shared the zip code of the bank's branches.[139] In addition to such evidence, which highlighted the

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[138] Doehler, to Perry, May 30, 1975; Home Mortgage Disclosure Act of 1975–Redlining; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[139] Senate Committee on Banking, Housing and Urban Affairs, *Home Mortgage Disclosure Act of 1975: Hearings before the Committee on Banking, Housing, and Urban Affairs, 94th Cong., 1st sess.* (Washington, DC: GPO, 1975), 168.

virtual absence of lending in particular neighborhoods, Illinois Governor Dan Walker and Cincotta both stressed the subtler forms of redlining, including higher rates and/or down payments, and shorter mortgage terms.[140] In other words, while discrimination and redlining could still mean exclusion from access to housing or financing, more and more, it meant access on unequal terms.

The community activists all explicitly or implicitly expressed the conviction that depository institutions had an obligation to issue loans where they collected deposits. Cincotta pleaded "we are not asking for handouts. All we are asking for is a fair return on our savings into our communities."[141] Senator Sparkman (D-AL) agreed with this view of the role of depository institutions, "I have the old time feeling about a savings and loan association that it is a community affair and ought to serve the community from which it gets its savings."[142] Governor Walker argued that depository institutions, by virtue of their charter had a "limited form of monopoly" and thus, an obligation to serve their community.[143] But others challenged this vision, indicating that Sparkman's "old time feeling" was exactly that, one that no longer conformed to the imperatives of a modern economy.

Countering the traditional view, Fed Chairman Arthur Burns wrote to Proxmire of the proposed HMDA, "one of the main functions of financial intermediaries is to provide greater mobility for the economy's savings and investments…. To insist that capital should not normally flow out of a lender's market is to risk inhibiting the flow of capital

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[140] Ibid., 174.

[141] Ibid., 171.

[142] Ibid., 164.

[143] Ibid., 166.

that is essential to support vigorous economic growth in the nation as a whole."[144] Senator Garn also challenged the premise that local deposits should be used for local credit, positing instead that intermediaries properly functioned to divert capital from areas of surplus to areas of deficiency.[145] FHLBB Chairman Garth Marston likewise noted that there was no statutory duty for S&Ls to invest in particular neighborhoods, "rather this is left to be determined by the institutions themselves in the exercise of sound business judgment."[146]

Debating the HMDA in the House, Representative John Rousselot (R CA), too, questioned the notion that depository institutions should reinvest locally, arguing that such a practice would "undermine more than forty years of Federal effort to assist in the development of effective secondary mortgage markets for the express purpose of facilitating the transfer of money from areas where funds are plentiful to other areas where they are needed."[147] Proxmire anticipated such an objection in Home Mortgage Disclosure hearings, conceding, "admittedly, we need to recognize the importance of maintaining a flexible secondary mortgage market and a national pool of mortgage credit. But how can we tell a citizen of Boston, for example, whose neighborhood is redlined, that Massachusetts is considered a 'capital surplus area' and that his savings have gone to build condominiums in Arizona?"[148]

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[144] Ibid., 20-21.

[145] Garn, *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 27601.

[146] Garth Marston, to Walter Fauntroy, October 22, 1975; Home Mortgage Disclosure Act of 1975–Redlining; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[147] Rousselot, *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 34565.

[148] Senate Committee on Banking, Housing and Urban Affairs, *Home Mortgage Disclosure Act of 1975*, 2.

Theodore Snyder of the Alliance of Concerned Citizens in Milwaukee indicated that Proxmire's redlined Boston resident was not merely a hypothetical example. He testified, "I have been told straight out that it's much more attractive to resell mortgages to FNMA or GNMA that are out in Brookfield or in some other suburban area of Milwaukee than it is to sell a mortgage that is on 23d and Vine down on the West Side. So in a way the Government has sort of helped this along too with the extra money-raising scheme of the secondary mortgage market."[149] Proxmire walked a fine line, wanting both the additional capital that could be raised for residential mortgages in a national market, but desiring greater accountability to particular localities.

Echoing earlier debates on the Fair Housing Act, HMDA opponents claimed that any intervention in the free flow of capital embroiled the government in the decidedly un-American activity of "credit allocation." John Perkins, testifying for the American Bankers Association, grumbled "I have an increasing concern about the tendency to write into law ways and processes which will allocate credit. America was built on the free market system which has been highly productive and efficient in developing the highest standard of living in the world."[150] Garn warned that the bill was "the first step toward credit allocation," though conceding that mere disclosure did not constitute credit allocation by itself.[151] Following Garn's "first step" logic, proposed anti-redlining regulations in California contributed to concern over where disclosure requirements might eventually lead. An internal FHLBB memo reviewing the California rules

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[149] Ibid., 403.

[150] Ibid., 885.

[151] *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 27602.

concluded that their proposed "Boards of Inquiry" and "a 'shared-risk pool of mortgage money… goes far beyond simple disclosure, with its notion that the public can decide what to do with its own money when it has enough information, and clearly involves a form of credit allocation which will prove uneconomic and counterproductive."[152]

The invocation of the specter of "credit allocation" by HMDA opponents rested on and enhanced the complementary argument that activists intended to use disclosure to force banks into unsound lending. Governor Walker, like other proponents, countered that "there really is no evidence that we are talking about a higher risk in these [redlined] neighborhoods."[153] Rather, as Proxmire argued, the reluctance of lenders to enter particular neighborhoods based on increased risk became "a self-fulfilling reality."[154] Others insisted that valid economic considerations indeed constituted a higher risk in some neighborhoods.[155] Senator Taft (R-OH) argued, "in most cases the credit 'discrimination' probably results from a good-faith business judgment concerning the lending risks involved. Rather than blatant intentional discrimination as we usually use the term … the financial institution may feel that it can afford to be extremely conservative because it has plenty of business in the suburbs or wealthier neighborhoods."[156] As long as lenders could claim that sound business practice and objective assessments of risk dictated lending patterns, they could argue that geographic

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[152] "Internal Document–For Discussion Purposes Only: Preliminary Position Paper on California's Proposed 'Redlining' Regulation," September 11, 1975; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[153] Senate Committee on Banking, Housing and Urban Affairs, *Home Mortgage Disclosure Act of 1975*, 166.

[154] Ibid., 1.

[155] See, for example, Wille, to Proxmire, April 29, 1975, in ibid., 19.

[156] *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 27613.

and racial disparities resulted only incidentally to purely market-driven business imperatives: this as they affirmed their compliance with the Fair Housing Act as equal housing lenders.

The disclosure title's detractors mounted a serious challenge to the scope of its provisions. Garn, along with Senators Sparkman, Tower, Helms, Morgan, and Stone, offered an amendment that would have reduced the bill to a three-year, twenty metropolitan area pilot program, but the amendment was defeated 41 to 40.[157] The Senate then passed the nationwide disclosure initiative by a count of 45 to 37.[158] In the House, an amendment to delete the HMDA altogether failed, 152 to 191.[159] A second amendment, which would have reduced the act to an experimental program encompassing no more than twenty metropolitan areas, came just shy at 165 to 167, with three representatives, Joe Skubitz (R-KS), Butler Derrick (D-SC), and Bill Cohen (R-ME), changing their votes from "no" to "aye."[160] The full bill, which also included a two-year extension of Regulation Q, passed 177 to 147.[161] The Committee of Conference merged the Regulation Q extension, though reduced to 14 months, with the Home Mortgage Disclosure Title, including a House amendment stating, "nothing in this title is intended to, nor shall it be construed to, encourage unsound lending practices or the allocation of

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[157] *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 27618.

[158] There was 1 "present" vote, and 17 not voting. Ibid., 27623.

[159] Ibid., 34573. There were 5 "present" votes and 85 not voting.

[160] Ibid., 34575-6. There were 4 "present" votes and 98 not voting.

[161] Ibid., 34578. There were 11 "present" votes and 98 not voting. The Committee of Conference reduced the Regulation Q extension to fourteen months.

credit."[162] Both houses agreed to the Conference Report without roll call votes in mid-December, and President Ford signed the bill into law on December 31, 1975.

The enacted version of the Home Mortgage Disclosure Act responded to the finding that "some depository institutions have sometimes contributed to the decline of certain geographic areas by their failure pursuant to their chartering responsibilities to provide adequate home financing to qualified applicants on reasonable terms and conditions."[163] It required depository institutions within standard metropolitan statistical areas to disclose lending data broken down by census tract or zip code (as determined by the Fed) and allowed public officials to consider an institution's lending record to determine the placement of public sector investments. Senator Proxmire characterized the intent of the act, "citizens and public officials will be more successful in discouraging the practice of 'red-lining' or the refusal to lend mortgage money in older urban neighborhoods if they are armed with the facts."[164] Proxmire called disclosure the "least painful remedy" to the problem of urban disinvestment.[165]

Attentive to the act's express prohibition of "credit allocation," the financial regulators interpreted the scope of the law narrowly. In November 1976, Franklin L. Wright, an attorney in the FHLBB's Legislative Division wrote to Stephen Ege, Associate General Counsel that the legislative history of HDMA did not indicate that the

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[162] House, Committee of Conference, *Home Mortgage Disclosure Act,* 94th Congress 1st sess., H. rpt. 94-726 (Washington, DC: GPO, 1975). *Proquest Congressional* (accessed October 10, 2011).

[163] P.L. 94-200. Institutions with under $10,000,000 in total assets were exempted from the act's requirements. The vehicle bill, including the Home Mortgage Disclosure title passed the Senate by a vote of 45 to 37 on September 4, 1975. *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 27623.

[164] Proxmire, *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 40606.

[165] Ibid.

act required the regulatory agencies to compile HMDA data, but rather "the Act was intended to provide citizens with the information they need to determine whether depository institutions are fulfilling their obligations and to assist local public officials in their determination of the distribution of public sector investments."[166] "The intent of disclosure," Wright explained, "was to allow the use of the power of market competition–competition for the savers' dollar and for the business of potential homeowners–to encourage lenders to do a better job in their local service area."[167] Proxmire himself had endorsed this market-mechanism approach saying, "'I have proposed a simple disclosure law that would give local citizens the right to know where their neighborhood banks and savings and loan associations are making their mortgage loans, and I would expect an informed citizenry to do the rest.'"[168]

Despite the shared origins of the fair housing and community reinvestment movements and continuity in key Congressional advocates like Proxmire, once at the level of federal policymaking, implementation diverged in important ways that were related to the sequence of their passage. By the time that debate over redlining of urban neighborhoods commenced in Congress, non-discrimination on the basis of race had achieved reflexive, if hollow, acquiescence, despite the persistence of discrimination in practice and the delay in issuance of fair housing regulations. In large part, this removed explicit consideration of race from the debate over urban disinvestment. Civil rights advocates such as William Taylor and Clarence Mitchell, and even Senator Proxmire,

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[166] Franklin L. Wright, to Stephen Ege, November 9, 1976; Home Mortgage Disclosure Act of 1975–Redlining; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[167] Ibid.

[168] William Proxmire, quoted in "The Thin Red Line," *The New Republic* 172, no. 25 (June 21, 1975): 3-4. *Ebscohost* (accessed August 16, 2011).

noted the disproportionate effect of disinvestment on racial minorities,[169] but consensus over non-discrimination facilitated opponents' separation of the issue of urban disinvestment from race. Exemplifying this deliberate disconnection, FDIC Chairman Frank Wille wrote to Proxmire:

> to blame the degeneration of certain neighborhoods principally on the reluctance of financial institutions to invest in these neighborhoods is to ignore the realities of crime, poverty, delinquency, vandalism, and all the other social problems prevalent in today's world. This is not meant in any way to condone discrimination based on race, color, religion, or national origin, but rather to emphasize that there are legitimate economic considerations which banks should be permitted to assess in the granting of real estate loans, particularly in declining neighborhoods.[170]

Of course, Wille could argue, discrimination on the basis of race was wrong, but urban disinvestment was a separate issue, one based in "realities," in "legitimate economic considerations." But by relating the two issues, feeling the need to state that he was not condoning discrimination, he betrayed the deep association between race and ideas about neighborhood decline. On one hand, Wille's separation of the issues acceded to a central contention of fair housing advocates, that race had no inherent relationship to creditworthiness. On the other hand, insisting that "real," "economic considerations" had nothing to do with race robbed reinvestment proponents of a powerful argument, that the economic conditions of declining neighborhoods had everything to do with the consequences of past and continuing racial discrimination. This elision made nonsensical talk about credit allocation seem sensible. How else could legislators rail against impending credit allocation that would result from disclosure and reinvestment policies

[169] Taylor, for example, testified that the "redlining practices that you are concerned with in these hearings are often racially based …. Even when redlining is not explicitly based on race, minority groups suffer because they are disproportionately represented in areas that are redlined." Taylor, in Senate Committee on Banking, Housing and Urban Affairs, *Home Mortgage Disclosure Act of 1975,* 528-9.

[170] Wille, to Proxmire, April 29, 1975, in ibid., 19.

except to continue to ignore the fact that the previous 40 years of federal policy had been exactly that: credit allocation–to white, male suburban homeowners?

In his signing statement for the HDMA, President Ford tied together affirmation of nondiscrimination and opposition to new regulation and what he considered unacceptable credit allocation. Ford objected to the potentially costly and burdensome requirements of the title, though being sure to add, "I firmly believe, as do most people, that discrimination on racial or ethnic grounds is a practice which is abhorrent to our American way of life."[171] Ford also cautioned of a capital shortage and urged, "rather than support capital allocation, my Administration is committed to improve and strengthen the free market mechanisms used for raising and investing capital–particularly for housing."[172] Though capital allocation had worked against racial minorities in the postwar decades, Ford sought free capital markets that would foreclose the possibility of credit allocation that worked *for* racial minorities in neglected urban neighborhoods.

In this context, reinvestment proponents had to bend to the objections against credit allocation. There would be no affirmative mechanism to redress the decades of credit allocation away from both cities, and, not coincidentally, minority households. Instead, policies would include explicit prohibition of credit allocation, and muster only a mechanism to provide depositors with more information to weigh in making decisions about where to place their money. Community activists would make the most of this tool, using data from disclosure to expose institutions that, the groups claimed, did not fulfill

[171] Gerald R. Ford, "Legislation Concerning Financial Institutions, the National Commission on Electronic Fund Transfers, and Home Mortgages," January 1, 1976, *Weekly Compilation of Presidential Documents* 12, no. 1 (1976): 13-14. *HeinOnline* (accessed August 22, 2011).

[172] Ibid.

their obligation to meet local credit needs. As they did, they continued to advocate for yet greater leverage over the financial institutions. Again led by Cincotta in cooperation with Proxmire, these efforts focused on legislation that would become the Community Reinvestment Act.

There would not have been a Community Reinvestment Act without the backing of Senator Proxmire. Activists might have found another sympathetic ear in Congress, but not one so favorably positioned as the Chairman of the Senate Committee on Banking, Housing, and Urban Affairs. While Proxmire's receptivity and position made him the optimal partner to National People's Action and other community and consumer advocacy groups, his conception of an effective community reinvestment law fell somewhat short of the proactive program envisioned by Cincotta and other activists. Whether due to his assessment of what was politically feasible, or to his own reluctance to wield too heavy a government hand in the private sector, Proxmire steered the CRA away from the affirmative action model used in equal employment policy (and that favored by Cincotta) towards a more modest program in which regulators would merely *encourage* lenders to meet local credit needs.

Proxmire's reluctance to create an intrusive federal mechanism for community reinvestment grew out of his self-fashioned political identity as a taxpayer watchdog. To the extent that he had a national reputation, Americans knew Proxmire for his "Golden Fleece" award, which he periodically bestowed on government programs or policies that he found to be particularly wasteful. Though not an extremist, Proxmire leaned towards containing government spending whenever possible, whether he considered the cause wasteful or, as in this case, worthy. The community groups largely agreed with Proxmire

that community reinvestment should come from the private sector. For her part, Cincotta believed that conventional lenders considered a direct government financing presence in a neighborhood a sign of high credit risk and instability, thereby precipitating redlining by the private sector if it did not exist already. For somewhat different reasons, then, both Proxmire and Cincotta sought to harness the considerable capital resources of private lenders to revitalize America's inner cities.

The obstacles to a community reinvestment act became apparent as soon as Proxmire floated the proposal to the regulators at the end of 1976. Echoing criticism of HMDA, FHLBB economist Donald Kaplan questioned the very premise of the CRA, "at what point does preferential treatment of local market area loans become non-economic? Even aside from the fact that at some point, local market loans may not be the most profitable available, there is the issue of safety and soundness–that is the possibility that investment in unsound loans may be forced on lenders."[173] Another FHLBB staffer, Richard C. Pickering, wrote to Kaplan, the CRA "makes the unlikely (and undemonstrated) assumption that the primary market area of an institution is coterminous for deposits and loans."[174] As had become evident in debate over the HMDA, the community groups' vision of locally oriented and obligated financial institutions diverged from that of many policymakers who viewed the institutions as primarily oriented towards a national or even global capital market.

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[173] Donald Kaplan, "Attached Draft of Community Reinvestment Act," December 28, 1976; Community Reinvestment Act; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[174] Richard Pickering, to Kaplan, January 6, 1977; Community Reinvestment Act; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

Despite this icy initial reception, Proxmire forged ahead, introducing the CRA (as S. 406) on January 24, 1977. The bill required regulated depository institutions to demonstrate that they served the "convenience and needs," of their communities, explicitly including a "continuing and affirmative obligation to help meet the credit needs of the local communities in which they are chartered."[175] The bill called on the four financial regulatory agencies to use their chartering, examining, supervising, and regulatory authority to encourage institutions to meet those needs.[176] On the occasion of application for expanded authority, financial institutions would have to provide evidence of their efforts to delineate their primary service area, the deposit and credit needs of that area, the proportion of deposits from that area that would be reinvested there, and their actions to meet local credit needs. The bill also contained provisions to ensure that community involvement would be facilitated through hearings, and a requirement of periodic reports including data on deposits collected and credit extended.[177]

In preparation for hearings on the bill, Proxmire solicited comments from the four financial regulatory agencies. The FHLBB's response indicated agreement with the general objectives of the law, but declared that FHLBB policies already addressed those concerns, and maintained that "competition in the financial marketplace [is] the best mechanism to assure that diverse community needs are satisfied."[178] Arthur Burns

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[175] "S. 406, " in Senate Committee on Banking, Housing, and Urban Affairs, *Community Credit Needs: Hearings before the Committee on Banking, Housing, and Urban Affairs, United States Senate,* 95th Cong., 1st sess., (Washington, DC: GPO, 1977), 3-4.

[176] Ibid., 4.

[177] Ibid., 6.

[178] FHLBB, to Proxmire, March 7, 1977; Community Reinvestment Act of 1977; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP. Robert Bloom, Acting Comptroller of the Currency, responded similarly. Robert Bloom, to Proxmire, March 28, 1977; Community

responded to Proxmire similarly that the Federal Reserve already considered an institution's record on meeting community credit needs and that no additional legislation or regulation was required. Burns went further, however, to caution Proxmire that CRA regulations could be counter-productive if they restricted the flow of credit from capital-surplus areas to credit deficient communities, and that freely flowing capital with minimal restraints would better improve credit allocation. "We recognize, of course," Burns continued, "that markets do not always work in ways that maximize social priorities, and that thus there may be particular credit needs that public policy will need to encourage. But we should proceed more carefully and cautiously in imposing public policy objectives on private lending institutions since the effects on our present private competitive credit market system could be profound."[179] Burns reasoned that credit funneled to a particular use by law simply meant that some other credit need went unmet. He concluded, "indeed as long as depositors are free to move their funds where they perceive the highest return or the greatest safety, it may not be possible to mandate flows of credit into particular channels."[180] While the New Deal system of housing finance had long mandated the flow of credit into residential mortgages in exclusively white suburbs, deregulatory policies coupled with financial innovation and regulatory inaction were indeed enabling depositors to move their funds more freely. Burns and others could see financial markets moving in this direction, facilitated by federal policies, but activists continued to shape their policy initiatives to fit the traditional system.

Reinvestment Act; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[179] Arthur Burns, to Proxmire, March 21, 1977; Community Reinvestment Act of 1977; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[180] Ibid.

Representatives of the private sector such as California Federal CEO Robert Dockson assured CRA proponents that freer markets would benefit neglected neighborhoods: "Of all financial markets, the mortgage market has been the most afflicted by imperfections and barriers … the broader and freer the market, the better the … terms for borrowers and savers alike."[181] Dockson reasoned that communities needed to draw capital from any source and would benefit from the competition between local and non-local sources, which the CRA would limit. The CRA, he argued, "would make good guys out of institutions who both raised their money and lent it out in Beverly Hills, and bad guys out of Beverly Hills institutions who made all their loans in the Central City and East Los Angeles."[182] FHLBB economist Marshall Kaplan likewise observed the possibility of restrictions on institutions in high-income areas that sought to lend in low-income areas and noted, "Congress itself has enacted an institution designed to facilitate secondary market operations in mortgage markets that shift funds from capital surplus to capital deficient areas."[183] But Dockson and Kaplan defended hypothetical institutions that, as far as CRA proponents knew, did not exist. Which banks and savings and loans, exactly, took deposits from Beverly Hills to invest in East Los Angeles?

Mindful of these early reactions as well as the debates over the HMDA, Proxmire sought to squash the line of objection that contended that the CRA would require credit allocation. Though not commenting on *historical* credit allocation for suburban housing, Proxmire countered:

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[181] Robert Dockson, to Alan Cranston, April 15, 1977; Community Reinvestment Act; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[182] Ibid.

[183] Marshall Kaplan, to Donald Kaplan, January 5, 1977; Community Reinvestment Act; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

> We already have credit allocation… for the fortune five hundred…. We already have numerous structural forms of credit allocation the form of specialized credit intermediaries such as the farm credit banks, FNMA, Ex-Im Bank, and so on, which have preferential access to Treasury borrowings. We have structural credit allocation in the form of a specialized home loan bank system, mortgage insurance, and guaranteed small business loans.[184]

Proxmire's incisive assessment of the endemic credit allocating mechanisms within capital markets contrasted starkly to the more common view that erased the federal hand in structuring credit markets altogether.[185] This preemptive strike failed to curb accusations of legislative over-reach into private business affairs, however. Senator Tower, who had literally been out of the room while Proxmire made his case, charged "if Government sponsored credit allocation is used to channel credit to other borrowers, it necessarily will use the credit for less productive purposes [than borrowers 'willing to pay the highest interest rates after allowance for risks'] and the economic well-being of the Nation as a whole will suffer."[186]

Senator Garn had also been absent for Proxmire's lecture on the pervasive role of the federal government in allocating credit. In an angry outburst following Proxmire's testy exchange with a witness from the American Bankers Association, Garn took the opposing position. "Damn it to hell," Garn ranted, "we have had 200 years of the private sector building the greatest country…. The answer isn't more rules and regulations. Piecemeal, we are heading for credit allocation and Government bureaucrats sitting back here interfering with the private sector. I'm sick and tired of the antibusiness attitude of

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[184] Senate Committee on Banking, Housing, and Urban Affairs, *Community Credit Needs*, 2.

[185] David M.P. Freund, *Colored Property: State Policy & White Racial Politics in Suburban America* (Chicago: University of Chicago Press, 2007). 139.

[186] Senate Committee on Banking, Housing, and Urban Affairs, *Community Credit Needs*, 153.

this committee."[187] Referring to the ABA witness, Garn continued, "you are insulted day after day, treated rudely, but the Kathleen O'Reillys, the Ralph Nader's have their asses kissed every day and are told how wonderful their testimony is over and over again, while we are building up a regulatory burden that is going to destroy the housing industry in this country."[188]

Community reinvestment and consumer advocates challenged Tower and Garn's assumption that local credit needs targeted by the CRA represented unproductive purposes. They articulated a vision of financial institutions cooperatively obligated to the communities in which they had been chartered. Echoing Proxmire, Ralph Nader testified that the CRA embodied the principle that "if the Federal Government is going to extend a whole array of benefits, privileges and subsidies to banking institutions, that the same government should condition these privileges and subsidies on the grounds of some general criteria of responsiveness to the community where the subsidized institution is operating and receiving its deposits."[189] He added, "for too long the Federal Government has looked on its chartering responsibility as a mechanical clerical function, instead of asking what kinds of performance should be obtained within the market structure, so that these charters can have some sort of recompense in terms of the public interest."[190] Proxmire argued that by virtue of accepting a charter to a "semiexclusive franchise" with limited entry of competitors, deposit insurance, low cost credit via the Federal Reserve and Federal Home Loan Banks, and low cost funds, protected by interest rate ceilings

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[187] Ibid., 324.

[188] Ibid.

[189] Ibid., 18.

[190] Ibid., 21.

(Regulation Q), the institutions obliged themselves to serve the "'convenience and needs'" of their local community. Proxmire sought through the CRA to emphasize that convenience and needs included credit needs.[191]

Though encouraged by the general thrust of the bill, several of the witnesses called for a more forceful community reinvestment law than what Proxmire had introduced. Cincotta argued that all financial institutions must be obligated to undertake affirmative steps to meet local needs, not merely those in the process of applying for charter, branching, or merger.[192] She further argued that the act should take account of historical neglect of particular neighborhoods and require affirmative action to meet the needs of those areas. Cincotta, in calling for an affirmative obligation to "historically neglected neighborhoods," reasoned, "it wasn't good enough to say we will hire minorities, you had to put a program together and have disclosure to see how your program was working."[193] Cincotta, in particular, indicated a preference for a more proactive policy, as Proxmire put it, "like the affirmative action we have in the civil rights program."[194]

Henry Schechter, an economist representing the AFL-CIO, pushed for a more comprehensive assessment of the financial institutions' reinvestment records. Recognizing the ambiguity between "legitimate economic considerations," and the discriminatory practices they sought to end, he argued, "there is a need for a record that would enable a Federal financial supervisory agency to judge whether the individual

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[191] Ibid., 9-10.

[192] Ibid., 132.

[193] Ibid., 159.

[194] Ibid.

institutional assessment of risk is or is not reasonable."[195] To accomplish this, he recommended that every applicant who was refused a loan be provided with a written explanation that would also be available for the review of the financial regulators.[196] Conrad Weiler, the Chairman of the Alliance for Neighborhood Government, based in Philadelphia, too called for additional reporting requirements. He recommended a "Neighborhood Reinvestment Impact Statement" to ensure that community reinvestment did not cause displacement by facilitating an inflow of middle income homebuyers, as he put it, "re-suburbanizing the city."[197] Schechter and Weiler believed that the additional information would be essential to an effective community reinvestment policy, but the requirements would undoubtedly elicit protest from lenders who felt they were already overburdened with regulation. Proxmire proved reluctant to push in the direction of additional reporting requirements, seeking to deprive opponents of the objection that the CRA paperwork would be unduly arduous.

The CRA hearings again revealed the divergent visions of the role of depository institutions as capital intermediaries. The CRA reflected the position that the institutions should have a local orientation. Yet even some proponents of the law indicated that institutions had long been trending away from a community-centered mission. Nader noted that the savings and loans and mutual savings banks had lost their original character in which "they were to be controlled by depositors in fact, not just in law. And they were to be responsive to the local community, because of that local control."[198]

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[195] Ibid., 151.

[196] Ibid.

[197] Ibid., 218-9.

[198] Ibid., 163.

Nader prophesied "an increasing sophistication of international [capital] flight," that would make it ever more difficult to provide for local needs.[199] Edwin Brooks, representing the U.S. League of Savings Associations, insisted that financial institutions should not be bound by community boundaries. He argued, "the markets for savings and for loans are distinct and separate. They cannot be linked as S. 406 suggests. Loans may be needed by younger families in bedroom neighborhoods and suburbs; savings may be available in downtown locations near jobs or in retirement communities."[200]

The competing views, and the challenge their divergence posed for reinvestment, were especially apparent in an exchange between Senator Sarbanes (D-MD) and FHLBB Chairman Garth Marston.

> Sarbanes: "if market forces are working won't they put the money clearly where they can get the greatest return?"
> Marston: "Sure, I think they should."
> Sarbanes: "Don't they have other places where they could put the money where they will get an adequate return? We're not asking them to lose their money or lend it out at no return, but where they will get an adequate return. Yet the push will always be to go to the top end of the spectrum, will it not?"
> Marston: "Yes sir."
> Sarbanes: "How do you get them, then, to service areas from which they are drawing their money?"[201]
> Marston: "I think the approach to that is to make those loans less risky."[202]

Marston had returned, then, to carrots, not the relatively soft stick of the CRA, indicating that this might occur through government insurance of loans.[203]

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[199] Ibid., 164.

[200] Ibid., 364.

[201] Ibid., 267.

[202] Ibid., 268.

[203] Ibid., 273.

Proxmire's star witnesses, more so than Cincotta and Nader, were two bankers, Ronald Grzywinski of Chicago, and Todd Cooke of Philadelphia who testified of their positive, and profitable, experiences lending in previously redlined neighborhoods in their respective cities.[204] They offered proof that reinvestment could be carried out by the private sector and that it could be done profitably and without increased risk to the lenders. Grzywinski and Cooke could not be easily dismissed by Garn and Tower. Grzywinski, Chairman of the Executive Committee, South Shore National Bank of Chicago testified that since the bank had committed to investing in South Shore, home values had increased by 50%. In its reinvestment orientation, however, he found his bank to be an exception in Chicago, "the unfortunate conclusion I have come to is that bank managers may be well-intentioned on [reinvestment], but the simple fact of the matter is that the system rewards earnings, and development or reinvestment in neighborhood is an additional short-term cost…. It seems as though nothing much is going to happen, if we don't do something."[205]

Like Grzywinski, Cooke argued that financial institutions had a "primary and continuing responsibility to the community in which it is authorized to operate." He went on to support the use of the regulatory agencies' "chartering, examining, supervising and regulating authority," to encourage lenders to meet that obligation.[206] Cooke cautioned, however, against "permitting socially desirable constraints to overbalance [the] vital economic role [of transferring funds from areas of surplus to those of shortage]," which

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[204] Ibid., 1-2.

[205] Ibid., 299.

[206] Ibid., 292.

he claimed, "will cripple financial institutions and their ability to function effectively in the public interest in either capacity."[207] He also warned that excessive rulemaking by the financial regulators could create undue burdens for institutions without corresponding benefit to the public.[208]

In committee mark-up, Proxmire and the rest of the committee bent toward the warnings of Cooke and compromise with the bill's opponents rather than to the calls of Schechter and Cincotta for a more aggressive law. Instead of the additional reporting requirements that Schechter had advocated, the marked-up CRA relied primarily on the data already required by HMDA. And despite Proxmire's argument that markets already contained structural mechanisms of credit allocation, the CRA, like the HMDA, had to meet a double standard requiring explicit prohibition of credit allocation. This put Cincotta's call for affirmative action in the vein of equal employment programs outside of future debate over the CRA.

The committee report explained that while the financial regulators had the authority to encourage financial institutions to meet local credit needs under existing law, "the need for new legislation arises because regulating agencies lack systematic, affirmative programs to encourage lenders to give priority to the credit needs of the home areas."[209] Eager to curb cases in which "local lenders export savings despite sound local lending opportunities," the report argued that the regulatory agencies, without any new data collection requirements, could make a more affirmative effort to encourage local

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[207] Ibid., 291.

[208] Ibid.

[209] Senate Committee on Banking, Housing, and Urban Affairs, *Housing and Community Development Act of 1977*, 95th Cong., 1st sess., S. rpt. 95-175 (Washington, DC: GPO, 1977), 33.

lending. Specifically, it urged the regulators to leverage approval of merger and branching applications to ensure that institutions met local credit needs.[210] The committee rejected the possibility of setting percentage targets of local lending, as its explanation of the title concluded, "the Committee rejects the assertion that this Title allocates credit. It simply underscores the long-standing obligation to an institution's local service area implicit in existing law."[211] In a dissenting view, Senators Morgan, Lugar, Schmidt, Tower, and Garn argued that the CRA "would have adverse effects upon the free flow of capital within our economy, and 'a rose by any other name' is still 'credit allocation'."[212] They contended that increased record keeping requirements would ultimately reduce the amount of credit available in communities in need.[213]

Compared to the Fair Housing Act and the Home Mortgage Disclosure Act, the CRA had a stealthy journey through Congress. Proxmire added the CRA to the larger Housing and Community Development bill during committee mark-up. Surviving an effort to remove it from the bill,[214] the CRA passed along with the full housing and community development bill by a count of 79 to 7, with 14 not voting.[215] In Conference, the House acceded to the Senate provisions that required the financial regulators to weigh an institution's community reinvestment record in decisions regarding applications with an amendment narrowing consideration of the credit needs of "'the entire community,

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[210] Ibid., 33-35.

[211] Ibid., 35.

[212] Ibid., 85.

[213] Ibid.

[214] *Congressional Record,* 95th Cong., 1st sess., 1977, 123: 17637.

[215] Ibid., 17862.

including its low and moderate income neighborhoods’,” to those of its “‘primary service area’.”[216] Though the latter designation implied a more restricted geographical scope, neither offered an unambiguous definition of community. On October 1, the Senate agreed to the conference report by a vote of 55 to 19, with 26 senators not voting. The House followed suit a few days later, and President Jimmy Carter signed the bill into law on October 12, 1977.

The lesson learned from the decade long struggle to force the federal regulators to issue fair housing regulations, the CRA included the statutory requirement that regulations take effect within 390 days of enactment of the CRA. The agencies issued proposed regulations early in 1978 and collected public comments. Predictably, bankers responded strongly against proposed CRA regulations. They lodged familiar objections to additional “red-tape”[217] and “another batch of paperwork,”[218] that would increase costs. As they had with fair housing regulations, some rural bankers complained that the issue was a problem for big city banks, but did not concern them.[219] Thomas J. Aron, a President of a bank in Nebraska, wrote, “one can not consider making a loan to every

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[216] House Committee of Conference, *Housing and Community Development Act of 1977,* 95th Cong. 1st sess., H. rpt. 95-634 (Washington, DC: GPO, 1977), 76. *Proquest Congressional* (accessed October 11, 2011).

[217] Donald Rogers, Association of Bank Holding Companies, to Secretary, Board of Governors, Federal Reserve System, February 17, 1978; Implementation of Community Reinvestment Act; Comment Letters–1978; Comment Letters Concerning Proposed Changes to Regulations, 1975-1980; Office of the Executive Secretary; Records of the Federal Deposit Insurance Corporation; RG 34; NACP.

[218] Max Kiernan, President, Alton Savings Bank, Alton, IA, to Secretary, Board of Governors, Federal Reserve System, February 2, 1978; Implementation of Community Reinvestment Act; Comment Letters–1978; Comment Letters Concerning Proposed Changes to Regulations, 1975-1980; Office of the Executive Secretary; Records of the Federal Deposit Insurance Corporation; RG 34; NACP.

[219] See Kiernan, and David Hanna, Jr., President, First Federal Savings of Newton, Newton, KS, to Secretary, Board of Governors, Federal Reserve System, February 6, 1978; ibid.

would-be applicant. Fortunately, our community does not have a color or ethnic problem. We will continue to serve the community to the best of our ability."[220]

Many charged that the language of the regulations was too vague, particularly on defining "community." Wisconsin bank president L.L. Riley mused, "if and when we have a second coming of Christ, perhaps we could get a good definition and in the meantime I doubt that any earthly human being could properly define 'entire community'."[221] Riley argued that "credit needs" could no more easily be defined, especially against credit demands. The regulators sought to allay the concerns over defining community while still allowing some flexibility to the institutions. They suggested using existing boundaries, such as county lines, or the area from which the institution drew over half of its deposits and contiguous neighborhoods, so long as neither redlined low-income neighborhoods. The regulations did little however, to help institutions negotiate the determination of credit needs versus demands.

The bankers saved their most virulent comments to charge that the CRA constituted "credit allocation," and would invariably lead to lenders being forced to make unsound loans. "Government dictated credit allocation," Edwin M. Bergsmack wrote, "is the ultimate fear of the banking community. If great care is not taken in drafting

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[220] Thomas J. Aron, President, Crete State Bank, Crete, NE, to Alan Miller, FDIC, February 2, 1978; Implementation of Community Reinvestment Act; ibid.

[221] L.L. Riley, President, Bank of Sparta, Sparta, WI, to Secretary, Board of Governors, Federal Reserve System, February 8, 1978; Implementation of Community Reinvestment Act; ibid. See also, Ralph L. Hodgkins, Jr.,, President, Mid-Maine Mutual Savings Bank, Auburn, ME, to Secretary, Board of Governors, Federal Reserve System, n.d.; Kenneth Birch, President, Hudson City Savings Bank, to Secretary, Board of Governors, Federal Reserve System, February 10, 1978; C.R. Stahl, Jr., Executive V.P., Alamo Savings Association, to Theodore Allison, Board of Governors, Federal Reserve System, February 15, 1978; Implementation of Community Reinvestment Act; ibid.

regulation to implement compliance with the act, this fear may be realized."[222] L.J. Herbert, Jr., agreed, "it seems to me that this is a move on the part of Congress to allocate credit on a social basis rather than credit allocation according to market needs and demands."[223]

The four financial agencies used nearly all of their 390 day allotment, issuing final rules on October 12, 1978, with an effective date of November 6, 1978. The regulations required each institution to map its community, with explicit direction not to exclude low- and moderate-income neighborhoods. The lenders had ninety days to adopt a community reinvestment statement that would be available both to regulators and to the public. The agencies indicated that an institution's record of meeting the credit needs of its community would be taken into account when considering applications for charter or change in charter, branching, merger, or membership, and that an application could be denied on the basis of a poor record. Affirmative attempts to discern credit need, affirmative marketing, allegations of discrimination or attempts to discourage loan applications, the geographic distribution of credit extension, applications, and denials, origination of residential mortgage loans in its community, and participation in government insurance programs could be considered as part of an institution's record.

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[222] Edwin M. Bergsmack, Executive V.P., The Toledo Trust Company, Toledo, OH, to Secretary, Board of Governors, Federal Reserve System, February 23, 1978; ibid.

[223] L.J. Herbert, Jr., President, LaFourche National Bank of Thibodaux, Thibodaux, LA, to Secretary, Board of Governors, Federal Reserve System, February 23, 1978; ibid. "In essence you are saying that the Free Enterprise system is dead," wrote one Illinois banker. Lawrence A. Stevens, Loan Officer, First National Bank of Bloomington, Bloomington, IL, to Secretary, Board of Governors, Federal Reserve System, February 3, 1978; ibid. Ray Ponton argued that the "American system of free enterprise <u>competition</u> would adequately ensure that the <u>legitimate</u> credit needs of the entire community were being met." Ray Ponton, V.P., First–Taylor National Bank, Taylor, TX, to Secretary, Board of Governors, Federal Reserve System, February 22, 1978; ibid.

The agencies also increased the frequency of public notifications required to announce applications, in order to facilitate greater public participation in the process.[224]

An April memo to the Chairman outlined the FHLBB's recommendations for CRA enforcement. The Office of Community Investment recommended defining "local community" as both the geographic area in which an institution makes the majority of its loans and the areas proximate to an institution's offices. The OCI urged that local government officials and representatives of community groups be included in CRA compliance examinations.[225] A second memo later that month recommended that FHLBB urge S&Ls to proactively formulate "Community Investment Plans" to allow the institutions to set their own reinvestment standards and suggested "defusing future potential protest by involving local government and community groups in the planning process."[226] The memo outlined two separate review protocols depending on the existence of CRA-related protest. In the case of substantial protest, the memo recommended hearings that "at least initially, …should facilitate strong community involvement," including oral testimony from community members.[227]

An internal FHLBB memo set the following criteria for assessing an institution's record for meeting local credit needs:

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[224] Comptroller of the Currency, et al., *Federal Register* 43, no. 198 (October 12, 1978): 47144-47162.

[225] Office of Community Investment, to Chairman McKinney, "Key Board Questions for CRA Implementation with Specific Recommendations on Each Question," April 5, 1978; Community Reinvestment Act of 1977; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[226] Alvin Hirshen, Director, Office of Community Investment, to Chairman McKinney, "Description of Recommended CRA Regulation and Implementation Process," April 18, 1978; Community Reinvestment Act of 1977; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[227] Ibid.

> The extent of the institution's marketing and special credit-related programs to make community members aware of the credit services the institution offers. The institution's participation, including investments, in local community development or redevelopment projects or programs. The institution's participation in government-insured guaranteed or subsidized loan programs for housing, small business or small farms.[228]

CRA enforcement was effectively envisioned as a market mechanism–given information about where institutions invested, consumers could decide where to put their deposits. A January 1979 press release by the Federal Reserve on behalf of the financial regulatory agencies urged institutions to follow the "spirit of the [CRA] legislation, and try to avoid narrow, legalistic interpretations."[229] Richard Marisco argues that up to mid-1997, CRA enforcement, in accordance with the prohibition on credit allocation, focused on institutions' efforts to market their services in local communities, rather than their actual lending.[230] The FHLBB did consider any record of formal complaints of discrimination or other consumer complaints when reviewing a community service record in conjunction with an application.[231] Mobilization by community organizations could gain the attention of the regulators and potentially block branch openings and mergers. As imperfect as this mechanism remained, community activists finally had recourse to fight redlining.

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By the close of the 1970s, fair housing and community reinvestment advocates could look back on a decade of hard-won legislative and regulatory achievements. The

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[228] "Programs which May Help Meet Credit Needs," November 9, 1978; Community Reinvestment Act of 1977; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[229] Federal Reserve, "Press Release," January 15, 1979; Community Reinvestment Act of 1977; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[230] Marisco, 6.

[231] See, for example, Federal Home Loan Bank Board, "Resolution No. 79-493," *Minutes of FHLBB,* 185 (1979); General Records; Records of the Federal Home Loan Bank Board; RG 195; NACP.

overwhelming majority of mortgage lending depository institutions operated under the authority of fair housing regulations that prohibited lending discrimination on the basis of race, national origin, age, sex, and location and age of property. Furthermore, the regulatory agencies required those institutions to record and report data that enabled both the regulators and the public to monitor lending patterns and with some recourse to enforcement mechanisms that promised to hold institutions accountable. Advocates were acutely aware of the limitations of these tools, but nonetheless sought to employ them to achieve a truly equal market for housing and the revitalization of the nation's cities.

Critically, the proponents of fair housing and community reinvestment had failed to shift debate over credit allocation. Despite Proxmire's efforts, most of the actors involved refused to acknowledge the pervasive role of the federal government in allocating credit towards certain types of housing. Even Proxmire failed to acknowledge the consequences of past government credit allocation in building a dual, racialized housing market and a residentially segregated nation. While past credit allocation remained largely invisible to most, any hint of credit allocation towards inner cities and their residents elicited quick and harsh repudiation from opponents. That both the HMDA and CRA contained explicit prohibitions against credit allocation indicate the considerable sway of the arguments against what had long been an endemic feature of U.S. housing markets, just with different beneficiaries. In this climate, activists such as Gale Cincotta had little hope of advancing the case for affirmative financing programs modeled after the principles of affirmative action programs in employment or higher education.

Yet even a more aggressive, affirmative policy like that envisioned by Cincotta, so long as it depended on the authority of the financial regulators, would have been severely undercut by the policy changes that would occur in the late 1970s and early 1980s. Both the decade-long battle for fair housing regulation of lenders and the Community Reinvestment Act hinged on vigorous enforcement by, or at least, the authority of, the four financial regulatory agencies. During the 1970s, as advocates waged these battles, the majority of mortgage lending originated in institutions regulated by those agencies. Yet, as documented above, the debates over fair housing regulation and community reinvestment revealed an underlying debate over the role of financial intermediaries. Though the battle had not been settled by the end of the 1970s, those advocating freer capital markets, with depository institutions fully integrated into national or global markets and obliged to the highest return rather than to any local responsibility had, by the mid-1980s, won the debate. This left community reinvestment grounded in a view of depository institutions that increasingly diverged from reality. By the mid-1980s, mortgage brokers and secondary market investors would increasingly dominate mortgage markets, largely outside the reach of the regulatory agencies. A small handful of the witnesses who testified in hearings on HMDA and CRA urged lawmakers to extend the reach of the acts to cover the activities of mortgage brokers and the government-sponsored enterprises in the growing secondary markets, but those recommendations fell on deaf ears.[232] The debates over the deregulatory policies that would so severely

[232] See, for example, Governor Dan Walker, who testified that HMDA should be expanded to included mortgage bankers. He argued, “mortgage bankers are deeply involved in this problem, primarily through the FHA programs.” Walker, in Senate Committee on Banking, Housing and Urban Affairs, *Home Mortgage Disclosure Act of 1975*, 24. See also, Edwin Brooks, who pointed out that the reach of the CRA as written, extended only to the lenders under the jurisdiction of the four financial regulators, and thereby did not include “mortgage bankers, insurance companies, pension funds, finance companies, [or] credit

undermine the fair housing and community reinvestment regulatory regime seldom considered the possibility. In fact, the deregulation of interest rate ceilings, which would precipitate further deregulation, found its champion in Senator William Proxmire, who seemed to see no contradiction in his advocacy for both deregulation and community reinvestment.

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unions." Brooks, in Senate Committee on Banking, Housing, and Urban Affairs, *Community Credit Needs*, 365-6.

Chapter 3

The Fight to End Regulation Q, 1971-1980

Howard Healy of Milwaukee wrote to Senator Proxmire in 1979, "Why does the government limit the interest paid by banks on savings accounts? Inflation is far ahead of interest. How can I save for retirement? My earnings are being confiscated by a greedy government. We are angry."[1] Healy's interest rate was limited by Regulation Q. A ceiling on the amount of interest that banks and, eventually, thrifts could pay on deposits, Regulation Q helped ensure a source of low-cost capital for housing. If banks and savings and loans paid 3% interest on the deposits they collected, the logic went, they could issue relatively low interest mortgages at 6% and still clear a profit. While the savings and loan industry credibly argued that this system made homeownership more widely attainable, some critics argued that the rate ceilings distorted the efficient flow of capital, and others, like Healy, argued that it was just unfair.

As early as the 1961 Report of the Commission on Money and Credit, modification of Regulation Q had been part of a wider agenda to reorganize the nation's financial structure. This broader deregulatory agenda sought to erode the specialization of financial institutions–or at least ensure that specialization resulted from choice and not statute–in order to foster greater competition among all types of financial institutions. The underlying philosophy, that competition in a free market would achieve the most efficient allocation of resources, flew in the face of the then decades old New Deal

[1] Howard T. Healy, to Proxmire, March 3, 1970; Folder #28 "Small savers, 1979," Box 93A, William Proxmire Papers, Wisconsin Historical Society, Madison, WI.

system of housing finance that employed law and regulation to allocate credit to achieve the social goal of homeownership for an increasing number of white Americans.

This chapter documents the protracted and contentious process by which Regulation Q was challenged through proposed legislation, financial innovations, regulatory actions, and a critique on behalf of, and eventually by, "small savers." Structural weaknesses in the regulatory regime, including competition from unregulated financial services firms and a dual-banking system in which regulatory responsibility was split between state and federal authorities, made Regulation Q vulnerable. This chapter, along with chapter four, seeks to demonstrate how decisions made by regulators early in the 1970s shaped *but did not determine* subsequent policy options. It argues that deregulation of interest rate ceilings was not inevitable. Rather, a strong defense of Regulation Q by many bankers, nearly all thrift officials, organized labor, and for most of the decade, the majority of lawmakers, made Regulation Q exceedingly resilient.

Recovering the contingency and contentiousness of the debate over Regulation Q serves to highlight the process by which proponents of deregulation and restructuring of the New Deal system of housing finance (and the financial services industry more broadly) struggled to advance their agenda until they were joined by supporters of the comparatively narrower push to deregulate interest rate ceilings. In the latter group were lawmakers such as Senator Proxmire, who while eager to eliminate interest rate ceilings remained dubious about, or deeply opposed to other elements of the broader deregulatory agenda of the former group.

I argue that the critical development in the advancement of the narrow agenda of deregulation of interest rate ceilings was advocates' framing of liberalization of

Regulation Q as essential to allowing consumer-savers to battle soaring inflation. Even then, Regulation Q might have persisted if not for deft legislative maneuvering that linked a phase-out of interest rate ceilings to authorization of popular consumer accounts already in use. The push to achieve market rates of return for small savers merged with a defense of the accounts to break the logjam of competing interests that had fought over Regulation Q throughout the 1970s, tipping the balance toward deregulation of rate-ceilings.

The small saver emerged first as a theoretical construct, briefly, but symbolically significantly, as a protest movement, and, most importantly, as an inapt but effective phrase employed by policymakers to describe the group of saver-investors who were not particularly small and who disrupted the New Deal system by pulling their savings out of depository institutions to seek higher yields through alternative investment instruments. Increasing numbers of savers opted out of the New Deal regulatory structure or demanded that the structure be changed to yield them market rates, and lawmakers responded. Remarkably, in adopting the cause of the "small saver," policymakers privileged the interests of consumer-savers over those of consumer-borrowers. Borrowers, as regulators and lenders alike repeatedly assured lawmakers, would bear the costs of "fair," market rates of return for savers, through higher interest rates and fees (that savers would also pay). Finally, this chapter shows how advocates of broad deregulation linked the deregulation of interest rate ceilings to deregulation of the investment powers of banks and thrifts to a limited extent in the DIDMCA. Chapters five and six will demonstrate how this leveraging resulted in further deregulation of bank and thrift asset powers in the early 1980s.

A Brief History of Regulation Q

In response to the Great Depression, policymakers devised a complex of new laws and regulations that they hoped would restore the safety and soundness of the nation's financial system. The Banking Act of 1933, more famous for its establishment of federal deposit insurance, authorized the Federal Reserve to set a ceiling, which came to be known as Regulation Q, on the rates of interest paid by Federal Reserve member commercial banks to attract deposits. Further solidifying the new regulatory regime, the Banking Act of 1935 extended this authorization to cover nonmember commercial banks through the Federal Deposit Insurance Corporation (FDIC).[2] Lawmakers intended the ceilings to limit competition for deposits and thereby boost bank profits. They hoped that this profit protection would make banks less likely to pursue the types of risky (and potentially profitable) investments that had contributed to the Depression and would offset the cost of newly created deposit insurance premiums.[3] Policymakers also believed that Regulation Q would make rural banks more prone to reinvest locally than to direct their deposits to large, money center banks.[4]

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[2] R. Alton Gilbert, "Requiem for Regulation Q: What It Did and Why It Passed Away," *Federal Reserve Bank of St. Louis Review* (1986): 22-37. http://research.stlouisfed.org/publications/review/86/02/Requiem_Feb1986.pdf (accessed October 17, 2011). Technically, Regulation Q refers only to the Federal Reserve regulation governing member banks. The FDIC and Comptroller of the Currency, and, after 1966, the FHLBB, set interest rate ceilings for their respective regulated institutions. These ceilings were coordinated, however, as they had to be uniform for banks, and at no greater than the statutory differential higher for thrifts. In practice, policymakers and lawmakers typically referred to all of these interest rate ceilings as "Regulation Q."

[3] Ibid.

[4] Gilbert finds that small banks actually tripled their holding in money-center banks by 1941. Greta R. Krippner notes that Regulation Q, by inducing disintermediation, could cause a slowdown in the construction industry which, in turn, could curtail expansion of the economy. Accordingly, policymakers could use Regulation Q as a course tool for managing the economy. See Krippner, *Capitalizing on Crisis: The Political Origins of the Rise of Finance* (Cambridge: Harvard University Press, 2011), 61-2.

The consequences of the interest rate ceilings, however, were much wider than policymakers had intended, particularly in promoting housing finance. Commercial banks could not offer more than the Regulation Q ceiling on deposits, but savings and loans, institutions singularly focused on residential mortgage lending, could. By offering rates slightly higher than the Regulation Q ceiling, S&Ls could enjoy a competitive advantage over the commercial banks, but still have a predictably low cost of funds. As Leon T. Kendall of the U.S. Savings and Loan League would argue in 1962, the higher returns offered by thrift institutions were "the primary reason that savings association growth in savings volume exceeds that at other deposit-type institutions," and could thereby support the residential mortgage market.[5] From 1947 to 1960, while commercial banks held steady at around 30% share of household savings, S&Ls increased their share from 8.7% to 28.7% (from $9.8 billion to $62.2 billion).[6] If Kendall's attribution was correct, the ability of S&Ls to outbid commercial banks for savings had dramatically expanded the volume of capital attracted by the institutions statutorily obligated to support housing.

This system operated with minimal controversy until 1966. That year, believing that competition between banks and thrifts (mutual savings banks and savings and loans, both of which specialized in residential mortgage lending) for household deposits had contributed to a sharp rise in general interest rates, Congress extended Regulation Q authority again, this time to include the nation's thrift institutions. In order to assure the flow of credit to residential mortgages, Congress mandated that the ceiling for the latter institutions would be slightly higher than that for commercial banks.[7] This slightly higher

[5] Leon T. Kendall, *The Savings and Loan Business* (Englewood Cliffs, NJ: Prentice-Hall, Inc., 1962), 44.

[6] Ibid., 39. U.S. Savings bonds lost about 20% of their market share over this period.

[7] Ibid.

rate, which came to be called "the housing differential," or just, "the differential," became a persistent point of contention between commercial bankers who charged that the differential was discriminatory and thrift officials who maintained that the differential was essential to the vitality of the housing market. Lawmakers justified the differential based not only on the desirability of funneling capital toward housing, but also on the competitive advantage enjoyed by commercial banks to offer check-writing, a power denied to the thrifts.

In July 1970, following another period of rising interest rates and disintermediation–the transfer of deposits from one financial intermediary into other investment outlets–the Federal Reserve exempted deposits of over $100,000 with maturities between 30 and 90 days from Regulation Q ceilings.[8] Like the differential, this latter change too would cast a long shadow over subsequent debate over Regulation Q. The exemption of large denomination CD's created a two-tiered system of deposits, separating corporations and wealthy depositors whose savings did not fall under Regulation Q ceilings from the majority of individual savers whose savings did. Prior regulations had already established different, and higher, ceilings for deposits over $100,000,[9] but the July regulations created a *ceilingless* category available only to those who could meet the $100,000 minimum. In 1973, the Federal Reserve eliminated Regulation Q ceilings on certificates over $100,000 of any maturity, thereby completing

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[8] Federal Reserve System, "Part 217–Interest on Deposits," *Federal Register* 35, no. 125 (1970): 10501.

[9] Effective January 21, 1970, for example, 30-59 day maturity certificates of over $100,000 could earn a maximum of 6¼% while certificates of the same maturity but less than $100,000 could earn a maximum of 5%. See, Federal Reserve System, "Part 217–Interest on Deposits," *Federal Register* 35, no. 20 (1970): 1156.

the differentiation of deposit accounts above and below that amount.[10] These early actions by Federal Reserve regulators created crucial context for subsequent political and economic developments that precipitated further, ultimately complete, deregulation of interest rate ceilings. First, the regulatory distinction between rates of return available to savers with over $100,000 to invest and those without that amount gave meaning to the claim that Regulation Q discriminated against small savers. This claim, in turn, provided the basis for a populist, pro-consumer argument in favor of deregulating interest rate ceilings. Second, the exemption of account categories over $100,000 from rate ceilings directly led to the development of money market mutual funds, funds that pooled money from many depositors in order to reach the $100,000 minimum. Competitive pressure from these accounts then prompted regulators to loosen Regulation Q ceilings on several categories of thrift and bank accounts. Though the regulators' actions in 1970 and 1973 proved critical in the eventual elimination of Regulation Q, both the political (the discrimination against small savers argument) and economic (money market mutual funds) challenges to interest rate ceilings developed slowly over the course of the 1970s.[11]

The prevailing understanding of Regulation Q throughout much of the decade remained that the interest rate ceilings promoted housing finance. Bank and, especially, thrift executives came to understand Regulation Q as a vital tool in keeping their cost of money low, thereby enabling them to lend money at relatively low rates and still make a

[10] Federal Reserve System, "Part 217–Interest on Deposits: Large-Denomination Certificates of Deposit," *Federal Register* 38, no. 101 (1973): 13728.

[11] Furthermore, as will be discussed in chapter four, these early actions were not inherently irreversible, though they possessed attributes which fostered "positive feedback," giving the policies considerable inertia. On positive feedback and inertia, see Paul Pierson, *Politics in Time: History, Institutions, and Social Analysis* (Princeton: Princeton University Press, 2004).

profit. This became a sort of conventional wisdom, captured by some variation of the "3-6-3 rule," as Niall Ferguson has written, the "3-6-3 rule: pay 3 per cent on deposits, lend money at 6 per cent and be on the golf course by 3 o'clock every afternoon."[12] Though, as noted above, the original reasons for the ceilings were not explicitly related to housing, Deputy Treasury Secretary Stephen Gardner, for example, could (inaccurately, but sincerely) testify in 1975, "Regulation Q ceilings on deposit rates were initially intended to assure funds for housing by protecting thrift institutions from competition for savings deposits."[13] By limiting lenders' cost of funds and by making that cost relatively stable and predictable, Regulation Q joined a host of other New Deal interventions to create a distinct and privileged capital market for owner-occupied housing in the United States.[14] Eager to promote homeownership and the health of the construction and real estate industries, Congress routinely reauthorized the financial regulatory agencies' power to set Regulation Q and related ceilings from 1966 to 1980.

Congressional reauthorization, however, became less reflexive and more contentious over the course of the 1970s. Increasing volatility in interest rates created more frequent periods of disintermediation. When market rates rose above Regulation Q ceilings, some depositors would remove their savings from thrift institutions, tightening the availability of credit for housing. Consequently, residential construction alternately boomed and busted over the decade. As rising inflation during the late 1970s widened the

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[12] For just one, recent iteration of this formulation, see Niall Ferguson, *The Ascent of Money: A Financial History of the World* (New York: Penguin Press, 2008), 251.

[13] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Variable-rate Mortgage Proposal and Regulation Q: Hearings before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance,* 94th Cong., 1st sess., (Washington, DC: GPO, 1975), 329.

[14] Ann Meyerson, "The Changing Structure of Housing Finance in the United States," *International Journal of Urban and Regional Research* 10, no. 4 (1986): 465-497.

difference between market rates and the Regulation Q ceilings on deposits, more and more policymakers argued that the rate ceilings discriminated against small savers. Given the recent record of instability in the flow of credit to housing, many of those policymakers believed that the trade-off, protected, low-cost capital for housing, no longer justified the low returns to savers. Others, especially those in the thrift industry, clung to the older model, claiming that if inflation could be contained, the system could continue to function well, and that in any case, removal of Regulation Q would hasten the demise of the thrift industry and the availability of credit for housing with it.

Challenges to Regulation Q

Despite its remarkable success in expanding homeownership, the New Deal system of housing finance had its critics from its inception and a critique of certain aspects, including Regulation Q, became formalized at several points through the postwar decades.[15] Some economists supported the case against Regulation Q, arguing that interest rate ceilings stood in the way of the efficient operations of the market, failed to adequately provide a stable source of capital for housing (especially during periods of inflation), and discriminated against "small savers." Two national commissions, the Commission on Money and Credit (CMC) in 1961, and the Hunt Commission in 1971, as well as the 1975 Financial Institutions in the Nation's Economy (FINE) Study by the House Banking Committee, called for modification or outright removal of Regulation

[15] For a history of the opposition to New Deal housing finance regulations beginning with the Committee for Economic Development in 1942, see Richard Florida, "The Origins of Financial Deregulation: The CMC, Heller Committee, and the Friend Study," in Florida, ed., *Housing and the New Financial Markets* (New Brunswick, NJ: Rutgers, 1986): 49-65.

Q.[16] Financial innovations also challenged the integrity of Regulation Q. Unregulated[17] non-bank financial institutions created new instruments including money market mutual funds and variable-rate debt offerings that competed with banks and thrifts for household savings, but were not subject to the same rate ceilings. This left regulators with the option to seek broader authority to extend Regulation Q to cover the new instruments, to loosen restrictions on regulated institutions to permit them to compete with the deposit-alternatives, or to do nothing, allowing the innovators to circumvent and undermine Regulation Q. For their part, the financial regulators appeared increasingly ambivalent or conflicted towards Regulation Q. Both Republican and Democratically appointed regulators jockeyed with Congress and with their constituent institutions to balance various parochial interests against contested national social and economic goals. Finally, by the late 1970s, consumer groups and advocates including Consumers Union, the Gray Panthers, and Ralph Nader began to actively protest Regulation Q ceilings as a grievous injustice against savers. Under assault from these various fronts for over a decade, Regulation Q proved remarkably resilient until the late 1970s. Not until elimination of Regulation Q became identified as a populist measure to aid inflation-embattled small savers did a majority coalition of lawmakers back the end of interest rate ceilings over the objections of the majority of bank and thrift officials.

In the 1960s and 1970s, two national commissions, the Commission on Money and Credit and the Hunt Commission, and the House Banking Committee (through the

[16] Similar assessments of financial structure and regulation include those of the Heller and Dillon Committees and the FHLBB-sponsored Friend Study in the 1960s, see Florida.

[17] That is, not regulated by the agencies responsible for interest rate ceilings. In many cases, the institutions introducing innovative instruments fell under the purview of the Securities and Exchange Commission.

FINE study) convened to comprehensively study the workings of the financial structure of the United States, and issue recommendations for reform. Though a pervasive deregulatory impulse is less clear in the case of the CMC, both the Hunt Commission and, later, the FINE study, endorsed broad deregulation of financial institutions and the system of housing finance. These early articulations of a case for financial deregulation offer important insight into the intellectual tradition that informed debate on deregulation in the late 1970s. Much of the substance of what financial deregulation did take place in the late 1970s and 1980s emerged from these commissions and studies. Yet most of the deregulatory recommendations of the CMC, Hunt Commission, and FINE Study, including those regarding Regulation Q and variable-rate mortgages, failed to gain majority support in Congress until the early 1980s. The intellectual force of the ideas regarding deregulation was not sufficient to alter federal policy. Only when political circumstances allowed, namely once these ideas became fused with an agenda on behalf of consumer-savers, did they become the basis for broad financial restructuring.

The first of these, the Commission on Money and Credit (CMC),[18] a privately funded group charged with making general recommendations for the U.S. economy, suggested a modest modification of Regulation Q. The CMC recommended that Regulation Q authority be revised to make the regulation a "stand-by authority rather than continuous regulation," engaged only in cases when competition for deposits posed

[18] The Commission members were: Frazar B. Wilde (Chairman), H. Christian Sonne (Vice Chairman), Adolf Berle, Jr. (withdrew), James Black, Joseph Dodge, Marriner Eccles, Lamar Flemming Jr., Henry H. Fowler (resigned), Gaylord Freeman, Fred T. Greene (died), Philip Klutznick (resigned), Fred Lazarus, Jr., Isador Lubin, J. Irwin Miller, Robert Nathan, Emil Reve, David Rockefeller, Beardsley Ruml, Stanley Ruttenberg, Charles Sawyer, William Schnitzler (resigned), Earl B. Schwulst, Charles Shuman, Jesse Tapp, J. Camerson Thomson, Willard L. Thorp, Theodore Yntema.

a threat to the public interest.[19] It also suggested that this stand-by authority should apply to mutual savings banks and savings and loans as well as commercial banks. Stanley Ruttenberg, one of two representatives of the AFL-CIO on the Commission, dissented, arguing, “the interest rate ceiling has served an exceedingly useful purpose in relieving the pressure for increased earnings which lead to imprudent loans and investments.”[20] Ruttenberg did concede that thrift institutions should have the same ceiling as commercial banks.[21] This latter concession indicated that the labor representative, at this time, did not see the ceilings primarily in relation to housing, but rather, in terms of the general safety and stability of the financial system. Neither lawmakers nor regulators acted on the CMC’s recommendations. When lawmakers did, in 1966, extend the ceilings to cover the thrift industry, they gave the S&Ls a higher ceiling (the differential), and subsequent reauthorizations of this authority made the regulations effectively continuous, not stand-by, as the CMC had proposed.

A decade after the report of the CMC, President Nixon convened a Commission on Financial Structure & Regulation, known as the Hunt Commission, to again assess the condition of the nation’s financial structure. The commission brought together representatives of various financial institutions, academics, and Lane Kirkland as the sole representative of organized labor. Notably, Kirkland refused to sign the completed report, offering a dissent instead. The general thrust of the report moved “as far as possible

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[19] Commission on Money and Credit, *Money and Credit: Their Influence on Jobs, Prices, and Growth* (Englewood Cliffs, NJ: Prentice-Hall, Inc., 1961), 166-168.

[20] Ibid., 168.

[21] Ibid. The thrift industry did not share Ruttenburg’s assessment, nor would subsequent representatives of the AFL-CIO as debate over Regulation Q continued into the 1970s. After Congress extended Regulation Q to cover thrifts in 1966, at a differential, the link between the ceiling and credit for housing became more apparent. See testimony of Henry Schechter of the AFL-CIO below.

toward freedom of financial markets and [to] equip all institutions with the powers necessary to compete in such markets … [to] work more efficiently in the allocation of funds."[22] The Commission aimed especially to dissolve all statutory and regulatory distinctions between financial institutions, while recognizing the need to do so gradually, in order to allow institutions to adjust to new competitive conditions. The Commission reported a preference for direct subsidies or tax credits to achieve social goals unmet by the market, arguing "financing through control of the portfolios of financial institutions [such as the requirement that S&Ls invest in residential mortgages] is a costly and inefficient means of allocating resources."[23]

Reform of Regulation Q topped the list of the Commission's recommendations. The report called for the immediate removal of rate ceilings for all deposits over $100,000 (as regulators did in 1973), and, like the CMC, recommended that ceilings on other accounts be used only on an emergency, stand-by basis when needed to prevent disintermediation. This stand-by authority, the report continued, should be removed after ten years. In its explanation, the report argued that disintermediation during periods in which market rates exceeded Regulation Q ceilings had led to a contraction of mortgage funds, leaving consumers with higher borrowing rates. The Commission also claimed that "interest rate regulations have discriminated against small savers."[24]

In tandem with their recommendation to phase-out Regulation Q, the Commission proposed a broadening of investment authority for savings and loans including power to

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[22] President's Commission on Financial Structure and Regulation, *The Report of the President's Commission on Financial Structure & Regulation* (Washington, DC: GPO, 1971), 9.

[23] Ibid., 17.

[24] Ibid., 26.

issue mortgages of any kind, consumer loans (up to 10% of total assets), some types of equity securities, checking accounts, and credit cards. The report advocated the removal of any geographic limitations on lending, implicitly abandoning the notion advanced by community reinvestment advocates that an institution had a special obligation to serve its local community. In a separate section on "Housing and Mortgage Markets," the Commission also proposed the authorization of variable-rate mortgages. Significantly, the report suggested several consumer safeguards for such instruments "including full explanation of the terms to borrowers, the offer of an alternative fixed rate mortgage, limits on the permissible rate change, a publicly announced index on which rate changes are based, and, after an initial period, opportunities for 'no penalty' refinancing."[25] The Commission's final housing recommendation stated "in the event that mortgage financing is not adequate to achieve national housing goals, Congress should provide direct subsidies to consumers," explaining "direct subsidies avoid the warping of financial institutions, they are visible, and they are less inflationary than agency borrowings."[26]

The Hunt Commission Report informed debate over financial regulation for the next decade. It provided a baseline for a deregulatory agenda, though political considerations led proponents to pursue the various recommendations at different times rather than as a package. A cynical reading of the Commission's admonition that social goals, if not met by the free market, should be pursued through direct subsidy might conclude that the members expected that making subsidies more visible would also make them less politically palatable. Yet it is also feasible to conclude that the commission

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[25] Ibid., 77.

[26] Ibid., 78, 86.

members simply believed direct subsidies would be more efficient and cost-effective. In either event, a later generation of deregulation proponents, those ushered into power by the election of Ronald Reagan, would largely abandon this position, instead reasoning that if the market did not provide capital for a particular use, it was not only inefficient, but not a worthwhile social goal.

Though Regulation Q authority rested with the federal financial agencies, Congress had created the ceilings, and subsequently reauthorized them, with the expectation that they be enforced. Whether they agreed with the idea of ceilings or not, the regulators dared not eschew their authority to set Regulation Q unless the Congress specifically directed them to do so. Likewise, federal law dictated the specialization of financial institutions and governed the broad outlines of deposit and asset powers. Though a vision for a deregulated financial structure solidified by 1970 in the Hunt Commission Report, realization of that vision would require action by Congress. The Nixon and Ford administrations attempted to implement most if not all of the Hunt Commission recommendations through comprehensive financial legislation, but faced a resistant legislature. To the enduring frustration of reformers, not until 1980, in the form of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA), did some semblance of the broad financial deregulation envisioned by the Hunt Commission garner sufficient support to become law.

The Hunt Commission offered a slate of recommendations that, it urged, should be adopted as a package. The report warned that "piece-meal adoption of the recommendations raises the danger of creating new and greater imbalances."[27] The

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[27] Ibid., 9.

political realities of the day, namely the Democratic majority, as well as divided committee jurisdiction over the various proposals, however, made such comprehensive reform unfeasible. In October 1973, the Nixon Administration proposed The Financial Institutions Act of 1973.[28] The proposal reflected the general thrust of the Commission recommendations, but the Administration cherry-picked the initiatives that it felt stood the best chance of Congressional approval. The streamlined version left out the Hunt Commission recommendations on variable-rate mortgages, removal of state usury ceilings, and an end to restrictions on statewide branching, and proposed a five and a half year phase-out of Regulation Q (while the Hunt Commission had recommended ten years). Finally, responding to the innovation of a Massachusetts Savings Bank to join third-party payment (essentially check-writing) to an interest-bearing savings account called a Negotiable Order of Withdrawal (NOW) account, the bill proposed authorization of NOW accounts for all banks and thrifts. The 93rd Congress held extensive hearings on the proposal but took no action, despite the bill's selective scope.[29]

Greta Krippner writes that this legislation "pleased almost no one."[30] Displeasure stemmed from either objection to the particulars of the bill or the fact that it did not encompass the full range of reforms outlined by the Hunt Commission.[31] The federal

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[28] S. 2591, co-sponsored by Senators John Sparkman (D-AL) and John Tower (R-TX).

[29] Jay Brenneman, to Arthur Burns, March 17, 1977; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[30] Krippner, *Capitalizing on Crisis,* 74.

[31] The American Bankers Association (ABA), for example, expressed its disappointment that the proposed legislation did not include the full "package" recommended by the Hunt Commission, particularly as they sensed that movement on authorization of third-party payment (checking) accounts for all depository institutions might precede moves to even the competitive balance of thrifts and banks. Willis W. Alexander, Executive Vice President, American Bankers Association, "Executive Report," April 23, 1973, Folder "ABA 1973," Box B1, Arthur Burns Papers, Gerald R. Ford Library, Ann Arbor, MI.

financial regulators dutifully voiced support for the bill, though FHLBB Chairman Thomas Bomar expressed regret that it did not include variable-rate mortgage authorization,[32] and Federal Reserve Governor Robert Holland indicated that the Board of Governors feared that "proposed new investment powers for S.&L.'s might well not be sufficient to assure that thrift institutions could compete effectively for deposits during periods of high interest rates."[33] Robert Shay, a professor of banking, and representative of Consumers Union, the publishers of *Consumer Reports*, opposed the legislation for doing too little, urging a speed-up in the phasing out of Regulation Q, from five and a half years to two.[34]

Critics of the bill included ABA President and former Hunt Commission member Rex Morthland and AFL-CIO representative Nat Goldfinger. Morthand voiced the ABA's opposition to the Financial Institutions Act, including his admonition that "we do not believe that the public interest would be best served by eliminating Regulation Q ceilings now or in the foreseeable future," and that NOW accounts should not be authorized for either thrifts or banks.[35] Goldfinger too testified against the bill, though ironically in a way consistent with the Hunt Commission report's recommendation of direct subsidies to meet social goals, suggesting instead "a method of mandatory [credit]

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[32] Senate Subcommittee on Financial Institutions, *Financial Structure and Regulation: Hearings before the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs*, 93d Cong., 1st sess. (Washington, DC: GPO, 1973), 112.

[33] Ibid., 149.

[34] Senate Subcommittee on Financial Institutions, *Reform of Financial Institutions–1973: Hearings before the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs*, 93d Cong., 2d sess. (Washington, DC: GPO, 1974), 627.

[35] Speech draft, Rex Morthland, "Managing Change in Our Financial Institutions," before the Arizona Bankers Association, Phoenix, AZ, November 1, 1973, Folder "ABA 1974," Box B1; Arthur Burns Papers; Gerald R. Ford Library, Ann Arbor, MI.

allocation based upon social priorities," including housing.[36] Norman Strunk of the U.S. Savings and Loan League supported the expansion of thrift asset powers such as consumer lending, but added, "the proposals relative to Regulation Q ceilings could rather swiftly bury our business."[37] Like Bomar, Strunk faulted the bill especially for the absence of provisions allowing variable-rate mortgages. The rocky reception of the bill portended the myriad obstacles to comprehensive financial reform. The various vested interests, even if enthusiastic about deregulation in general, clung tightly to those regulations that afforded them competitive advantage or protection. Lawmakers risked offending one or more of several powerful lobbies (commercial banks, thrifts, organized labor) representing those interests by acting on the bill, and neither house brought the bill to the floor for a vote.

The Ford administration renewed reform efforts via the Financial Institutions Act of 1975. The bill again called for a five and a half year phase-out of Regulation Q, but with the additional caveat that at the end of that period, the administration would conduct an investigation to ensure that thrift institutions had indeed been able to adjust their portfolios sufficiently to be able to weather the removal of the protective ceilings.[38] The respective support and opposition of the regulatory agencies and industry groups lined up as they had during the previous Congress. Notably, consumers received fuller representation in 1975 than during the previous Congress when only Robert Shay of

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[36] Senate Subcommittee on Financial Institutions, *Reform of Financial Institutions–1973*, 595.

[37] Senate Subcommittee on Financial Institutions, *Financial Institutions Act–1973: Hearings before the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs*, 93d Cong., 2d sess. (Washington, DC: GPO, 1974), 381.

[38] Senate Subcommittee on Financial Institutions, *Financial Institutions Act of 1975: Hearings before the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs*, 94th Cong., 1st sess. (Washington, DC: GPO, 1975), 4.

Consumers Union testified specifically for consumers. In 1975, Jonathan Brown of the Public Interest Research Group testified, "regulation Q has, in effect, generated a hidden transfer of income from small savers to homeowners."[39] He added that many small savers would never be able to afford homeownership and thereby benefit from the subsidy. When Senator McIntyre asked Brown about variable-rate mortgages, however, Brown refused to link his opposition to Regulation Q to an endorsement of VRMs, saying "we are very much opposed to them."[40] This time the Senate passed the bill, which, like the 1973 bill, did not include authorization of variable-rate mortgages (VRMs).[41]

Senate passage of the bill indicated an increasing consensus among members of that body that Regulation Q should eventually be eliminated, but did not demonstrate an accompanying acceptance of the asset powers that thrifts insisted would best enable them to adjust to a post-Regulation Q environment, particularly the authority to issue VRMs. The House took no action on the bill, instead inaugurating its own comprehensive study of the financial system, and thereby stalling any significant legislative change governing regulation of financial institutions. A comprehensive bill was again proposed in 1976, but the only significant legislation passed regarding Regulation Q until DIDMCA in early 1980 were *extensions* of Regulation Q and related ceilings.

Within the authority bestowed by Congress to establish interest rate ceilings and maintain the differential, regulators at the Federal Reserve and FHLBB exercised

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[39] Ibid., 734.

[40] Ibid., 735. Kathleen O'Reilly, representing the Consumer Federation of America, also condemned both discriminatory interest rate ceilings and variable-rate mortgages. O'Reilly favored instead a requirement that all financial institutions devote a percentage of their portfolio to housing. Ibid., 740-1.

[41] *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 39964. *Lexis Congressional* (accessed November 1, 2011).

discretion in setting the level of the ceilings and determining which accounts and instruments should be subject to them. During the 1970s, the presidentially appointed regulators were largely sympathetic to the Hunt Commission recommendations and the legislative proposals to implement them. Both in their adjustments of existing regulations and decisions regarding market innovations, at several points during the decade, the actions of the regulators challenged the very premise of Regulation Q. Yet, owing to their accountability to Congress and their responsibility to the overall health of the economy, on other occasions regulators defended Regulation Q. Through the 1970s, tension persisted within the agencies between defenders of the New Deal regulatory regime with its rate ceilings and specialized lenders and those seeking the competitive environment envisioned by the Hunt Commission.

Regulators' first serious challenge to interest rate ceilings came in 1973, when they extended the exemption of ceilings on thirty to eighty-nine day maturity CDs over $100,000 to all CDs over that amount, as the Hunt Commission had recommended. Acknowledging that this move would be of little help to small savers, and hoping to prevent disintermediation as interest rates rose, regulators authorized a $1,000 minimum, four year or higher maturity, ceiling-less (exempt from Regulation Q) CD, effective July 1, 1973.[42] These instruments were called "wild-card" CDs due to their varying rates. Initially, banks could offer as many of these accounts as they wished, while the FHLBB limited S&Ls to having no more than 5% of their total deposits in wild-cards (in order to contain the increase in their cost of funds as depositors invested in the certificates). Freed to offer higher rates, the banks bid up interest rates seeking to enlarge their market share.

[42] Edward J. Kane, "Getting Along Without Regulation Q: Testing the Standard View of Deposit-Rate Competition During the 'Wild-Card Experience,'" *The Journal of Finance* 33, no. 3 (Jun., 1978): 921-932.

Fearing the consequences of a bidding war, less than a month after the authorization, regulators extended the 5% limit to banks.[43]

Authorization of the wildcard certificates generated tremendous controversy. S&L officials bombarded Congress and regulators with letters and telegrams of protest. Mrs. Helen O. Martin, for example, wrote to Fed Chairman Arthur Burns, "The long term four year category with no maximum rate is creating havoc in our area, since Commercial Banks are paying 8% or 8½%."[44] Martin pointed out the special problem this posed for lenders in Alabama, which had an 8% usury limit. When lenders had to pay at or near 8% to attract deposits, an 8% mortgage offered no profit, and extension of mortgage credit came to an abrupt halt. S&L President B. R. Bonds implored Burns, "Please sir, use your powers to stop this foolish 'Rat race' between the commercial banks …. I am sure it was not your intention to attempt to destroy the savings and loan industry."[45] Reflecting the same logic behind Congress's extension of Regulation Q to the thrifts in 1966, others charged that the banks' bidding war contributed to inflation.

California Representative and member of the House Committee on Banking and Currency Clair Burgener reported to Burns, "I am besieged by complaints from the industry in my District as well as from prospective home purchasers who find themselves in limbo…. Mortgage money at the new and higher interest rates will increase the monthly payments to a point where many prospective buyers are priced out of the

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[43] Ibid., 925.

[44] Letter, Helen O. Martin to Arthur Burns, July 19, 1973, folder "Savings and Loan Interest Rate Increase Correspondence Alabama–Georgia, 7/73," Box B94, Arthur Burns Papers, Gerald R. Ford Library, Ann Arbor, MI.

[45] Letter, B.R. Bonds, President Guaranty Savings and Loan Association, Birmingham, AL, to Burns, July 19, 1973, ibid. See, for example, Brooks Yeilding to Arthur Burns, July 18, 1973, and William R. McCranie, President, Bartow Federal Savings and Loan Association, Bartow, FL, ibid.

market."[46] Borrowers were not the only unhappy consumers, however. In order to ensure that depositors would not simply move money from one account to a higher yielding wild-card account within the same institution or from one depository institution to another (the idea was to attract *new* savings money), regulators had established withdrawal penalties punitive enough to discourage such transfers. This drew the ire of depositors like Leo Ricker, who wrote to his Congressman, "Rates are NOW skyrocketing–but I don't dare remove the money [from a 6% certificate] or I'll lose 3 months interest which is MORE than I'd gain at 8 ½ % … why should they make money on me?"[47]

During the second half of 1973, as the Wild Cards proliferated, thrift institutions' lending dropped to 500,000 new mortgages compared to 700,000 in the first half of the year.[48] Amid the uproar from S&Ls, homebuyers, and even some savers, Congress passed a Joint Resolution in October (PL 93-123) calling the regulators to "take action to limit the rates of interest or dividends which may be paid on time deposits of less than $100,000."[49] To Regulation Q advocates, the wild-card experience definitively demonstrated the perils of interest rate ceiling removal. Congress's swift reaction to re-

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[46] Letter, Clair Burgener to Arthur Burns, July 18, 1973, ibid.

[47] Letter, Leo Ricker, Miami, FL, to Congressman [Dante Fascell], July 21, 1973, ibid.

[48] Arthur Edgeworth, Counsel, U.S. League of Savings Associations, to Representative Fernand St. Germain, May 15, 1974, in House Subcommittee on Bank Supervision and Insurance, *Consumer Home Mortgage Assistance Act of 1974: Hearings before the Subcommittee on Bank Supervision and Insurance of the Committee on Banking and Currency* 93d Cong., 2d sess. (Washington, DC: GPO, 1974), 104.

[49] P.L. 93-123. Representative Frank Annunzio (D-IL) later said of the wild cards, "we passed Regulation Q extending it to December of 1974, and we gave these nonelected public officials the right to exercise flexibility. Well, they almost flexed most of you fellows [S&L officials] out of business." House Committee on Banking and Currency, *The Credit Crunch and Reform of Financial Institutions: Hearings before the Committee on Banking and Currency*, 93d Cong., 1st sess. (Washington, DC: GPO, 1973), 240.

impose Regulation Q protection gave the thrift industry reason to believe that lawmakers would continue to protect the housing lenders against competition for deposits.

For five years, regulators and lawmakers indeed backed away from ceilingless accounts. But into the late 1970s, as inflation continued to rise, money market mutual funds[50] proliferated, and a larger group of policymakers positioned themselves as defenders of the "small saver," regulators moved to give depository institutions a more competitive instrument to stem disintermediation. Effective June 1, 1978, regulators authorized a six-month, $10,000 minimum denomination "Money Market Certificate" (MMC), with a rate tied to that of six-month treasury bills. As depositors moved savings into the new accounts, the MMCs shifted thrift portfolios toward higher-cost, short-term deposits, precipitating an acute earnings crunch for the thrifts.[51] By the end of the year, 10.1% of S&L deposits ($42.8 billion) were in MMCs, a figure that rose to 27.6% ($127.3 billion) in December 1979.[52] The MMCs did allow thrifts to retain deposits that might otherwise have been lost to the money market mutual funds or Treasury offerings, but did so at increasing, and unsustainable, costs. S&L profitability plummeted. Thrifts' net income as a percentage of average assets fell from just over 0.8 in 1978 to less than 0.2 by 1980.[53] Regulators cautiously trod the fine line of balancing the competing

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[50] Money market mutual funds were financial instruments that allowed savers to pool their money to meet the $100,000 minimum for ceilingless CDs. See below, and Chapter Four.

[51] Barbara Miles, "Housing Finance: Developments and Evolution in Mortgage Markets," in Florida, ed., *Housing and the New Financial Markets* (New Brunswick, NJ: Rutgers, 1986): 3-24, 11-12.

[52] Kent W. Colton, "Financial Reform: A Review of the Past and Prospects for the Future," in Florida, ed., *Housing and the New Financial Markets* (New Brunswick, NJ: Rutgers, 1986): 103-119, 114.

[53] Andrew S. Carron, "The Political Economy of Financial Regulation," in Florida, ed., *Housing and the New Financial Markets* (New Brunswick, NJ: Rutgers, 1986): 123-137, 130.

pressures to give savers a market return, keep money flowing to housing, and maintain the solvency of thrifts–all while attempting to contain inflation.

Pressure from key lawmakers, however, tipped heavily towards assuring market returns to savers over competing concerns. This despite the almost debilitating costs borne by the thrifts, and the fact that no one could credibly argue that the MMCs (with a $10,000 minimum denomination) met the needs of small savers. Senator Proxmire sought to rectify this latter injustice through Senate Resolution 59 that called for a reduction of the minimum denomination of MMCs to $1,000. The proposal elicited a backlash from the thrifts reminiscent of the reaction to the Wild Card Certificates. Some thrift officials claimed the MMCs had forced them to drastically cut mortgage lending,[54] while others simply called the proposal to reduce the MMC minimum to $1,000 "horribly inflationary and unnecessary."[55]

To the thrift industry and its regulators, Proxmire's rush to aid the small saver endangered the survival of the nation's primary home lenders, and threatened to put homeownership out of reach for borrowers.[56] Thrift officials accused Proxmire of

[54] C. Harrison Newman, February 13, 1979; Testimony, Small Savers Equity; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP. See also, W.F. Holle, Jr., to McKinney, February 13, 1979; ibid. P. Holle, Jr., President of First Federal of Lagrange expressed concern over whether the MMCs would help housing, and while he had objected to the MMCs, he found that competition forced his institution to bid for the high-cost, short-term money available through the certificates.

[55] Ibid. John D. Page, President of Maury County Federal, protested, "I can say without the slightest hesitation, the impact of the Money Market Certificated is the worst thing that has happened to our association in the twenty seven years experience as a managing officer." John D. Page, to McKinney, February 13, 1979; ibid.

[56] C.G. Ganster of Chicago Federal Savings wrote to FHLBB Chairman Robert McKinney, "the paying of higher interest rates to our savings customers can only result in higher interest rates on mortgage loans, and make the purchase of new homes out of reach for many Americans." C.G. Ganster, to McKinney, February 14, 1979; ibid. Elmer Arn, Mt. Airy S&L Association (Ohio), to Proxmire, February 14, 1979; ibid. George Hartman of Sewickley S&L warned, "due to the higher interest rates which would be necessary on home loans if Senator Proxmire's anticipated legislation is enacted, the dream of millions of Americans to own

abandoning the logic of the New Deal system, as one argued, "Mr. Proxmire should not overlook the fact that for every saver earning low rates on savings accounts there is a mortgage borrower who is still paying a low rate of interest on a home loan."[57] Proxmire's proposal seemed especially galling in light of his vociferous opposition to variable-rate mortgages, which thrift officials claimed would help them to adjust to the higher cost of funds induced by MMCs.[58]

Chairman McKinney and the FHLBB likewise argued that a reduction in the MMC minimum denomination would do more harm than good. "Little would be gained," wrote one FHLBB staffer, "by increasing returns to small savers if the cost of this involved insolvency of savings and loan associations."[59] While the Carter Administration had linked increased returns on savings to expanded asset powers, including VRMs, Proxmire's resolution sought higher returns for savers without giving any expanded thrift asset powers in return.[60] In other words, Proxmire fully endorsed a particular, saver-friendly deregulation of interest rate ceilings, but not widespread financial deregulation, especially of thrift asset powers. The regulators undoubtedly got Proxmire's message, and many of them were already sympathetic to his concerns for small savers. Ultimately, however, the regulators took a moderate stance, instead of lowering the minimum denomination of MMCs, the Fed eliminated the $1,000 minimum denomination on

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their own home would become just that–a dream." George E. Hartman, to McKinney, February 15, 1979; ibid.

[57] John D. Page, to Senator Jim Sasser, February 13, 1979; ibid.

[58] Ibid. Ganster.

[59] "Second Draft, April 5, 1979, Statement of Robert H. McKinney, Chairman, FHLBB"; Community Reinvestment Act; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[60] Ibid.

higher yield certificates with maturities of 4 years or more. At the same time, the Fed created a no-minimum, 4-year or longer maturity, nonnegotiable certificate tied to the yield on 4-year Treasury securities.[61] Small savers still could not participate in the short-term MMCs, but theoretically, the longer-term (over 4 years) certificates made higher yields more widely available. Practically, however, the longer maturities prohibited savers who also valued or required liquidity, and small savers were those least able to tie-up their savings for years at a time. Though unintended, the MMCs nonetheless contributed to the achievement of ceilingless accounts for the truly small savers because they created urgent earnings problems that increased the likelihood of a legislative response.

Rex Duwe, the President of Farmers State Bank in Kansas, testified before Congress in 1974, "it is my personal belief that pressure from the unregulated sector of the money market will eventually force the relaxation of restrictions imposed by regulation Q and related deposit rate ceilings, and indeed perhaps their removal."[62] A series of financial innovations indeed placed considerable pressure on the viability of the interest rate ceilings. Yet just as decisive as the market innovations that drove changes in housing finance were policymakers' responses. Policymakers did not have to accommodate the regulatory apparatus to new financial instruments, but could, and sometimes did, ensure that new products fit within the existing regulatory structure or restrict them when they did not. Congress had sent an emphatic message to the regulators in the wake of the Wild-Card "experiment" that they should uphold the spirit of

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[61] Federal Reserve System, "Interest on Deposits; Early Withdrawal Penalty and Maximum Rates of Interest," *Federal Register* 44, no. 111 (June 7, 1979): 32647.

[62] Senate Subcommittee on Financial Institutions, *Financial Institutions Act–1973*, 309.

Regulation Q. FDIC Chairman Frank Wille, however, indicated that this would be a difficult feat, "Whenever rate ceilings have significantly impaired the ability of insured institutions to compete against an open market rate structure for the savings dollar," he argued, "the incentives for circumventing rate ceilings increase proportionately, and effective enforcement of the spirit and intent of regulation Q-type ceilings becomes more and more difficult."[63]

Throughout the 1970s, financial innovations emerged to circumvent interest rate ceilings. In each instance regulators chose how to respond, in some cases moving to contain the new instruments and in others allowing them to go unchecked. This pattern of ambivalence reflected the difficulty of balancing the competing interests of different financial institutions and different types of consumers, the differing scales of the impact of various instruments, and disagreement among policymakers over the appropriate response. Consistent in each response, however, was some measure of a "wait and see" approach to regulation. Each of the innovations had a chance to take hold among consumers, making regulatory constraint more difficult.

The first innovation to pose a serious threat to Regulation Q was the 1974 Citicorp debt offering. Citicorp, a bank holding company, not First National City Bank, its subsidiary, announced an offering of "'floating interest rate notes'" with an initial rate of 9.7%.[64] Well above the Regulation Q ceiling, the notes promised to appeal to savers.

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[63] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Regulation Q: Hearings before the Subcommittee on Financial Institutions Supervision, Regulation, and Insurance, of the Committee on Banking, Currency and Housing*, 94th Cong., 1st sess. (Washington, DC: GPO, 1975), 2239, 2240, 2241.

[64] House Committee on Banking and Currency, *Providing for Regulation of Debt Obligations* , 93rd Congress, 2d sess., H. Rpt 93-1259, (Washington, DC: GPO, 1974), 2. *Lexis Congressional* (accessed August 10, 2011).

Representative Wright Patman (D-TX) called the notes "an obvious attempt to circumvent the interest rate ceilings imposed under Regulation Q," while AFL-CIO President George Meany charged that the administration's failure to stop the issue compounded a series of actions "that are clubbing residential construction into a depression."[65] Representative James Hanley (D-NY) suggested that the notes would divert capital from S&Ls, and housing, into international corporate investment.[66] Bearing out these predictions, in late June, a California broker telegrammed Fed Governor Andrew Brimmer that he "would definitely recommend many accounts to withdraw their savings [from S&Ls] and receive at the present and possibly for a lengthy time a much higher rate of interest via this new investment vehicle."[67] The broker warned that other bank holding companies would likely issue their own debt offerings.

At the urging of Patman, coupled with pressure from the U.S. League of Savings Associations and National Association of Mutual Savings Banks, Fed Chairman Arthur Burns requested that Citicorp Chairman Walter Wriston postpone the issue until the regulatory agencies could study their potential impact.[68] Fed Vice Chairman George W.

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[65] *Congressional Record,* 93d Cong., 2nd sess., 1974, 120: 22684. *Lexis Congressional* (accessed August 10, 2011). George Meany, "Statement," in U.S. House, Committee on Banking and Currency, *To Provide for the Regulation of the Issuance and Sale of Debt Obligations by Bank Holding Companies and their Subsidiaries*, *Hearing before the Committee on Banking and Currency, House of Representatives, Ninety-Third Congress, 2nd sess.*, July 15, 1974 (Washington, DC: GPO, 1974), 60. *Lexis Congressional* (accessed August 10, 2011).

[66] House Committee on Banking and Currency, *Regulation of the Issuance and Sale of Debt Obligations*, 93. *Lexis Congressional* (accessed August 10, 2011).

[67] Telegram, Lawrence (illegible) to Andrew Brimmer, June 27, 1974, folder "Citicorp, 1974," Box B13, Arthur Burns Papers; Gerald R. Ford Library, Ann Arbor, MI.

[68] Patman suggested that Burns could use "moral suasion" to "jawbone" Wriston into temporarily delaying the offering. Letter, Wright Patman to Arthur Burns, July 8, 1974, folder "Citicorp, 1974," Box B13, Arthur Burns Papers; Gerald R. Ford Library, Ann Arbor, MI. "Reserve Opposes Citicorp's Notes," *The New York Times,* July 3, 1974. *ProQuest Historical Newspapers* (accessed August 10, 2011). Burns, to Wriston, July 9, 1974, in *Congressional Record,* 93d Cong., 2nd sess., 1974, 120: 22685. *Lexis Congressional* (accessed August 10, 2011). Jensen, Michael C., "Savings Associations Oppose Proposed

Mitchell had already concluded that due to the threat of disintermediation and the impact on housing that, "it is not clear, therefore, that an offering of this type is in the public interest at this time."[69] In the meantime, Chase Manhattan worked on a comparable instrument,[70] while a group of savings banks filed a lawsuit to stop the Citicorp issue.[71] Citicorp did delay its release date as the SEC considered approval, and eventually agreed to modify the instruments to make them redeemable after two years rather than every six months.[72] This satisfied Burns and the Fed, who had concluded that present law did "not authorize it either to prevent or regulate the terms of the Citicorp issue,"[73] but Patman and Proxmire and others in Congress sought to close the loophole that had given Citicorp its opening to circumvent Regulation Q.[74]

Estimating that as much as $5 billion of similar debentures would be issued by U.S. companies, and thereby posing a substantial threat to the flow of housing credit, Patman described "an emergency situation," that could have been avoided with foresight

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Citicorp Note Issue," *New York Times*, July 2, 1974. *ProQuest Historical Newspapers* (accessed August 10, 2011).

[69] Letter, George W. Mitchell to Ray Garrett, Jr., July 2, 1974, folder "Citicorp, 1974," Box B13, Arthur Burns Papers; Gerald R. Ford Library, Ann Arbor, MI. Mitchell recommended that the SEC could intervene to at least require disclosure that the "Citicorp Notes are not obligations of a bank and are not insured by the Federal Deposit Insurance Corporation."

[70] "Chase Also Plans A 'Floating' Note Issue," *Chicago Tribune*, July 4, 1974. *ProQuest Historical Newspapers* (accessed August 10, 2011).

[71] United States District Court for the Southern District of New York, July 5, 1974, folder "Citicorp, 1974," Box B13, Arthur Burns Papers; Gerald R. Ford Library, Ann Arbor, MI. "Savings Banks Sue to Bar Notes At Floating Rates," *Wall Street Journal*, July 8, 1974. *ProQuest Historical Newspapers* (accessed August 10, 2011).

[72] Letter, Walter Wriston to Arthur Burns, July 11, 1974, , folder "Citicorp, 1974," Box B13, Arthur Burns Papers; Gerald R. Ford Library, Ann Arbor, MI. "Fed Says Citibank Agreed to Modify Floating Rate Notes," *Los Angeles Times*, July 13, 1974. *ProQuest Historical Newspapers* (accessed August 10, 2011).

[73] Letter, George W. Mitchell to Ray Garrett, Jr., July 2, 1974, folder "Citicorp, 1974," Box B13, Arthur Burns Papers; Gerald R. Ford Library, Ann Arbor, MI.

[74] Letter, Arthur Burns to Walter Wriston, July 12, 1974, ibid.

and decisive action by the Federal Reserve.[75] Instead, Fed officials had waffled, even though they recognized the potential threat to housing credit. Mitchell, reversing his initial caution, now claimed that the notes should be left alone as they offered "improved opportunities for individual savers and investors to get better yields."[76]

Ultimately Congress passed a Senate bill that made explicit the authority of the regulatory agencies to restrict debentures issued by bank holding companies.[77] The Act granted "authority to the financial institutions regulatory agencies over obligations issued by bank holding companies and their affiliates… in order to respond to the highly competitive floating rate notes which were beginning to come on the market at that time."[78] Representative Fernand St. Germain indicated that the law should enable the regulatory agencies to "deal effectively with these debt issues and prevent any destructive competition with either banks or thrift institutions."[79] The House report stated "while this innovative approach may well be commendable, [the debt offerings'] appearance in the money market at a time when interest rates are at a all time high and mortgage money

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[75] House Committee on Banking and Currency, *Regulation of the Issuance and Sale of Debt Obligations*, 1, 16.

[76] Ibid., 17.

[77] For some Congressmen, this was not enough. James Hanley wrote of the similarly modest House precursor, "we know from our hearings… the [Federal Reserve] board is not going to stop this practice [that] violate[s] the letter and spirit of Regulation Q. If the board will not outlaw the practice, the Congress should." Ibid., 19.

[78] P.L. 93-501.

[79] *Congressional Record,* 93d Cong., 2nd sess., 1974, 120: 35468. *Lexis Congressional* (accessed August 10, 2011).

virtually nonexistent presented sufficient cause for grave and serious concern by the 6,000 thrift institutions….”[80]

Though Citicorp reduced its offering from $850 million to $650 million, it sold that value of notes in one day.[81] In addition to Chase, Mellon National, Crocker National, and Standard Oil Company of Indiana[82] offered similar notes.[83] Fearing that the Citicorp and related issues only signaled a beginning, Benjamin Blackburn (R-GA) observed that attempts to curb evasions of Regulation Q would be "like trying to keep water in a bag under pressure. [Money] is going to find a way out….”[84] Blackburn offered a feeble reconciliation of the problem for housing, "It may be unpleasant to pay higher interest rates on our homes, yet if we allowed our savings institutions to pay higher rates, our young people would be encouraged to save more money so they could pay more down on their houses.”[85] Despite Blackburn's skepticism over the regulators' ability to effectively enforce Regulation Q, the directive of Congress clearly stated that the regulators should exercise their authority to prevent evasions like the Citicorp offering in the future.

The $650 million raised by the Citicorp offering paled in comparison to the capital attracted by another financial innovation of the 1970s, the Money Market Mutual

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[80] House Committee on Banking and Currency, *Providing for Regulation of Debt Obligations*, 93rd Congress, 2d sess., H. Rpt 93-1259, (Washington, DC: GPO, 1974), 2. *Lexis Congressional* (accessed August 10, 2011).

[81] "Citicorp's Notes All Sold," *Chicago Tribune*, July 25, 1974, *Proquest Historical Newspapers* (accessed August 10, 2011).

[82] Standard Oil's entry into this market exemplifies the increasing financialization of the economy.

[83] "Standard (ind.) to Offer Floating Rate Note," *Chicago Tribune*, July 31, 1974. *ProQuest Historical Newspapers* (accessed August 10, 2011).

[84] House, Committee on Banking and Currency, *Regulation of the Issuance and Sale of Debt Obligations*, 43.

[85] Ibid., 44.

Fund (MMMF). The funds grew slowly in the early to mid-70s, but in the early 1980s topped an astounding $100 billion dollars. In 1976, regulators gave considerable thought to extending Regulation Q to cover pooled deposits, a move that observers believed would significantly curtail the growth of money market mutual funds. Out of concern for ensuring market returns for investors, however, the Fed and FDIC ultimately decided not to issue the regulations. Like the liberalization of rate ceilings on accounts over $100,000 that gave rise to the MMMFs, this relatively early decision constrained subsequent options. The MMMFs continued to grow, keeping persistent pressure on the traditional depository institutions to compete for savings money and concretely representing the difference between Regulation Q ceilings and "market rates." As more and more savers invested in MMMFs, action curtailing them became less politically feasible, even as pressure from regulators, banks, and thrifts to do something to limit the funds grew in the early 1980s. This critical development and its relationship to the politics of financial deregulation will be covered in greater detail in Chapter Four.

While the MMMFs remained the most substantial threat to the efficacy of interest rate ceilings, other innovations continued to present regulators with opportunities to defend the integrity of Regulation Q or let such innovations flourish. In 1977, Person-to-Person Financial Center, a Citicorp subsidiary, offered small denomination debentures, starting at $500, with a rate that would rise from 6½ % to 9½ % over five years.[86] The "rising rate" notes, which were issued by Person-to Person branches in Arizona and Colorado, caught the notice of the US Savings League as well as the Fed and FHLBB. FHLBB staffer Rebecca Laird wrote to Daniel Goldberg of the FHLBB Counsel's office

[86] John Holusha, "Fed Allows Citicorp to Sell Notes with Rising Interest," *Sarasota Herald-Tribune*, December 30, 1977. *Google News Archive* (accessed August 10, 2011).

that although the thrift lobby recognized that the instruments were not a financially significant threat at that time, officials believed that for "the Federal Reserve to let the Citicorp action go unchallenged would set a precedent which would in the future make it much more difficult to halt such 'extra curricular fund raising' by bank holding companies."[87] Laird urged that the Fed should exercise the power Congress granted it in 1974 and "take action to maintain the continued integrity of Regulation Q."[88] Fed regulators, however, chose to simply monitor their impact,[89] while developing regulations establishing Fed guidelines on determining what issues qualified as deposits for future cases.[90]

The rising rate notes did not make the same impact as the 1974 Citicorp issue, or the MMMFs, but the episode revealed the continuing tension among regulators regarding Regulation Q. Some, like Laird, in this case, felt that regulators should "maintain the integrity" of interest rate ceilings, while others erred on the side of allowing innovations to sink or swim in the market before ruling. The occasion also exposed a divide over whether action should be triggered by principle (if an innovation undermined existing regulation, it should be checked), or by the scale of the problem an innovation posed (act only if it turned out to cause significant disintermediation). The latter course tended to win out, and while not an issue in the case of the rising rate notes, had the potential

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[87] Rebecca Larid, to Daniel J. Goldberg, Office of the General Counsel, November 30, 1977; PL 93-501; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[88] Ibid.

[89] Griffith L. Garwood, Deputy Secretary, Federal Reserve, to Federal Reserve Banks, July 7, 1978; PL 93-501; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[90] Anne P. Jones, General Counsel, to Stephen M. Ego, Assistant to the Chairman, January 18, 1978; ibid.

danger of allowing a product to gain a popular (political) foothold *as* it became a problem, making it more difficult to curb once it did pose a threat to the public interest.

The innovations of bank holding companies and their subsidiaries that fell outside of the jurisdiction of the Fed, FHLBB, FDIC, and Comptroller of the Currency represented one weak spot in the regulatory structure; the so-called dual-banking system that split regulation between state and federal regulators according to their charter was another. Though many state-chartered institutions came under some measure of federal control due to their participation in federal deposit insurance, state regulations dictated their asset powers. Differences in asset and investment authority between state- and federally-chartered institutions in the same markets created competitive imbalances. Anytime state-regulated institutions' powers outstripped those of their federal counterparts, the latter would plead for equal authority. Similarly, while institutions could not open branches across state lines, consumers could deposit in neighboring states, and disparities in services in contiguous states led to calls for equalization of powers.

One instrument that entered the market through this hole in the regulatory structure was the negotiable order of withdrawal (NOW) account, a savings account that allowed a withdrawal payable to a third-party, arguably in violation of the statutory prohibition of payment of interest on checking accounts. NOW accounts originated in Massachusetts in 1972 under state regulation before incrementally being authorized for federal institutions. In 1968, Ronald Haselton, a former commercial banker, became president of Worcester Five Cent Savings Bank, later Consumers Savings Bank. Frustrated with the more restricted services that a savings bank could offer, Haselton petitioned the Massachusetts Banking Department to approve third party payment

accounts. When the state regulators refused authorization, Haselton appealed to the Massachusetts Supreme Judicial Court, which in 1972, ruled that the accounts were legal.[91]

The first federal authorization of negotiable order of withdrawal accounts, for institutions in Massachusetts and New Hampshire only, was folded into the 1973 extension of Regulation Q (P.L. 93-100). The authorization corrected the competitive imbalance between the state- and federally-chartered institutions in those states, but reinforced the imbalance between the depositors of those states and those of the rest of the nation. The act's conferees intended the authorization as "an experiment for this type of service to see whether it should be extended on a national basis."[92] Yet, by giving savers in two states access to services not available elsewhere, lawmakers again discriminated against a group of savers. This particular feature of the experiment made expansion of NOW accounts all but certain, as it would be much more politically feasible to give than to take away. By November 1974, sixty-five savings banks in Massachusetts and fourteen in New Hampshire offered NOW accounts. The success of the accounts in those states left institutions in neighboring states clamoring for similar powers, and in a sort of falling domino pattern, federal authorization followed incrementally for the rest of New England and New York in 1976,[93] and New Jersey effective January 1980,[94] before

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[91] James P. Riordan, "Negotiable Orders of Withdrawal," *The Business Lawyer* 30 (November 1974): 151-164, 151-152.

[92] *Congressional Record*, 93d Cong., 1st sess., 1973, 119: 28021.

[93] P.L. 94-222.

[94] P.L. 96-161.

national authorization through the Depository Institution Deregulation and Monetary Control Act of 1980.

The expansion of NOW accounts, however, did give policymakers pause, as it promised to increase costs for depository institutions. Paralleling the debate over loosening or eliminating Regulation Q, NOW accounts offered higher (but still limited) returns for savers, but also posed a threat to the profitability of banks and thrifts, and, by extension, the flow of credit. Ultimately, regulators erred on the side of favoring services for consumer-savers. FDIC Chairman Frank Wille wrote to St. Germain in 1973, "'I am personally convinced that the payment of interest to depositors on accounts against which third-party orders may be drawn is almost inevitable and in the public interest…there is no inherent virtue in a rigid separation between traditional checking and savings accounts in the banking system.'"[95] Wille's assumption of the inevitability of interest-bearing checking accounts, coupled with the "experimental" piecemeal extension of NOW accounts, made national authority a more likely, if not certain outcome. The prolonged deliberation over national authorization kept NOW accounts in the middle of the debate over financial restructuring into the late 1970s. Along with elimination of Regulation Q, NOW accounts remained on the table as a consumer (saver)-friendly initiative and bargaining chip for expanded asset powers. National NOW account authorization ultimately proved pivotal in the legislative back and forth that led to passage of the DIDMCA.

In 1977, FDIC Chairman Robert Barnett quoted former ABA president Rex Duwe, "if Regulation Q is phased out, it won't be because banks want it or because they

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[95] Frank Wille to St. Germain, March 20, 1973, quoted in Riordan, 156.

don't want it, or because thrifts want it or don't want it, or because thrifts want it or don't want it. It will be because consumers want it."[96] Critics of Regulation Q had long noted that the interest rate ceilings could unfairly prevent savers from earning market rates of return on their deposits. As early as 1971, the Hunt Commission Report had charged that "interest rate regulations have discriminated against small savers,"[97] an indictment repeated publicly by President Nixon.[98] Yet these early protests failed to resonate widely in Congress, where most lawmakers reflexively accepted Regulation Q as a component of the unassailably popular cause of promoting homeownership.

By the close of the decade, however, ending "discrimination against small savers" had become an unassailable position of its own, and something of a crusade for some key lawmakers (especially Senators Thomas McIntyre and William Proxmire), ultimately gaining consensus in Congress. Several developments contributed to this turnabout. Acute periods of inflation caused unprecedented spreads between Regulation Q ceilings and market rates, making the "injustice" to small savers that much more visible. A small handful of scholars attempted to quantify these spreads, which they described as "lost" savings. Placing that figure in the billions of dollars, these studies caught the attention of policymakers, and, usually when cited by a newspaper columnist, that of a broader public

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[96] Quoted in, speech, Robert Barnett, Chairman FDIC, "H.R. 1901, Regulation Q, NOW Accounts, and Payment of Interest on Demand Deposits," before the New York State Bankers Association, New York, NY, January 24, 1977, folder "Regulation Q, 1976-77," Box B92, Arthur Burns Papers; Gerald R. Ford Library, Ann Arbor, MI.

[97] President's Commission on Financial Structure and Regulation, 26.

[98] Nixon wrote to Congress, "In the late 1960s… small savers, who depended on banks and other saving institutions, were denied a fair rate of return on their money." President Richard M. Nixon, "U.S. Financial System: The President's Message to the Congress on Recommendations for Change in the System," August 3, 1973, *Weekly Compilation of Presidential Documents* 9, no. 31 (August 6, 1973): 953.

as well.[99] Savers themselves drew attention to the issue when they withdrew their deposits from banks and thrifts to seek higher yields of the uninsured money markets (though the majority of savers did not do this). As market interest rates continued to rise into the late 1970s and thrifts struggled to sustain deposit growth, it became less clear to policymakers that the rate ceilings were achieving the presumed trade-off for the low returns, a cheap source of capital for housing. If Regulation Q was not providing a steady stream of credit for housing, policymakers found the lower returns to savers indefensible. Finally, though all of these developments preceded any discernible popular public protest against Regulation Q, when disgruntled savers did take to the streets in 1978, they gave a public face to the small savers that policymakers had begun to champion.

The small saver, both real and rhetorical, imbued the push against Regulation Q with a righteousness sufficient to make a position that could be viewed as inimical to homeownership into a populist one. Invoking the interests of small savers, policymakers opposed traditionally powerful interests including the thrift and construction lobbies. Lawmakers who remained deeply suspicious about some of the items of the broad deregulatory agenda laid out by the Hunt Commission, especially variable-rate mortgages, came to embrace the particular deregulation of interest rate ceilings. Still, until the ceilings were completely eliminated, the actions on behalf of small savers did not benefit the smallest of savers. When regulators gradually allowed traditional depository institutions to offer higher yield instruments, they did so at minimum denominations that were prohibitive to most savers. The major beneficiaries, then, of the

[99] See, for example, Jack Miller, "How Nation's Savers Lost Billions in Interest," *San Francisco Sunday Examiner and Chronicle*, April 4, 1976. Comment Letters Concerning Proposed Changes to Regulations, 1975-1980, Records of the Federal Deposit Insurance Corporation, RG 34, NACP. Several comment letters referred specifically to the Miller article.

campaign to achieve equity for small savers, were middle class saver/investors, those with enough money to reach the $10,000, $5,000, or, at best, $1,000 minimum denominations of higher yield savings instruments.

A few critics attempted to point out the mismatch between rhetoric and policy. In 1974, during debate over the Citicorp debt offering, Congressman Frank Annunzio (D-IL) mused, "I hear all of you talking about small depositors, and what a great break they are apparently going to get. What is your definition of a small depositor? I do not know anybody in my district who has $5,000 or $1,000. What is a small depositor?"[100] A 1971-72 survey of consumers by the Survey Research Center at Ann Arbor estimated that only about 16½ % of American families could afford to even consider buying an instrument with a $5,000 minimum.[101] Yet the idea of a small saver weighed more heavily in debates than such numbers would indicate and remained an important symbol. Representative Henry Reuss (D-WI), revealed who he imagined as the small depositor: "Archie Bunker."[102] Despite the constant evocation of the "small saver" in arguing against restrictions on the investments, unless he had $5,000 he would not have to touch for several years, Archie Bunker had little to gain from the Citicorp debt offering or other high minimum instruments.

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[100] House Committee on Banking and Currency, *Regulation of the Issuance and Sale of Debt Obligations*, 50.

[101] Ibid., 94.

[102] Ibid., 46.

Small saver rhetoric notwithstanding, through the early 1970s, the real threat of disintermediation came from "big savers," corporations and wealthy individuals.[103] Policymakers and bank officials conceptually separated depositors with over $100,000, which they considered "sophisticated investors who are extremely yield conscious,"[104] from the "consumer deposits" under $100,000 that were "more concerned with availability and safety than yield."[105] Yet by the mid-1970s, observers began to note the increasing sophistication and interest rate sensitivity of consumer depositors below the $100,000 line.[106] In 1973, for example, FHLBB Chairman Thomas Bomar remarked, "over the long-run the typical saver is becoming increasingly more sophisticated." Attempting to explain this phenomenon, Bomar added, "the more the average saver is exposed to certificates, the more willing and able he becomes to search out other savings opportunities."[107] In other words, the proliferation of financial innovations that circumvented Regulation Q, such as the MMMFs, Citicorp notes, or even the Wildcard certificates, served to educate the saving public about higher yield alternatives.

Sensitivity to discrimination against small savers among both policymakers and savers heightened due to a sustained academic critique of interest rate ceilings. In 1970, Boston College Economics Professor Edward J. Kane published an article that argued that the federal government, through interest rate ceilings on time deposits and high

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[103] As ABA President Clausen wrote, "funds held in large deposits immediately flow out of the banking system into higher yielding investments." Letter, A.W. Clausen to Arthur Burns, September 21, 1970, Folder "ABA Oct.-Dec. 1970," Box B1, Arthur Burns Papers, Gerald R. Ford Library, Ann Arbor, MI.

[104] Ibid.

[105] Ibid.

[106] On this phenomenon, see Joseph Nocera, *A Piece of the Action: How the Middle Class Joined the Money Class* (New York: Simon & Schuster, 1994).

[107] Senate Subcommittee on Financial Institutions, *Financial Structure and Regulation*, 144.

minimums on other investment instruments including U.S. savings bonds, systematically kept lower income Americans from receiving market rates of interest in order to prop up the thrift and construction industries. These "small savers" largely unwittingly subsidized those industries in collusion with federal policymakers. Kane rejected the idea that the ceilings and high minimums were necessary to prevent disintermediation, offering alternatives such as expanding the asset powers of the thrifts or providing a more explicit (visible) subsidy to ailing thrifts.[108] Kane charged that only the disproportionate influence of the thrift lobby allowed the continuation of a "system of mortgage subsidization and deposit-rate ceilings [that] imposes a regressive tax on interest income and a perverse subsidy on interest expense."[109]

Kane contributed to a growing counter narrative that sought to expose the quaint 3-6-3 rule as a scheme to deprive "the nation's least-wealthy (and especially its *older* and *unlanded*) citizens of the savings opportunities that the market would give them if it were free to operate without government interference."[110] According to this logic, savers had effectively "lost" money that they would have earned in the absence of Regulation Q. This created something of a puzzle for interested economists: exactly how much interest earnings had depositors lost? David H. Pyle, a professor at the University of California, Berkeley took up the challenge, and his findings quickly became ammunition for opponents of Regulation Q. Pyle devised a model to estimate the rates that savers would have earned between 1968-1970, subtracted the amount savers did earn in that period,

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[108] Edward J. Kane, "Short-Changing the Small Saver: Federal Government Discrimination Against Small Savers During the Vietnam War: Comment," *Journal of Money, Credit and Banking* 2, no. 4 (Nov., 1970): 513-522.

[109] Ibid., 518.

[110] Ibid., 521.

and came up with a staggering figure: $5 billion.[111] Pyle updated this research in 1978 to estimate losses of $22 billion from 1968-1975.[112] In a similar study, Bruce Morgan, of Golembe Associates for the ABA in 1978, estimated losses to deposits of under $100,000 to have reached as high as $6 billion annually.[113] Readily citable amounts of savings lost to Regulation Q bolstered the case that the interest rate ceilings unfairly discriminated against savers. Senator McIntyre argued, "Why should the younger generation, young people of today, be subsidized at the expense of older people, when the older generation does not even realize they are doing it?"[114] Ignoring, for the moment, that the market might value larger sums of money more highly, observers like McIntyre compared the plight of the "little guy" unfavorably to the options available to the wealthy investor.

Through the mid-1970s, the small saver remained largely invisible. The small saver invoked by the Hunt Commission report had been little more than a theoretical

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[111] David H. Pyle, "The Losses on Savings Deposits from Interest Rate Regulation," *The Bell Journal of Economics and Management Science* 5, no. 2 (Autumn, 1974): 614-622. Pyle characterized his research as "a quantification of the discrimination discussed by Kane."

[112] David H. Pyle, "Interest-Rate Ceilings and Net Worth Losses by Savers," in Kenneth E. Boulding and Thomas Frederick Wilson, eds., *Redistribution through the Financial System: The Grants Economics of Money and Credit* (New York: Praeger Publishers, 1978): 87-101.

[113] Bruce W. Morgan, "Ceilings on Deposit Interest Rates, the Saving Public, and Housing Finance," (August 1978), in Senate Subcommittee on Financial Institutions, *Equity for the Small Saver: Hearings before the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs*, 96th Cong., 1st sess., 1979 (Washington, DC: GPO, 1979). Robert A. Taggart, Jr. estimates losses of half a billion from 1970-1975 in Massachusetts alone. Taggart, Jr., "Effects of Deposit Rate Ceilings: The Evidence from Massachusetts Savings Banks," *Journal of Money, Credit, and Banking* 10, no. 2 (May 1978): 139-157.

[114] Senate Subcommittee on Financial Institutions, *Financial Institutions Act–1973*, 510. See also, House Committee on Banking and Currency, *Providing for Regulation of Debt Obligations*, 93rd Congress, 2d sess., H. Rpt 93-1259, (Washington, DC: GPO, 1974), 21. *Lexis Congressional* (accessed August 10, 2011). Representative Edward Koch (D-NY) argued, "No one wants to assure the availability of adequate funds on reasonable terms for residential mortgage loans more than I, but not at the expense of the small saver." Koch objected to "a policy which forces small savers to subsidize mortgage borrowers, big and small, by curtailing their investment opportunities, thereby blocking them from full participation in the free enterprise system. At the same time, large wealthy depositors are left unrestrained to maximize profits through investment in high-yielding Federal and corporate debt paper."

construct. In some instances, as when the Fed and FDIC proposed regulations prohibiting pooling of deposits to circumvent Regulation Q ceilings, a handful of savers wrote letters of protest to Congress and directly to the regulators. And some savers made their presence felt by withdrawing their deposits from banks and thrifts to pursue higher yields elsewhere. Yet until 1978, the small saver lacked a public face, and even then the vast majority of savers played at most a passive, though critical, role in the crusade against Regulation Q carried out in their name. An exception to this general rule, a small group of mostly elderly savers took an active role in protesting against interest rate ceilings. On October 19, 1978, a group from the San Francisco chapter of the Gray Panthers, along with the California Legislative Council for Older Americans, petitioned the federal regulators of depository institutions to ensure that savings rates kept up with inflation, or else require depository institutions to post cigarette package-style warnings saying "savings deposits may be dangerous to your wealth." Members of the groups picketed outside of the Federal Reserve Building in San Francisco as a copy of the petition was hand delivered there.[115]

The petition, reinforced by the protest, garnered the attention of policymakers in Washington, and both Houses of Congress invited representatives of the Gray Panthers to testify on Regulation Q. The attorney representing the group, Robert Gnaizda, called Regulation Q "the largest government-led consumer fraud in American history."[116] Thelma Rutherford, another Gray Panthers representative, testified to the Senate:

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[115] "Elderly Find Banks a Hazard to Wealth," *The Milwaukee Journal*, October 21, 1978. *Google News Archive Search* (accessed September 21, 2011).

[116] Senate Subcommittee on Financial Institutions, *Equity for the Small Saver,* 7.

> The family units who did not own any real estate assets at all and who are the big losers in regulation Q are namely the black, the female, the poor and the young… We, who are in the aged category, feel with the disadvantaged, but we, too, are disadvantaged when our interest rates are held to a minimum while others may obtain the maximum rates.[117]

Rutherford acknowledged that liberalization of Regulation Q could raise the barriers to homeownership through higher borrowing rates, but reasoned that potential homeowners could save up for the higher rates and down payments, and continued to argue that the ceilings were unfair to the elderly. The President of the San Francisco Chapter of the Gray Panthers, Hilda Cloud, fumed, "We, the elders of this country, helped to build it, and we helped to make this country great. Is this how we are being repaid?"[118] That Cloud could assert that her generation had made the country great without reference to the federal interventions that aided them, including Regulation Q and the New Deal housing finance regime, reflected the prevailing culture of meritocracy, which reigned in no small part due to the efforts of federal officials to erase the government's role in "making the country great."[119] The Gray Panthers' formal proposal did include a direct government subsidy to savings and loans with "an unduly large number of low interest mortgages," indicating that they had no aversion to subsidy of mortgages so long as the government, not the depositor, paid the price (eliding, for the moment, the role of the

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[117] Ibid., 5.

[118] House Committee on Government Operations, *Interest Rate Regulation on Small Savings Accounts: Hearings before a Subcommittee of the Government Operations, House of Representatives, 96th Cong., 1st sess.* (Washington, DC: GPO, 1979), 14.

[119] On a culture of meritocracy, see Matthew D. Lassiter, *The Silent Majority: Suburban Politics in the Sunbelt South* (Princeton: Princeton University Press, 2006). On government officials' erasure of the federal role in post war America, see David M.P. Freund, *Colored Property: State Policy and White Racial Politics in Suburban America* (Chicago: Chicago University Press, 2007).

depositor-tax payer).[120] Though not active in picketing, the American Association of Retired Persons and the National Retired Teachers Association joined the Gray Panthers in testifying against Regulation Q.[121]

Policymakers took notice of the protests. Even those who had long spoken of the small saver, like Congressman St. Germain, felt the added pressure of a vocal and active group of sympathetic, largely elderly, savers marching in the streets. He remarked, "We have the Grey Panthers attacking us. They want more money for their savings, and they are a formidable group. We have the Consumer Federation of America, they want more money for their savings and they are a formidable group."[122] Other savers wrote directly to their Congressional representatives, crying for help.

"Equity for the small saver," an imperative all the more urgent in light of increasing inflation and grassroots protest, became the issue that broke the legislative logjam that had held up financial reform for a decade. Lawmakers who had hesitated to embrace the deregulatory agenda proposed by the Hunt Commission, had come around on at least the issue of deregulation of interest rate ceilings. The consensus behind the commitment to eliminate "discrimination against small savers" solidified in Senate Concurrent Resolution 5 on February 8, 1979. The resolution directed the federal financial agencies to "provide an appropriate method under which the interest rate on small savings deposits and accounts is increased equitably in order to reduce the adverse

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[120] Senate Subcommittee on Financial Institutions, *Equity for the Small Saver,* 10.

[121] Ibid., 15.

[122] House Committee on Banking, Finance, and Urban Affairs, *Regulation Q and Related Measures: Hearings before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance, of the Committee on Banking, Finance, and Urban Affairs, House of Representatives, 96th Cong., 2d sess.* (Washington, DC: GPO, 1980), 577.

impact of such Regulation [Q and related ceilings] on the holders of such deposits and accounts."[123] This was easier resolved than done, as Garth Marston reminded Proxmire that the FHLBB was aware of the need to improve returns for small savers but that this must be balanced "with the need to ensure the continuing financial viability of the nation's primary source of mortgage credit."[124] Additionally, once committed to ending rate ceilings, lawmakers found themselves engaged in a negotiation that pulled them deeper and deeper into a broader deregulatory agenda, even as many remained deeply suspicious of some of its features, none more so than the variable-rate mortgage.

In Defense of Regulation Q

The deregulationist critique of the New Deal regulatory regime (and interest rate ceilings in particular), the emergence of financial innovations to circumvent Regulation Q, and protest from small savers combined to challenge the New Deal system of housing finance, yet Regulation Q proved doggedly persistent. In 1971 Federal Reserve Bank of Philadelphia President David Eastburn wrote, "All the political pressures seem to work in the direction of continuing and strengthening the ceilings. If the [Federal Reserve] System is to disengage, it will have to do so by conscious and deliberate effort."[125] The remarkable fact about the various commission recommendations to eliminate Regulation Q and the decade of legislative attempts to implement them was that Congress repeatedly rejected them. The thrift industry and the majority of small commercial banks steadfastly

[123] *Congressional Record,* 96th Cong., 1st sess., 1979, 125: 2187.

[124] Marston, to Proxmire, March 23, 1979; S. Con. Res. 5; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[125] Letter, David Eastburn to Arthur Burns, August 3, 1971, folder "Regulation Q (Interest Rate Ceilings 1970-1974)," Box B92, Arthur Burns Papers; Gerald R. Ford Library, Ann Arbor, MI.

clung to Regulation Q as their lifeblood. Regulators at the various federal financial agencies displayed greater ambivalence–with factions for and against strict enforcement of Regulation Q, but even those philosophically against it sometimes stood up for the ceilings at least temporarily.

Eastburn's assessment that "all political pressures" remained behind continuance of rate ceilings largely held through mid-decade. The most vociferous defenders of Regulation Q and the differential were, of course, the thrifts and their regulators. In large measure, this position reflected self-interest. Many thrift officials believed that the rate ceilings ensured low cost-funds, allowing their portfolios of long-term mortgages to remain profitable and that the small competitive advantage they enjoyed over banks through the differential allowed them to attract more capital than they otherwise could. As the nation's foremost housing lenders, this self-interested defense merged with a broader defense of homeownership. Thrift officials and FHLBB regulators made a credible case that Regulation Q and the differential played a substantial role in the historic expansion of homeownership in post-World War II America.

John Horne, a former chairman of the FHLBB and then chairman of the board of Investors Mortgage Insurance Co., testified in 1973, "Unquestionably, without Regulation Q as now structured the almost unbelievable growth of the savings and loan and the mutual savings banks industries would not have been possible. And neither would it have been possible to reach the unprecedented volume of more than 2 million housing units annually."[126] Even before Congress extended the ceilings to thrifts in 1966 and

[126] Senate Subcommittee on Financial Institutions, *Extension of Regulation Q and NOW Accounts: Hearings before the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs*, 93d Cong., 1st sess. (Washington, DC: GPO, 1973), 313.

instituted the differential, Regulation Q protection had allowed thrifts to increase their share of household savings by 20% between 1947 and 1960. And even during the height of anti-Regulation Q sentiment, S&L official Donald Lotrich maintained, "Everyone in the industry and the bankers throughout the country recognize that Regulation 'Q' has given the Savings and Loans the opportunity to obtain funds and make thousands of residential loans for American families that they could never do without Regulation 'Q'."[127] Horne and other thrift industry representatives continually asserted that the future of homeownership depended on the health of the thrifts, which, in turn, depended on Regulation Q.

Raleigh W. Greene of the National League of Savings Associations, charged that Regulation Q opponents had no viable alternative for delivering long-term, low-interest mortgages.[128] By protecting a source of predictable, low-cost funds, Regulation Q enabled S&Ls to accept the risk of making long-term mortgages (they could make a 30 year loan at 6% if they could be reasonably sure that the cost of their deposits would be around 3%). Greene implied that without Regulation Q and the other statutory protections and advantages for the specialized lenders, no private institution would take on such interest risk. In 1977, a somewhat more objective observer, Lawrence Simons, Assistant Secretary for Housing, Federal Housing Commission, HUD, similarly concluded, "We

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[127] Donald Lotrich, Sterling S&L Association (Chicago), to Anita Miller, August 21, 1979; Consumer Checking Account Equity Act of 1979; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[128] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Regulation Q*, 2304.

must have a sound alternative method of promoting housing production before we abandon the structure that we have in place."[129]

As the critique of Regulation Q developed, the extensions became more and more contentious, but even for those who wanted to eliminate Regulation Q, "now" was never the time.[130] Though lawmakers continued to reauthorize the extension on a temporary basis, they did so eleven times between 1966 and 1980.[131] Regulation Q authority lapsed once, between June 1 and August 16, 1973, pending conference negotiations on legislation to extend the ceilings. During that period the Federal Reserve "called on member banks to observe existing rate ceilings…notwithstanding a temporary hiatus in that authority."[132] Similarly, following the lead of the Hunt Commission recommendations, calls for removal of interest rate ceilings always came in the form of a gradual phase-out in order to give the thrifts time to adjust.

The first sign of a break in the pattern of nearly automatic Congressional reauthorization came in 1976. In a speech to the National Savings and Loan League, Senator McIntyre (D-NH) warned, "There are not likely to be such things as 'simple' extensions of Regulation Q anymore."[133] McIntyre, who had supported the successive

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[129] Senate Subcommittee on Financial Institutions, *NOW Accounts, Federal Reserve Membership, and Related Issues: Hearings before the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs* 95th Cong., 1st sess. (Washington, DC: GPO, 1977), 68.

[130] See, for example, House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Regulation Q*, 2239, 2240, 2244.

[131] After the 1966 law, PL 89-597, the reauthorizations were: PL 90-87, PL 90-505, PL 91-151, PL 92-8, PL 92-15, PL 93-100, PL 93-495 (which also included the Equal Credit Opportunity Act), PL 94-200 (which also included the Home Mortgage Disclosure Act), PL 95-22, 95-188, and PL 95-630.

[132] Press Release, Federal Reserve, June 1, 1973, folder "Regulation Q (Interest Rate Ceilings 1970-1974)," Box B92, Arthur Burns Papers; Gerald R. Ford Library, Ann Arbor, MI.

[133] Speech, Thomas McIntyre, "Innovation, Competition…and the Public Interest," at the Annual Convention of the National Savings and Loan League, San Francisco, CA, October 18, 1976, folder Oct.

attempts at financial reform by the Nixon and Ford administrations, considered Regulation Q both "anti-competitive and anti-consumer."[134] He warned his audience of thrift officials to begin preparing for life after Regulation Q. McIntyre attempted to make due on his threat, but Congress again reauthorized the ceilings through December 15, 1980.

Defenders of Regulation Q understood that of the many arguments against interest rate ceilings, the premise that Regulation Q discriminated against small savers held the greatest potential to undercut their contention that theirs was the populist position–the one that defended homeownership. Some proponents of Regulation Q weighed the ceilings in the context of savers *and* borrowers, arguing that lower returns to savers made widespread homeownership possible. During 1973 hearings, Senator Proxmire, who would later lead the charge against Regulation Q, questioned the lone representative of the consumer "victims," Robert Shay of Consumers Union. The Senator asked, "Who are your members though? I heard, maybe this unfair, that they represent, by and large, a professional middle-class group that already owns their homes, are savers and aren't too concerned, by and large, about the young people who are forming families now and buying homes."[135] Proxmire implied that the interests of the consumer-borrower too, should be considered in debates over the ceilings. Mike Sumichrast, an economist with the National Association of Home Builders made the case concrete in his response to calls for higher returns for small savers, "You are suggesting that we should pay [the

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16-31, 1976, Box O12, Arthur Burns Papers, Congressional Correspondence, Gerald R. Ford Library, Ann Arbor, MI.

[134] Ibid.

[135] Senate Subcommittee on Financial Institutions, *Reform of Financial Institutions–1973,* 631-2.

small saver] over and above what we are paying him now, and he should be the beneficiary of the high dividends. So you pay him a percentage, 1½ percent more, in order that his son might buy a house and pay a 12-percent mortgage rate."[136] Rather than viewing Regulation Q as a system that unfairly forced savers to subsidize homeowners, AFL-CIO economist Henry B. Schechter argued, "What we have been doing is one generation helping another become homeowners."[137] Schechter acknowledged the potentially under-market rates of return on savings, but viewed this "cost" as the price paid for a system that promoted homeownership, a system that must continue so that subsequent generations could reap the same benefits.

Others, instead of arguing that the good outweighed the bad, took on the very premise that ceilings discriminated against small savers. In 1974, Gilbert Roessner of the National Savings and Loan League argued, "This business with the small saver getting the rap is getting a lot of publicity [but] I talk to a good many of our depositors. They are very happy with our 7½ percent certificate. They never dreamed they would earn 7½ percent. Now they are getting restless because they are paying greater and greater prices at the grocery store, but the small saver does not think he is taking a rap."[138] Depository institutions offered convenience, liquidity, and safety, in the form of federal deposit

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[136] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Regulation Q*, 2561.

[137] Senate Committee on Banking, Housing, and Urban Affairs, *Alternative Mortgages: Hearings before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Ninety-fifth Congress, Second Session, August 21 and 22, 1978* (Washington, DC: GPO, 1978), 30-31.

[138] Senate Subcommittee on Financial Institutions, *Financial Institutions Act–1973*, 510-511.

insurance. Regulation Q defenders suggested that savers quite reasonably accepted lower rates in exchange for those benefits.[139]

Ultimately, small savers were best served, Tom Scott of the U.S. Savings and Loan League, and Morris D. Crawford of the National Association of Mutual Savings Banks argued, by a viable thrift industry. Scott testified, "The truth of the matter is that over any given period of time the thrift institutions have done much better for the small saver, if this is the proper term, than the security market has and can do."[140] The President of the National Association of Home Builders, George C. Martin, added that the idea of the system was that people "left their money in a place that was federally insured and guaranteed, and deposited at a reasonable rate of interest…. Now, the whole concept of the wheeler-dealer, chasing the fastest buck and putting your money where you can get it, is all right to pursue if you want to destroy the system that has created savings and created our basic financial structure."[141] Martin argued that the consumer-saver earning higher interest would pay for that rate through inflated rates and prices across the board, concluding, "it is going to cause your children to pay more for housing."[142]

In 1979, S&L President Max Johnson charged, "Senator Proxmire refers to small savers subsidizing us. We also have what is called a small borrower. I don't really know

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[139] Ibid., 386. See also, House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Regulation Q*, 2561, House Committee on Banking and Currency, *The Credit Crunch and Reform of Financial Institutions*, 407, Leary to Garry Brown, October 19, 1973, ibid., 486, and "Second Draft, April 5, 1979, Statement of Robert H. McKinney, Chairman, FHLBB"; Community Reinvestment Act; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[140] House Committee on Banking and Currency, *The Credit Crunch and Reform of Financial Institutions*, 204.

[141] Ibid., 205.

[142] Ibid.

how this borrower can afford the interest rates we now have to charge."[143] Throughout the decade of debate over Regulation Q, critics warned and advocates soberly assented that the removal of interest rate ceilings would result in higher costs for borrowers. During 1973 hearings, AFL-CIO representative Nat Goldfinger responded to Senator McIntyre, "The small saver may get some benefit from an increased interest rate on his savings. But he gets hit to a much greater degree, Mr. Chairman, by the high cost of interest that the has to pay on his own loans, on mortgages, on consumer loans, installment loans, and also by the increase in prices, by the inflationary impact of high interest rates."[144] ABA President Rex Morthland put it more succinctly, "if the user gets it, the borrower pays for it."[145] The expectation that increased cost of funds would mean increased costs to borrowers was repeated again and again from bankers, thrift officials, regulators, and other observers. Law professor John Spanogle argued, the small saver "has been discriminated against, and that's wrong. But you should look at the side effect that it will have if these [deposit] interest rates are allowed to rise. The interest rates, the cost of money to the thrift institutions, will also rise as the interest rates to savers go up, and therefore, the interest rates charged to borrowers will have to rise."[146] Given the overwhelming consensus and logic of the case that borrowers would pay the cost of any

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[143] E. Max Johnson, President, Iowa Falls Federal S&L, to McKinney, February 12, 1979; Testimony, Small Savers Equity; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP. See also, Eileen Bowerman, VP First Federal S&L Association of Delta (Ohio); Testimony, Small Savers Equity; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP. Bowerman wrote frankly, "when the cost of our money for mortgages is raised, we, in turn, must raise the interest rate charged to the borrowers."

[144] Senate Subcommittee on Financial Institutions, *Reform of Financial Institutions–1973*, 598.

[145] Senate Subcommittee on Financial Institutions, *Financial Institutions Act–1973*, 304.

[146] Senate Subcommittee on Financial Institutions, *Reform of Financial Institutions–1973*, 623. See also, McIntyre, in Senate Subcommittee on Financial Institutions, *Financial Structure and Regulation*, 398, and Proxmire, in ibid., 15.

benefits to savers, such costs cannot be considered unintended consequences.[147] Though they might have been undesirable consequences, lawmakers had every reason to believe that if they helped savers, then they would hurt borrowers, and they decided to so anyway.

As long as housing finance came from depository institutions, it seemed that the interests of consumer savers and consumer borrowers would continue to conflict. FHLBB Chairman Garth Marston explained, "There are about five savers to every one borrower. They are the ones who put up the funds for the home-purchase borrower. In turn, the borrowers provide the income to the savers. There is no other way around the fact they both need the help of each other."[148] Opponents of Regulation Q proposed a recalibration of the balance of those competing interests, arguing that it was only fair to tip the balance toward the consumer-saver. This appraisal failed to account for the fact that many savers themselves were also borrowers, and the temporal measure of fairness; changing the system meant borrowers prior to the change enjoyed terms that would not be available to borrowers after the removal of the ceilings.

S&L V.P. Warren Bain wrote in 1979, "What Senator Proxmire does not address or state is that <u>many</u> home purchasers are also <u>small savers</u>, and in the event that the small saver is able to obtain a greater yield on his/her savings of say $1,000 or $2,000,

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[147] This interpretation differs from that of Greta Krippner who argues that policymakers did not foresee deregulation of interest rate ceilings leading to higher prices for credit. See Krippner, *Capitalizing on Crisis*, 58-9.

[148] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Regulation Q*, 2239, 2240, 2243.

how much more will it cost that same small saver to purchase a home!!?"[149] Bain argued that is was not savers who subsidized borrowers, but current homebuyers subsidizing the past low rates of earlier homebuyers. Bain concluded, "Too many of the 'small savers' Senator Proxmire has so eloquently spoken about will be effectively priced out of the housing market for good…."[150] Consumers were savers and borrowers, and often both at once. Even if a consumer-saver was not and did not become a borrower, that customer could still bear the cost of increased rates through new fees and service charges. Lloyd Bowles of the U.S. League of Savings Associations warned in 1977, "frankly, we fear that without Regulation Q, the big banks will eventually 'gobble up' the smaller banks and the thrift institutions and we will end up in this country with a dozen or so super banks. There is no guarantee that the consumer saver will prosper under such a free savings environment."[151]

Deregulatory Quid Pro Quo

Over the course of debate over financial restructuring, elimination of Regulation Q became wedded to asset deregulation for thrifts. During hearings on the Nixon Administration's Financial Institutions Act of 1973, Senator Proxmire observed, "it might have been a political judgment on the part of Mr. Simon and others who drafted this [bill] that if they're going to get regulation Q changed, there would have to be some kind of a

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[149] Warren J. Bain, VP, First Federal S&L Association of New River Valley, to Proxmire, February 15, 1979; Testimony, Small Savers Equity; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[150] Ibid.

[151] Senate Subcommittee on Financial Institutions, *NOW Accounts, Federal Reserve Membership, and Related Issues*, 180. See also, Easterly, in Senate Subcommittee on Financial Institutions, *Financial Institutions Act–1973*, 373.

quid pro quo; otherwise, you will get the S. & L.'s, who are strong and represent a vigorous and effective force up here."[152] The Hunt Commission recommendations had anticipated as much, outlining a ten year period to phase-out Regulation Q that it argued should be adopted in tandem with broadened asset powers. But the offer to the thrifts would have to be very sweet, as while many thrift officials eagerly sought new asset powers, they proved extremely reluctant to make concessions on Regulation Q to achieve them. The reforms of the 1973 legislative proposal did not go far enough, as AFL-CIO economist Nat Goldfinger noted, "It would be a bad bargain for the thrift institutions to accept the tax changes and increased investment powers as a quid pro quo for the removal of Regulation Q. The net effect would be a greater competitive advantage for commercial banks than they now have."[153]

For the most part, policymakers remained convinced that removal of Regulation Q had to be joined by new asset powers to allow the thrifts to survive an increase in their cost of funds and a loss of the competitive advantage afforded by the differential. Fed Secretary Tynan Smith wrote to then Deputy Secretary of the Treasury William Simon in 1973, "The Board supports the general goal of eventually eliminating interest rate ceilings on time and savings deposits, but only as the portfolios of thrift institutions have become sufficiently adjusted to permit them to compete effectively for funds even during periods of credit restraint."[154] Consensus over just what asset powers would be necessary,

[152] Senate Subcommittee on Financial Institutions, *Reform of Financial Institutions–1973*, 632.

[153] Ibid., 616.

[154] Letter, Tynan Smith to William Simon, April 5, 1973, Folder "(Hunt Commission) Apr–Jun 1973 (8)," Box B46; Arthur Burns Papers; Gerald R. Ford Library, Ann Arbor, MI. See also, Edward Schmults, Treasury Undersecretary, in House Committee on Banking and Currency, *Regulation of the Issuance and Sale of Debt Obligations*, 29, and, in 1979, Anita Miller, FHLBB, to Donald Lotrich, Sterling S&L Association (Chicago), September 5, 1979; Consumer Checking Account Equity Act of 1979; Legislative

however, was harder to achieve. ABA President Rex Morthland argued, "to make feasible elimination of deposit rate ceilings, State usury ceilings on loan interest rates must be removed, raised, or preempted. We cannot pay higher rates on time deposits if we cannot earn the higher rates of interest on our assets."[155] Yet thrift officials continued to be suspicious of recommendations like those from the ABA that promised changes that would apply to all financial institutions, offering no continued competitive protection.

Speaking to the National Savings and Loan League in 1976, Senator McIntyre scolded his audience for allowing themselves to be held hostage to the differential, declining to advocate for enhanced asset powers for fear that the differential be taken away in exchange. McIntyre challenged, "Forget about the Hunt Commission, forget about the Financial Institutions Act, forget about the Financial Reform Act. Decide for yourselves what will best serve the needs of your industry and the public as well… stand up and be counted."[156] FHLBB Chief Economist and Director of the Office of Economic Research, Donald Kaplan reinforced this message, speaking to the same group that fall. Kaplan warned that Senator McIntyre had indicated that piecemeal financial reforms were more likely than comprehensive legislation. In such an event, Kaplan contended, "The savings and loan industry will face some real risks with regard to what many of you feel are the 'quid pro quos' for Reg. Q and the differential. We can be sure that as soon as

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Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP. Miller wrote, "Rate control can not be ended without severe damage to the thrift industry until such time as thrifts not only have been granted new powers–such as the ability to offer NOW accounts and make consumer loans–but have had sufficient time to learn to use the new authority in an efficient and competitive manner."

[155] Senate Subcommittee on Financial Institutions, *Financial Institutions Act of 1975*, 262. See also, House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Regulation Q*, 2501.

[156] Speech, Thomas McIntyre, "Innovation, Competition…and the Public Interest," at the Annual Convention of the National Savings and Loan League, San Francisco, CA, October 18, 1976, folder Oct. 16-31, 1976, Box O12, Arthur Burns Papers, Congressional Correspondence, Gerald R. Ford Library, Ann Arbor, MI.

one broadened power is achieved, there will be those that will argue that the differential should be narrowed and/or the ceiling raised, immediately."[157] Given a piecemeal approach, Kaplan suggested that the savings and loans would find it difficult to win all of the asset powers they sought, as they would be "in the awkward, and unfortunate, position of arguing against new powers that you want, and need, and which some of you sought as part of a package of powers only a short time ago," because they will be opposed to the concomitant liberalization of Regulation Q ceilings and/or the differential.[158] The differential, Kaplan asserted, would be in danger anytime that thrift earnings rose, and "in the long run, it is new financial services such as NOW accounts and consumer loans, that the public will want, not a quarter of one percent differential."[159] Some thrift officials began to sense that Regulation Q and the differential would not survive in the long-term. While they continued to fight tooth and nail to hold on to both as long as possible, they heeded McIntyre's advice and upped the ante on pressing for the expanded powers they would want in a post-Regulation Q environment.

First and foremost, that meant variable-rate mortgages. Lloyd Bowles, of the U.S. League of Savings Associations, referring to a resolution recommending authorization of some type of flexible-rate instrument, said, "if that were permitted, Mr. Chairman, then I'm saying to you–as an individual savings and loan operator–and you give us 7 or 8 years with some protection, then I will assure you that our outlook on regulation Q will

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[157] Donald Kaplan, "Current Regulatory Issues Facing the Savings and Loan Industry," October 19, 1976, National Savings and Loan League 33rd Annual Meeting; Home Mortgage Disclosure Act of 1975–Redlining; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[158] Ibid.

[159] Ibid.

be entirely different."[160] This presented a problem for lawmakers like Senator Proxmire, who, for the same kinds of reasons that they desperately wanted to see that small savers earned market returns, wanted consumer protections against usury and variable-rate mortgages.[161]

While House Democrats hesitated to proceed with expansive deregulation, a presidential task force on Regulation Q recommended deregulation of both the assets and liabilities of depository institutions. The task force included representatives from Treasury, HUD, OMB, CEA, FDIC, FHLBB, OCC, the National Credit Union Administration, the Federal Reserve, and the Special Assistant to the President for Consumer Affairs.[162] The report highlighted three main problems, arguing that Regulation Q, caused disintermediation, leading to a contraction of funds available for housing, unfairly penalized savers who get below market rates on deposits, and made the market inefficient.[163] The task force recommended a gradual phase-out of Regulation Q coupled with the loosening of regulations on the assets of savings institutions, including the authorization of VRMs, allowing federally chartered S&Ls to make consumer loans (up to 10% of their portfolios), and the authorization of negotiated order withdrawal (NOW) accounts (the interest-bearing transaction accounts).[164]

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[160] Senate Subcommittee on Financial Institutions, *NOW Accounts, Federal Reserve Membership, and Related Issues*, 241.

[161] Ibid., 3.

[162] *Deposit Interest Rate Ceilings and Housing Credit: The Report of the President's Inter-Agency Task Force on Regulation Q*. (Washington, DC: GPO, 1979).

[163] Ibid., x.

[164] Ibid., x-xi.

The task force reasoned that given the fact that Regulation Q failed to stop the cyclicality of housing markets and was contributing to disintermediation, the costs, the below market return to depositors and "market inefficiency," no longer justified an attempt to secure a cheap pool of housing credit through Regulation Q. Without Regulation Q, they argued, savings institutions would be free to compete for money against unregulated instruments such as money market mutual funds, and therefore could ensure the flow of credit for housing.[165] The task force recognized that if savings institutions were to compete for funds they would need broader investment powers in order to survive.[166] The task force, then, firmly linked the deregulation of savings institutions' liabilities to the deregulation of their assets, with the qualification that a gradual phase-out of Regulation Q would offer the thrifts a period of adjustment.

As they made their case, the task force repeatedly underscored the unfairness of Regulation Q to *small* depositors, "the current system of rate ceilings is manifestly unfair to small depositors [whereas] large depositors can receive market rates because of the exemption from the ceilings of CDs of $100,000 or more."[167] In fact, all of the regulatory efforts to stem disintermediation targeted large depositors, as all of the new instruments designed to compete with unregulated savings/investment instruments had high minimum buy-ins, often $10,000 or more. It is likely however, that disintermediation was caused by medium to large depositors, not the small depositors the task force seemed to be suddenly championing. The report cited the studies of economists David H. Pyle and Edward J.

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[165] Ibid., 1.

[166] Ibid., 2.

[167] Ibid., 13.

Kane estimating the "loss" to small depositors. Kane's most recent calculation estimated that between 1968 and 1979, the figure was close to $42 billion.[168] Consequently, the task force argued that Regulation Q, "cruelly discriminates against our older citizens, many of whom depend in part on the income from savings for their livelihood. It discourages saving, preventing many Americans from improving their standards of living in the future through this traditional means."[169]

At the same time, however, the task force also maintained that Regulation Q "fostered the development of new institutions and markets ready to meet the demands of the customer."[170] Though bemoaning the lack of saving, they argued that consumers were becoming increasingly sensitive to interest rates, and therefore were quite responsive to the new markets and their services and comparatively high-interest instruments. Perhaps the most popular of such investment options were money market funds with check writing options. The task force noted that once such instruments were available it would be exceedingly difficult, meaning politically untenable, to retroactively regulate or prohibit them. They predicted that consumers were likely to divert their savings into these unregulated (and thereby uninsured) instruments in greater and greater numbers. "Such a development," they argued, "would not portend well for either the overall safety and soundness of our financial markets, including our savings institutions, or the maintenance of an adequate flow of funds to the housing sector."[171] This assessment pointed toward policy changes that joined higher yields to deposit insurance.

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[168] Ibid., 15.

[169] Ibid., 14.

[170] Ibid., 17.

[171] Ibid., 25.

Around the time that the Carter Administration began to receive attention from the media for its recommendation to eliminate Regulation Q, Citibank took a more aggressive public position against the ceilings. In a full page advertisement, the nation's second largest bank cleverly addressed members of Congress. The ad read, "'Deposit $500 with us today, and we'll give you back $475 next year.'" With no apparent fear that the ad would be misunderstood by consumers, the text went on to explain:

> If a bank ran an ad like the one above, imagines the reaction of the Congress. Imagine the public reaction. But an American who puts $500 into a regular savings account today loses about $25 a year in purchasing power. That's because the law won't let banks pay more than 5 or 5¼ percent interest on regular savings accounts, while inflation keeps reducing the value of the money in these accounts.

The ad signaled the cleavage between the very largest banks, Bank of America, Citibank, and a few others, and the great majority of depository institutions over Regulation Q. The largest banks felt confident that they could compete against the money funds, and weather the increase in cost of funds that such competition would engender. And the largest banks had learned that the best way to pressure Congress for the elimination of interest rate ceilings was to enumerate the benefits to inflation-battling savers. "If banks are given an opportunity to compete among themselves and with others who offer financial services," that ad concluded, "the consumer will end up the winner."[172]

The Beginning of the End of Regulation Q: The Depository Institutions Deregulation and Monetary Control Act of 1980

The seemingly conflicting goals of achieving equity for small savers, assuring the financial vitality of the thrifts, and maintaining a stable flow of credit for housing came to a head in the legislative battles culminating in passage of the Depository Institutions

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[172] Advertisement, Citibank, *The Washington Post,* May 24, 1979. *ProQuest Historical Newspapers* (accessed March 24, 2013).

Deregulation and Monetary Control Act of 1980 (DIDMCA). The process by which this far-reaching legislation ground through Congress underscores the pivotal role of an ostensibly consumer-centered politics in providing an entering wedge for broader financial deregulatory reform. Since the Hunt Commission, proponents of reform had attempted to advance comprehensive deregulation of both interest rate ceilings and the asset powers of banks and thrifts, but Congressional ambivalence and outright resistance, especially in the House, stalled progress on either front. That the largest commercial banks had come to back the elimination of Regulation Q helped the cause of lawmakers like Proxmire, but the conflicting interests of the overwhelming majority of depository institutions remained a significant counterweight. As the following narrative demonstrates, proponents of financial deregulation succeeded in achieving concessions on interest rate ceilings and modest expansion of asset powers only after they hitched their initiatives to consumer-oriented legislation with broad support and urgent, court-imposed deadlines. Highlighting the contingency of the passage of the DIDMCA serves to cast the politics of the small saver as the glue that held broad reform together and, at long last, pushed the deregulation of interest rate ceilings through both houses of Congress.[173]

What eventually became the DIDMCA emerged out of at least three separate bills (two in the House and one in the Senate). The primary House bill (H.R. 4986) and the primary Senate bill (S. 1347) overlapped only on the issues of the authorization of

[173] For an account of the DIDMCA with greater attention to the Fed membership and reserve requirement aspects of the bill, see Marianne J. Scholte, "The Circumvention and Reform of Banking Legislation: An Institutionalist Case Study of the Years 1960-1982" (PhD diss., University of Notre Dame, 1990). In contrast to the argument that follows, Scholte "finds that the reform of banking law was inevitable…." Scholte, i.

Negotiable Order of Withdrawal accounts, accounts with automatic transfers and/or remote service unit withdrawals, and share draft accounts for Federal credit unions. All of these accounts in some way attempted to circumvent the prohibition of interest-bearing checking accounts. These were the critical, purportedly pro-consumer initiatives that carried the other, more controversial, portions of the DIDMCA, such as the phase-out of Regulation Q, through Congress. Legislation on the common issues of NOW accounts and share draft accounts became necessary in response to a decision of the District of Columbia U.S. Court of Appeals on April 20, 1979 that ruled that such accounts were illegal under current law. In its decision, the Court stayed prohibition of the accounts until January 1, 1980, giving Congress time to legally authorize the popular accounts. Lawmakers of both houses and parties eagerly sought to meet the court imposed deadline, but while the House bill focused exclusively on authorizing the expiring accounts, the Senate bill joined the narrow issue of authorization of these interest-bearing checking accounts to the long-standing and wider debate over financial reform. Gambling that the Congress would not dare to let the accounts disappear, the Senate bill's managers sought to break the logjam on interest rate ceilings by linking the elimination of Regulation Q to the issue to the virtually unassailable NOW and share accounts.

In addition to addressing the authorization of the accounts set to expire January 1st, the Senate bill, S. 1347, named the Depository Institutions Deregulation Act of 1979, included authorization of reserve requirements for all institutions offering NOW accounts, federal pre-emption of state usury ceilings, and the paired initiatives of expanding thrift asset powers and a ten year phase-out of regulation Q.[174] Senator

[174] *Congressional Record,* 96th Cong., 1st sess., 1979, 125: 14886-7. Senators Alan Cranston (D-CA) and Proxmire introduced S. 1347 into the record on June 14, 1979.The latter provisions replicated those of the

Proxmire, who along with Alan Cranston (D-CA) sponsored the bill, set the consumer-oriented tone for support of the bill, saying it would correct "one of the great inequities and injustices in our country today," the Regulation Q limitation on interest paid on deposits.[175] Making the case against Regulation Q, Proxmire argued that the interest rate ceilings were not achieving their purpose of ensuring the flow of funds to housing. Only the Money Market Certificates had staved off a mortgage credit crunch, he argued, and those, because of their $10,000 minimum denomination were "blatantly discriminatory against the small saver."[176] Proxmire argued that the Regulation Q barrier to market rates for savings would be particularly galling in light of the Federal Home Loan Bank Board's recent approval of limited authority to issue certain types of variable-rate mortgages.[177] Yet even Proxmire allowed that thrifts would require expanded powers (other than VRMs) in order to adjust to a phase-out of Regulation Q, which the bill offered in the form of authorization of consumer lending and investment in commercial paper of up to a total of ten percent of assets.[178] By joining asset power deregulation, though modest, and liability (interest rate ceiling) deregulation, the bill offered something to proponents of broad financial deregulation while still being palatable to those who, like Proxmire, were primarily concerned with ending Regulation Q.

Financial Institutions Act of 1975, the bill that the Senate passed, but the House never considered. Senate Subcommittee on Financial Institutions. *Financial Institutions Act of 1975*. The Senate passed the bill, S. 1267, by a vote of 79 to 14 on December 11, 1975. *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 39964. *Lexis Congressional* (accessed November 1, 2011).

[175] *Congressional Record,* 96th Cong., 1st sess., 1979, 125: 14890.

[176] Ibid., 14891.

[177] *Congressional Record,* 96th Cong., 1st sess., 1979, 125: 14891. See chapter 5. Proxmire said, "if there is to be simple justice the approval of variable rate mortgages, which is already an accomplished fact, must signal the end of Government imposed ceilings on the amount of interest payable on deposits."

[178] *Congressional Record,* 96th Cong., 1st sess., 1979, 125: 14890.

While the Senate continued its consideration of the sweeping reforms contained in S. 1347, the bill's much narrower House counterpart, H.R. 4986, the Consumer Checking Account Equity Act of 1979, remained strictly directed at authorizing the accounts that the Court of Appeals had declared illegal.[179] Free of the more controversial deregulatory reforms of the Senate bill, H.R. 4986 had the support of the U.S. League of Savings Associations, the Credit Union National Association, the National Association of Federal Credit Unions, the National Association of Mutual Savings Banks, the Public Interest Research Group, the Grey Panthers, the Consumer Federation of America and the AFL-CIO, and over 250 co-sponsors.[180]

Despite the long list of supporters, there were some critics of the bill, of whom Representative Frank Annunzio (D-IL) proved the most persistent and outspoken. Pointing to an effort by the bank lobby to attach an amendment to remove the housing differential in favor of thrifts, Annunzio revealed his primary concern that the bill would either include such an amendment or that the authorization of NOW accounts (for both thrifts and commercial banks) could be used as leverage against the differential in the future. In other words, if the thrifts and banks could offer the same services, the banks could argue that as a matter of fairness, they should be subject to the same interest rate ceilings. Annunzio, of course, was also well aware that the checking accounts already had been tied to the phase-out of Regulation Q (and with it, the differential) in the Senate, and sought assurance from St. Germain that no such yoking of NOW accounts to the differential would occur under H.R. 4986. St. Germain obliged, adding that he had

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[179] Ibid., 23790.

[180] St. Germane and Wylie, to "Dear Colleague," July 30, 1979, in ibid., 23793-4.

spoken with members of the Senate in order to make clear that such a "trade off [of] the most innovative consumer benefit in recent memory [interest bearing checking accounts] in the name of so-called financial reform [removal of the differential]" would be considered non-germane and would not be accepted by the House.[181]

Beyond his concern for the thrift industry and the fate of the differential, Annunzio questioned the merits of the NOW accounts themselves. During mark-up of the 1979 Consumer Checking Account Equity Act, he sought to expose what he saw as disingenuous arguments used to support the bill. Annunzio argued that "under the guise that they are helping the small saver," supporters of the bill were actually doing nothing to help the over 35 million depositors with less than $200 in their checking accounts.[182] Annunzio offered an amendment that would allow no greater than $100 as a minimum for any type of NOW account in order to give "everybody a chance to get a piece of the action, rather than making the bill a vehicle for those that are wealthy or rich."[183] In return for the low minimum, and in a concession he begrudgingly added to the previous version of the amendment that he had offered in the subcommittee, Annunzio's amendment would allow banks to make service charges on accounts with low balances and high activity. The exclusion of the truly small saver was particularly unjust, according to Annunzio, because they would not be able to earn higher returns on their money, but would bear the cost of NOW accounts through higher fees and interest rates. He warned, "you have got to remember…when you start paying these interest rates, that

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[181] Ibid., 23796.

[182] Committee on Banking, Finance, and Urban Affairs, "Transcript of Proceedings: Markup H.R. 4986– The Consumer Checking Account Equity Act of 1979" September 6, 1979, 14; Legislative Files; RG 233; Records of the U.S. House of Representatives. National Archives Building, Washington, DC.

[183] Ibid, 15.

somebody is going to have to pay for it, and it is the American public that is going to have to pay."[184] Representative St. Germain deflected this argument about unfairness with one of his own. The injustice that had to be righted through the bill was to allow consumers in the rest of the nation to enjoy the same kind of NOW accounts that depositors in New England and New York already enjoyed. Annunzio's amendment mandating a maximum $100 minimum on NOW account balances fell in a twenty-two to ten vote.

While Annunzio failed on this front, his efforts to ensure that NOW authorization would not be traded for the elimination of the differential resonated more widely. Several members of the committee, including the chairman, made clear that their endorsement of NOW accounts came entirely separate from any consideration of Regulation Q and the interest rate differential. Emblematic of the continuing ambivalence that many in the House held on Regulation Q, Representative Jerry Patterson (D-CA) argued for the decoupling of the issue from the NOW accounts, "I cannot view the differential and Regulation Q in term of one class of consumers. The argument has been made by some that [authorization of NOW accounts] means an additional power, therefore you give up Regulation Q. We should think of the consumer not only as a depositor but also as a homeowner, as a person who makes loans for the purchase of homes."[185] Both Annunzio and St. Germain reiterated Patterson's comments emphasizing that the committee's intentions were to authorize NOW accounts but, in St. Germain's words, "We're taking

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[184] Ibid. 16.

[185] Ibid, 34-5.

no position with regard to the differential or other Regulation Q matters."[186] In short, as late as 1979, key members of Congress remained unconvinced that Regulation Q should be eliminated. The House passed H.R. 4986, with no mention of Regulation Q, with 367 yea votes on September 11, 1979.

As the House considered and passed a bill that merely responded to the Court of Appeals' decision, Senators Tsongas, Lugar, and Morgan proposed comparably narrow bills as alternatives to S. 1347. [187] With Proxmire at the head of the Committee on Banking, Housing, and Urban Affairs, however, such initiatives stood little chance of seeing the Senate floor as a true opportunity to move on the expiring accounts without also acting on Regulation Q. Put simply, the urgency of the expiring accounts gave Proxmire leverage to push for the elimination of Regulation Q. He would not risk losing that opportunity even if a majority in the House and least some in the Senate were prepared to authorize the accounts without addressing any other financial reforms.

In late October, when the Senate began debating the House bill, still technically H.R. 4986, Proxmire offered an amendment in committee, substituting the text of S. 1347, thus yoking the phase-out of Regulation Q along with a host of other reforms to the House's narrow Consumer Checking Equity initiative. The House bill, a "NOW Account bill," Proxmire argued, was "incomplete because it does not address the gut issues of survival of thrift institutions and their commitment to housing over the long haul."[188] In

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[186] Ibid, 36.

[187] On August 1, 1979, Senator Tsongas sponsored S. 1627, the Consumer Checking Account Equity Act. Senators Lugar and Morgan introduced S. 1729, a bill to authorize automatic transfers, NOW accounts, RSUs, and Credit Union share draft accounts on September 10, and, Tsongas and Gravel co-sponsored a similar bill on September 17. *Congressional Record,* 96th Cong., 1st sess., 1979, 125: 21824, 23899, 24834.

[188] Ibid., 29099.

order to address those concerns, he concluded, Regulation Q had to be phased out. The full Senate never had the chance to debate a bill that authorized the expiring accounts without also beginning the elimination of interest rate ceilings.

In addition to authorizing the expiring accounts, the Senate substitute bill provided for a ten-year, gradual phase-out of Regulation Q ceilings,[189] the pre-emption of state usury ceilings, authorization of reserve requirements on the new transaction accounts for Fed member banks *and* non-member banks, as well as expanded asset powers for thrifts (which would be permitted to hold up to ten percent of assets in commercial paper and consumer loans). Proxmire bolstered his case against Regulation Q by citing the recent authorization of variable-rate mortgages by the regulatory agencies. "I would oppose as unconscionable variable-rate mortgage authority for the thrifts if not coupled with a phase-out of regulation Q," Proxmire asserted.[190] With a phase-out, and with stringent consumer safeguards, however, the long-time VRM opponent implied that he could tolerate the instruments.

Senator Robert Morgan, a North Carolina Democrat, took it upon himself to mount a counteroffensive to the Senate bill. Though, like Annunzio, Morgan's positions reflected his close association with the savings and loan industry, he offered a prescient critique of the implications of deregulation. Morgan sought to strip the bill of the Senate additions and return it to a form closer to that passed in the House.[191] He objected to the "homogenization" of financial institutions that would result from the proposed

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[189] The bill granted discretion on the timing and amount of increases of rate ceilings falling to the Fed, with consultation from FDIC, FHLBB, and the NCUA.

[190] *Congressional Record,* 96th Cong., 1st sess., 1979, 125: 29102.

[191] Ibid., 29102-7.

legislation, particularly the erosion of the special role for thrifts in housing finance. The thrift industry, he predicted, would disappear through a combination of bankruptcies, mergers, and reallocation of assets to non-housing consumer loans (he also predicted that the thrifts would soon come to Congress asking for an increase in the ten-percent limit on non-housing assets). Morgan believed, and he thought that the bill's co-sponsor Alan Cranston also believed, that the reforms would inevitably lead to a government bailout of the thrifts.[192] Unlike pro-deregulation economists, Morgan foresaw the bill leading to a future in which "the only financing that will be available for homeownership will be that provided by the Federal Government."[193]

Morgan credibly argued that any bill that went beyond the House version would doom the bill's chances of passage, thereby endangering the authorization of the checking accounts prior to the court-imposed deadline on January 1, 1980. St. Germain had explained to Proxmire and Cranston that House votes for H.R. 4986 the previous month had hinged on the "firm and often repeated commitment" that the bill dealt with the "share draft- NOW account issue [and was not] a stalking horse for other issues."[194] But Proxmire countered that all of the additional issues addressed by the Senate version of the bill had been thoroughly studied and debated in the House.

A few points of Morgan's critique gained some ground among fellow Senators. A provision to lower the minimum denomination on MMCs, though it would fulfill Proxmire's admonition to stop discriminating against small savers, remained

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[192] Ibid., 29104.

[193] Ibid., 29102-3. "Where are the young couple going to get a loan to build a home? They are going to have to come with their hands in front of them begging for another federal program to finance home loans."

[194] St. Germain, to Proxmire and Cranston, October 17, 1979, in ibid., 29106.

controversial under strong opposition from many in the thrift industry. Senators Bentsen (D-TX) and Garn (R-UT) pushed an alternative measure that would have substituted a tax exemption for savings interest in place of a lowered minimum denomination for MMCs. Morgan also gained some support in attacking federal pre-emption of state usury ceilings as a violation of states' rights. Morgan asked if there would be any limit on mortgage rates if the usury pre-emption passed. Proxmire replied that there would indeed be a limit, the limit set by the market. Calling Morgan a "solid free-enterpriser," Proxmire suggested that surely Morgan would agree that "letting the market work" would be the proper course. Though throughout the debate Morgan appeared happy to accept the title of "free enterpriser," he retorted, "there have to be some exceptions in the marketplace [and] I believe there should be some limitations on interest no matter where they come from."[195]

Morgan thus revealed some measure of ambivalence towards the marketplace and in favor of regulation. Indeed, Proxmire himself remained weary of deregulation of asset powers, but accepted it as a necessary trade-off to achieve the phase-out of Regulation Q. In light of the threat that Morgan's amendments could strip some (and maybe not all) of the various measures in H.R. 4986, Proxmire sought to make explicitly clear that expanded asset powers for thrifts remained on the table "only on the condition that regulation Q be phased out."[196] What appeared to Morgan to be a series of "extreme measures" tacked on to the core issue of authorizing the expiring checking accounts, was to Proxmire a carefully balanced package of compromises designed to protect the core issue of phasing out interest rate ceilings.

[195] Ibid., 29911.

[196] Ibid., 29913.

The proposed phase-out came under scrutiny from Senators Tsongas (D-MA) and Ford (D-KY) who pressed Proxmire on the question of whether or not higher ceilings would mean higher interest rates for borrowers. Proxmire responded that the cost of funds was but one of many factors that determined interest rates for borrowers and that "the decisive factor is what happens to interest rates generally and what the opportunity cost of money is."[197] Inflation then, remained the central issue to Proxmire, even as he ignored or explained away any possible contribution that higher rate ceilings might make to inflation.[198]

An exchange between Tsongas and Ford revealed a central dilemma. Tsongas argued for equity for the depositor while Ford focused on the borrower. Ford argued, "what I see us doing here is a phased-in increased interest rate which is now at 13 ¼ to 13 ¾, and it is almost impossible for young people to borrow money to buy a home with…"[199] As Tsongas summed it up, "you have, in essence, the small saver subsidizing the mortgage rate now being paid out by the borrower, so there are inequities on both sides."[200] Ford went on to argue that the truly small savers would be hurt by NOW accounts, "The only people who are going to get hurt with the NOW accounts are those who have no money. They are going to absolutely be hurt… because they are having to

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[197] Ibid., 29923.

[198] See, for example, House Committee on Banking and Currency, *Regulation of the Issuance and Sale of Debt Obligations*, 92. James Hanley testified, "with reference to the witnesses who appeared this morning [FED, FHLBB, FDIC, Treasury], there was a great deal of colloquy about inflation, and I never cease to be puzzled about the reluctance on the part of so many money experts [who] refuse to associate the cost of money as a contributing factor to inflation."

[199] *Congressional Record,* 96th Cong., 1st sess., 1979, 125: 29923.

[200] Ibid.

pay through their noses."[201] To Proxmire's argument that Regulation Q simply was not working (preventing disintermediation), Ford responded, "in my state we just want to be left alone."[202] Proxmire retorted, "Regulation Q is unfair to small savers which we have been trying to establish and there are small savers in Kentucky, North Carolina, Utah, Massachusetts, and elsewhere. Regulation Q is responsible for inefficiencies in the marketplace. For all these reasons we are trying to end this kind of bureaucracy, this kind of determination, not by the marketplace, but regulation by bureaucratic fiat. It just is not working well."[203]

Senator Garn, rising to support Ford on his questioning of the reduction of the MMC minimum denomination to $1,000 argued, "In the name of the small saver we get these populist things going on, and that is the big thing in the Banking Committee lately, let us do something for the small saver as long as it looks like it will be helping the small saver, without regard to the costs and how that will be translated back … in higher interest rates."[204] Garn said of MMCs in particular, "I realize how politically popular it is to stand up and yell, 'I'm trying to help the small saver,' [but] I do not really believe that it will."[205] Morgan suggested the ultimate beneficiary, instead of the small saver, would be the big banks. Mentioning Citibank, Chase Manhattan, and Bank of America by name, Morgan ruminated about the possibility of those banks moving into his hometown of Lillington, NC, "I wonder if my banking friends down in North Carolina would be so

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[201] Ibid.

[202] Ibid., 29924.

[203] Ibid.

[204] Ibid.

[205] Ibid.

enthusiastic about this bill then."[206] Morgan again predicted that the bill would lead to some combination of government bailouts and large bank buyouts of the thrifts.

Morgan's attempt to amend the Proxmire bill, substituting a version closer to that already passed by the House, failed by a margin of fifty-seven to thirty-eight.[207] Unable to stop the broader bill, Morgan zeroed in on one of the more controversial proposals, the so-called "small saver provision" that would cut the minimum denomination of MMCs to $1,000. Joining Morgan, Senator Donald Riegle (D-MI) said of the proposal, "while it has a very popular ring to it, we have to really evaluate what the consequences are to these same people when they come in to seek money to finance a home."[208] A reduction of the MMC minimum would come at enormous cost to the thrifts, as more savers qualified for uncapped rates of return. The pinch on the thrifts would translate to increasing borrowing costs and/or severe tightening of credit. But against this legitimate concern for the thrifts and for borrowers, Proxmire pressed the case of the small saver as the more sympathetic victims, going as far as claiming, "Borrowers in many cases are better off financially than savers."[209] Citing an estimate of $20 billion in lost interest rates over the last 13 years due to Regulation Q, Proxmire then imagined the story of a retired couple with $6,000 of savings that lost $22.50 per month, or, as he put it, enough for a hot breakfast every day for a month. Framing the issue for the Senate, Proxmire concluded, "A vote against the small saver provision is a vote against the small saver … the small saver is entitled to fair rate of return. The small saver should not be required to

[206] Ibid., 29932.

[207] Ibid., 30301.

[208] Ibid., 30312.

[209] Ibid., 30313.

subsidize borrowers."[210] Despite the concerns raised by Morgan over the possible negative consequences for borrowers and for the survival of the thrift industry, Proxmire's bill carried the day, approved by a vote of seventy-six to nine.[211]

The conference committee met in early December to reconcile two wildly divergent bills, but failed to agree on a bill to return to the respective Houses for passage. This left the Congress under the looming January 1 deadline upon which the account types struck down by the Court of Appeals would expire. With no hope of a bill out of conference, legislators sought a stop-gap solution. Proxmire hijacked an unrelated bill that had been passed by the House and awaited hearing in his committee, repurposing it by amendment to temporarily authorize the expiring accounts until the end of March.[212] Both Proxmire and Senator Jake Garn expressed regret that they were not voting on H.R. 4986 and indicated that the more comprehensive legislation had been held up by the House Conferees' insistence that they hold hearings on the Senate-proposed phase-out of Regulation Q.[213] Yet, by making the authorization temporary, the bill would force the House to take up the phase-out of Regulation Q in the new year. Garn urged quick action by the House to ensure that the deadline on the expiring accounts would be extended and thus allay the concerns of depository institutions and consumers alike.[214]

The House agreed to the temporary extension. Though many, including St. Germain and Wylie, preferred permanent authorization, they dared not test the Senate and

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[210] Ibid., 30313.

[211] Ibid., 30662.

[212] Ibid., 35264-7.

[213] Ibid., 35267.

[214] Ibid., 35267.

risk allowing the accounts to expire.[215] St. Germain turned the blame for the failure of the Conference Committee to return H.R. 4986 for a vote onto the Senate, first for having loaded the bill with "unrelated [to the original, House-passed bill] financial measures," and for then refusing to move on any compromise bill that did not include a phase-out of Regulation Q.[216] The compromise meant that St. Germain and Stanton's assurances to Annunzio and others that the NOW and share accounts would not be linked to Regulation Q would be broken.[217] The expiring accounts were extended to the end of March 1980, assuring that Congress would have to revisit the issue. President Carter signed H.R. 4998 into law on December 28, 1979.[218] Carter expressed his hope that more comprehensive financial reform legislation, including the phase-out of Regulation Q, measures to bolster Federal Reserve membership, and expanded thrift powers, would reach his desk early in the following year.[219]

A December 13, 1979 Treasury Department legislative report noted that though Congress would pass something to comply with the Court-imposed deadline, "the Federal Reserve Proposal and Reg Q reform will await next year when much will be expected and because of election year demands, much will be difficult to deliver."[220] Yet conferees slogged through negotiations in early 1980 despite the election concerns and in late

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[215] Ibid., 36393.

[216] Ibid., 36391-2.

[217] Ibid., 36404.

[218] P.L. 96-161.

[219] Jimmy Carter, "Financial Institutions Deregulation Legislation," *Weekly Compilation of Presidential Documents* 15, no. 52 (December 31, 1979): 2288-9. *HeinOnline* (accessed November 23, 2011).

[220] Gene Godley, to Miller, December 13, 1979; Legislative Reports; Subject File of Lawrence M. Baskir, Deputy Assistant Secretary for Legislative Affairs, 1977-1979; General Records of the Department of the Treasury; RG 56; NACP.

March, just before the deadline of the extension of the expiring accounts, returned a bill to Congress. When H.R. 4986 returned to the Senate floor, Proxmire referred to "sharp and heated" disagreements in the committee, but heralded the compromise-laden bill that emerged as "the most significant banking legislation … since the passage of the Federal Reserve Act of 1913."[221] The modernized system, Proxmire extolled, "relies more on the forces of the marketplace and less on the forces of regulation in shaping the structure of our financial system."[222] Proxmire pointed to the "historic departure from past efforts to lower the cost of credit at the expense of the saver," as a major victory for "saver equity."[223] Yet even Proxmire, after the many compromises struck in Conference Committee, found many distasteful aspects of the resulting bill. Proxmire particularly set out to clarify the relationship between expanded thrift asset powers and the Regulation Q phase-out, namely that they had to happen in tandem, and that a requirement in the bill for a study on the possibility of federal subsidization of low-yielding mortgages should not signal that depository institutions should expect a government bailout in the event of thrift insolvencies. Proxmire stated unequivocally, "Let us give the message loud and clear: No bailouts. This is a free and competitive economy. There is no guarantee of survival in a free economy."[224]

St. Germain indicated that the conferees had struck a number of compromises, and as did a few others, expressed the sentiment that the bill fell short of perfection but remained deserving of support. St. Germain freely admitted, however, that the bill left

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[221] *Congressional Record,* 96th Cong., 2d sess., 1979, 125: 6893.

[222] Ibid.

[223] Ibid., 6900.

[224] Ibid.

several "imponderables" including the question of housing affordability.[225] He conceded that new solutions would be necessary to ensure an adequate supply of affordable housing credit and began to outline possible tax-based incentives to encourage mortgage lending. Despite the inclusion of the Regulation Q phase-out that many had insisted that conferees assure would not become part of the bill, the expiring accounts required immediate action and the bill passed with 380 yeas.[226]

On March 28, 1980, the final day of debate of the bill in the Senate, a small handful of senators expressed their concern about both the substance of the bill and the procedures by which it was amended and would be acted upon. Senator Exon (D-NE) decried the pre-emption of state usury ceilings as "a gross violation of states rights" and a "centralization of control of money into Federal hands."[227] Senator Armstrong (R-CO), who had voted against the bill in committee, reiterated his objections and added that the changes made in conference only gave him greater reason for concern. Armstrong opposed the extension of reserve requirements to all depository institutions offering NOW accounts, which he characterized not as deregulation but as "further concentrat[ion] of economic decisionmaking in Washington."[228]

Armstrong directed his main objection, however, to procedural issues. The Conference Report, he argued, represented, "a very significant policy decision being made without consultation of the Senate, in a way which is contrary to the express will of

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[225] Ibid., 6972.

[226] There were thirteen nays (eight Democrats and five Republicans), eleven present (two Democrats and nine Republicans), and twenty-seven not voting (sixteen Democrats and eleven Republicans).

[227] Ibid., 7062.

[228] Ibid., 7063.

the Senate Banking Committee, made behind closed doors in a conference committee by a handful of people operating against a deadline and in a high-pressure environment."[229] Even more troubling to Armstrong was the unanimous consent agreement struck by the majority and minority leaderships that would preclude a roll-call vote on the Conference Report. Senator Morgan, the bill's primary Senate opponent during the previous fall, joined Armstrong in accusing Proxmire of the "arrogance of power" to go to conference to get everything in the bill that he had wanted, disregarding debate and even a vote of the Senate [in favor of a Morgan amendment to strike reserve requirements on NOW accounts]."[230] Morgan continued his criticism of several aspects of the bill that, he claimed, would "expedite the demise of the savings and loan institutions," which, he hinted, "would need that $100,000 . . . insurance very badly."[231] Proxmire defended the bill, including each compromise struck by the conference committee. He argued that both Houses had been debating financial regulatory overhaul for a decade, that while the Senate bill had not included the Conference version's provisions for Federal Reserve membership, neither had the House version contained provision for the phase-out of Regulation Q, and, using his trump card, that the nation urgently needed both policies to combat inflation.[232]

The reasoning behind the unanimous consent agreement never emerged explicitly from the exchange, but Senator Robert Byrd's reference to "extenuating circumstances" suggests that his explanation would have emphasized the time crunch, the 28th being a

[229] Ibid.

[230] Ibid., 7068.

[231] Ibid., 7067, 7072.

[232] Ibid., 7064.

Friday, and the expiration of authorization of NOW Accounts, credit union share draft accounts, and remote service units at midnight the following Tuesday, and the custom of not holding votes on Fridays. A more cynical interpretation would highlight the convenience of not having a record for the review of a long list of powerful interest groups opposed to various as parts of the bill. With unanimous consent, the Senate passed the bill, which President Carter eagerly signed into law.

President Carter's remarks during the signing of the DIDMCA focused on its promise to fight inflation, strengthen financial institutions, and help small savers. Carter credited the efforts of Bill Miller (as Fed Chair, then Treasury Secretary), Proxmire, Reuss, St. Germain, Stanton, and Garn for ushering the bill to passage. Among its many provisions, the Act created the Depository Institution Deregulation Committee (DIDC) and charged it with the task of overseeing the gradual phase-out of Regulation Q, with a deadline of 1986 for the complete removal of interest rate ceilings. Congress gave the DIDC a great deal of flexibility in determining the pace of deregulation within these broad parameters so that the committee could give the depository institutions sufficient time to adjust to the increasing cost of deposits. The "Statement of Managers" indicated the legislators' intent, "The conferees felt that the small saver needs to be accorded equity in the marketplace as quickly as feasible. Accordingly the conferees adopted provisions to phase-out Regulation Q just as soon as is feasible. The [DIDC] retains sufficient flexibility to ensure that thrift earnings suffice to enable them to survive in a market environment and enable them to pay competitive rates for funds."[233] To reiterate the latter

[233] Committee on Banking, Finance, and Urban Affairs. "Statement of Managers H.R. 4986," March 7, 1980, 6. Legislative Files; Records of the U.S. House of Representatives, RG 233; National Archives Building, Washington, DC.

point, the report went on to state, “The conferees also agreed that the phase-out must be handled with due regard for the financial condition of depository institutions.”[234]

The dual charges to the DIDC, to secure the small saver a market rate and to ensure the “safety and soundness” of the depository institutions that would pay that market rate, were not inherently contradictory. In theory, as deregulation proponents would later argue, depository institutions that paid market rates for funds could compensate for the increased cost of funds by attracting more deposits. However, during the life of the DIDC, the spread between “market rates” offered by MMMFs and the regulated cost of funds was so great that increased cost could easily outpace increased deposits. In such an environment, the DIDC, from its inception, faced a fundamental dilemma as its responsibility to the “small saver” contradicted its obligation to the depository institutions. The solution to this dilemma was not clear. To some, like Fed Chair Paul Volcker, it was imperative to maintain the institutions’ access to low cost funds as long as they needed them. For others, especially new regulators appointed by President Reagan, the answer was to let the institutions compete for funds by offering market rates. The contentious tenure of the DIDC will be covered in detail in Chapter Six.

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The long and tumultuous road to legislation initiating the phase-out of Regulation Q demonstrates the deep ambivalence of lawmakers toward deregulation. The special role that thrift institutions had played in financing home ownership in post-war America and

[234] Ibid.

their unflagging insistence that they needed Regulation Q protection, made many lawmakers hesitant to remove rate ceilings. But other lawmakers became insistent on achieving market rates for savers despite the costs that would be borne by thrifts and new borrowers. Though the argument that Regulation Q unfairly barred savers from market returns dated back to the early 1970s, it gained sufficient traction only in the context of historically high inflation at the end of the decade, particularly in the light of the higher returns offered by financial instruments beyond the reach of Regulation Q. Decisions made by regulations early in the decade aroused little fanfare when they were made, including exemption of CDs over $100,000 and not bringing various new financial instruments under Regulation Q ceilings, but made the discrimination against small savers seem all the more punitive during high inflation. Even then, only legislative maneuvering overcame the hesitation of many members of the House who as late as 1979 tried to keep action on Regulation Q separate from pro-consumer initiatives to legalize interest-bearing checking accounts.

Whether by demanding higher interest rates on bank and thrift deposits, as did the Gray Panthers along with countless unorganized depositors, or by seeking higher rates outside of the traditional banking structure, increasing numbers of savers, small and otherwise, simply refused to continue to play along with the rules of the New Deal system of housing finance. The first 3 in the 3-6-3 rule (by the late 70s, a 5% return on savings) was not enough, they reasoned, and by then, a majority of American households had already locked-in the 6, the low-rate mortgage, and had little use for maintaining the system, even if it meant that future borrowers would have to pay higher rates for their mortgages. AFL-CIO economist Henry Schechter's view, that depositors accepted lower

than market returns on savings in order to help another generation become homeowners, found less and less support among depositors desperately attempting to stay ahead of inflation. These homeowning saver-investors through letter-writing, picketing, and most significantly withdrawing money from banks and thrifts, got the attention of policymakers like Proxmire, and compelled them to respond by pursuing deregulation, at least narrowly.

Along with the deregulation of interest rate ceilings, the DIDMCA contained limited deregulation of thrift assets. While some, like Senator Morgan, felt that these powers would lead to homogenization of financial institutions, leaving no institutions devoted to residential mortgage financing, deregulation could have ended there, with S&Ls enjoying modest consumer lending powers, but otherwise remaining primarily housing lenders. But in the coming years regulators and thrift officials would leverage the deregulation of interest rate ceilings, which proved much more difficult than the DIDMCA conferees had anticipated, for further deregulation of assets, claiming that the future of the industry hung in the balance. The result would be a system of housing finance that looked and operated much differently than the New Deal system that had facilitated the post-war expansion of homeownership and that had only recently been, ostensibly, at least, opened to all borrowers through the Fair Housing, Equal Credit Opportunity, and Community Reinvestment Acts.

Chapter 4

To Regulate or Not To Regulate–Money Market Mutual Funds, 1975-1982

"WILD! CRAZY! …I disagree totally with all the alleged facts and every single policy recommendation in this testimony." [1] Hand-scrawled in red ink, these words belonged to Marshall Kaplan, Acting Director of the Federal Home Loan Bank Board's Office of Policy and Economic Research. What had so exasperated Kaplan was a draft of congressional testimony, scheduled for delivery by the Bank Board chairman in April 1981. The draft, written by Randall McFarlane, called for increased regulation of money market mutual funds (MMMFs). McFarlane argued that reserve requirements, liquidity requirements, community reinvestment obligations, and/or deposit rate controls (Regulation Q) should be considered for the money funds.[2] But to Kaplan the idea of regulating the money funds was "so incredibly wrong in every respect… and completely insensitive to anything having to do with the reasons consumers want the high yields of [Money Market Funds] in a highly inflationary economy."[3]

Underlying this passionate exchange over proposed congressional testimony were divergent visions of the financial marketplace. In arguing for regulation, McFarlane sought to protect the community-oriented depository institutions and insulated source of

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[1] "Draft: Statement of the Federal Home Loan Bank Board on Money Market Funds before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, April 8, 1981"; Money Market Funds Testimony; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[2] Ibid. "Because of the competitive inequities that exist between money market funds and depository institutions, I will recommend in my remarks today that consideration be given to subjecting money market funds to regulations similar to those covering depository institutions…."

[3] Ibid.

low-cost funds central to the New Deal System of housing finance. This arrangement, he argued, "should not be jeopardized by allowing relatively unregulated competitors to drain away the deposit base upon which the system depends."[4] Consistent with the design of the Community Reinvestment Act, McFarlane viewed local banks and thrifts as the best intermediary of household savings, drawing in deposits and reinvesting that capital through mortgage and business loans into the community in which it was based. Though offering savers the safety of insured deposits, the convenience of local branches, and the liquidity of easy withdrawals and checking, this vision leaned towards concern for borrowers, especially would-be homeowners. In contrast, Kaplan advocated leaving the funds unchecked, allowing savers to earn higher returns wherever they might be found, and capital to flow to whatever institutions could compete to get it, without special regard for channeling capital to housing or to local communities.

These competing views were the same that divided perspective on Regulation Q and the New Deal system of housing finance more generally, but the money market mutual funds raised the stakes for all concerned parties. For savers, the funds were an attractive alternative to Regulation Q-capped savings accounts at depository institutions. MMMFs offered market rates with many of the conveniences of a bank or thrift account, often including check-writing privileges. In comparison to a bank or thrift account, all the MMMF lacked was federal deposit insurance. As MMMF yields reached double digits in the late 1970s, twice as high as Regulation Q-limited accounts, the difference between interest rate ceilings and MMMF rates became a concrete representation of the "market rate for savings" and the money "lost" to savers due to "discriminatory" ceilings. This unfavorable comparison of Regulation Q ceilings to much higher market rates on

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[4] Ibid.

MMMFs fueled both the demands for higher rates at insured depository institutions and disintermediation, or transfer of money, from depository institutions to the money funds. For borrowers, the funds tightened the availability of credit and increased its cost as lenders struggled to retain funds and/or paid more to keep them. The increasing flow of household savings to money funds based in cities like New York and Chicago undermined the very premise of community reinvestment.

MMMFs raised the stakes for depository institutions because, unlike the other financial innovations designed to circumvent Regulation Q such as the 1974 Citicorp offering,[5] MMMFs attracted savings money on such a scale as to challenge the actual underpinnings of housing finance. Saver/investors diverted tens, eventually hundreds, of billions of dollars into the funds, creating a severe threat to the viability of depository institutions and to housing finance. So great was the danger posed by competition with the funds that a range of influential interest groups and policymakers, including some who generally favored deregulation, came together to support the extension of regulations to cover MMMFs. Between the springs of 1980 and 1981, Fed Chairman Paul Volcker, Bank Board Chairman Richard Pratt, the Consumer Federation of America, the National Associations of Realtors, Home Builders, and Mutual Savings Banks, the AFL-CIO, and an unlikely partnership between the American Bankers Association and the U.S. League of Savings Associations all called for federal regulation to contain the growth of money market mutual funds. Both Houses of Congress held hearings to consider the imposition of restrictions on the funds and several state legislatures debated increased regulation and limitations for the funds.

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[5] See Chapter 3.

Yet the stakes were not always so high. In the mid-1970s, when MMMFs still measured under $4 billion, regulators saw the funds both as a violation of the spirit of Regulation Q and as a *potential* threat to depository institutions and housing finance. In 1976, regulators at the Federal Reserve and the FDIC formally proposed regulations to curb the growth of the money funds. It would have been much easier to impose restrictions then, before so many American households had invested in the funds. But regulators ultimately did not impose the proposed restrictions. Instead they bowed to pressure from a few influential lawmakers who sought to keep access to market rates through MMMFs open to middle-class investors.

With MMMFs left unchecked, by the late 1970s and early 1980s, the potential threat was becoming real, and regulators responded by authorizing banks and savings and loans to issue ceilingless Money Market Certificates and continued to liberalize interest rate ceilings that depository institutions could compete with the money funds. But the competition created severe earnings problems, especially for the thrifts, as the cost of funds rose dramatically. As banks and S&Ls struggled to keep funds into the early 1980s, regulators again considered imposing regulations on the money funds. Yet as in 1976, in the interest of protecting access to market yields for middle-class investors (and over the calls of the long list of powerful policymakers and interest groups above), policymakers opted not to extend regulations to cover MMMFs. With investors' stake in the funds then over $100 billion, too many middle-class Americans had too much to lose for lawmakers to take a stand against them.

Had policymakers imposed regulations to restrict MMMFs in 1976, the politics of financial deregulation would have played out much differently. Without competition

from MMMFs, there would have been no market rate alternative to Regulation Q-capped accounts that offered the same convenience, liquidity, and checking privileges. Disintermediation would likely have been considerably less severe, high-cost funds such as MMCs would have been unnecessary, and, consequently, depository institutions would have been in much better financial condition. And even if policymakers had left the funds untouched in 1976, but had imposed restrictions later, in 1980 or 1981, subsequent policy likely would have been different. Reduced competition from MMMFs might have bought enough time for the thrifts, in particular, to ride out the high interest rates of the early 1980s without needing expanded asset powers (though S&L officials would undoubtedly have asked for expanded powers, lawmakers would have been under less pressure to acquiesce). But the point here is not to imagine an alternative past that never happened, rather, it is to highlight that policymakers made a choice, among alternative possibilities, to follow the path that they did.[6]

The explanation offered here is that the influence of middle-class saver/investors, through direct pressure on lawmakers to ensure higher yields on savings and through the problems that disintermediation created for depository institutions, pushed policymakers to pursue first liability (interest rate ceilings), and then asset (lending powers), deregulation, even if deregulation of both sides of the ledger meant higher costs and risks for borrowers and the erosion of the protected status of housing finance. Time after time,

[6] In contrast, for example, R. Alton Gilbert explains the deregulation of interest rate ceilings, "realizing that Regulation Q was not yielding the desired results of restraining competition for deposits or increasing the supply of mortgage credit, Congress responded by passing the [DID]MCA in March 1980, which established a procedure for phasing out Regulation Q." In this more typical account, Congress, and policymakers more broadly, were only responding to existing problems that they were implicitly able to alter only through deregulation. R. Alton Gilbert, "Requiem for Regulation Q: What It Did and Why It Passed Away," *Federal Reserve Bank of St. Louis Review* (1986): 22-37. http://research.stlouisfed.org/publications/review/86/02/Requiem_Feb1986.pdf (accessed October 17, 2011).

when various financial interest groups were pitted against one another, policymakers' responsiveness to the interests of saver/investors tipped the balance toward deregulatory policies. Those deregulatory policies, in turn, steered housing finance away from the vision expressed by Randall McFarlane and community reinvestment activists of locally-oriented and obligated depository institutions channeling deposits to affordable mortgages.

Money Market Mutual Funds

Historically, when interest rates in money markets rose well above the rates offered by depository institutions, most depositors had no way of accessing those higher rates. Consequently, disintermediation typically meant that depository institutions lost high-minimum deposit accounts, not low-cost passbook savings (the savings deposits earning the proverbial 3%). The average passbook savings depositor lacked the knowledge and connections to invest in short-term money markets and, most likely, an amount of money necessary to do so (most instruments had minimum denominations of $1,000 and higher when in 1974, for example, the average savings balance was $1,200).[7] Money market mutual funds solved both of these problems as brokers with ready access to money markets pooled the funds of hundreds, eventually thousands, of small investors to invest in money market instruments including certificates of deposit, government securities, and commercial paper.[8] Whereas large investors had long been able to avail

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[7] "How Not to Provide More Housing Funds," *Deseret News*, December 25, 1974. *Google News Archive* (accessed December 26, 2012).

[8] After 1970, Regulation Q ceilings no longer applied to bank and thrift accounts over $100,000. See Federal Reserve System, "Part 217 – Interest on Deposits," *Federal Register* 35, no. 125 (1970): 10501.

themselves of such investment opportunities directly, the MMMFs opened these outlets up to smaller investors. As many policymakers would later say, the money market funds filled a market need by connecting small depositors to the money markets and their (typically) higher interest rates.[9]

The funds grew slowly at first, as depositors/investors learned more about the new investment opportunity. The first fund became available to the public in 1972, when the SEC approved the prospectus for the Reserve Fund of New York. The innovation of two pension fund managers, Henry B. R. Brown and Bruce R. Bent, the Reserve Fund took off when short-term interest rates rose over Regulation Q ceilings in 1973. In 1974, the Dreyfus Corporation offered its version of the MMMF, called Dreyfus Liquid Assets, and in June of that year, Fidelity Investments followed with the Daily Income Trust. By the end of the decade, Paine, Webber, Shearson, and Merrill Lynch too had offered MMMFs. These larger investment firms, though later entrants, used their infrastructure and resources to dominate the market. Merrill Lynch, in particular, capitalized on its existing network of brokers and customers to make first its Ready Assets fund and then its Cash Management Account into the leading funds, amassing hundreds of billions of dollars by the 1990s.[10]

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[9] Proxmire called the funds, "a textbook example of a market response to the need for financial services that were not being offered by other financial intermediaries." William Proxmire, in Senate Subcommittee on Financial Institutions, Committee on Banking, Housing, and Urban Affairs, *Money Market Mutual Funds: Hearings before the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs, United States Senate,* 96th Congress, 2d sess., January 24 and 30, 1980 (Washington, DC: Government Printing Office, 1980), 2. Jake Garn in John Charles Daly, Jake Garn, American Enterprise Institute for Public Policy, et al., *Money and Housing* (Washington, DC: AEI, 1981), 17.

[10] Steven P. Schnaars, *Managing Imitation Strategies: How Later Entrants Seize Markets from Pioneers* (New York: The Free Press, 1994), 118-121.

As late as the end of 1977, MMMF assets totaled only between $3 and $4 billion.[11] But as inflation increased in the late 1970s and early 1980s, banks and thrifts, the mutual savings banks, credit unions and savings and loans, experienced declines or even loses in deposits, while money market mutual funds experienced exponential growth. By March 1981, the value of MMMF assets topped $101 billion.[12] Precisely how much of that capital made its way back into depository institutions via MMMF purchase of bank certificates of deposit remained uncertain, but most policymakers, bankers, and thrift officials assumed that the incredible growth of the MMMFs came at the expense of traditional depository institutions.[13]

A Case for Regulating Money Market Mutual Funds

Under the authority of the Investment Company Act of 1940, the SEC initially assumed responsibility for the regulation of MMMFs.[14] According to their charge, the SEC regarded money placed with a money market fund to be an investment, not a deposit. The line between deposit and investment blurred, however, as MMMFs began to offer check-writing privileges. As money funds' services increasingly resembled those offered by traditional depository institutions, the case for subjecting the funds to banking regulations grew stronger. If the MMMF was a transaction account subject to banking

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[11] Timothy Q. Cook and Jeremy G. Duffield, "Money Market Mutual Funds: A Reaction to Government Regulations Or A Lasting Financial Innovation?" *Federal Reserve Bank of Richmond Economic Review* 65 (July/August 1979): 15.

[12] Tom Herman, "Engine of Inflation?: Money-Market Funds Rise 3% to $101.21 Billion, Setting Record in 10th Consecutive Weekly Gain, *Wall Street Journal*, March 13, 1981.

[13] Lee Gunderson, in *Money Market Mutual Funds*, 420.

[14] *Money Market Mutual Funds,* 9.

regulation, it would be covered by Regulation Q rate ceilings, reserve requirements, and the Community Reinvestment Act, among other regulations. As it was, the checkable money funds likely breached Glass-Steagall, the 1933 law that separated deposit functions from investment banking. A logical case, then, could be made that the MMMFs violated existing regulations.

On March 8, 1976, the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Board of Governors (FRB) made that case through proposed amendments to Regulation Q.[15] Pooling funds for the purpose of meeting minimum amounts for high-yield CDs, the Board argued, "act[s] contrary to the spirit of the interest rate limitations," and constituted a threat to housing finance.[16] The proposal explained, "in light of the potentially adverse effects that pooling may have on member and nonmember financial institutions due to potentially disruptive shifts of funds, the Board believes it appropriate to amend Regulation Q to specifically prohibit the payment of interest in excess of the rate established for deposits of less than $100,000 on pooled deposits."[17] The FDIC and FRB identified exceptions to the proposed rule including banks or attorneys combining trust or escrow accounts, and the implications for mutual funds remained ambiguous under an additional exception for "mutual funds which have a stated investment objective of investing in other than deposit obligations and whose

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[15] FDIC, "Interest on Deposits," *Federal Register* 41, no. 46 (March 8, 1976): 9896.

[16] Federal Reserve System, "Interest on Deposits," *Federal Register* 41, no. 51 (March 15, 1976): 10917. See also, Burns to Proxmire, April 19, 1976, folder "Apr. 7-20," Box O10, Arthur Burns Papers, Gerald R. Ford Library, Ann Arbor, MI. Burns explained, "Although the Board favors the elimination of rate ceiling limitations in concert with other financial institution reforms, we believe that until such legislation is adopted, pooling of funds to avoid interest rate limitations represents a loophole that violates the spirit of the existing legislation and creates some potential for market disintermediation."

[17] Ibid.

deposit obligations normally constitute a minimal percentage of the fund portfolio may be offered a large denomination Certificate of Deposit by a member bank."[18] But in case any ambiguity remained, Fed Chairman Arthur Burns clearly indicated that the prohibition would apply to "the so-called 'money market funds' that are engaged in obtaining funds for the purpose of pooling."[19]

Like the overwhelming majority of federal regulations, these proposed rules would have gone unnoticed by anyone, much less the average money fund investor. But in a letter published on March 10, 1976, Princeton Economics Professor Lawrence J. White wrote to the *New York Times* that the regulations proposed by the Federal Reserve, FDIC, and FHLBB promised to "put the money market mutual funds out of business and relegate the small saver to low-interest yields."[20] White advocated looser regulation to allow more competition for the benefit of the small saver and called both the proposed regulations and Regulation Q itself, "regulatory outrage."[21] Highlighted by this and other news items, the proposals elicited a torrent of comments from depository institutions, MMMF firms, and individual investors.[22] In direct correspondence with the FDIC, individual investors uniformly railed against the proposed curbs, calling them blatant

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[18] Ibid.

[19] Burns to Proxmire, April 19, 1976, folder "Apr. 7-20," Box O10, Arthur Burns Papers, Gerald R. Ford Library, Ann Arbor, MI. Burns wrote, "many money market funds have been established and operated for the primary purpose of providing a vehicle for pooling smaller units of consumer funds to permit purchases of money market time deposit instruments. It is these types of activities… that are the focus of the proposed amendment."

[20] Lawrence J. White, letter to the editor, *New York Times*, March 18, 1976.

[21] Ibid.

[22] John Getze, "'Pooled' CD Purchase Ban: Money-Market Funds Face Threat," *Los Angeles Times*, March 22, 1976.

discrimination”[23] against the small saver who would be “kept a prisoner of Regulation Q.”[24] “We, the middle class, feel threatened,” one commenter wrote, “if the banks are to be kept solvent, all Americans should be asked to bear the sacrifice of lower interest rates….”[25] Economics Professor J. Huston McCulloch defended the MMMFs as “a wholesome, all-American means of negating the pernicious effects of Regulation Q.”[26] The comment letters from individual investors captured their anger about inflation and their opposition to any action perceived to inhibit an investor’s ability to fight it. Their comments appealed to principles of justice and fairness to argue that they had a right to the same returns available to those with over $100,000 to invest.[27]

For their part, most thrift officials supported the idea of the curbs but did not yet feel especially threatened by the funds. Representing the National Association of Mutual Savings Banks, P. James Riordan wrote, “the purpose of deposit interest rate ceilings are being substantially undermined [and the Association] supports the proposed amendment as an attempt to prevent avoidance of federal deposit rate regulations and as a probable aid to the development of funds for housing.”[28] Minnesota banker Clifford Zaffke added

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[23] Albert Green, to FDIC, April 10, 1976; Comment Letters; Office of the Executive Secretary; Records of the Federal Deposit Insurance Corporation; RG 34; NACP (hereafter FDIC Comment Letters).

[24] J.G. Bass, Jr., to Chairman, FDIC, April 7, 1976; FDIC Comment Letters.

[25] Tamara Root, to President Gerald Ford, March 30, 1976; FDIC Comment Letters. Another letter writer noted, “here’s another kick in the pants for the poor little guy–of which I am one.” Ann Marie [illegible], to Congressman James J. Florio, April 8, 1976; FDIC Comment Letters.

[26] J. Huston McCulloch, to FDIC, April 1, 1976; FDIC Comment Letters.

[27] Kevin Learned to FDIC, April 2, 1976; FDIC Comment Letters. Douglas J. Munson to Senator Hubert Humphrey, March 24, 1976; FDIC Comment Letters. Ford C. Perne to Federal Reserve Board, March 25, 1976; FDIC Comment Letters. Dean F. Minzner to Frank Willis, Chairman FDIC, March 22, 1976; FDIC Comment Letters. C. Robert Bell to FDIC, March 22, 1976; FDIC Comment Letters. Robert Keeley to Dr. Arthur Burns, Federal Reserve Board, March 11, 1976. William C. Lutz to Arthur Burns, March 12, 1976; FDIC Comment Letters.

[28] P. James Riordan, to Alan Miller, Executive Secretary, FDIC, April 6, 1976; FDIC Comment Letters.

that pooling of funds threatened to draw funds from rural areas into money centers, leaving local banks unable to meet local credit needs.[29] Commercial bankers gave a more varied response than the thrift officials. Some argued that the regulations could not be effectively enforced,[30] while others suggested that cutting off access to certificates of deposit would just prompt investors to find other instruments, and potentially, to invest funds overseas.[31] While the regulations promised to check the growth of MMMFs and thus reduce competition against depository institutions, they did so only by limiting MMMF investments in bank-issued CDs. The banks that received this business, typically the larger, money-center banks, did not wish to lose this business and consequently opposed the regulations.

Predictably, the MMMF industry lobby, the Investment Company Institute (ICI), also strongly opposed the proposed regulations. ICI President Robert L. Augenblick wrote that the rules "involve unfair discrimination between financial institutions, are probably beyond the legal power of the Board and the FDIC to promulgate, [are] devoid of economic justification, and would be harmful to small corporations and individual investors as well as to banks."[32] Many consumer advocates agreed. Helen Nelson, Director of the University of Wisconsin-Extension Center for Consumer Affairs, called the proposed regulations, "discriminatory and inimical to consumer interest," and claimed

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[29] Clifford H. Zaffke, President Polk County State Bank, to FDIC, March 25, 1976; FDIC Comment Letters.

[30] Herb Mueller, President, North Valley Bank, to FDIC, March 29, 1976; FDIC Comment Letters.

[31] Park Adikes, to Alan Miller, FDIC, March 12, 1976; FDIC Comment Letters.

[32] Robert L. Augenblick, to Alan Miller, FDIC, July 9, 1976; FDIC Comment Letters.

that they would "'ghettoize' the consumers' options."[33] Nelson's view of consumer interest remained narrowed to that of the investor, however, and did not consider the possible implications for the credit needs of, or costs to, borrowers.

Angry investors, who feared that the regulations would take away a rare hedge against inflation, also directed a barrage of letters at lawmakers. In late March, Senator William Proxmire, a Wisconsin Democrat and Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, forwarded a constituent letter to Federal Reserve Chairman Arthur Burns requesting that he report back to the committee:

> (1) What adverse effects has the Board documented that are directly attributable to purchases of negotiable certificated of deposit by pooled funds? (2) What is the justification for treating trust departments of member banks differently from investment advisors or broker-dealers who desire to pool customers' idle balances? (3) What request or events prompted the Board to publish this proposal?[34]

To Proxmire, the Fed's assessment that banks pooled funds for the express purpose of evading Regulation Q did not, in itself, justify an attempt to enforce the regulation. Proxmire's constituent, Dorothy Lichty, who likely learned of the proposed changes from Professor White's letter to the *Times*, wrote to Proxmire that the proposed regulations "will only hurt the small investors."[35] Lichty explained that she "didn't happen to have $100,000 lying around," but through a mutual fund, she could earn "11 or 12% on [her] money, just like the big guys."[36] Like Proxmire, Senator Harrison "Pete" Williams (D-NJ) pressed Burns for an explanation for the proposed regulations, indicating that he was

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[33] Helen Nelson, to FDIC, March 26, 1976; FDIC Comment Letters.

[34] William Proxmire, to Arthur Burns, March 25, 1976, in *Money Market Mutual Funds*, 311.

[35] Dorothy L. Lichty, to William Proxmire, March 10, 1976, in *Money Market Mutual Funds*, 312.

[36] Ibid. Also quoted in Greta R. Krippner, *Capitalizing on Crisis: The Political Origins of the Rise of Finance* (Cambridge: Harvard University Press, 2011), 79.

"disturbed … [by their] significant discrimination against small investors and substantial anti-competitive effect on non-bank financial institutions."[37] Republican Senator John Tower of Texas wrote to the FDIC Chairman, "small savers deserve the same right as wealthier individuals and corporations to earn a market-determined rate of return on their savings.[38]

Chairman Burns responded that "the market conditions in 1974 resulted in increased interest in pooling as a means of avoiding the existing deposit interest rate limitations [and] during that year money market funds began their pooling activities on a large scale."[39] The increased scale meant that the funds might pose a real threat to the viability of depository institutions and thus, the federal regulators, who began to receive pressure on the issue from bankers, felt compelled to intervene. To explain the timing of the release of the proposed regulations, Burns noted that the high interest rate pressures that caused the rapid growth of deposit pooling had abated and "the current environment thus was viewed as an appropriate time to obtain public comments on these activities."[40]

Through the summer and into the fall, the regulators took no action on the proposal. In an October speech to the National Savings and Loan League, FHLBB economist Donald Kaplan noted that the proposed regulations were "a very emotional issue," and indicated that "because of many strong public comments, including one by

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[37] Harrison Williams, to Arthur Burns, April 21, 1976, in *Money Market Mutual Funds*, 313-315. Fed Vice Chairman Stephen Gardner replied to Williams with the same rationale that Burns supplied to Proxmire, adding that as alternative, the regulators were considering removal of federal insurance for pooled funds. See Gardner to Williams, May 11, 1976, folder "May 11-31, 1976," Box O11, Arthur Burns Papers, Gerald R. Ford Library, Ann Arbor, MI.

[38] John Tower to Chairman, FDIC, April 12, 1976; FDIC Comment Letters.

[39] Burns to Proxmire, April 19, 1976, folder "Apr. 7-20," Box O10, Arthur Burns Papers, Gerald R. Ford Library, Ann Arbor, MI.

[40] Ibid.

the Council on Wage and Price Stability, the Fed and FDIC have moved slowly on it."[41] The Council on Wage and Price Stability had suggested that the prohibition of pooling might be inflationary.[42] Amidst such pressure from Congress and having drawn the ire of investors across the country, the Fed and the FDIC backed off and did not impose the regulations as proposed. The agencies stalled in taking any action until June 6, 1979, when they issued a much weaker prohibition ruling that banks could accept pooled deposits but could not advertise or announce higher rates through pooling.[43] By the time of this ruling, what Burns had referred to as "so-called money market funds" in 1976 had become one of the "well-established practices" not included in the prohibition.[44]

Given the slow early growth of the MMMFs, the political costs of limiting the funds in defense of Regulation Q and traditional depository institutions would have been much lower earlier in the 1970s than they would become later in the decade and into the early 1980s. As late as May 1976, the Council on Wage and Price Stability concluded that the funds "have not thus far been quantitatively important."[45] The regulators' attempts to keep the funds from *becoming* a threat to depository institutions, however, did not resonate with depository institutions that had not yet experienced substantial ill-

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[41] Donald Kaplan, "Current Regulatory Issues Facing the Savings and Loan Industry," October 19, 1976, National Savings and Loan League 33rd Annual Meeting; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[42] Benjamin Rosenthal, to Burns, July 27, 1976, folder "Aug. 1-10, 1976," Box O11, Arthur Burns Papers, Gerald R. Ford Library, Ann Arbor, MI.

[43] Federal Reserve System, "Interest on Deposits; Pooling of Funds to Obtain Higher Interest Rates," *Federal Register* 44, No. 110 (June 6, 1979): 32352-3.

[44] Ibid. In its section on exemptions, the regulation read, "this interpretation is not intended to affect other well-established practices which involve pooling of funds such as money market mutual funds."

[45] "Comments of the Council on Wage and Price Stability" Interest on Deposits Pooling of Funds," received by FDIC, May 10, 1976; FDIC Comment Letters.

effects from the MMMFs, but did elicit a strong response from the relatively few investors who had experienced the benefits of MMMFs. Proxmire, Tower, and other policymakers proved unwilling to risk offending those investors. Five years later, after the funds had topped $100 billion, depository institutions cried for just the kind of regulations the FRB and FDIC had proposed in 1976, but by then the interests lined up in favor of the funds had only grown stronger. Lichty's response to the regulations in 1976, as well as White's and Proxmire's, anticipated those of the battles over the money funds in the early 1980s. Had the FRB and FDIC enacted the proposed regulations in 1976, the MMMFs likely would have grown more slowly than they did, placing less stress on depository institutions through either lost or higher-cost deposits. Some observers, then and since, would argue that regulating the MMMFs would only prompt a new innovation to fill what they understood as a demand for market rates of interest.[46] Early, decisive action, however, would have signaled the regulators' resolve to enforce Regulation Q, and subsequent innovations could have been subjected to the same level of scrutiny and regulation. Failing to act early only raised the political stakes and the economic costs of later action. The decision to leave the funds unchecked both demonstrated that MMMF investors had already become politically influential, and ensured that the number of investors would continue to grow. The more the funds grew in popularity, the more difficult it would become to change course by imposing stricter regulations on the funds.[47]

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[46] Steve Skancke, to Representative John Erlenborn, November 10, 1981 (copy); Congressional Correspondence; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP (hereafter DIDC, Congressional Correspondence).

[47] For a general statement of this dynamic, see Paul Pierson, *Politics in Time: History, Institutions, and Social Analysis* (Princeton: Princeton University Press, 2004), 2.

Regulation Reconsidered

After the March 1976 proposal, regulators tabled the possibility of regulating the MMMFs. But by the end of the decade, the funds' awesome growth and their threat to traditional depository institutions forced the issue back into debate. A 1979 article in the Federal Reserve Bank of Richmond's *Economic Review* reported that money market funds grew at a pace of $2 billion per month during the first five months of that year.[48] The report cited a survey by the Investment Company Institute that found that individual investors held 46% of MMMF asset value in 1979. FHLBB Chief Economist Kenneth Biederman projected that MMMFs would gain an even greater share when they began to advertise on television, "'once these funds start using television to advertise their yields, people aren't going to leave their money in passbook accounts.'"[49] As late as September 1979, a Senate Banking Committee staffer said that the committee had not been pressured to regulate the money funds, but by the end of the year, signs of a Congressional inquiry began to appear.[50]

The first sign that Congress had taken notice of the tremendous growth of MMMFs came in the form of a request for a Congressional Research Services report on the impact of the funds in December 1979. The report, authored by Roger S. White, concluded that one possible restriction on money market funds, reserve requirements, would reduce their earnings and their returns to investors, but that the implications for

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[48] Cook and Duffield, 15.

[49] Brian Sullam, "Money Market Funds Squeeze Bank, S&L Deposits," *Baltimore Sun*, September 23, 1979.

[50] Ibid.

depository institutions would depend both on just how much the requirements would reduce the return to investors and whether that reduction would be enough to make them comparable to the return on savings deposits.[51] White added that the impact would also depend on the motives of depositors/investors. Depositors who valued the money market funds for their high yields and transaction features would be more prone to move their funds to depository institutions than would investors, who would more likely seek out investment alternatives that did not have reserve requirements. With such an inconclusive recommendation, policymakers had little reason to think that they could have much impact on the funds via increased regulation. Federal Reserve Chairman William Miller wrote to Proxmire that reserve requirements should be placed on all transaction accounts whether held in a bank or non-bank institution. Miller added, "aggregate transactions balances at nonbank depository institutions are presently relatively small, and the opportunity should be taken to apply reserve requirements to them now, while the impact of required reserves on the institutions would still be relatively slight."[52]

Despite the increasing spread between the interest rates offered by MMMFs and the Regulation Q-capped rates of small time deposits and passbook savings, some bankers remained unworried. *Chicago Tribune* reporter Bill Barnhart wrote in October 1979, that despite recent publicity of record-high interest rates, "many community bankers in the Chicago area are confident their savings-account customers won't start

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[51] U.S. Congressional Research Service. *Reserve Requirements on Money Market Mutual Funds: Implications for the Competitive Environment for Depository Financial Institutions* (December 3, 1979), by Roger S. White.

[52] G. William Miller, to Proxmire, January 4, 1979; Federal Reserve Requirement Act of 1978; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

demanding that those rates be paid to them."[53] These "small bankers" remained skeptical of the warnings that without the removal of Regulation Q, the banks would face debilitating disintermediation. Three local bankers reported strong growth in deposits over the past year. One of them, C. Paul Johnson of Colonial Bank and Trust, a Chicago area bank, said, "'we don't rely on hot money, so we're not paying the same rates the big banks are.'"[54] Countering their optimism, New York banking analyst Harry Keefe retorted, "'your community bankers have got their heads in a bucket… the worst competitor they've got is the Merrill Lynch Ready Asset Fund.'"[55] Irwin A. Goodman, President of Deerbrook State Bank, observed that though his bank's deposits had not been yet been hurt by competition with the money market funds, that the funds could present a problem in the long run because "people who were not sophisticated are becoming sophisticated."[56] Others did not think that investing in the funds required any particular sophistication. As Senator Jake Garn would later say, "savers are going to take their money out of savings deposits and put it where they can earn 15 percent. They would be foolish not to."[57] To underscore the point Garn continued, "even a senator is smart enough to understand the difference between 5 and 15 percent interest."[58]

Concern over the growth of the funds grew sufficiently that in January 1980, the Senate Subcommittee on Financial Institutions, chaired by California Senator Alan

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[53] Bill Barnhart, "Small Bankers Say Savers Aren't Pulling Out," *Chicago Tribune*, October 14, 1979.

[54] Ibid.

[55] Harry Keefe, quoted in Barnhart.

[56] Irwin Goodwin, quoted in Barnhart.

[57] Daly and Garn, *Money and Housing*, 4.

[58] Ibid.

Cranston,[59] convened hearings on the regulation and impact of MMMFs. Cranston explained that he called the hearings "because of the potential negative impact of these funds on the regulated financial marketplace, legislative proposals pending in Congress on Regulation Q, and the increasing consumer interest in them."[60] Senator Proxmire, then deep in his battle to win passage of what would become the DIDMCA, did not pass up the opportunity to take a shot at Regulation Q and offered a ringing endorsement of the money market funds, which he hailed as a "positive development [that] will work toward the ultimate demise of both Regulation Q and the prohibition of interest on demand deposits [and] will benefit the small saver…."[61]

Regulators and interest groups aired their views on MMMFs at the hearings. During the first of two days of testimony, the Committee heard from the SEC regulators responsible for oversight of MMMFs, bank, thrift, and credit union regulators, industry representatives, and one academic selected by the industry's trade lobby.[62] SEC Chairman Irving Pollack explained that his agency already regulated money market funds sufficiently. Though he affirmed that the check writing privileges offered by many funds operated just like any other check writing, he argued that the instruments should not be regulated as banks, because as investment instruments they were legally distinct from deposits.[63] Pollack allowed, however, that while he did not recommend increased

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[59] Cranston would later be reprimanded by the Select Committee on Ethics for his involvement with the Lincoln Savings and Loan scandal.

[60] Cranston, *Money Market Mutual Funds*, 1.

[61] Ibid., 3.

[62] Ibid., III-IV.

[63] Ibid., 7, 17-18.

regulation, that "where there are diverse and possible competing social objectives and economic goals, the Congress is expected to weigh and balance very complex elements of public policy."[64] Pollack thus acknowledged that the public interest was not clearly defined, but that competing interests might be at stake.

In what Investment Company Institute President David Silver would later describe as "a miracle," the other major financial regulators, including FHLBB Chairman Jay Janis, largely agreed that increased regulation of money market funds were not necessary at that time.[65] The Comptroller of the Currency, John Heimann, and the Administrator of the National Credit Union Administration, Lawrence Connell, like Proxmire, turned the issue of regulating the Money Market Mutual Funds into an opportunity to argue for deregulation of depository institutions, particularly the phase-out of Regulation Q.[66] Similarly, Federal Reserve Governor Charles Partee argued that "to limit yields on money market funds … would be anti-consumer–and inconsistent with the Nation's need to encourage savings."[67] Janis would not join his colleagues in attacking Regulation Q, but rather focused his attention on deregulation of thrift assets, "the growth of MMF's underscores even more importantly the ability of savings and loans to provide a full package of consumer finance powers…."[68] With new powers, Janis assured the Subcommittee, "savings and loans need not fear the competition from MMF's, nor would

[64] Ibid, 12-14.

[65] Ibid., 273, 264.

[66] Ibid., 230, 251.

[67] Ibid., 245.

[68] Ibid., 249.

the availability of mortgage money be threatened by MMF's."[69] The chief thrift regulator suggested that reserve requirements, even if they reduced the yield of the money market funds, might in fact make them more popular by appearing less risky, cutting into the one advantage the banks and thrifts still had, federal deposit insurance.[70]

The testimony of the regulators underscored the fact that much about the funds' impact remained uncertain. Heimann, in his submitted testimony, allowed that "existing data on MMF investors is incomplete,"[71] and Janis conceded that the FHLBB estimate that the money market funds "may have helped divert $5 to $6 billion from the mortgage market,"[72] was only a "rough estimate."[73] The most comprehensive information came from the money market funds' lobby, the Investment Company Institute. Quoting a recent Institute study, Silver testified that at the end of 1979, individuals held 53.5% of MMF assets, the remainder being institutional investors.[74] Among the unknowns regarding the MMFs was exactly how much of the money that seemed to be leaving banks for the funds returned to banks when the funds purchased CDs. Janis indicated that he wanted to see more of that money being invested in S&Ls.[75] Heimann expressed great concern over the concentration of MMF investments in "the top 25 to 50 banks and to very few, if any,

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[69] Ibid., 249-50.

[70] Ibid.

[71] Ibid., 240.

[72] Ibid., 249.

[73] Ibid., 266.

[74] Ibid., 274-5.

[75] Ibid., 267.

savings and loan associations."[76] He went on to predict, "if acceptance of money market funds spreads from the major urban areas to the smaller cities and communities, funds from local savings and time deposits may move from community and regional institutions to the large urban banks and thrifts."[77] Such movement of capital would threaten both the solvency of the institutions and the ability of borrowers to meet their credit needs.[78] Silver argued that increased restrictions on MMFs that lowered yields would simply force those who could afford to do so to invest directly in money markets, leaving smaller investors, as he put it, as victims of "Government-Sponsored discrimination."[79]

Representatives of the major depository institution lobbies were divided on the question of regulation. Harry W. Albright Jr., in behalf of the National Association of Mutual Savings Banks, argued that the funds hampered the Federal Reserve's anti-inflation policies, diverted money from thrifts into large commercial banks, thereby hurting housing, and that "MMFs have engaged in certain practices which are questionable under existing federal law … [such as] the check writing feature offered by many funds."[80] A representative of the U.S. League of Savings Associations, James Cirona, echoed that the MMMFs, "are reallocating credit out of the communities of America into the giant money-center commercial banking institutions," and ultimately overseas.[81] Both Lee Gunderson of the American Bankers Association and Richard

[76] Ibid., 242.

[77] Ibid.

[78] Ibid., 242-3.

[79] Ibid., 276.

[80] Ibid., 411.

[81] Ibid., 417.

Lawton of the National Savings and Loan League indicated a preference for broad deregulation, but argued that extensions of regulation, such as prohibition of checking privileges were necessary at least in the short term.[82] Lawton specifically noted that MMMFs were not subject to "redlining statutes and regulations and other laws such as the Community Reinvestment Act."[83] The Independent Bankers Association of America representative also complained in a letter to the committee of the MMMF's redistributive effects,[84] and The Bowery, a New York Mutual Savings bank submitted a letter to the committee pointing out that MMMFs "have no responsibilities to make mortgages; invest in certain acceptable investments that are perceived to be safe, sound, and in the public interest; nor comply with the Community Reinvestment Act."[85] The letter from the Bowery went on to argue that regulators should allow banks and thrifts to invest in MMMFs, *instead of* phasing out Regulation Q, to avoid the "unanticipated dangers of deregulating Regulation Q."[86]

To many policymakers, the logical solution became apparent: either the MMMFs had to be regulated, or the regulation of the banks and thrifts (Regulation Q, at least) had to be relaxed.[87] Representatives of the MMMF industry did not invite regulation, though they did not particularly favor loosened regulations of banks. Banking regulations, after all, had created the market that MMMFs filled, and they were not eager to invite

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[82] Ibid.

[83] Ibid., 426.

[84] Raymond D. Campbell, to Senator Cranston, January 28, 1980, in ibid., 463.

[85] Ellis T. Gravette Jr. to Senator Cranston, January 25, 1980, in ibid., 471.

[86] Ibid.

[87] See, for example, Garn, in Daly and Garn, 17.

competition with banks with their large institutional apparatuses, roots in local communities, and existing pools of customers. Most small banks and thrifts wanted stricter regulation of MMMFs and did not favor the rescission of Regulation Q. If not for the competition from the funds, they reasoned, Regulation Q could continue to function to ensure a cheap source of capital. Other banks, and fewer thrifts, especially the largest ones, initially favored regulation of the MMMFs, but reached a tipping point at which, confident in their ability to compete with the MMMFs, they dropped their calls for regulation of MMMFs and instead used the unregulated status of the funds to leverage their arguments for bank deregulation, insisting on a "level playing field."[88]

By spring 1980, the money market funds had grown into enough of a threat to depository institutions that thrift and banking lobbies set aside their long-standing differences over competitive equality between them, to focus their efforts on curbing the funds. In March, *The Washington Post* reported that the presidents of the American Bankers Association (ABA) and the United States League of Savings Associations (US League) had agreed that the time had come to join forces against the "virtually unregulated" money funds.[89] ABA President C.C. Hope Jr. suggested, "'If we are to be realists, the regulated industries need to make certain that we work together with the Congress to level out the playing field…'."[90] Additional reports confirm that the ABA

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[88] House Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance, and Urban Affairs, *Expansion of Reserve Requirements to Include Other Transaction Accounts and Mechanisms (Money Market Mutual Funds): Hearings before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance, and Urban Affairs*, 97th Cong., 1st sess., April 8, June 25, and October 1, 1981 (Washington, DC: Government Printing Office, 1981), 342.

[89] Merrill Brown, "Banks, S&Ls Unite to Stop Money Market Funds Rise: Bankers, S&Ls Fight Money Market Funds," *Washington Post*, March 11, 1980.

[90] Ibid.

had indeed taken aim at the money funds into the following spring.[91] An ABA "Money Market Mutual Fund Strike Force" concluded that while a deregulated marketplace remained a goal, the ABA's "action program must include immediate unfair competitive imbalances favoring the money funds."[92] Against concern for depository institutions and responsiveness to their influential lobbies, however, weighed concern for small investors. Representative of those with misgivings about the possibility of regulating MMMFs, Bob Edgar (D-PA) wrote that though he recognized that they increasingly pressured savings institutions, he "would be concerned about proposals to restrict these funds since they benefit so many 'small savers' who are unable to invest in certificates requiring $10,000 deposits."[93]

For the most part, consideration of additional regulations for money market mutual funds was confined to the possibility of imposing reserve requirements or prohibiting third-party checking. A more drastic measure would have been to extend rate ceilings to MMMFs, which could have been billed as an anti-inflationary measure as well as an effort to "level the playing field" between the regulated and unregulated institutions.

One such proposal, although it was never seriously considered, is illustrative because it demonstrates how concern for small investors, more so than the truly small savers, defined the parameters of debate over MMMF regulation. The extension of rate

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[91] Ron Scherer reported, "the American Bankers Association, one of the most powerful lobbying groups in Washington, has positioned the money market funds as its chief target during the current legislative session." Scherer, "Money Market Funds: Billions Richer Weekly," *Christian Science Monitor*, April 10, 1981.

[92] American Bankers Association, "Report of the Money Market Mutual Fund Strike Force," n.d.; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[93] Robert Edgar, to Paul Volcker, May 26, 1981 (copy); DIDC, Congressional Correspondence.

ceilings to the MMMFs figured centrally in the creative compromise deregulation proposal pitched to the Depository Institutions Deregulation Committee (DIDC–the body charged with overseeing the phase-out of Regulation Q) by a Savings Bank Official in Springfield, Massachusetts named Daniel F. O'Gorman. O'Gorman suggested what he considered to be a "saner and fairer" plan for deregulation that would raise the passbook savings rate ceiling to 9%, eliminate all other types of accounts (such as the congressionally created Money Market Certificates that after being uncapped by DIDC were paying a rate of 17-18%), and extend the 9% ceiling to the MMMFs, all for a period of 5 years. O'Gorman's proposal would increase costs to thrifts on passbook savings, but offered the benefit of eliminating the uncapped accounts that increasingly dominated their portfolios. The proposal was kicked from O'Gorman's Representative to the Department of the Treasury, and ultimately to the DIDC.[94] There, DIDC secretary Steven Skancke dismissed O'Gorman's suggestion of rate ceilings for MMMFs, or otherwise, saying "artificial rate ceilings, whether set at 5 ½ percent or 9 percent just won't work anymore. Savers are becoming more and more interest rate sensitive."[95] Skancke reasoned that savers would more likely save less than save at lower rates (though the 9% rate would have been considerably higher for the truly small denomination savers). He imagined that rate ceilings on MMMFs would simply force investors to seek still other investment possibilities, not to return their money to depository institutions.[96] Furthermore, Skancke maintained that regulating the money funds "may give rise only to

[94] Edward Boland, to W. Dennis Thomas, October 9, 1981 (copy); DIDC, Congressional Correspondence.

[95] Steve Skancke, to Edward Boland, January 4, 1982 (copy); DIDC, Congressional Correspondence.

[96] Ibid.

other unregulated instruments."[97] Skancke's reply exhibited an increasingly popular assumption, that regulation could not, aside from the question of whether it should or not, contain market forces.

In the late 1970s and early 1980s, money market mutual funds represented the possibilities for a deregulated financial industry, the future that the Hunt Commission and other free market advocates had envisioned. The funds raised their capital primarily in small denominations from individual depositors/investors, just like traditional depository institutions, but unlike the banks and thrifts, the money funds could then invest that money with little to no restrictions or regulations. Some bankers and thrift officials, especially those of the largest institutions, saw great potential in a deregulated environment. But while they were still subject to regulation, and unfairly, they cried, competing with the unregulated MMMFs, they were among the first to point out how the unregulated funds undermined the goals of the Community Reinvestment Act. Banker Kenneth Nelson raised questions about the accountability of the MMMFs to local communities. "It is disheartening and of great concern to us to see the money flow from our community," Nelson wrote. He continued, "Is Merrill Lynch concerned with South St. Paul Minnesota? What is the Community Reinvestment program for money market mutual funds? That is the question that needs to be addressed."[98] The problem of redistribution of capital alarmed many in states far a field of the major money centers. In 1981, several state legislatures, including those in Utah, Georgia, Oklahoma,[99] Arkansas,

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[97] Steve Skancke, to Representative John Erlenborn, November 10, 1981 (copy); DIDC, Congressional Correspondence.

[98] Kenneth R. Nelson, President, Drovers State Bank, St. Paul, MN, to Steven Skancke, November 10, 1981 (copy); DIDC, Congressional Correspondence.

[99] Jane Quinn Bryant, "Banks, Thrifts Out to Get the Money Market Mutual Funds," *Pittsburgh Press*, February 19, 1981. *Google News Archive Search* (Accessed October 28, 2010).

Massachusetts,[100] Kansas,[101] and North Carolina,[102] considered restrictions on the operation of MMMFs in their states. *Time* magazine reported "in Massachusetts, a proposal has been made that would require money market funds to make investments wherever depositors live," and editorialized, "that would be like asking General Motors to set up a factory in each shareholder's hometown."[103]

However, state officials' concern for stemming the flow of capital from their states appeared to be pitted against the interests small investors who sought the "market rates" of the money funds. John Malarkey, representing the Conference of State Bank Supervisors, testified before Congress, "even though some citizens gained [from MMMFs], the cost to the public at large has been very high…. Money market mutual funds are bleeding numerous state and local communities of their economic lifeblood."[104] To the extent that regulators concerned themselves with protecting the "public interest," it was not entirely clear how the public interest should be defined. Malarkey noted that a market rate on savings, safety and soundness of depository institutions, and borrowing

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[100] Thomas Watterson, "Close Look Coming for Money Funds," *Deseret News*, March 21, 1981. *Google News Archive Search* (Accessed October 28, 2010).

[101] "House Passes Money Market Measure," *Daily Union*, March 26, 1981. *Google News Archive Search* (Accessed October 28, 2010).

[102] "Don't Regulate Money Funds," editorial, *Wilmington Morning-Star*, April 12, 1981. *Google News Archive Search* (Accessed October 28, 2010).

[103] "Shooting at Money Market Funds," *Time*, March 23, 1981. *Google News Archive Search* (Accessed October 28, 2010).

[104] *Expansion of Reserve Requirements to Include Other Transaction Accounts and Mechanisms (Money Market Mutual Funds*), 45.

needs were three competing public interests; the question was one of balancing the three.[105]

As state legislatures took up the question of regulation of MMMFs, the money funds and their lobby, the Investment Company Institute, fought back. In *A Piece of the Action*, Joe Nocera recounts a particularly important legislative battle in Utah in March 1981, in which the bankers narrowly lost their bid to impose stricter regulations on MMMFs amidst protest from MMMF investors and deft legislative maneuvering by money fund proponents.[106] In Kansas, an amendment to restrict MMMFs passed the House, but, according to the amendment's sponsor, Representative Jerry Andre, "was defeated in the Senate through a massive, misleading advertising blitz by the MMMF industry."[107] Emblematic of this campaign, United Cash Management, Inc. President Benjamin C. Korschot had written to United Fund shareholders "the high yield of United Cash Management may soon be unavailable to YOU. Recent legislation has been introduced by the Kansas banking and savings and loan industries. This bill could… eliminate United Cash Management from being offered in Kansas."[108] Korschot implored, "don't let special interest groups take away one of your best hedges against

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[105] Ibid.

[106] Joseph Nocera, "Please Don't Take it Away!" in *A Piece of the Action: How the Middle Class Joined the Money Class* (New York: Simon & Schuster, 1994): 187-206.

[107] Jerry Andre, to Senator Jake Garn, June 12, 1981, in U.S. Senate Committee on Banking, Housing, and Urban Affairs, *Competition and Conditions in the Financial System: Hearings before the Committee on Banking, Housing, and Urban Affairs, Part II*, 97th Cong., 1st sees., May 13, 14, 18, and 19, 1981 (Washington, DC: Government Printing Office, 1981), 1504.

[108] Benjamin C. Korschot, to "United Fund Shareholder," n.d., in "Public Statement of Kansas Bankers Association Effects of Money Market Mutual Funds on Kansas' Economy, April 1981"; Money Market Fund Testimony; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

inflation… call, or send a telegram to your state legislator….”[109] For his part, Andre denied that he had introduced the measure on the part of any interest group and that the amendment would prohibit the fund from being offered in Kansas.[110] Andre pleaded to Senator Garn for federal help, both because he felt that state legislators could not withstand the pressure of the MMMF lobby, and because “problems relating to MMMF’s and their impact on the economy and individual investors transcend state boundaries.”[111] Andre had been sent scrambling to assure voters that the restrictions he had proposed would not have eliminated MMMFs, as he perceived that many of his constituents had been convinced by the Investment Company Institute to believe.[112] The Kansas Bankers Association likewise pressed Garn for action, claiming that the Investment Company Institute had “instill[ed] unnecessary alarm and fear in the minds of many citizens,” and that instead of patchwork, state-by state legislation, the problems posed by interstate money market fund companies “MUST BE ADDRESSED AT THE FEDERAL LEVEL.”[113]

In a public statement, the Kansas Bankers Association claimed that the money market funds had raised $755 million from Kansas and railed “THE PROBLEM IS

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[109] Benjamin C. Korschot, to “United Fund Shareholder,” n.d., in “Public Statement of Kansas Bankers Association Effects of Money Market Mutual Funds on Kansas’ Economy, April 1981”; Money Market Fund Testimony; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[110] “Statement by Representative Jerry Andre to House-Senate Conference Committee on Senate Bill 131,” April 2, 1981, in ibid.

[111] Ibid., 1505.

[112] Jerry Andre, “Statement by Representative Jerry Andre to House-Senate Conference Committee on Senate Bill 131, in *Competition and Conditions in the Financial System*, 1507.

[113] Harold A. Stones, Sr. VP, Kansas Bankers Association, to Jake Garn, April 3, 1981; Money Market Fund Testimony; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

THAT THESE MUTUAL FUND COMPANIES ARE INVESTING LITTLE, IF ANY, MONEY BACK INTO THIS STATE!"[114] Though acknowledging the inflation-hedging benefits to savers, the association argued that the money funds had crossed the line from investments to a checking account, without the regulations placed on depository institutions. Rural states like Kansas, the statement suggested, bore the brunt of capital loss, while money center states remained unaffected. The KBA insisted that either curbs be placed on the money funds, or the banks be allowed to offer money market fund accounts (by amendment to Glass-Steagall). In the case of the latter, the statement said of the Investment Company Institute, "perhaps their ringing defense of free enterprise will carry as far as the U.S. Congressional hearing rooms and Kansas financial institutions will be given the ability to compete on a level basis."[115]

In early 1981, as battles raged in state legislatures, federal policymakers seemed as close as ever to imposing restrictions on the Money Market Funds. In March, Walter Fauntroy introduced H.R. 2591, a bill to place reserve requirements on MMMFs with check writing privileges. The bill also included language authorizing the DIDC to "establish the maximum rate of return which is payable on funds invested in a money market mutual fund."[116] On the Senate side, Senator Garn convened hearings on

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[114] "Public Statement of Kansas Bankers Association Effects of Money Market Mutual Funds on Kansas' Economy, April 1981"; Money Market Fund Testimony; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[115] Ibid.

[116] "H.R. 2591: To Amend the Federal Reserve Act to Facilitate the Implementation of Monetary Policy by Establishing Reserve Requirements on Certain Accounts," in U.S. House Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance, and Urban Affairs, *Expansion of Reserve Requirements to Include Other Transaction Accounts and Mechanisms (Money Market Mutual Funds): Hearings before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance, and Urban Affairs*, 97th Cong., 1st sess., April 8, June 25, October 1, 1981 (Washington, DC: Government Printing Office, 1981), 2.

"competition and conditions in the financial system," of which MMMFs were a central topic of discussion. The arrival of Reagan appointees, and the ascension of Senator Garn to the chairmanship of the Senate Committee on Banking, Housing, and Urban Affairs, heightened, rather than dampened, discussion of regulation for MMMFs. Columnist Jane Bryant Quinn commented, "it is ironic that in today's 'new' political atmosphere, one of the first actions by conservatives may be to impose new, costly and unnecessary regulations on a rapidly growing industry that has found a way of paying high interest rates to small savers."[117] Generally speaking, deregulation had long since been embraced by policymakers across the political spectrum, from Ted Kennedy and Jimmy Carter, to Ronald Reagan, for a range of industries, including telecommunications and trucking. Certainly the ascendance of Reagan only strengthened that trend, but the increasingly dire condition of the thrift industry made even those most committed to deregulation to pause and consider at least temporary restrictions on MMMFs. Policymakers had to decide whether to curb the funds, or hope that the depository institutions, with possible loosening of regulation of their assets, could survive the competition.

Policymakers' ambivalence regarding regulation is evident in the FHLBB's internal planning for the House hearing that included the exchange between staffers Kaplan and MacFarlane cited above. A strong case was being made by some regulators that regulations should be extended to cover the funds, while others reflected the ascending free market ideology that erred on the side of deregulation. The draft version of FHLBB Chairman John H. Dalton's testimony to be delivered to the House Subcommittee on Domestic Monetary Policy on April 8, 1981, included the following:

[117] Jane Bryant Quinn, "Banks, Thrifts Out to Kill Money Market Mutual Funds," *Pittsburgh Press*, February 19, 1981.

> Because of the competitive inequities that exist between money market funds and depository institutions, I will recommend in my remarks today that consideration be given to subjecting money market funds to regulations similar to those covering depository institutions….[118]

The draft testimony argued "money market funds have a governmentally created advantage over depository institutions," and suggested that in the interest of competitive equity, reserve requirements, liquidity requirements, community reinvestment obligations, and/or deposit rate control should be considered for the money market funds.[119] Of the four options, the draft placed emphasis on the imposition of reserve requirements, but also suggested the possibility of placing regulation of money market funds under the authority of the DIDC.

Here competing visions of the financial marketplace came to a head. The lead author of the draft, Randall H. McFarlane, sought protection for the specialized function of thrifts as the primary mortgage lenders, while Marshall A. Kaplan, Acting Director of the FHLBB Office of Policy and Economic Research, eviscerated McFarlane's draft. To the drafted suggestion that Congress grant the DIDC authority over money market funds, Kaplan wrote, "Were you ordered to put this in? This is the most horrible policy recommendation that I have ever seen espoused in any Bank Board testimony, is it <u>in addition</u> to imposing reserve requirements?" McFarlane's draft struck a tone of urgency, and while expressing reluctance about the idea of creating new regulations, concluded, "under the circumstances, we no longer can afford to turn a blind eye to the monumental end-run around rate control represented by money market fund yields." Expressing his

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[118] "Draft: Statement of the Federal Home Loan Bank Board on Money Market Funds before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, April 8, 1981"; Money Market Funds Testimony; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[119] Ibid.

utter dismay, Kaplan noted, "the end-run is the result of consumers' desires being met by MMFs….This would completely destroy the MMF industry & is the wildest thing I've ever heard."[120]

The divide between McFarlane and Kaplan ran deeper still, over the very role of the savings and loan industry. McFarlane wrote, "we believe [the] case-by-case, community-oriented approach to credit generally offered by banks and S&Ls is an extremely valuable one" that should be protected.[121] Kaplan retorted, the "bulk of bank credit is not community-oriented, but is made without regard to location by money market and large regional banks."[122] Amid the controversy generated by the draft testimony, Dalton wrote to Chairman Fauntroy to decline the invitation to testify on money market mutual funds. Dalton explained that the issue required more study before the FHLBB could testify. Dalton's letter carefully pointed out the "competitive inequities" between the money funds and traditional depository institutions, arguing that "money market funds have a governmentally-created advantage over depository institutions," but did not suggest that the solution to that inequity would be to increase regulation of the money funds as the draft testimony had.[123] For the moment, at least, Kaplan's view of deposit capital flowing freely to its most efficient use had triumphed

[120] Ibid.

[121] Ibid.

[122] Ibid.

[123] John H. Dalton, to Walter Fauntroy, April 7, 1981, in U.S. House Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance, and Urban Affairs, *Expansion of Reserve Requirements to Include Other Transaction Accounts and Mechanisms (Money Market Mutual Funds): Hearings before the Subcommittee on Domestic Monetary Policy of the Committee on Banking, Finance, and Urban Affairs*, 97th Cong., 1st sess., April 8, June 25, October 1, 1981 (Washington, DC: Government Printing Office, 1981), 96-98.

over MacFarlane's contention that regulation should protect the ability of local depository institutions to attract low-cost deposits for local credit needs.

But the incoming FHLBB chairman had indicated his own leaning toward restrictions for the funds. Just the day before Dalton's scheduled appearance, Reagan appointee, Richard T. Pratt sat before the Senate Banking Committee for his nomination hearing to become the new chairman. In a remarkable exchange, two avowed free market champions, Pratt and Committee Chairman Garn, made the case for at least temporary restrictions on MMMFs. Indicative of the grave threat the funds posed for the thrift industry, even these great deregulation proponents recognized the necessity of restraining the growth of the funds. Pratt told the committee that he believed that deregulation of depository institutions remained the best long-term direction for the economy, but that "in the short run, [protecting the interests of the thrift industry and housing] means considering some additional regulations of money market funds, such as the imposition of reserves on transaction balances."[124] Though he preferred the end goal of a deregulated, competitive financial services sector, Pratt could stomach, and even favor additional regulation of the money market funds to ensure that the thrifts survived the process of deregulation. In the meantime, Pratt felt that the money funds "provide[d] an end-run around Public Law 96-221 [DIDMCA] and [the] depository institution deregulation committee," which Congress had charged to ensure an orderly transition to a deregulated environment.[125] "To the extent that [money funds] are providing the same

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[124] Richard Pratt, Senate Committee on Banking, Housing, and Urban Affairs, *Nomination of Richard T. Pratt*: *Hearing before the Committee on Banking, Housing, and Urban Affairs*, 97th cong., 1st sess., April 6, 1981 (Washington, DC: Government Printing Office, 1981), 13.

[125] Ibid. 9.

services as regulated financial institutions," Pratt argued, "it would seem that competitive equity would require that they be subject to some of the same restrictions."[126] Pratt reiterated this stance later that month, "as a free-market economist, I am not happy to make this recommendation. But, there are periods when controls are necessary, and this is one of them."[127]

Senator Garn, who chaired the nomination hearing, agreed, and went to great pains to clarify his position on the issue of regulation of money market mutual funds. He did not, as he indicated many of his constituents had concluded, favor "trying to do away with the money market funds."[128] He did oppose, however, the third-party check writing privileges that many of the funds offered, arguing, "they are unfairly involved in transaction accounts. And I don't like that kind of dishonesty." Not only did Garn find the money market funds' bank-like services to be unfair competition, he also still stung from what he considered the unfair fighting that the industry engaged in during the battle over restrictive legislation in Utah. Garn, who refused to take a side on the Utah bill, had nonetheless been painted as an opponent of the funds. Garn fumed, "the nature of my mail indicates that the campaign to defeat that bill [to impose limitations on MMMFs in Utah] was based primarily on telling all of securities firm customers that, if those third-

[126] Ibid., 10.

[127] Richard T. Pratt, "Statement of Richard T. Pratt, Chairman Federal Home Loan Bank Board, before the Committee on Banking, Housing, and Urban Affairs of the United States Senate: Hearings on Financial Institutions Oversight, April 28, 1981."; Testimony/Transcript HR 2591; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[128] Garn, *Nomination of Richard T. Pratt*, 8, 10.

party check writing privileges were removed, that they would remove the money market funds. And that is a bunch of boloney."[129]

Policymakers' recognition of the need for MMMF regulations in order to protect the thrifts, weighed against the interests of saver/investors. Garn believed that he was, and wanted to be perceived as being, on the side of the small saver or small investor. His defense of his stance revealed some ambivalence, however, regarding the interests of the small investor:

> I certainly am bright enough to understand the difference between 5 ¼ percent and 15 percent. I certainly can understand why they are popular in an inflationary cycle, particularly for small savers to have that opportunity. I would doubt very much though, that the average saver who is realizing those benefits looks at the more overall implications of this disintermediation that is taking place; what the effects could be in the longer term, as far as where they are going to get their mortgage loan in the future. Certainly not from the money market funds.[130]

Momentarily taking a broader view of consumer interest, Garn saw the virtue of questioning the impact of the money market funds on credit cost and distribution. Echoing John Malarkey of the Conference of State Bank Supervisors, Garn identified investors' right to a market return as only one of many competing interests, including the interests of borrowers.

Federal Reserve Chairman Paul Volcker added to the chorus calling for restrictions on the MMMFs. Both out of consideration of equity for depository institutions and to facilitate monetary policy, Volcker (like Miller before him) favored reserve requirements for all transaction accounts. Volcker wanted to be able to differentiate between MMMFs funds that investors thought of as savings, and those that

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[129] Ibid.

[130] Ibid., 8.

investors considered liquid. The reserve requirements, he reasoned, would create enough of a spread in returns that investors would commit what funds they intended as savings into the higher yield, no reserves, no checking, accounts. Volcker argued that this would greatly enhance the effectiveness of the Federal Reserve's anti-inflation policies.[131]

Support for restrictions on MMMFs had never been stronger than in the spring of 1981. If the banking and thrift lobbies, the Conference of State Bank Supervisors, and regulators including Richard Pratt and Paul Volcker had their way, either reserve requirements would have been imposed on MMMFs, or check-writing privileges on MMMFs would have been prohibited. Supporters of curbs on the MMMFs argued sensibly that the regulations would help states and local communities to stem the drain of capital to money-centers, the Federal Reserve would be better able to conduct anti-inflation monetary policy, and banks and thrifts would be able to adjust to the phase-out of Regulation Q without fear of insolvency due to disintermediation. But on the other side of this debate stood the relatively new and small lobby, the Investment Company Institute, and legions of small investors. It was the legions of small investors, not just the ICI, that tipped the balance in favor of leaving the money funds alone. As an unnamed House Banking Committee staffer told the *Bureau of National Affairs,* "'people who have their money invested in money market mutual funds are solid citizens… they're the kind who keep in contact with their congressman, who are good contributors, and who vote every time. No congressman wants to tangle with them."[132] Even if the funds themselves

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[131] Volcker, *Expansion of Reserve Requirements*, 242-243.

[132] Unnamed source, quoted in "Money Market Mutual Funds: Fight Moves Towards Congress," *Bureau of National Affairs* (March 30, 1981), in "Public Statement of Kansas Bankers Association Effects of Money Market Mutual Funds on Kansas' Economy, April 1981"; Money Market Fund Testimony; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

were inflationary, limiting their returns could only be framed as policymakers taking away one of the few opportunities that the average consumer had to stay afloat. Learning from the constituent backlash over proposed regulation of MMMFs at the state level, none learning better than Garn, Congress backed off the idea of additional regulation of the funds.

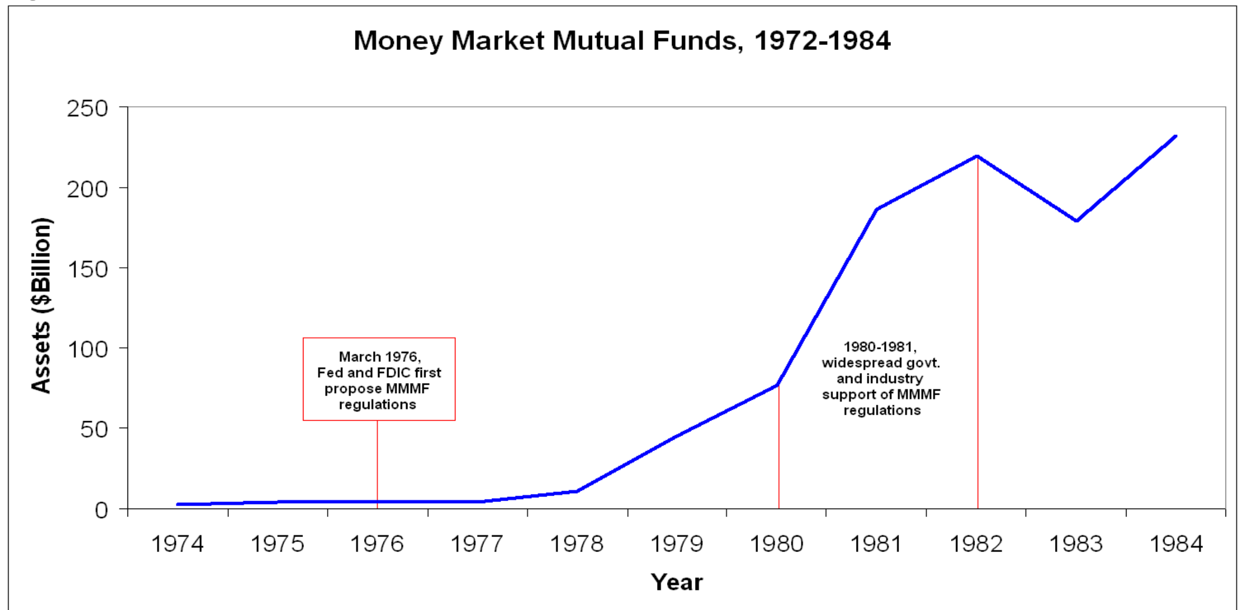
It would have been more politically tenable to have restricted the funds before so many Americans became invested, like in 1976, when fund assets remained under $4 billion. But then, even though the Fed projected that the funds would later create problems for depository institutions, and, by extension, housing, the institutions had yet to feel the pain of competition with the funds and thus offered only tepid support for regulations. Yet once the problem had become acute for banks and thrifts, and they pleaded for intervention, far too many investors had bought into the funds, making action too politically costly. The more the funds grew, the harder it would be to restrict them. As late as the summer of 1982, when the peak of Congressional attention to MMMFs had passed, Volcker was still urging some kind of action on the funds, arguing, "you're not going to have a fully competitive instrument with a money market fund so long as banks have reserve requirements and money markets do not … and I would suggest that is an area that someone ought to address themselves to."[133] FDIC Chairman William Isaac concurred, "its high time Congress took up that issue and treated banks and money market funds and thrifts alike with respect to reserves."[134] But the moment to impose

[133] Transcript, "DIDC Meeting 6/29/1982"; Records of DIDC Meetings, May 6, 1980-Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Treasury; RG 56; NACP, 35.

[134] Ibid.

restrictions on the funds without eliciting the ire of thousands of fund investors had long since passed.

Figure 1



Source: Federal Reserve Board of Governors, *Flow of Funds Accounts of the United States: Annual Flows and Outstandings, 1975-1984*, http://www.federalreserve.gov/releases/z1/current/annuals/a1975-1984.pdf (accessed March 26, 2012).

Policymakers had every reason to place at least minimal restrictions on MMMFs, but ultimately could not side against the (short-term) interests of inflation-weary middle-class saver/investors. During a period in which nearly everyone agreed that inflation posed the greatest threat to the American economy, Volcker and others argued that reserve requirements on the funds would enhance the Federal Reserve's ability to control inflation through monetary policy. The funds themselves, with their double-digit yields, likely contributed to inflation.[135] Existing regulations including Glass-Steagall, the

[135] MMF opponents did not fail to take up this argument. William B. O'Connell, Executive V.P. of the United States League of Savings Associations, wrote in a letter to all Senators and Congressmen, "while fund shareholders, like savers everywhere, have been penalized by inflation, borrowers who pay 15% or more for home loans and close to 20% for business and consumer financing are penalized even more in today's economy. The money funds are helping to sustain these high-rate burdens." O'Connell, to Henry S. Reuss, April 6, 1981; Money Market Fund Testimony; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

McFadden Act that prohibited interstate banking, Regulation Q, and the Community Reinvestment Act arguably applied to the funds, or at least those offering bank-like services. Finally, powerful interest groups, including the American Bankers Association and the AFL-CIO favored the curbs. Yet, Congress instead turned its attention to "leveling the playing field" by allowing banks and thrifts to compete directly with the money funds. The benefit to the small saver, or at least, the desire to avoid being tagged as siding against the small saver, tipped the balance away from even modest restrictions on MMMFs. The logic of competitive equality then pointed towards allowing depository institutions the ability to compete with MMMFs for deposit-capital.

Unchecked by regulation, the growth of the money funds, and the disintermediation they facilitated, fueled arguments for both the elimination of interest rate ceilings and relaxation of thrift investment powers. While the debates and policies leading to these two phases of deregulation are explicated more fully in other chapters,[136] it is important to note here that the 1982 Garn–St. Germain Act directed the DIDC to authorize an account "directly equivalent to and competitive with money market mutual funds…" and that had "no limitation on the maximum rate or rates of interest payable on deposit accounts."[137] On November 15, 1982, the DIDC issued for comment a deposit account with no rate ceiling, unless the account balance fell below $2,500, and that allowed three drafts per month.[138] The *Wall Street Journal* heralded the policy changes,

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[136] Chapter 3 focuses on the deregulation of interest rate ceilings, and Chapter 6 on the deregulation of thrift asset powers.

[137] U.S. Senate. *Garn-St. Germain Depository Institutions Act of 1982*. S. rpt. 97-641. 97th Cong., 2d sess. (Washington, DC: Government Printing Office, 1982), 35.

[138] Depository Institutions Deregulation Committee, "Press Release: Money Market Deposit Account" ; Records of DIDC Meetings, May 6, 1980-Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Treasury; RG 56; NACP.

arguing that "the consumer will be the winner…."[139] The consumers of the new account, and of the still unregulated MMMFs would win, in the short term at least, but whether consumers as borrowers, and that other public interest, the safety and soundness of the depository institutions, would be "winners" remained to be seen. As it turned out, and as bank and thrift officials incessantly promised lawmakers, borrowers would have to pay higher rates and all customers would pay higher fees in order for the institutions to cover their increasing cost of funds (and still, they hoped, turn a profit).

The authorization of a competitive account, named a Money Market Deposit Account (MMDA), stemmed the tide of disintermediation to MMMFs, but came at substantial cost to the depository institutions. In January 1983, the *Wall Street Journal* reported, "the estimated $21.8 billion deposited in the new accounts in the week after their Dec. 14 introduction included only $3.2 billion from money-market mutual funds," while the remainder "came from existing S&L accounts."[140] In other words, for the most part, they were paying more interest on deposits they already had. The increased costs to the depository institutions for the funds that they kept in MMDAs and other ceilingless accounts had their own fairness implications, according to the thrift and banking industries. Richard Pratt summed up this position in his nomination hearing,

> Given the public policy decision, which I understand has been made, and which I share, that savers should earn a full market rate of interest on their savings; the unavoidable concomitant is that borrowers will be paying a full market rate for their mortgages. I think mortgage instruments should be designed to reflect and pass through the cost of funds which exists in the economy…. I believe if we are

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[139] Jill Bettner, "Your Money Matters: New Money-Market Deposit Accounts Will Spur Competition for Funds and Benefit Consumers," *Wall Street Journal*, November 15, 1982.

[140] "S&L Draw Big Deposits In Unregulated Accounts," *Wall Street Journal*, January 5, 1983.

> going to pay market rates for savings, that market rates for mortgages must be charged… the borrowing public is also the savings public.[141]

The right of the small saver to a market return, a right championed by Senator Proxmire and other members of Congress and cited by regulators such as Comptroller of the Currency John Heimann among others, became joined, in a long protracted process, to broader deregulation of depository institutions and housing finance. Along with powerful financial interests, and academic economists committed to deregulation and free markets, the politics of deregulation featured, and as the question of regulating the MMMFs shows, turned on, the influence and interests of middle class investors.

The decision to leave the MMMFs unregulated had ambivalent implications for opportunities for homeownership and for the Community Reinvestment Act. On one hand, the MMMFs remained unaccountable to the intent of the Community Reinvestment Act, and the funds continued to draw money from across the nation, which they then invested primarily in the largest banks or in capital markets distant from the communities from which the investments originated. On the other hand, by deregulating banks and thrifts and enabling them to compete with MMMFs without interest rate ceilings, the depository institutions that remained subject to the Community Reinvestment Act diverted some investments from the MMMFs and retained them in community-based institutions. However, even where deposits remained in local institutions to be reinvested within the community, the broader implications of deregulation meant that banks and thrifts retained deposits at higher cost, in competition with the MMMFs and other capital markets. To offset those costs, the institutions employed their newly won asset powers, those changes negotiated as companionate measures to the deregulation of deposit

[141] Richard Pratt, *Nomination of Richard T. Pratt*, 13-14.

ceilings and the lack of regulation of MMMFs, including adjustable rate mortgages and, for thrifts, the leeway to invest in outlets other than housing. Adjustable rate mortgages, which shifted interest rate risk from lenders to borrowers, comprised an increasing portion of mortgages as it competed against the traditional 30 year fixed credit instrument. The savings and loans used their expanded asset powers to invest in commercial real estate and other speculative investments, which ultimately resulted in the S&L crisis of the late 1980s, at enormous cost to taxpayers who footed the bill of an industry bailout. As the S&Ls became less and less devoted to housing, an increasing share of home mortgages were originated by largely unregulated mortgage brokers who, like the MMMFs, were not beholden to the Community Reinvestment Act.

Chapter 5

Leveraging Deregulation–Adjustable-Rate Mortgages

Said one borrower who had unwittingly signed on for a variable rate mortgage, "As one who bought one of these babies, I can tell you that it is no picnic."[1] Compared to a fixed-rate mortgage, the mortgage instrument that fueled the massive post-war expansion of homeownership, adjustable-rate mortgages shifted interest rate risk to borrowers. The added risk did not always mean escalating rates for borrowers–rates could fall as well as rise–but if rates did rise, so would monthly payments. Sudden rate hikes could be debilitating for borrowers, potentially leading to default and foreclosure. The borrower quoted above, Senator William Proxmire, was able to manage what he nonetheless termed a "very cruel" increase, but less well-off borrowers might not fare so well.[2] Jon Brown, Staff Attorney of the Public Interest Research Group, argued that the risk shift posed an unacceptable burden, concluding, "Any widespread change from the standard, fixed-rate mortgages to a variable-rate mortgage tied to interest rates would have a detrimental impact on the availability of mortgage credit for low- and moderate-income families."[3] The stakes seemed especially high for minority borrowers, as Steven

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[1] Senate Committee on Banking, Housing and Urban Affairs, *Markup [on Declining Membership in the Federal Reserve System]*, unpublished, September 28, 1978, 64. *ProQuest Congressional* (accessed January 3, 2012). "Having been victimized once, I can testify that it is not a happy experience." Ibid., 66.

[2] Ibid., 64.

[3] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Variable-rate Mortgage Proposal and Regulation Q: Hearings before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance,* 94th Cong., 1st sess., (Washington, DC: GPO, 1975), 356.

Rohde of the Center for National Policy Review put it, "In sum, I think the purposes of the Fair Housing Act would be subverted by a variable-rate mortgage plan."[4]

The decade-long process by which flexible-rate mortgage instruments (including variable-rate mortgages, renegotiable-rate mortgages, and adjustable-rate mortgages) were proposed, rejected, and ultimately authorized supports the two main arguments of this study: that the pursuit of a narrow agenda of deposit rate ceiling deregulation opened the door to broader deregulation of housing finance, and that this broader deregulation undermined fair housing and community reinvestment policies. This chapter will show that authorization of various forms of market sensitive mortgage instruments became tacitly linked to the loosening of interest rate ceilings. Each time federal regulators proposed or authorized new mortgage instruments, they were directly responding to a liberalization of interest rate ceilings. Lawmakers, who vehemently opposed variable-rate mortgages (VRMs) in 1975 on the grounds that they were unfair to borrowers, gradually accepted VRMs and other flexible-rate instruments as a necessary concession in the bargain to secure market rates for savers.

That both liability (deposit rate ceilings) and asset (mortgage instruments) deregulation came to pass reflected a negotiation in which lawmakers acceded to the former to ensure the latter. Financial deregulation was not uniformly supported or subscribed to, even among representatives of financial institutions. This chapter introduces the alignment of interests for and against the deregulation of mortgage powers (authorization of alternative mortgage instruments), which, alongside the alignment of interests for and against the deregulation of interest rate ceilings as discussed in chapter

[4] Ibid., 369.

three, shows just how selectively all but the most ideologically committed parties adhered to deregulation as a policy course. The most ardent supporters of variable-rate mortgages, the lenders, deeply opposed the elimination of Regulation Q, while champions of the small saver who advocated deposit ceiling deregulation like Senator William Proxmire, were most suspicious of variable-rate mortgages.

That the authorization of flexible-rate mortgage instruments undermined fair housing policies was not immediately apparent. It *was* clear that adjustable-rate mortgages shifted interest rate risk from lenders to borrowers. From the variable-rate mortgage proposal by the Hunt Commission in 1972 through the FHLBB's authorization of adjustable-rate mortgages in 1981, all parties conceded this point. But because the instruments were introduced as interest rates peaked in the early 1980s, borrowers did not experience any ill effects from this additional risk. That risk remained latent, however, perhaps all the more dangerous because the relatively painless early period allowed borrowers and policymakers alike to forget about it.

Flexible-rate mortgage critics who opposed the instruments on fair housing grounds rightly predicted increased discrimination against minority borrowers, but proved entirely wrong about how that discrimination would manifest. In the 1970s, civil rights and consumer advocates argued that lenders would exclude minority borrowers from VRMs (that they thought would soon dominate the market, replacing the fixed-rate option) whom the lenders would not consider "upwardly mobile" and thus able to afford the potentially increasing payments of a VRM. But because of parallel changes in housing finance, primarily the separation of mortgage origination and servicing from asset ownership (the subject of the following two chapters) that freed mortgage

originators from the risk of default, exclusion was not the problem. Instead, ARMs increased access, but facilitated discrimination in mortgage terms, flourishing in the subprime market that developed beginning in the mid-1990s. Both the discriminatory terms and the underlying risk of escalating rates contributed to the construction of an inequitable and unsustainable system of housing finance into the twenty first century.

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In the immediate post-war decades, the fixed-rate mortgage had served the thrifts, and millions of homebuyers, well. As explained in Chapter One, the innovation of the long-term fixed-rate mortgage made homeownership accessible to more buyers by spreading the otherwise prohibitive cost of a home into regular, affordable monthly payments. Because banks and thrifts enjoyed a low and predictable cost of funds as a result of Regulation Q rate ceilings (limits on the amount of money paid to savers for their deposits), this arrangement benefited lenders too. As long as the interest rates that thrifts paid on deposits remained relatively stable over the 20 to 30-year maturity of the loans they issued, thrift assets (the mortgages they held, earning income through borrowers' monthly payments) remained profitably matched with thrift liabilities (the savings accounts on which they paid interest to depositors). In 1959, for example, when an S&L paid 3.25% on savings to raise funds, the 4.5% interest it earned on a fixed-rate mortgage it had issued in 1944 still netted the institution a profit. More recently issued loans returned even higher rates to the lender, around 6% for a mortgage issued in 1959, leaving the S&L with a healthy and profitable portfolio. It was a good time to run a

savings and loan, when the "3-6-3" rule of paying 3% on deposits, lending at 6% on mortgages, and being on the golf course by 3 o'clock closely resembled reality.

But these "good times" would not last forever. In the mid-1960s, tight money conditions, and an accompanying spike in interest rates, shocked the thrift industry out of its reflexive trust in the 3-6-3 rule. Regulation Q ceilings had helped protect banks and thrifts from the inherent risk in "lending long," issuing loans at 20 to 30-year maturities, while "borrowing short," raising money by paying interest on deposits that could be withdrawn at any time, or at some interval such as one a one year CD. But prior to 1966, Regulation Q only indirectly protected the thrifts by limiting competition with banks; the ceilings did not apply to the thrifts themselves. Then, in 1965, the Federal Reserve Board voted to increase the Regulation Q ceiling, shaking lenders' faith that Regulation Q would insulate them from sudden increases in interest rates.[5] Though rates quickly returned to the levels of the immediate post-war decades, the 1966 experience prompted thrift officials and their regulators to seek policy changes that would better protect the S&Ls against similar rate volatility in the future. One response, the extension of Regulation Q to S&Ls and mutual savings banks (with the housing differential) sought to stabilize thrifts' cost of funds. But since the Fed had demonstrated that it would increase Regulation Q ceilings when market rates rose, thrift officials, and their regulators, also desired broader asset flexibility to weather tight money periods. Authorization of a flexible mortgage instrument tied to changes in market rates topped their list of coveted powers.

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[5] Allan H. Meltzer, "Origins of the Great Inflation," *Federal Reserve Bank of St. Louis Review* 87, no. 2 (March/April 2005): 145-175, 164.

The possibility of sudden increases to lenders' cost of funds reintroduced the risk in borrowing short and lending long, and lenders eagerly sought to mitigate that risk. Variable-rate mortgages, they argued, would do just that. Instead of being locked into a fixed-rate for up to 30 years, a variable-rate mortgage would allow the revenue paid to a lender to fluctuate along with the rates it paid to depositors. Beginning in 1969, during another "credit crunch," thrift officials and FHLBB regulators pursued authorization of variable-rate mortgages for federally-chartered S&Ls. Finding members of the relevant congressional committees unreceptive, the regulators tabled their 1969 proposal, but the continuing volatility of interest rates in the late 1960s and early 1970s kept the variable-rate concept alive.[6] For the thrifts, the urgency for flexible instruments only became more acute as their assets and liabilities became increasingly mismatched. By 1979, when an S&L was paying 7.5% to savers to attract funds, the 5.75% interest it earned on a fixed-rate mortgage it had issued in 1964 was no longer profitable. "The fixed-rate option is a bad concept," an S&L official complained in 1979. Advocating authorization of an adjustable-rate alternative, he pleaded to FHLBB regulators, "give us a chance to survive!"[7] Not only were market rates rising in the late 1970s, but as the two previous chapters documented, policymakers increasingly insisted that depository institutions pay those higher market rates to savers. The Money Market Certificates [MMCs], which regulators authorized in 1978 to allow banks and thrifts to better compete with money market mutual funds, helped the depository institutions to attract and retain funds but

[6] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Variable-rate Mortgage Proposal and Regulation Q*, 1.

[7] Marshall Graves, to Anita Miller, August 21, 1979; Consumer Checking Account Equity Act of 1979; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

drove their cost of funds ever higher, up to 7.47% for the thrifts, from 6.44% in 1977.[8] Rates on newly originated mortgages kept pace with increasing costs, but the larger portion of thrift portfolios consisted of older mortgages earning substantially lower rates.

It is easy to see, then, why lenders would desire authorization of market sensitive, variable-rate mortgages. This chapter traces the attempts of FHLBB regulators to authorize federally-chartered savings and loans to issue flexible-rate mortgage instruments through the 1970s and into the early 1980s. It documents a shift from emphatic congressional opposition to ambivalence and eventual embrace of flexible-rate instruments. It argues that congressional insistence on market returns for savers both emboldened regulators to seek flexible-rate authority and made congressional opponents reluctant to continue their fight against what they still considered potentially dangerous products. Furthermore, policymakers approved flexible-rate instruments over the objections of consumer and civil rights advocates who argued that the loans would unfairly shift interest rate risk to borrowers and would largely exclude borrowers whom underwriters did not consider to be upwardly mobile, likely the very groups of borrowers, women and racial minorities, who had been barred from housing finance in the past. For their part, regulators conceded that flexible-rate mortgage instruments would not be appropriate for some borrowers, but insisted that market-sensitive assets were essential to the very survival of the thrift industry. They argued that under conditions in which institutions had to pay market rates for savings, borrowers would increasingly have to bear the cost.

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[8] *Federal Home Loan Bank Board Journal*, various issues.

After the regulators' abortive attempt to propose VRMs in 1969, the most significant of the early flexible-rate mortgage proposals came in the report of the Hunt Commission. Included in its broad deregulatory agenda, the Commission's general endorsement of variable-rate mortgages[9] set two critical precedents. First, it linked VRM authorization to the phase-out of Regulation Q. If depository institutions were to pay market rates to savers, as the Commission recommended, those institutions, it held, should be allowed to charge market-sensitive rates to borrowers. The more that thrift portfolios could take on this flexibility, the better the thrifts would manage periods of inflation and rising interest rates. Second, recognizing that "the variable-rate mortgage shifts interest rate risk from the lender to the borrower," and that borrowers were least able to understand and evaluate that risk, the commission's report outlined several consumer safeguards.[10] In order to protect individual borrowers as well as the financial system as a whole, the report recommended "full explanation of the terms to borrowers, the offer of an alternative fixed-rate mortgage, limits on the permissible rate change, a publicly announced index on which rate changes are based, and, after an initial period, opportunities for 'no penalty' refinancing."[11] For VRM opponents, these suggested consumer protections represented the minimum standard for acceptable safeguards should variable-rate instruments be approved.

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[9] To expand market acceptance and usage of VRMs, the Commission recommended that HUD authorize variable-rate options on FHA-and VA-insured mortgages and that FNMA and FHLMC include variable-rate mortgages in their secondary market purchases.

[10] President's Commission on Financial Structure and Regulation, *The Report of the President's Commission on Financial Structure & Regulation* (Washington, DC: GPO, 1971), 82.

[11] Ibid., 77.

While the Hunt Commission report formed the basis of much of the Nixon administration's Financial Institutions Act of 1973, the proposed legislation did not address VRMs. Asked about the omission later, Deputy Secretary of the Treasury William Simon responded that after consideration, he decided to work with the FHLBB on developing a proposal, but not to include authorization in the FIA.[12] This decision may have reflected both sensitivity to the negative response to the 1969 proposal and recognition of the fact that VRMs did not strictly require congressional approval–FHLBB regulators had the power to authorize VRMs simply by issuing new regulations. The Bank Board did advance a proposal in 1972, but despite support from policymakers such as Federal Reserve Chairman Arthur Burns, [13] "the Board… backed off at that time because of the extreme political pressure to do so."[14] Senator William Proxmire, for example, called VRMs "imaginative," but dismissed them as a useful policy option.[15]

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[12] Simon, in Senate Subcommittee on Financial Institutions, *Financial Structure and Regulation: Hearings before the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs*, 93d Cong., 1st sess. (Washington, DC: GPO, 1973), 94.

[13] In December, testifying before a Senate subcommittee, Burns stated that authorization of variable-rate mortgages could go a long way toward leveling the "feast or famine" cycles in the housing industry. He suggested that limited variation in interest rates could be achieved by altering the maturity of the loan term, while keeping monthly payments fixed. Subcommittee on Priorities and Economy in Government, Joint Economic Committee, *Housing Subsidies and Housing Policies: Hearings before the Subcommittee on Priorities and Economy in Government of the Joint Economic Committee,* 92d Cong., 2d sess., (Washington, DC: GPO, 1973), 340-341. FHLBB Chairman Thomas Bomar would testify in 1975 that Burns's maturity adjustment approach would not work under circumstances in which the initial payments of a 30-year mortgage were already 100% interest. House Subcommittee on HUD and Independent Agencies Appropriations, *Department of Housing and Urban Development, Independent Agencies Appropriations for FY76, Part 4: Hearings before the Subcommittee on HUD and Independent Agencies Appropriations of the Committee on Appropriations,* 94th Cong., 1st sess., (Washington, DC: GPO, 1975), 125.

[14] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Variable-rate Mortgage Proposal and Regulation Q*, 248.

[15] Subcommittee on Priorities and Economy in Government, Joint Economic Committee, *Housing Subsidies and Housing Policies*, 342.

The majority of lawmakers remained wedded to the fixed-rate mortgage and considered VRMs unfair to consumers.

Congress, or at least the relevant figures with control over financial committees, clearly was not receptive to the idea of broadening beyond the fixed-rate mortgage. And, for the moment at least, FHLBB officials were not prepared to issue regulations without explicit congressional support. Yet the regulators, at the behest of thrift officials, would keep VRMs on their agenda, particularly in light of on-going debate over the elimination of interest rate ceilings. Though it did not include the Hunt Commission's VRMs recommendation, the Nixon administration's Financial Institutions Act (FIA) did call for the gradual phase-out of Regulation Q. While desperate to keep Regulation Q protection, thrift managers were equally determined that without the ceilings, they would be freed to issue variable-rate mortgages. Some observers specifically sought to head-off such an exchange. Testifying on the possibility that a phase-out of Regulation Q as proposed by the FIA would promote the case for variable-rate mortgages, State University of New York Law Professor John Andrew Spanogle, Jr. warned:

> Any final legislation [phasing out Regulation Q] should have a section which just clearly bans such mortgages. Either that, or you should have provisions which very closely regulate them, and make them tolerable to the general public which will find these mortgages crammed down their throat. If you know of this potential abuse, which will be brought on by the abolition of regulation Q, and you do not regulate this potential abuse, then you have not dealt with the complete problem as you can see it.[16]

Spanogle's testimony, along with opposition from organized labor, attuned FHLBB regulators to the importance of consumer safeguards in making any VRM proposal

[16] John Andrew Spanogle, Jr., in Senate Subcommittee on Financial Institutions, *Reform of Financial Institutions – 1973: Hearings before the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs*, 93d Cong., 2d sess. (Washington, DC: GPO, 1974), 640.

politically palatable, but in no way diminished the regulators' resolve to secure the coveted asset power.[17]

In 1974, in the wake of the Fed's inaction on the Citicorp floating note, FHLBB Chairman Thomas Bomar would in fact be emboldened to resuscitate the VRM proposal.[18] If the Fed was allowing the effective relaxation of rate-ceilings to the detriment of the thrifts, he reasoned, thrifts should have every power to compete and survive. During his testimony on the Citicorp note in 1974, Bomar indicated the agency's intention to authorize variable-rate mortgages. Sensitive to the concerns of skeptics such as Proxmire and Spanogle, he added that such an action would come only, "with adequate consumer protection," and after consultation with key members of Congress.[19]

The following spring, the FHLBB published proposed regulations to allow federally chartered savings and loans to issue variable-rate mortgages. The new instruments were warranted, the regulations read, in order to "provide a larger and more stable flow of funds for home mortgage lending… to enable associations to pay more competitive rates of return on savings accounts… [and] to reduce the extent to which savers and new borrowers in effect subsidize the lower rates paid by existing

[17] Nat Goldfinger, of the AFL-CIO, testified in 1974, "we are opposed to variable-rate mortgages. We feel that the mortgages would rise during inflationary periods, subjecting home buyers to higher outlays at the same time that other costs are rising. Second, we believe that home buyers would be forced to demand higher wages and salaries to meet the increased demands on their incomes, under those circumstances." Goldfinger, in Senate Subcommittee on Financial Institutions, *Reform of Financial Institutions – 1973*, 604.

[18] See Chapter 3.

[19] Bomar, Thomas, in U.S. House, Committee on Banking and Currency, *To Provide for the Regulation of the Issuance and Sale of Debt Obligations by Bank Holding Companies and their Subsidiaries*, *Hearing before the Committee on Banking and Currency, House of Representatives, Ninety-Third Congress, 2nd sess.*, July 15, 1974 (Washington, DC: GPO, 1974), 58-59.

borrowers."[20] Consistent with the precedent set by the Hunt Commission recommendations, the proposal outlined several consumer safeguards including a cap of 2.5% on the overall rate increase and no more than 1% per year, a limit to adjustments of no more often than every six months, mandatory rate decreases (increases were optional), and a FHLBB approved index for rate adjustments.

The most significant aspect of this proposal, however, was the response it elicited from Congress: explicit and emphatic opposition. Whereas the FHLBB's first two proposals were swiftly headed off by Congressional opponents, the third attempt received formal hearings in both chambers of Congress. In both houses, voting majorities supported bills expressly prohibiting VRMs.[21] Though no law emerged from these bills, the message to the FHLBB that VRM regulations would not be welcomed was clear. The hearings revealed three key aspects of the debates surrounding VRMs as they stood in 1975. First, the majority of lawmakers agreed with VRM critics that the instruments unfairly shifted risk to borrowers. Second, most lawmakers similarly agreed that VRMs posed a particular threat to minority borrowers, and they cited this concern prominently in their opposition to VRMs. Third, even as they rejected VRMs on these grounds, key figures such as Fred St. Germain (D-RI) and Senator John Tower (R-TX) implied that they would be more receptive to future VRM proposals if Regulation Q ceilings were loosened.

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[20] Federal Home Loan Bank Board, "Proposed Amendments Relating to Interest Rate Adjustments," *Federal Register* 40, no. 32 (February 14, 1975): 6870-6874.

[21] The House passed a bill by a vote of 291 to 104, while the Senate passed a similar concurrent resolution by voice vote. *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 13631. *ProQuest Congressional* (accessed January 3, 2012). *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 18991. *ProQuest Congressional* (accessed December 8, 2011).

It is worth recounting the legislative debates concerning VRMs in 1975 both to document the critique of VRMs made on behalf of the interests of borrowers and minorities and to emphasize just how far policymakers had strayed from their defense of those interests when they acceded to authorization of various forms of flexible-rate mortgages in 1979, 1980, and 1981. Between 1975 and the ultimate authorization of adjustable-rate mortgage instruments, I argue here, policymakers struck an implicit bargain, allowing thrifts and banks to issue variable- and adjustable-rate mortgages in exchange for the loosening and eventual elimination of interest rate ceilings. This about-face underscores the central arguments of this study: that the narrow agenda of interest rate ceiling deregulation on behalf of consumer-savers opened the door to further deregulation (in this case, of mortgage instruments), to the detriment of consumer-borrowers and fair housing policies.

Debate in the House centered on a bill (H.R. 6209) sponsored by Representative Fernand "Fred" St. Germain, which would prohibit VRM authorization for federally-chartered institutions.[22] The three days of hearings on the resolution before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance showcased the opposing views on VRMs. FHLBB Chairman Thomas Bomar and industry representatives, mainly from the state of California, testified in favor of the proposed regulations. They argued that VRMs were essential to the survival of the thrift industry, and, by extension, to the availability of residential mortgage credit. Witnesses

[22] Wright Patman (D-TX) had offered a bill that would prohibit any depository institution, regardless of state- or federal-charter, to issue variable-rate mortgages. Because a few states allowed its depository institutions to issue flexible-rate mortgages, this bill would have *taken away* some existing powers. St. Germain's bill, then offered a more moderate response. H.R. 5532, in *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 8996. *ProQuest Congressional.*

from consumer groups and organized labor countered that the instruments unfairly shifted risk unto borrowers who were ill-equipped to understand it. Finally, civil rights leaders argued that as lenders moved towards VRMs, they would become less likely to issue mortgages to racial minorities (because, they argued, lenders would tend not think of those minorities as being upwardly mobile and thus able to afford the potentially increasing payments of a VRM).

Following the lead of the rationale outlined in the published proposal, proponents claimed that VRMs would help stabilize the flow of capital to housing, and pointed to a series of issues of unfairness that VRMs would rectify. First, they argued that under the current system savers subsidized borrowers by earning lower than market rates of return on their savings. Second, VRM proponents reasoned that current borrowers generally subsidized the low rates of earlier borrowers, or as happened during erratic swings of interest rates, people who borrowed when rates were highest subsidized those who borrowed when rates were lower. VRM advocates claimed that the market sensitive instruments would spread the burden of the low-rate mortgages more evenly across borrowers regardless of when in the housing cycle and at what rate a mortgage was originated. Finally, VRM supporters argued that federally-chartered S&Ls in states in which state-chartered institutions could issue VRMs should be allowed to compete on a level playing field.

The hearings, titled, *Variable-rate Mortgage Proposal and Regulation Q*, unapologetically linked VRM authorization to the elimination of deposit rate ceilings (and, thus, higher returns to savers), though witnesses both for and against VRMs refused to support the idea of a strict quid pro quo. The thrift industry representatives who sought

VRMs insisted that they needed continuing Regulation Q protection while some, though not all, VRM opponents hoped for higher returns for savers without expanded asset powers.[23] Yet continued insistence on the necessity of retention of Regulation Q did not stop some proponents from leveraging the promise of *eventual* higher returns to savers in return for the *immediate* power to issue VRMs. Raymond D. Edwards, the chairman of a large California S&L, argued,

> The management of Glendale Federal Savings and Loan Association would like nothing more than to be able to pay our savers a higher rate of return on their funds–if we could be assured that sufficient changes will be made in our investment capabilities so as to ensure the higher earnings necessary to pay a higher savings rate…. We simply cannot generate the extra income needed to compete effectively without variable-rate mortgages.[24]

Edwards emphatically maintained, however, that Regulation Q protection must remain in place for at least five and half years while thrifts sought to build the proportion of VRMs in their portfolios.[25]

To St. Germain's frustration, other thrift representatives refused to commit even to a five and a half year timetable for removal of Regulation Q. "In return for your variable-rate program," he asked Dean Cannon of the California Savings and Loan League, "would you be willing to give up immediately the protection you now enjoy under regulation Q, the tax subsidy program, and the insurance premium you make in FSLIC to more accurately reflect the actual exposure of the fund?"[26] Cannon replied,

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[23] Most consumer groups, including Consumers Union and the Consumer Federation of America, opposed VRMs but called for the elimination of interest rate ceilings, whereas the AFL-CIO opposed both VRMs and the elimination of interest rate ceilings.

[24] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Variable-rate Mortgage Proposal and Regulation Q*, 40.

[25] Ibid., 41.

[26] Ibid., 115.

"Mr. Chairman, it sounds like you are even more convinced of the variable-rate as the answer to all the ills, or the problems that the thrift institutions have–probably even to a greater extent than I am."[27] Like Cannon, most VRM proponents at once argued that the more flexible instruments were both vitally necessary and insufficient to address the problems facing the thrift industry. William Mortensen, President of First Federal Savings and Loan Association of Santa Monica, added, "The variable-rate is absolutely not a panacea to the problems that we face. The only real solution, it would seem to me, is to have a reduction in inflation and a more stable economy."[28] Mortensen elided the logic that his "real solution," would eliminate the primary justification for VRMs: inflation and instability of interest rates. The slippage allowed him to argue for the indefinite continuation of interest rate ceilings, and the differential, leaving the exasperated chairman to remark to his colleague, "the variable will not remove regulation Q, Mr. [Henry] Hyde. That is the problem."[29]

Taking the pro-Regulation Q position to its extreme, Edward Johnson, Chairman and President of Financial Federation, Inc., Los Angeles, CA, testified, "if you are going to give VIR [variable interest rates] in the name of destroying regulation Q. I think that is immoral, and I think it is dangerous…. Regulation Q is still a private enterprise function to protect the homeowner. It is a special arrangement. [It] may well be the homeowner's last stand…."[30] Johnson warned that in the absence of Regulation Q protection, even the

[27] Ibid., 115-6.

[28] Ibid., 53. See also, Kenneth Birchby, President, National Association of Mutual Savings Banks, "Nor would the introduction of VRM's lessen the need for continuing Federal authority to establish deposit interest ceilings with meaningful differentials for thrift institutions." Ibid., 226.

[29] Ibid., 120.

[30] Ibid., 337-8, 341.

promised low initial rate on VRMs would be pushed higher, likely to a level prohibitive for many borrowers.[31] He thereby merged a pro-deregulation defense of VRMs and an anti-deregulation defense of Regulation Q, cloaking both under a defense of homeownership.

Chairman Bomar offered the committee little additional hope that VRMs could lead to elimination of Regulation Q in the near future, predicting, "with variable-rate mortgages alone, if they were used exclusively by all the lenders in the country, beginning today, I would presume it would be at least 5 years before the mortgage portfolios of the institutions would allow them sufficient income flexibility to do without some kind of rate ceilings."[32] Only VRM opponents claimed that the instruments would rival fixed-rate mortgages in thrift portfolios; Bomar and the thrift representatives assured the committee that lenders would not use VRMs exclusively. Stephen Gardner, Deputy Secretary of the Treasury, supported this assessment, arguing, "market forces will eventually determine the place of the variable-rate mortgage… I am convinced that fixed-rate mortgages will continue to be readily available as long as there is any consumer demand for them."[33] If they were correct that variable-rate instruments would not dominate thrift portfolios, then Bomar's five year projection represented a minimum estimate of the thrifts' continued need for Regulation Q. Bomar did indicate, however, that VRMs constituted an essential part of the push to achieve higher returns for savers

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[31] Ibid., 387.

[32] Ibid., 268.

[33] Ibid., 328. Gardner conveyed that while the Treasury Department did not object to VRMs, neither did it find them adequate to address the pressing problems of disintermediation and cyclical flows of capital for housing. Those problems, he asserted, would be more fully addressed by the reforms proposed in the Financial Institutions Act. Ibid., 332.

and made that promise, however far off, a central argument in support of the proposed regulations. This did not impress St. Germain any more than the equivocations of the industry witnesses. He concluded, “So, frankly, we are no closer now if we were to adopt the variable to the removal of regulation Q and an increased rate to the depositor.”[34]

Though thoroughly convinced that savers should get higher returns, and thereby implicitly buying the argument that savers unfairly subsidized borrowers, St. Germain offered less sympathy to VRM proponents’ argument that current borrowers unfairly subsidized past borrowers. He asked a witness,

> The borrower who bought a car and financed it for 4 years… at a lower rate, he therefore is subsidizing all of the borrowers who bought a car later on, and are paying a higher rate of interest? …if you both live in the same community and you are paying taxes in that community, you are subsidizing [fellow witness] Mr. Mortensen by paying the taxes that pay for the schooling of his children, are you not? The point is that the American way of life is that people are subsidizing other people at all times are they not?[35]

Simultaneously holding that subsidizing other people was an “American way of life” and that savers should get higher returns, St. Germain implicitly privileged one set of consumers–savers, who should not be asked to subsidize borrowers, over another–new homebuyers, who should, by his logic, subsidize past borrowers simply because that was how the system worked.

The California delegation of industry witnesses and their congressional representatives argued that federal S&Ls in their state must be freed to compete fairly with state-chartered thrifts that could already offer VRMs. Others, such as Ohio Republicans Willis Gradison and Chalmers Wylie, argued that the truly fair course would

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[34] Ibid., 268.

[35] Ibid., 122-3.

be to authorize all institutions to offer the choice of VRMs and let the consumers in the market decide what should be allowed.[36] Short of a national authorization like that favored by Gradison and Wylie, the California delegation sought a more limited provision that would apply to federally-chartered institutions in states that explicitly allowed state-charters to offer VRMs, or at least in California. Congressman Thomas Rees (D-CA) proposed an "experimental" authorization: "what I would like to ask this subcommittee to do would be to do the same thing we did with the NOW Accounts. Let us try them out in California."[37] As with NOW accounts, the dual banking system by which institutions were chartered and regulated by either state or federal authorities provided an entering wedge for arguments about fair and free competition between institutions of state- and federal-charter. Reflecting a concern for consumer protection, however, Congress would prove less receptive to such arguments in the case of VRMs than it had with NOW accounts.

The AFL-CIO led the opposition to the FHLBB's proposed regulations. Their criticism represented two constituencies that VRM proponents claimed would be most helped by the new instruments: consumers and construction workers. Bob Georgine, President of the Building and Construction Trades Department of the AFL-CIO argued, "Variable interest rate mortgages would not solve the problem of sharp cyclical declines in homebuilding every few years. In fact, it would probably make the fluctuations and instability in homebuilding worse."[38] Instead, Georgine suggested, VRMs would

[36] Ibid., 67.

[37] Ibid., 62.

[38] Ibid., 56.

contribute to inflation. As monthly mortgage payments of a VRM increased, he reasoned, homeowners would be pressed to fight for higher wages to offset the new costs. Looking at past experience in which workers had struggled to cope with inflation-induced wage erosion, AFL-CIO President George Meany too saw VRMs as a potentially exacerbating factor. He wrote to St. Germain, "during 1974, for example, real gross average weekly earnings of workers declined by almost 5 percent. Interest rates on variable-rate mortgages linked to corporate bond yields could have been raised a full percentage point in 1974."[39] Under such conditions, and predicting a continuation of the long history of rising interest rates, Georgine concluded, "The average workingman would have much more to lose than to gain from variable-rate mortgage interest rates."[40] Both John Sheehan, Legislative Director of the United Steelworkers of America, and George Miller, Executive Vice President of the Communications Workers of America, reiterated that an increase in monthly mortgage payments would leave the average worker cutting back on other expenses such as food and clothing and would lead to greater wage demands at the bargaining table.[41] Chairman Bomar's written statement had anticipated the labor representatives' inflation argument and countered with a curious rebuttal, "When inflation is high and interest rates are rising, more of the homeowner's income will be used to make mortgage payments and less will be used for other purposes. Thus, inflation can more easily be brought under control."[42] St. Germain later remarked, "My note in the

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[39] Meany, to St. Germain, April 3, 1975, in House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Variable-rate Mortgage Proposal and Regulation Q*, 59.

[40] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Variable-rate Mortgage Proposal and Regulation Q*, 59.

[41] Ibid., 345, 351.

[42] Ibid., 174.

margin for that is, 'Wow!' is this the way we think we ought to control inflation, and determine what people are going to spend their money on?"[43] Bomar backed off this particular line of argumentation, but continued to deny that VRMs would be inflationary.

Nearly all parties involved in the debate recognized that variable-rate mortgages shifted interest rate risk from lenders to borrowers. St. Germain noted that the Hunt Commission had said as much in its report recommending their use, but some observers found this shift more problematic than had the commission.[44] Consumer Federation of America witness Kathleen O'Reilly argued that "clearly, the borrower is the party least able to analyze and assess the risk entailed in fluctuating rates."[45]

VRM opponents believed that, given the choice, lenders would seek to reallocate their portfolios predominantly to VRMs. The proposed regulations did not, as had the Hunt Commission recommendation and the FHLBB's 1972 proposal, include a requirement that a fixed-rate mortgage be offered alongside a VRM. Even with such a requirement, O'Reilly did not think consumers would truly have a choice. Financial institutions, she argued, "could make the fixed mortgage rates so onerous that, practically speaking, there would be no option…. Likewise, the savings and loan institutions could wait to offer the fixed-rate until the interest rate is at a high point, when it is to their advantage to allocate a percentage of their funds for the fixed-rate."[46] Proponents countered that lenders would have to make VRMs attractive enough, through lower initial rates, for borrowers to accept the additional interest risk. Consumer advocates like

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[43] Ibid., 152.

[44] Ibid., 135.

[45] Ibid., 236.

[46] Ibid., 258.

O'Reilly feared that lenders would hold all the bargaining leverage and could manipulate even a mandated fixed-rate option to suit their interests.

St. Germain shared the position that borrowers would be at a disadvantage, "How I can expect the consumer to understand enough about it in order to make an intelligent decision as to whether or not he or she–the consumer–should opt for a VRM as opposed to a fixed-rate mortgage."[47] Complicating the concern over the consumers' ability to understand the terms of a variable instrument, the regulations, as yet, had not named the index to which adjustments would be pegged. O'Reilly argued that there was no such index that met the criteria laid out in the regulations of "proven reliability in moving with market interest rates, is beyond the influence of the Federal savings and loan association using it, and is explainable in clear and simple terms to borrowers with the aid of publicly available information."[48] The absence of a named index contributed to a general distrust of the regulations. Rev. Msgr. Geno Baroni, President of the National Center for Urban Ethnic Affairs, especially objected to the fact that the regulations required Congress to intervene before the index was named.[49]

Civil rights advocates argued that some borrowers would likely be hurt more than others. While the debate over the transformation of the New Deal system of housing finance remained almost entirely separate from those concerning fair housing and community reinvestment, the spirited opposition to VRMs represent the lone exception. Civil rights advocates charged that lenders would employ underwriting standards for

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[47] Ibid., 267.

[48] Ibid., 237.

[49] Ibid., 214.

VRMs that would further isolate the traditionally excluded from home financing. Rev. Msgr. Baroni argued, “Underwriting standards will be more conservative and will place an additional burden on those who already have been excluded by the lenders–the working class and the poorer groups.”[50] If, as advocates claimed, VRMs would entice borrowers through lower initial rates that could then escalate, and would be best suited for homebuyers who expected their incomes to increase over the term of the loan, then lenders would have to figure the likelihood of upward mobility into their risk assessment. Of this prospect, Gale Cincotta of National People’s Action observed, “When they talk about upwardly mobile people, I do not know exactly who they are talking about, but they certainly are not usually talking about the people in our cities and in our inner-ring suburbs who are hit by the economy right now.”[51] NAACP Washington Bureau Director and long-time fair housing advocate Clarence Mitchell put it more bluntly, “This is geared to appeal to a market that does not include most of the black people of this country and would not include most of the blue-collar white people.”[52]

O’Reilly predicted, “The underwriting policies which would result from VRM’s would institutionalize discrimination against minorities, including the elderly, women, and those seeking loans in older neighborhoods…. Years of effort to guarantee equal opportunity in housing could crumble under the guise of sound business judgment.”[53] O’Reilly and others feared that “sound business judgment” evaluations of risk would allow “upward mobility” to function as a stand-in for the types of discrimination that had

[50] Ibid., 213.

[51] Ibid., 222.

[52] Ibid., 233.

[53] Ibid., 236.

been made illegal under fair housing law. Rev. Baroni added that borrowers in racially heterogeneous neighborhoods too might be labeled as higher risks, amounting to red-lining of those neighborhoods.[54]

Under this barrage of criticism, Bomar conceded, "This proposal does not go to the very legitimate needs of the low-income borrowers or the underlying problems of our cities."[55] Bomar stressed that the VRM should be optional, noting in particular that VRMs would not be appropriate for "people who operate on modest incomes and are not upwardly mobile."[56] For the FHLBB chairman, the question of thrift asset powers and the stability of the flow of mortgage credit could be addressed separately from the problem of urban disinvestment. Yet for the community activists, this bifurcation of policy issues was itself part of the problem facing borrowers, particularly those who had been excluded in the past. Mitchell thundered,

> The Government working in partnership with the lending institutions has subverted the intention that we had many years ago, to provide homes for the ill housed, to preserve the neighborhoods that might be preserved and to make it possible for people of modest means to acquire housing as owners and to live in decent neighborhoods. I would say that this proposal on variable interest rates is but another link in the chain that has held back progress in this country.[57]

Few, if any of the committee members would have gone as far as Mitchell, yet the majority did find that the VRM proposal posed a threat to consumer interests. In 1975, at least, the consumer and civil rights advocates carried the day. Though in limited use in

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[54] Ibid., 213.

[55] Ibid., 253.

[56] House Subcommittee on HUD and Independent Agencies Appropriations, *Department of Housing and Urban Development, Independent Agencies Appropriations for FY76, Part 4*, 125.

[57] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Variable-rate Mortgage Proposal and Regulation Q*, 232.

some areas of the country by state-chartered S&Ls, the VRM was still largely an unfamiliar instrument, particularly in comparison to the fixed-rate mortgage, considered by many to the be the bedrock of the "American dream" of homeownership.

The House Committee on Banking, Currency, and Housing considered the testimony and reported its interpretation that the FHLBB's "primary constituency [is] the borrowing public [and that] the majority of the committee believes variable-rate mortgages could have a built-in pro-lender, anti-borrower bias."[58] Reflecting the influence of the testimony of VRM opponents, the committee report indicated a skepticism that fixed-rate mortgages would survive if VRMs were authorized, and expressed a particular concern over the potential changes in underwriting principles that would especially harm "working class families and minorities who do not have the 'upward mobility' to support a VRM loan."[59] The House report concluded, "An approach of this nature, dealing only with a part of the overall problem, simply should not be permitted until the problem of enabling the saver-depositor to receive a greater return on his investment is faced squarely."[60] While soundly rejecting the FHLBB's VRM proposal, this concluding language signaled that movement on Regulation Q could provide an entry-point for a reconsideration of VRMs.

The Senate made its own repudiation of the FHLBB variable-rate proposal. Senator Proxmire, emerged as the most vocal opponent of VRMs in the Senate,

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[58] House Committee on Banking, Currency, and Housing, *Prohibition of Variable Interest Rate Mortgages by Federally-Chartered Savings and Loan Associations* 94th Cong., 1st sess., H. rpt. 94-183 (Washington, DC: GPO, 1975), 4.

[59] Ibid., 4-6.

[60] Ibid., 8.

introducing a bill to prohibit their authorization.[61] Proxmire warned, "I, for one, am quite skeptical of the desirability of variable-rate mortgages in general and even more skeptical of the Bank Board's specific proposal. I believe the benefits of variable-rate mortgages have been greatly exaggerated."[62] Proxmire objected to the shifting of interest rate risk to borrowers, discrimination against "working-class families whose incomes are relatively fixed," the absence of a mandated fixed-rate option, and what he predicted to be inflationary implications of VRMs.[63] Proxmire challenged the VRM proponents to convince him otherwise, but after four days of hearings he remained unmoved. Though continuing to express his doubt of the merits of VRMs, Proxmire left the door open to the possibility of VRMs with more palatable safeguards, given statutory, not merely regulatory, authorization.

On June 16, 1975, the Senate agreed to Senate Concurrent Resolution 45 by voice vote, "expressing the sense of the Congress that the Federal Home Loan Bank Board shall refrain from authorizing variable-rate mortgages unless and until authorized by the Congress."[64] Reiterating that the resolution did not necessarily signal the death of the VRM, Senator John Tower (R-TX) added, "One thing that must be considered here is not just the welfare of borrowers, but also the welfare of savers, particularly small savers."[65]

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[61] *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 14186. *ProQuest Congressional* (accessed January 3, 2012).

[62] Senate Committee on Banking, Housing and Urban Affairs, *Variable-rate Mortgages: Hearings before the Committee on Banking, Housing and Urban Affairs* 94th Cong., 1st sess., (Washington, DC: GPO, 1975), 1.

[63] Ibid., 1-2.

[64] *Congressional Record,* 94th Cong., 1st sess., 1975, 121: 18991. *ProQuest Congressional* (accessed December 8, 2011).

[65] Ibid.,18992.

Proxmire seconded, "As long as we have regulation Q limiting the amount that can be paid to the saver, of course, we are in a position where the variable-rate mortgage is unlikely to do him much good."[66]

The accompanying Senate report noted the lack of consensus that VRMs would be in the public interest, citing the objections of labor and consumer organizations as well as some scholars. The report summarized the main objections to VRMs: risk is disproportionately shifted to borrowers; lenders, with superior market knowledge, will push VRMs when they expect rates to rise, and push fixed-rate mortgages when they expect rates to fall; VRMs will favor households considered to be upwardly mobile, and exclude working class and moderate income households; that VRMs would be inflationary; and that the proposed safeguards would be insufficient to protect consumers.[67]

The House did not act on the Senate Concurrent Resolution, but the resolution, coupled with the House's resounding vote in favor of H.R. 6209 sent a clear message to Bomar and the FHLBB to rescind the proposed regulations. Bomar complied, and the labor, civil rights, and consumer advocates scored a victory in blocking federal authorization of VRMs. The absence of a passed law prohibiting VRMs, however, left the door open for the FHLBB to revise their proposal, and for Congress to consider VRMs as part of the on-going debates over financial reform. Both houses had hinted that VRMs might be more acceptable if savers earned market rates on their deposits. For the moment, at least, neither supporters of deregulation of interest rate ceilings nor supporters of

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[66] Ibid., 18992.

[67] Senate Committee on Banking, Housing, and Urban Affairs, *Variable-rate Mortgages* 94th Cong., 1st sess., S. rpt. 94-170 (Washington, DC: GPO, 1975), 4-5.

deregulation of thrift asset powers could cobble together a majority. The thrifts were winning their battle to protect Regulation Q, but not their bid to achieve broader asset powers, including VRMs. Complicating the issue, some legislators, like Proxmire, badly wished to remove the rate ceilings while insisting that VRM authorization not be granted in exchange. Whereas deregulation in the name of the free market obliged support of both initiatives, deregulation in the name of consumer interest, for some, could mean only support of the elimination of rate ceilings, and even then, astute observers recognized that consumer-borrowers' interests were at stake too.

Despite the third congressional rejection of VRM authorization in six years, FHLBB regulators began a renewed push for broadened asset powers the following year. In the spring of 1976, the FHLBB initiated a comprehensive study of a wide range of alternatives to the fixed-rate mortgage (the AMIR study). In addition to variable-rate mortgages, the study examined a "rollover" instrument, for which the interest rate would be renegotiated at a set interval (a version used in Canada was renegotiated every 5 years), a graduated payment instrument with low initial rates that gradually increased, a "flexible-payment" instrument that moved all interest payment to the first five years of maturity, a "deferred-interest" instrument under which a borrower received a low, fixed-rate and in return, the lender would be paid deferred interest and a fee when the home was sold,[68] and an "escalator" instrument, which functioned as a VRM after an initial three year period. The study surveyed borrower preferences, considered secondary market implications, projected implications of various instruments for borrowers and lenders, and assessed consumer safeguards.

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[68] If the home did not sell within a pre-arranged period, the mortgage would convert to a conventional mortgage with the deferred interest and fee added to the outstanding portion of the loan.

FHLBB regulators used the extensive study as the basis of a revised and expanded regulatory proposal that would maximize the ability of thrift institutions to experiment with market sensitive instruments. Bolstering the competitive equity case for federal authorization of alternative instruments, the AMIR study found that as of 1976, state-chartered institutions had issued over 200,000 alternative mortgage instruments valued at over $8.5 billion, concentrated in California, New England, Wisconsin, and Ohio. The majority of these loans, 160,000 and $7.4 billion respectively, were variable-rate mortgages.[69] Yet these alternative instruments amounted to little more than 1% of the total mortgage debt outstanding.

In 1977, some members of Congress began indicating to Marston that the time had come to revisit VRM authorization. In February, Senator Tower along with Alan Cranston (D-CA), sponsored Senate Concurrent Resolution 9, which urged the FHLBB to authorize "a wide variety of flexible mortgage instruments (including variable-rate mortgages) in States where State-chartered savings and loan associations are permitted to offer variable-rate or other types of flexible mortgages to the public," and in other states on an experimental basis.[70] The resolution languished in Senator Proxmire's Banking Committee, but nonetheless indicated limited bipartisan interest in revisiting the variable-rate concept. Senator Thomas McIntyre (D-NH) too signaled to the FHLBB regulators and the thrift industry that Congress might reconsider a VRM proposal, sponsoring legislation drafted by the U.S. League of Savings Associations that included a title

[69] David P. Rochester and Richard G. Marcis, "National Survey of Current AMI Activity," in Federal Home Loan Bank Board, *Alternative Mortgage Instruments Research Study, Volume I* (Washington, DC: GPO, 1977).

[70] *Congressional Record,* 95th Cong., 1st sess., 1977, 123: 3544. *ProQuest Congressional* (accessed August 17, 2011).

modeled on Senate Concurrent Resolution 9.[71] Like Proxmire, McIntyre was committed to achieving higher returns for savers. Unlike his colleague from Wisconsin, however, McIntyre was willing to consider offering thrifts VRM authorization in order to get them.

Seeking a different outcome for the FHLBB's fourth flexible mortgage proposal, regulators sought to address the major objections to the 1975 version (that risk would be unfairly shifted to borrowers, borrowers would not be able to chose a fixed-rate alternative) without compromising on what they considered the essential needs of the thrift industry (an increasing portion of market sensitive mortgages in portfolio). Convinced that thrift portfolios would have to become more responsive to interest rate volatility through some form of flexible rate instrument, regulators focused on making the consumer safeguards more acceptable to lawmakers and VRM critics. The AMIRS paper on consumer safeguards, written by Maurice Weinrobe, concluded "It is appropriate to constrain the movement of debit rates on a periodic and on an overall basis," thus reaffirming the rate caps that had been included in previous FHLBB proposals.[72] Rather than hoping that the Weinrobe study would lead regulators to the best mix of consumer protection and thrift flexibility, however, FHLBB Chairman Garth Marston sought direct guidance from Congress. He wrote to Senator Proxmire, "It is

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[71] Senate Committee on Banking, Housing, and Urban Affairs. Subcommittee on Financial Institutions, *Alternative Mortgage Instruments: Hearings before the Subcommittee on Financial Institutions of the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Ninety-fifth Congress, First Session, October 6 and 7, 1977*, (Washington, DC: GPO, 1977), 82.

[72] Donald Kaplan, Richard Marcis, and Henry Cassidy, "AMIRS: An Overview and Summary," in Federal Home Loan Bank Board, *Alternative Mortgage Instruments Research Study, Volume I* (Washington, DC: GPO, 1977), 19.

essential that Congress clearly indicate what kinds of consumer safeguards are appropriate for a full range of flexible mortgage instruments."[73]

The FHLBB cast its renewed push for market sensitive mortgage instruments in pro-consumer terms. Donald M. Kaplan, Chief Economist and Director of the FHLBB Office of Economic Research, argued that AMIs offered a choice to consumers with different financial needs. Citing the increasing costs of homeownership, Kaplan argued that AMIs, including graduated payment mortgages (GPMs) as well as variable-rate mortgages, might better fit the needs of young, first-time home buyers who expected their incomes to increase over time. Kaplan's framing of AMIs in consumer-centric language emphasizing the financial needs of various points in their "life cycle" represented a new approach for FHLBB regulators' pursuit of flexible-mortgage instruments. Not until his fifth reason for the necessity of AMIs did Kaplan mention what had previously been the primary rationale for VRM authorization: the needs of lenders to have greater flexibility to combat problems of disintermediation and high interest rates.[74] In part, this change reflected the relative calm of interest rates at the time, but the shift in strategy also sought to counter the challenges raised in previous debates by consumer advocates by casting the regulations as pro-consumer.

Kaplan outlined five proposed consumer safeguards that included limits on the amount and frequency of annual payment increases, prohibition of balloon payments, and featured what FHLBB regulators called "documented choice." Answering the objections

[73] Garth Marston, to Proxmire, March 22, 1977; S. Con. Res. 9 (95); Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[74] Kaplan, U.S. Congress. Senate. Committee on Banking, Housing, and Urban Affairs. Subcommittee on Financial Institutions, *Alternative Mortgage Instruments*, 5.

to the absence of such a provision in the 1975 proposal (despite the recommendations of the Hunt Commission), documented choice mandated that federally chartered institutions that offered VRMs would also offer the option of a fixed-rate alternative and that the maximum liability for various mortgage options be disclosed to consumers.[75] Though otherwise expressing great confidence in the "free market place" to regulate prices and ensure that lenders would not induce consumers into taking on mortgages they could not afford, Kaplan conceded that the market alone would not guarantee that the fixed-rate option would be made available to all borrowers.[76] Kaplan maintained that with the documented choice safeguard, however, traditional fixed-rate, fixed-payment mortgages would remain the principal form in use.[77]

The consumer-centric framing did little to appease consumer advocates. Kathleen O'Reilly of the Consumer Federation of America criticized Kaplan for lumping various mortgage instruments together under the name alternative mortgage instruments, noting in particular the differences between GPMs and VRMs, implying that the catch-all "AMIs" was a Trojan horse designed to divert scrutiny from VRMs. VRMs, she argued, echoing her 1975 testimony, unfairly shifted risk onto consumers, and "pose[d] discriminatory effects on women, racial minorities and the elderly who do not traditionally have the upward economic mobility to demonstrate to cautious underwriters that not only can they meet the current monthly payment but that additionally, they can absorb future increases."[78]

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[75] *Alternative Mortgage Instruments*, 6-7.

[76] Ibid., 39, 47.

[77] Ibid., 4-5, 8.

[78] Ibid., 121-2.

When pressed by Senator Proxmire on the question of who would bear the cost of VRMs, Kaplan answered, "First, it is in all of our interests to make sure we keep a viable financial institution system in this country to keep mortgage credit flowing and to hopefully keep that credit flowing on as stable a basis as possible…."[79] Kaplan's second response, that documented choice would protect consumers from having alternative mortgage instruments forced on them, similarly elided Proxmire's question, but revealed something of the parameters of possible policy. Questions of cost and affordability were ultimately subservient to the question of the survival of financial institutions in a changing economic environment. Sen. McIntyre made this point even more starkly, "While interest rates and monthly payments are certainly important, is there not also a strong consumer objective to be served in guaranteeing a stable flow of mortgage money? In this regard, are not VRM's better than no mortgage money at all?"[80]

When the FHLBB formally unveiled its proposed slate of "alternative mortgage instruments" (AMIs) in July 1978, it did offer consumer safeguards that had not been included in the 1975 proposal.[81] Among these, the most important was the requirement that any type of AMI be offered alongside a standard fixed-rate mortgage and that the borrower be shown a detailed comparison of the instruments including a "worst case" payment schedule. Significantly, the proposal was also measured in geographical scope.

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[79] Ibid., 43.

[80] Ibid., 128.

[81] In addition to the previously considered VRM, the FHLBB proposal included the rollover mortgage (ROM), graduated payment mortgage (GPM), and reverse annuity mortgage (RAM). The AMIs, the FHLBB claimed, "are not new types of loans, but simply different, creative methods of payment for regular types of home loans." Federal Home Loan Bank Board, "Proposed Alternative Mortgage Instruments," *Federal Register* 43, no. 147 (July 31, 1978): 33255. *HeinOnline* (accessed January 4, 2012).

Instead of a national authorization, the implementation would follow the lead of the failed 1975 Rees amendment by which AMIs could be offered only in states in which state-chartered institutions already offered comparable instruments. An additional portfolio restriction limited the number of AMIs that could be offered to no more than half of the loans made and purchased by an institution in a calendar year.

The July proposal conveyed an entirely different rationale than its 1975 predecessor. Gone was the language promising higher returns to savers, greater stability in the flow of capital for housing, and a healthier thrift industry. In its place, the FHLBB had constructed a consumer-centric justification. As had been suggested by Kaplan's testimony, the regulations claimed that AMIs would offer greater choice for consumers and "better meet the needs of homeowners during different phases of their financial life cycles."[82] Yet, nothing about the FHLBB's consumer-centric framing of VRMs had diminished the concern of consumer advocates. The fundamental premise that VRMs shifted risk to borrowers remained at the heart of VRM opposition. But from the perspective of some policymakers, at least, the terms of debate were subtly shifting from concern over particular forms of mortgage financing to concern over the continuing availability of any financing at all.

In September 1978, seeking to send a clear message to the FHLBB to proceed, Senators Cranston and Tower proposed new language to Senate Concurrent Resolution 9, making it a Senate resolution calling for authorization of VRMs, GPMs, ROMs, and RAMs. Proxmire, fearing that the resolution, with only four committee members present,

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[82] Federal Home Loan Bank Board, "Proposed Alternative Mortgage Instruments," *Federal Register* 43, no. 147 (July 31, 1978): 33254. *HeinOnline* (accessed January 4, 2012).

would indeed prompt the FHLBB to move ahead with its July AMI proposal, objected "I am absolutely 100 percent – maybe I should say 1000 percent against this proposal. This is a situation where you are going to put the onus on the back of the borrower, rather than where in my view it belongs, which has traditionally been, in this country, on the lender."[83]

The Cranston-Tower endorsement never formalized as a resolution, but neither was there any congressional action prohibiting VRMs comparable to H.R. 6209 and S. Con. Res. 45 in 1975. Though Proxmire and others continued to express concern about the implications of alternative mortgage instruments, the FHLBB felt emboldened to issue the proposed regulations in December, effective January 1, 1979. The dramatic growth of higher-cost MMC deposits afforded regulators a justification for expanding thrift asset powers. Though noting the protests of thrift officials, the final regulations retained a 50% portfolio limit on AMIs (meaning at least 50% in traditional fixed-rate mortgages), and the restriction to states in which AMI authorization would address competitive imbalance. The latter limitation had been loosened somewhat in the final regulations to allow that competition might come from institutions other than state-chartered S&Ls, and such competition would be considered by FHLBB regulators in determining in which states federal-charters would be authorized to issue AMIs. The explanation acknowledged that VRMs, in particular, "have been controversial and [the FHLBB] deems it of the greatest importance that a real choice be made available to

[83] Senate Committee on Banking, Housing and Urban Affairs, *Markup [on Declining Membership in the Federal Reserve System]*, unpublished, September 28, 1978, 64. *ProQuest Congressional* (accessed January 3, 2012).

borrowers offered [VRMs]."[84] Accordingly, the "documented choice" requirements added a mandated statement indicating that a borrower could choose a standard mortgage instrument. The final rules were modest, especially in their limited geographical scope. FHLBB Chairman Richard Pratt would later testify that the authorized instruments were "not used by institutions to any degree because of [their] limitations."[85]

Yet the geographic restriction was short-lived. Effective July 1, 1979, the FHLBB authorized VRMs nationwide. To justify the change, FHLBB regulators revived their 1975 rationale, stating, "such investment authority is necessary to offset the costs of paying higher interest rates on savings accounts and … in order to maintain competitive balance with other financial institutions."[86] The period of relative interest rate stability that had afforded the opportunity to couch the 1978 proposal in consumer choice language had since passed. The new rules explained, "The rapid growth of money market certificates has exacerbated the 'lending long and borrowing short' problem of savings and loan associations, creating a severe competitive disadvantage for savings institutions as a group relative to other financial institutions with more flexible asset portfolios." According to this reasoning, the loosening of interest rate ceilings *required* deregulation of assets, authorization of VRMs in particular. As much as some legislators would have liked to have kept the issues separate, the FHLBB regulators became increasingly insistent that they be paired. Perhaps to appease VRM opponents, the revised regulations

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[84] Federal Home Loan Bank Board, "Alternative Mortgage Instruments," *Federal Register* 43, no. 245 (December 20, 1978): 59337. *HeinOnline* http://heinonline.org (accessed December 8, 2011).

[85] Richard Pratt, in House Committee on Banking, Finance and Urban Affairs, *Savings and Loan Policies in the Late 1970s: Hearings before the Committee on Banking, Finance and Urban Affairs* 101st Cong., 2d sess., (Washington, DC: GPO, 1990), 181.

[86] Federal Home Loan Bank Board, "Variable-rate Mortgages," *Federal Register* 44, no. 109 (June 5, 1979): 32199. *HeinOnline* http://heinonline.org (accessed December 8, 2011).

simultaneously amended the safeguards to extend the notification period of rate increases and window for penalty-free prepayment from 60 to 90 days. Additionally, along with a "worst case" payment schedule, lenders would be required to disclose a 10-year history of the national cost-of-funds index, in order to give borrowers a better understanding of the risk they were assuming.

Despite the move to national authorization, however, VRMs still failed to take hold as the regulators had hoped. As late as May 1980, Deputy Secretary of the Treasury John Mingo reported, "The experience with VRMs under the regulatory constraints under which Federal S&Ls have been authorized to issue VRMs has not been that good, especially outside of California," where VRMs comprised only 1% of thrift mortgage portfolios. FHLBB Chairman Jay Janis claimed that the 'worst case' disclosure requirement had doomed the VRM because it "distort[ed] the picture from a borrower's point of view."[87] Seeking wider flexibility for thrifts to find a more marketable alternative to the fixed-rate mortgage, in December 1979, the FHLBB proposed a new type of mortgage instrument, the Renegotiable Rate Mortgage (RRM), an automatically renewing short-term (three to five year) notes secured by a long-term mortgage. At each renewal, the interest rate would be renegotiated, presumably bringing it close to the prevailing market rate. The proposed rules limited the maximum rate increase to 0.5% in any year and 5% over the life of the loan, double the limit in prior VRM proposals.

During the comment period on the RRMs proposal, while the House and Senate Banking committees worked toward passage of H.R. 4986, the eventual DIDMCA, a

[87] House Subcommittee of the Committee on Government Operations, *'Renegotiable Rate' Mortgage Proposals of Federal Home Loan Bank Board: Hearings before a Subcommittee of the Committee on Government Operations* 96th Cong., 2d sess., (Washington, DC: GPO, 1980), 172.

House subcommittee of the Committee on Government Operations convened hearings on the RRM proposal. The hearings provided a platform to the regulators, who argued that RRMs would benefit both lenders and consumers, and to irate consumer advocates, who registered their shock at the new rules' departure from the limitations contained in previous proposals and regulations. FHLBB Chairman Janis explained that RRMs would "help savers by allowing the market rates to be paid on deposits, they will help borrowers by assuring that there will be an adequate flow of mortgage funds, and they will help lenders by allowing them to adjust to inflationary pressures."[88] Despite painting this rosy picture, when pressed, Janis later conceded that not everyone would benefit from RRMs. "In my view," he observed, "it is ignoring reality to believe S&Ls can pay market rates on deposits to enable savers to keep abreast of inflation, without mortgage borrowers bearing the brunt."[89] Citing inflation and the increasing proportion of thrift liabilities in market-yield MMCs, then 32%, Janis argued that thrifts could not survive if they continued to "bear the brunt" through "severe stress on earnings."[90] Out of the status quo of high inflation, market rates to savers through the MMCs, and thrift portfolios dominated by fixed-rate mortgages, something had to give. For Janis and the FHLBB, the answer was clear; "use of the long-term, fixed-rate mortgage is the prime reason why so many thrift portfolios are 'underwater' in terms of the low yielding loans they contain."[91]

Subcommittee Chairman Ben Rosenthal (D-NY) disagreed that the troubles of the thrifts should be remedied at the expense of borrowers. "It would be unfortunate indeed,"

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[88] Ibid., 165-6.

[89] Ibid., 205.

[90] Ibid., 166.

[91] Ibid.

he said, “if the burden of protecting the soundness of savings institutions, borne for so long by small savers, should now be shifted over to mortgage borrowers.”[92] Esther Peterson, director of the U.S. Office of Consumer Affairs shared Rosenthal’s sentiment, concluding in her submitted testimony, “In the final analysis, the consumer will be bailing the associations out of their economic problems.”[93]

In light of the FHLBB’s 1979 national authorization of VRMs, Peterson and most other consumer advocates had resigned themselves to living with alternative, flexible mortgage instruments and focused their attention on securing appropriate protections for borrowers. On this score, Peterson expressed “great disappointment at the Bank Board’s issuance of proposed regulations which contain virtually no consumer safeguards.”[94] Consumer advocates cited two main concerns, familiar from previous debates over variable-rate instruments: discrimination against borrowers not considered by lenders to be upwardly mobile, and the inability of borrowers to cope with rate hikes. Roger Kuhn, representing the Center for National Policy Review, argued that the expansion of the range of different mortgage instruments made consumer choice more difficult than ever, particularly for “those who, by reason of economic disadvantage and previous discrimination, have least experience in financing home ownership–that is, minorities and women.”[95] Peterson concluded, “Any replacement of the traditional mortgage with the

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[92] Ibid., 2.

[93] U.S. Office of Consumer Affairs, “Before the Federal Home Loan Bank Board, In the Matter of: Renegotiable Rate Mortgage Instruments,” in House Subcommittee of the Committee on Government Operations, *‘Renegotiable Rate’ Mortgage Proposals of Federal Home Loan Bank Board*, 41.

[94] Ibid, 39.

[95] Roger Kuhn, Center for National Policy Review, to J.J. Finn, Secretary, FHLBB, March 4, 1980, in House Subcommittee of the Committee on Government Operations, *‘Renegotiable Rate’ Mortgage Proposals of Federal Home Loan Bank Board*, 583. Peterson and Ellen Broadman, of Consumers Union,

RRM is likely to even further close the dream of their own home to the American minority and, if increases continue, will do so for the average American as well."[96]

"I cannot understand," Gail Cincotta told the subcommittee, "that, when we had a Republican administration and Tom Bomar was the head of the Federal Home Loan Bank, he had to have hearings in this Congress on variable-rate mortgages. Now we have Mr. Janis, who is going to do it by regulation."[97] Yet it was not just that VRMs had not been explicitly approved by Congress that bothered consumer advocates, they were especially upset by the dramatic reduction in consumer safeguards in the latest regulations. Kuhn argued, "Assuming that it is necessary to authorize an additional type of instrument to meet the needs of the savings and loan industry, we can see no justification for casting aside the borrower safeguards which were adopted just 15 months ago in the Board's VRM regulation."[98] Kuhn called for, at minimum, a mandated choice of a fixed-rate option, the portfolio limitation, and the 2.5% rate increase limit from the previous VRM regulations.

Successive FHLBB Chairmen had indeed become increasingly aggressive in their pursuit of flexible mortgage instruments. Bomar, in 1975, could have authorized VRMs without congressional approval. Not even the strong message sent through H.R. 6209 and Senate Concurrent Resolution 45 amounted to a statutory prohibition of VRMs. But

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the publishers of *Consumer Reports*, insisted that the absence of a mandated fixed-rate option would leave fixed-income borrowers with no option for home financing. Ibid., 84.

[96] U.S. Office of Consumer Affairs, "Before the Federal Home Loan Bank Board, In the Matter of: Renegotiable Rate Mortgage Instruments," in ibid., 50.

[97] House Subcommittee of the Committee on Government Operations, *'Renegotiable Rate' Mortgage Proposals of Federal Home Loan Bank Board*, 53.

[98] Kuhn, to J.J. Finn, March 4, 1980, 584.

Bomar elected not to override the clear opposition of majorities in each house. Garth Marston, his successor, too consulted with Congress, seeking guidance on consumer safeguards before formally proposing alternative instruments. McKinney had moved cautiously, both by working with Congress and by first authorizing VRMs on a limited basis. But the increasing erosion of Regulation Q protection through the MMCs had led McKinney to national authorization without explicit congressional direction, and Janis, closely watching H.R. 4896 becoming law, beginning the formal phase-out of Regulation Q altogether, also felt compelled to act.

In April 1980, the FHLBB issued final rules authorizing renegotiable rate mortgages (RRMs). The rules limited rate changes to a maximum increase of 5% and no more than 0.5% per year. The regulations explained, "The Board is of the opinion that a higher figure, such as one percent, could result in increases in mortgage payments that some borrowers would be unable to absorb."[99] The rules required a disclosure offering a comparison to a fixed-rate mortgage, but not "a more extensive 'worst case' disclosure," which the Board suggested might unduly create a competitive disadvantage (for example, with state-chartered institutions offering VRMs with no comparable "worst case" disclosure requirement).[100]

Though considerably less restrictive than the 1979 VRM regulations, the RRMs too made little impact on thrift portfolios (or borrowers). So scant was their acceptance that neither VRMs nor RRMs even registered in FHLBB annual data. Meanwhile, thrift

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[99] Federal Home Loan Bank Board, "Renegotiable Rate Mortgage Instruments," *Federal Register* 45, no. 70 (April 9, 1980: 24109-11. *HeinOnline*, http://heinonline.org (accessed January 4, 2012).

[100] The comparison to a fixed-rate alternative did not necessarily mean an *offer* of such an option. New Jersey Representative Robert Roe introduced a bill (H.R. 492) in January 1981 that would require a fixed-rate offer alongside an RRM, but nothing came of the bill.

liabilities continued to be loosened as the DIDMCA was implemented and thrifts' cost of deposits continued to rise, up to 8.78% in 1980 from 6.56% in 1978 (in 1965, the figure was 4.25%). The return on assets at FSLIC-insured institutions dipped to 0.14% in 1980, after 15 years in which that measure had not been below 0.46%.[101] Under these near crisis conditions, FHLBB regulators redoubled their efforts for a less restrictive instrument. This renewed effort coincided with the arrival of a new FHLBB Chairman, Reagan appointee Richard Pratt. An economics professor at the University of Utah and former Chief Economist for the U.S. Savings and Loan League, Pratt was a free market devotee, convinced that operational freedom for thrift managers was essential to the recovery of the industry.[102]

With like-minded John Heimann leading the Office of the Comptroller of the Currency (OCC), the regulator of national banks, federal regulators were primed to push for an instrument that banks and thrifts would finally embrace. Though as Heimann wrote to Rosenthal in 1979, "By long standing interpretation of this Office, national banks are permitted to issue variable rate mortgages where not prohibited by state law," explicit authorization would removal all doubt and perhaps encourage banks to experiment with the instruments.[103] On March 27, 1981, the OCC authorized federally chartered and/or regulated commercial banks to issue an instrument more flexible than the both the VRM

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[101] Federal Home Loan Bank Board, *Savings & Home Financing Source Book, 1987* (Washington, DC: GPO, 1987), B-66-68. The "cost of deposits" equals the interest and dividends paid on deposits divided by the average deposit balance and "return on assets" reflects net income after taxes divided by average assets.

[102] Senate Committee on Banking, Housing and Urban Affairs, *Nomination of Richard T. Pratt: Hearing before the Committee on Banking, Housing and Urban Affairs, Ninety-Seventh Congress, First Session, April 6, 1981* (Washington, DC: GPO, 1981), 4.

[103] John Heimann, to Rosenthal, July 3, 1979, in House Subcommittee of the Committee on Government Operations, *'Renegotiable Rate' Mortgage Proposals of Federal Home Loan Bank Board*, 459.

and RRM, the adjustable-rate mortgage (ARM). Less than a month later, on April 23, the Federal Home Loan Bank Board (FHLBB) followed suit, allowing federally chartered savings and loans to diversify their portfolios to include alternative mortgage instruments, subsuming renegotiable- and variable-rate mortgages under the umbrella of adjustable-rate mortgages. By the end of the summer, both the Federal National Mortgage Association (FNMA or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC or Freddie Mac) had announced that they would purchase a wide variety of adjustable-rate mortgages in the secondary market, thus assuring financial institutions of the liquidity of such loans.

The ARMs regulations broke from previous authorizations of VRMs and RRMs by eliminating the 2.5% (VRMs) and 5% (RRMs) limitation on the increase in the interest rate over the life of the loan. Additionally, whereas the RRM regulations indicated concern over borrowers' ability to handle a 1% per year increase, the new regulations allowed an increase of 2% each year. The new rules preempted the 50% portfolio restriction, and rescinded the requirement that lenders offer a fixed-rate option. Instead of designating a universal index, rate changes could be tied to any index "readily verifiable by the borrower and beyond the control of the lender." The FHLBB regulations explained that deregulation of interest rate ceilings and the increasing volatility of thrifts' cost of funds while only 7% of mortgages held by thrifts had variable-rates (and those under the 2.5% increase limit) made the new authorization not only necessary, but urgent. "The Board believes it is inconsistent and unsound," the explanation continued, "to expose associations to the impact of wide swings in the cost of funds, which occurred as a result of the deregulation of liabilities, without providing associations with the power to

attain complementary changes in the mortgage portfolio yield."[104] FHLBB regulators acknowledged consumers' concerns over rate and payment increases, but consumers would be best served, they argued, by encouraging thrifts to invest in housing. Under this reasoning, the only way to ensure that mortgage lending would remain a viable and profitable business was to provide maximum freedom for thrifts to design and use flexible mortgage instruments.

Unlike in 1975, when Congress held hearings on proposed regulations and intervened during the comment period, Congress did not hold hearings on ARMs until months after they had been nationally authorized. For those policymakers who still harbored misgivings about the flexible mortgage instruments, reeling regulations back in would prove much more difficult than preempting them. The hearings made clear that consumer advocates still objected to flexible-rate mortgages on the principle that they were unfair to borrowers, and, even more, that the existing consumer safeguards were woefully inadequate.[105] Though these concerns persisted, lawmakers mustered no formal response, much less a rebuke to the instruments and safeguards far more liberal than those that it had rejected in 1975.

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[104] Federal Home Loan Bank Board, "Adjustable Mortgage Loan Instruments," *Federal Register* 46, no. 83 (April 30, 1981): 24149. *HeinOnline* http://heinonline.org (accessed December 8, 2011).

[105] Henry B. Schechter, Director of the Office of Housing and Monetary Policy and Department of Urban Affairs of the AFL-CIO and frequent congressional witness on housing matters, led off the witnesses bemoaning the "permissive regulation" of the previous three years that had resulted in "a shift from standard fixed-rate, fixed-payment mortgages toward various types of adjustable-rate mortgage loans." Schechter argued that ARMs unfairly shifted interest rate risk onto borrowers and that stringent consumer safeguards were necessary to protect homebuyers. PIRG staff attorney Jonathan A. Brown echoed Schechter's call for consumer protection, noting that the FHLBB regulation contained few of the many safeguards that had been advocated by consumer groups (and included by the FHLBB) during previous debates on ARMs. Schechter, House Subcommittee on Financial Institutions Supervision, Regulation, and Insurance, Committee on Banking, Finance, and Urban Affairs, *Adjustable-rate Mortgages: Hearings before the Subcommittee on Financial Institutions Supervision, Regulation, and Insurance of the Committee on Banking, Finance, and Urban Affairs*, *House of Representatives,* 97th Cong., 1st sess., July 28 and September 22, 1981 (Washington, DC: GPO, 1981), 2.

For their part, though ARM opponents voiced a preference for fixed-rate, fixed-payment mortgages, their attention to amending consumer safeguards indicated a certain resignation to the arrival of ARMs. Representative Benjamin S. Rosenthal expressed this position, "I have come to accept the inevitability of the present trend toward adjustability and interest rate flexibility in mortgage loans for home purchase, but I cannot accept the elimination of essential consumer safeguards that has accompanied this trend."[106] Indicative of the political salience of deregulation, Rosenthal felt compelled to justify such safeguards saying that "systematic monitoring is not inconsistent with a philosophy of deregulation. You pursue deregulation because you believe that open competition in the private marketplace will serve the needs of society and lead to desirable results. But the proper regulatory attitude is to be openminded at all times to reconsider the need for specific regulation in the light of experience."[107] Rosenthal's call for safeguards, though consistent with precedent dating back to the Hunt Commission, fell on deaf ears at FHLBB.

Allen Fisheim, Director of the Neighborhood Revitalization Project of the Center for Community Change entered into the record a statement signed by 60 local and national organizations including the NAACP, National Urban League, and United Steel Workers, calling for rigorous consumer safeguards, though also warning of the potential for the loosening of regulations to lead to a "new form of redlining" that would price out would-be homebuyers.[108] Of the opponents to the new ARMs regulations testifying

[106] Ibid.,285.

[107] Ibid., 297.

[108] Ibid., 66.

before the House subcommittee, only Gale Cincotta maintained that a battle must still be fought against ARMs all together, and not just over the appropriate safeguards. Cincotta decried ARMs as a tourniquet for the ailing thrifts and argued that deregulation was in fact “re-regulation” that diverted credit allocation from housing to industry, representing a reordering of government priorities.[109] She too suggested that consumers faced an economic form of redlining in which “only the big banks and the major corporations are borrowing, investing, and profiting from America’s money supply.”[110]

Many of the Congressmen who participated in the hearings appeared sympathetic to the concerns raised by the consumer advocates. Majority Leader Jim Wright, a Texas Democrat, called the regulations “the most insidious scheme ever foisted upon the American home buyers” and suggested that “the American dream of homeownership” was at stake.[111] Committee Chairman Fred St. Germain matched Wright’s rhetoric concluding, “As to the American dream, I’m afraid it might be turning into a nightmare.”[112] But this rhetorical fanfare, mourning the apparent demise of the fixed-rate mortgage, did not translate into action. There would be no H.R. 6209 or Sen. Con. Res. 45, much less an enacted law requiring a prohibition of ARMs or even the reestablishment of a mandated fixed-rate option.

Soaring rhetoric notwithstanding, even the fiercest critics of flexible-rate mortgage instruments recognized that they were a necessary concession to gain higher returns to savers. Pratt left little doubt that this bargain was exactly how he justified

[109] Ibid., 180.

[110] Ibid., 49.

[111] Ibid., 281-2.

[112] Ibid., 282.

authorization of ARMs with minimal consumer safeguards. When St. Germain suggested that the FHLBB had removed a cap on rate increases from its safeguards because increases in the cost of money had outpaced capped increases in California, Pratt responded instead, "The reason that we did not all for a cap is that it appears to us that the clear intent of Congress, as expressed in H.R. 4986 [the vehicle bill for DIDMCA], was that institutions pay the market rate for funds. If you are not going to cap the cost of their funds, it is simply untenable to cap the sale price of the funds. And I think that it does the American public a disservice, that the true cost of funds should be transmitted to the borrower and he should see that cost."[113] Together, the new regulations, and the testimony of Pratt and others from the Reagan administration, indicated a transition from a position among regulators that deregulation must be accompanied by strong consumer safeguards to one advocating that safeguards were not necessary or desirable, and/or a change in circumstances that made the inclusion of consumer safeguards politically unnecessary.

The 97th Congress would later endorse the OCC and FHLBB's ARMs authorization through Title VIII of the Garn–St. Germain Act of 1982 (P.L. 97-320), known as the Alternative Mortgage Transaction Parity Act. The explicit purpose of the title was to "eliminate the discriminatory impact that those regulations have upon non-federally chartered housing creditors and provide them with parity with federally chartered institutions by authorizing all housing creditors to make, purchase, and enforce alternative mortgage transactions so long as the transactions are in conformity with the

[113] Ibid., 381. Philip Winn, FHA chairman and Assistant Secretary of HUD, also represented the Reagan administration in the hearings. When asked about the disappearance of previously proposed consumer safeguards, Winn recounted the department's history of communications to the FHLBB advocating strong safeguards, but maintained that HUD had not taken a position on the question. Ibid., 382.

regulations issued by the Federal agencies."[114] In order to assure housing credit to meet the demand of the 1980s, the title stated, all lenders would have to be freed from the constraints of fixed-term and fixed-rate instruments that did not function well in periods of interest rate volatility. The act made the federal safeguards the default standard for all lending institutions in which state law and/or regulation did not apply.

Table 1 Share of Adjustable-rate Conventional Single-family Residential Mortgages

Year	Percentage ARMs	Contract Interest Rate-ARMs	Contract Interest Rate-Fixed	Difference
1980	NA			
1981	NA			
1982	41			
1983	40			
1984	62			
1985	51	10.44	11.93	1.49
1986	30	9.10	10.09	0.99
1987	43	8.20	9.52	1.32
1988	58	8.21	10.04	1.83
1989	38	9.15	10.21	1.06
1990	28	8.90	10.06	1.16
1991	23	8.03	9.38	1.35
1992	20	6.37	8.21	1.84
1993	20	5.56	7.27	1.71

Source: Kenneth A. Snowden, "Terms on conventional single-family residential mortgages, by type of property and mortgage: 1963-1999," *Historical Statistics of the Unites States Millennial Edition Online*, edited by Susan Carter et al. (Cambridge University Press, 2006). Snowden, "Homeownership Rates," *Historical Statistics of the Unites States Millennial Edition Online*.

The extension of ARMs authority to all lenders coupled with the loosened restrictions in the 1981 regulations finally enabled the proliferation of flexible-rate mortgages that the VRM and RRM regulations had failed to produce. The FHLBB's count of the percentage of mortgages issued with adjustable rates jumped from an NA in 1980 to 41% in 1982.

[114] P.L. 97-320, Title VIII.

By 1982, the adjustable-rate mortgage had arrived. In the deregulated system of housing finance, the lynchpin of the New Deal system, the long-term, fixed-rate mortgage would compete alongside a variety of flexible-rate mortgage instruments. ARMs did offer the lower initial rates that regulators had promised, and because interest rates began to fall from their historic highs, borrowers were not hit with excessive increases despite the absence of federally mandated limits.

If VRMs had been authorized when FHLBB first proposed, in 1969, or in 1975, when they tried again, they may not have become so widespread–consumers may have been less likely to accept them, or if they had become widespread, there might have been an equally broad reaction against them. Since rates rose through the early 1980s, VRM holders would have seen increasing payments, and might have protested against them, or perhaps needed government bail-out/assistance in the late 1970s and/or early 1980s. That they were authorized later meant that they proliferated as inflation finally began to decrease. Borrowers did not, by and large, have increasing payments, and thus VRMs quietly became a normal part of the system of housing finance. The worst predictions of VRM opponents did not come true because rates were going down. The underlying concerns remained dormant however, likely to resurface if rates did sharply increase, with one exception. Opponents raised the likelihood that lenders would exclude those not considered to be upwardly mobile, with disproportionate implications for women and minorities. Yet in the years that VRMs/ARMs became a part of the system of housing finance, changes in mortgage origination and the role of the secondary market flipped the concern. Because mortgage originators rarely held onto a mortgage, they did not need to employ stricter underwriting standards, but rather were freed to loosen standards.

Originators could then entice borrowers with low introductory fees, then sell off the mortgage before rate escalation created any risk of default.

Thrift officials and their regulators at the FHLBB sought authorization of flexible-rate mortgages for a decade, but only after authorization of the new instruments became linked to the deregulation of interest rate ceilings did they make any headway. Congress flatly rejected flexible-rate mortgage proposals into the late 1970s on the basis that they would unfairly shift interest-rate risk to borrowers and could promote changes in underwriting standards that would exclude borrowers not considered upwardly mobile, with disproportionate impact on women and minorities. Yet as momentum for the elimination of interest-rate ceilings mounted, some members of Congress became willing to allow flexible-rate mortgage instruments in order to enable depository institutions to pay higher rates to savers. Even those in Congress who deeply opposed VRMs, such as Senator Proxmire, could accept the new asset powers if it meant an end to Regulation Q. Each proposal and authorization of flexible-rate mortgage instruments by the FHLBB followed a liberalization of interest-rate ceilings. Once Congress had committed to ending the ceilings all together, FHLBB regulators boldly moved to authorize instruments with minimal consumer safeguards. Congress prioritized the interests of consumer-savers over those of consumer-borrowers, accepting the shift of risk to borrowers and the decimated safeguards, all to ensure higher returns to savers.

Chapter 6

Leveraging Deregulation–The Garn–St. Germain Act of 1982

In 1980, policymakers' fervor for deregulation neared or perhaps reached its height. Major deregulatory reforms had or would soon be accomplished in the transportation, telecommunication, and energy industries, as well as banking, with widespread, bipartisan support. Rationalizations for deregulation as a policy solution for the economic woes of the 1970s came from "free market" economists who saw regulation as an unnecessary impediment to market efficiency, consumer advocates who identified regulations that restricted market competition that could benefit consumers, and business managers who contended that regulations imposed unnecessary costs.[1] Though most of the legislation that deregulated these industries was passed by Congresses with Democratic majorities in both houses and signed by President Jimmy Carter (including the DIDMCA), devotion to deregulation seemed only more prominent as Ronald Reagan and a Republican Senate majority came to power following the 1980 elections.

Yet, as this chapter demonstrates, despite broad support and lofty rhetoric touting the benefits of deregulation generally, and a legislative mandate for the particular deregulation of interest rate ceilings, in the area of banking (including housing finance), implementing deregulation proved exceedingly difficult. The group of regulators charged with overseeing the phase-out of Regulation Q, the Depository Institutions Deregulation

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[1] Richard H.K. Vietor, *Contrived Competition: Regulation and Deregulation in America* (Cambridge: Harvard University Press, 1994), 13-15. Vietor argues that "by 1984 the political momentum for deregulation was largely spent." 16. For some of the founding documents of the economists' attack on regulation see Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions* (New York: Wiley, 1970), and George Stigler, "The Theory of Economic Regulation," *Bell Journal of Economics and Management Science* 2, no. 1 (1971): 3-21.

Committee (DIDC), struggled continually to weigh competing concerns and interests, most critically, market returns for savers against the safety and soundness of depository institutions. Policymakers resolved this contradiction by deregulating thrift asset powers, giving them more flexibility in what they could invest in, allowing them to move away from their traditional singular devotion to residential mortgage lending. This chapter will show that the DIDC leveraged their mandate to secure market rates for savers to achieve the passage of legislation to deregulate thrift assets.

At a fundamental level, the difficulty of weighing competing financial interests stemmed from the special role that interest rate ceilings had played in the New Deal system of housing finance. Regulation Q and related ceilings ensured a source of low-cost funds to depository institutions that could in turn provide low-cost credit to borrowers, thus fostering healthy residential construction and mortgage financing industries. The inescapable logic of interest rate deregulation, at least when interest rates were high, as they were during the early 1980s, was that it would lead to a higher cost of funds for depository institutions that, even if they passed much of the cost on to borrowers, they might or might not be able to bear. As Bank of America President A.W. Clausen warned in 1970, "sharp across-the-board escalation of rates in the thrift area could lead to imprudent lending and investment practices in order to justify payment [of higher rates, which] may, of course, endanger the health of the banking system."[2] If this was true in 1970, the stakes would only be greater in the late 1970s and early 1980s as interest rates reached historic highs.

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[2] Letter, A.W. Clausen to Arthur Burns, September 21, 1970, Folder "ABA Oct.-Dec. 1970," Box B1, Arthur Burns Papers, Gerald R. Ford Library, Ann Arbor, MI.

Some institutions were better positioned to manage an increase in cost of funds than others. The greater the proportion of an institution's assets that was short-term, the more those assets would reflect market rates that could keep pace with increasing costs. This left large commercial banks most ready, and in some cases, eager, to accept an increasing cost of funds in order to compete with non-bank financial institutions, while smaller banks, and especially the thrifts, with large proportions of long-term, often low-yield assets such as mortgages, were least prepared to take on increased costs. Some deregulation advocates argued that the institutions *had* to pay the higher costs, whatever the danger, in order to compete with alternative deposit options such as money market mutual funds, which regulators had *decided* not to regulate. Once the institutions could stem the flow of savings going to MMMFs, the logic went, the amount of available credit they could offer would increase, and thus increased supply would pressure the cost of credit downward. But others, whether or not generally in favor of deregulation, countered that regard for the safety and soundness of depository institutions whose earnings would be severely pinched by an increasing cost of funds dictated a very slow pace of deregulation of rate ceilings. The latter group stood its ground through 1982, largely thwarting the agenda of the most ardent deregulation advocates who sought faster deregulation, *even as the Reagan administration came to power*. Reagan's appointee to chair the Federal Home Loan Bank Board, Richard Pratt, readily, and his Treasury Secretary, Donald Regan, more reluctantly, slowed the pace of rate deregulation out of concern for the safety and soundness of the thrift industry.

By slowing the pace of congressionally mandated interest rate ceiling liberalization, the DIDC turned this narrow deregulation into a much wider deregulation

of thrift asset or investment powers, significantly eroding their role as specialized housing lenders. Pratt and Regan helped make clear to the Congress that the full realization of their mandate that savers should receive market rates of return on their deposits could not be achieved unless and until the problems that rate deregulation posed for thrift earnings could be resolved. The DIDMCA had reflected a delicate, and ultimately untenable, balance of a few very specific consumer-oriented deregulations (phase-out of Regulation Q, authorization of NOW accounts) aimed at securing higher returns for savers, with continued specialization of thrifts as housing lenders. Pratt, Regan, and others who favored broad deregulation, leveraged the narrower agenda represented by the DIDMCA to achieve deregulation of thrift asset powers. In short, they argued that in order to achieve market returns for savers, and save the thrift industry, thrifts would have to become less like thrifts had been in the past, that is, less devoted to residential home lending.

In 1982, seeking to break the DIDC's stalemate over deregulation of rate ceilings and concern over thrift earnings, Congress passed the Garn–St. Germain Depository Institutions Act. In addition to expanding FDIC and FSLIC assistance powers, the legislation authorized thrifts to invest a large proportion of their portfolios in commercial, consumer, and non-residential real estate lending and government securities and insured certificates of deposit. The expanded powers granted by the Garn–St. Germain Act are widely credited with causing the collapse of the S&L industry in the late 1980s, but for the purposes of this study, the critical result of Garn-St. Germain was the dramatic reduction, throughout the decade, in the role of thrifts as lenders for residential housing. Largely severing the linkage between thrifts and housing, in enacting Garn–St. Germain,

lawmakers dealt a fatal blow to the New Deal System of housing finance. With it went the concomitant vision of the centrality of local depository institutions raising capital from household savings for the purposes of residential mortgage lending.

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In passing the Depository Institutions Deregulation and Monetary Control Act (DIDMCA), Congress committed to the eventual elimination of deposit rate ceilings. The DIDMCA created the Depository Institution Deregulation Committee (DIDC) and charged the committee with overseeing the phase-out of Regulation Q and related deposit ceilings over a period of up to six years, but "as rapidly as economic conditions warrant," in order to provide "all depositors with a market rate of return on their savings with due regard for the safety and soundness of depository institutions."[3] As simple and succinct as it seemed, as chapter three demonstrated, the directive reflected a long and contentious debate over Regulation Q. The unresolved internal contradiction of that debate, namely achieving market returns without endangering depository institutions with increasing costs, would plague the DIDC throughout its short life.

Congress had passed the buck, and now the messy business of implementing deposit rate deregulation fell to nation's financial regulators. Meeting for the first time on May 6, 1980, the DIDC[4] wasted little time in drawing the ire of nearly all interested observers, first by closing much of the meeting's proceedings to the public, and secondly

[3] P.L. 96-221.

[4] The committee members were Fed Chairman Paul Volcker (DIDC Chairman), Treasury Secretary William Miller, FHLBB Chairman Jay Janis, FDIC Chairman Irvine Sprague (DIDC Vice-Chairman), National Credit Union Administration Chairman Lawrence Connell, and a non-voting member, Comptroller of the Currency John Heimann.

by spending the bulk of their time discussing "premiums," non-monetary giveaways such as clocks and silverware, and withdrawal penalties. Because interest-rate ceilings limited the ability of depository institutions to compete for deposits by offering higher rates, many used premiums to gain an edge in enticing new depositors. At least two DIDC members, Jay Janis of the FHLBB and Irvine Sprague of the FDIC, argued that the committee should include the cost of premiums against rate ceilings (or prohibit premiums altogether). Sympathetic to the challenges that use of premiums posed to his fellow regulators, but also sensing the irony of the debate, National Credit Union Administration Chairman Lawrence Connell expressed his disappointment that "the first item considered by the Committee involved in a sense a further regulation of interest rates on deposits."[5] To Connell the symbolism was galling, the "deregulation committee" was already considering new regulations. The DIDC's discussion of premiums would also awaken the sleeping giant that came to be known as the "premium industry," which in turn aroused congressional representatives to their defense, contributing to the DIDC's burgeoning reputation as a magnet for special interests.[6] But more than just being deeply ironic and antagonizing toaster-oven makers, that the DIDC turned first to regulating premiums reflected the committee's tacit recognition that their charge to enable market returns for savers while ensuring the safety and soundness of depository institutions

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[5] Minutes of May 6, 1980 Meeting; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[6] Among the premium manufactures who wrote to Congress in protest of the DIDC proposal to ban premiums were Dart Industries, Microtime Inc., Oneida Ltd., and the Metal Cookware Manufacturers Association. Senators Claiborne Pell and John Chafee, both of Rhode Island testified before the House on behalf of premiums manufacturers. See House Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, *Oversight Hearings on Depository Institutions Deregulation Committee: Hearings before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance, 96th Cong., 2d sess., July 2; August 26, 1980* (Washington, DC: GPO, 1980), 250-267.

would be more easily resolved than done.[7] By comparison, regulating premiums was straightforward and achievable. On the subject of its primary mission, the DIDC directed its staff to study the implications of possible changes to interest rate ceilings, but took no further action regarding Regulation Q.

The DIDC met three more times that May, holding closed sessions despite the objections of Senators Garn and Proxmire as well as Janis, who felt that the thrifts' interests, especially the housing differential, would be better protected if the proceedings were public.[8] Not until its fourth meeting, on May 28, did the DIDC finally act on its charge to achieve market rates for savers. The committee voted to allow depository institutions to pay ¼% higher than the 6-month Treasury-bill on 6 month Money Market Certificates (MMCs). But rather than simply removing or raising the Regulation Q ceiling, in a complicated scheme, the committee set a "minimum ceiling," of 7 ¾%, meaning that institutions could pay that amount even if the 6-month T-bill average was lower than 7 ½%. Ohio Republican Chalmers Wylie would later call these minimum ceilings, "which actually operate as floors… reminiscent of the 'newspeak' and 'double think' of George Orwell's '1984'."[9] In an even more controversial move, the DIDC

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[7] Joe Nocera notes the irony of the DIDC's attention to premiums and suggests that the "discussion had the unmistakable feel of Nero fiddling while Rome burned." He argues that "at bottom… the DIDC's mission was a straightforward one: to deregulate interest rates." Joseph Nocera. *A Piece of the Action: How the Middle Class Joined the Money Class* (New York: Simon & Schuster, 1994), 209, 208. The argument here is that the DIDC's mission was anything but straightforward; rather, it was intrinsically contradictory, leading the committee unable to satisfy any of several competing interests. Minutes of May 6, 1980 Meeting, 2-3; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[8] Senator Jake Garn, to Paul Volcker, May 22, 1980 and Senator William Proxmire, to Volcker, May 22, 1980; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP. Minutes of May 23, 1980 Meeting; Ibid.

[9] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Oversight Hearings on Depository Institutions Deregulation Committee*, 3.

removed the differential when rates exceeded 8 ¾%, and though retaining the differential when rates were between 7 ¼% and 8 ¾%, ruled that banks could renew MMCs at the same rate as thrifts over the following 6 months. On 2 ½ year "small savers certificates" (SSCs), the DIDC established a minimum ceiling of 9 ¼% for commercial banks and 9 ½% for thrifts with caps of 11 ¾% and 12% respectively, thereby retaining the differential for the SSCs at all rates. Offering protection against depositors shifting money to higher yielding accounts within the same institution, the DIDC also imposed early withdrawal penalties equal to three months of interest.[10] In short, the committee loosened interest rate ceilings on some deposits to give savers higher returns, but did so in a way that confused nearly everyone and, in some cases, would offer less protection for S&Ls in competing against banks for deposits.

Thrift industry officials were livid. The DIDC scheme would raise thrifts' cost of funds and erode the protection of the housing differential. The U.S. League of Savings Institutions filed suit against the DIDC for violating administrative procedures law as well as its mandate regarding the safety and soundness of depository institutions. And for having finally gained the courage to alter interest rate ceilings to allow higher returns for savers, Congress rewarded the DIDC with oversight hearings. Fred St. Germain (D RI) remarked, "at this point, I am beginning to wonder whether we are all using the same dictionary to define 'deregulation.' Webster's very simply states that deregulation is 'the act or process of removing restrictions and regulations'…. Instead of removing regulations, the Deregulation Committee has interpreted Public Law 96-221 [DIDMCA]

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[10] Minutes of May 28, 1980 Meeting; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

as requiring a whole new set of rules and procedures."[11] DIDC Chairman Paul Volcker did not disagree, characterizing the new ceiling structure as "not primarily designed as part of the deregulation process, but rather to facilitate larger credit flows by depository institutions to specific credit markets–viz. for mortgage, agriculture, and small business credit," or, in words Volcker did not use, credit allocation.[12] To Volcker, at least, regulating the flow of credit remained as important as deregulating rate ceilings.

Citing bleak measures of residential construction activity, such as the lowest number of single-family building permits in the Chicago metropolitan area since WWII, thrift representatives and sympathetic lawmakers argued that the DIDC had moved too fast, too much in favor of the banks, and to the detriment of borrowers.[13] Congressman Frank Annunzio (D IL), an ardent supporter of the thrift industry who had opposed the DIDMCA, accused the DIDC of violating the spirit and letter of the law, exclaiming, "I am frankly shocked and appalled that the committee would try and compress a 6-year timetable into 6 weeks.... In our history, only termites have done more damage to the building industry than has the Deregulation Committee."[14] Neither savings institutions, nor their regulators, U.S. League of Savings Institutions President Edwin Brooks argued,

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[11] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Oversight Hearings on Depository Institutions Deregulation Committee*, 1.

[12] Paul Volcker to Alan Cranston, August 4, 1980, in Senate Committee on Banking, Housing and Urban Affairs, *Depository Institutions Deregulation Committee: Hearings before the Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 2d sess., August 5, 1980* (Washington, DC: GPO, 1980), 28.

[13] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Oversight Hearings on Depository Institutions Deregulation Committee*, 7. Senators Robert Morgan (D NC) and Alan Cranston (D CA) were among those in the Senate who similarly argued that the DIDC was moving too fast. Senate Committee on Banking, Housing and Urban Affairs, *Depository Institutions Deregulation Committee*, 23.

[14] House Subcommittee on Financial Institutions Supervision, Regulation and Insurance, *Oversight Hearings on Depository Institutions Deregulation Committee*, 4-5.

had been able to implement the new asset powers (including variable- and renegotiable-rate mortgages and NOW accounts) intended to allow the thrifts to adapt to loosened rate ceilings. "The DIDC," Brooks concluded, "has sentenced the American homebuyer and home seller to double-digit mortgage rates for the foreseeable future."[15]

Volcker defended the committee's actions, arguing that unregulated premiums complicated an orderly phase-out of rate ceilings, and that the new ceiling structure would better enable depository institutions to compete with investment alternatives such as money market mutual funds, thereby attracting more capital for housing, agriculture, and small business credit.[16] Senior Deputy Comptroller Lewis Odom added that the DIDC had weighed a range of concerns including returns for savers, safety and soundness of depository institutions, competitive equity among institutions, and the overall health of the economy, noting, "the balancing of these goals and interests is not easy–either for Congress or the DIDC."[17] Inaugurating a line of argumentation that his successor would later perfect, Janis argued that the problem with DIDC action to date had been that it was not adequately accompanied by new asset powers according to his reading of congressional intent for a "careful phase-in over time in order to protect housing and to protect the thrifts during a difficult period of transition."[18] New thrift asset powers, he

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[15] Ibid., 19. National Association of Home Builders Vice President Herman Smith concurred, arguing that the DIDC's minimum ceilings had created a floor for mortgage rates, just as rates had begun to go down and interest in home buying had resumed. Ibid., 345.

[16] Senate Committee on Banking, Housing and Urban Affairs, *Depository Institutions Deregulation Committee*, 8-11.

[17] Ibid., 37.

[18] Senate Committee on Banking, Housing and Urban Affairs, *Depository Institutions Deregulation Committee*, 54.

argued, “won’t become useful overnight and profitability won’t be improved by those new asset powers for several years.”[19]

Being called before both houses of Congress did little to alter the fundamental challenges facing the DIDC. Convening again in September 1980, the DIDC did scrap the idea of banning premiums altogether, instead discussing an increased limit on the cost of such giveaways.[20] On the more pressing, and daunting, issue of interest rate ceilings on passbook savings and other accounts, the committee considered several options, including one that would have lowered ceilings (and likely enraged some members of Congress) on NOW accounts in New England states. Volcker concluded that there was “no totally satisfactory answer,” given the competing concerns at stake.[21] He sought a cautious approach to deregulation, saying “we ain’t there yet,” and explaining that the DIDC “didn’t believe that the earnings of thrifts should be further strained by an increase in the passbook ceiling rate at this time.”[22] He noted, “judgments about the level of the ceiling rates and any modifications of differentials on new deposit classes will depend on a balancing of the special problems of the thrift and housing industries against the claims

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[19] Ibid.

[20] Minutes of September 9, 1980 Meeting; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[21] Minutes of May 28, 1980 Meeting, 28; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[22] Volcker, “Report of Activities of the DIDC,” 16; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP. Nocera argues that “the deregulation committee wasn’t deregulating largely because of its chairman, Paul Volcker.” He suggests that deregulating “rubbed against his grain so fiercely as to be nearly unimaginable….Volcker didn’t just disagree with [the premise that the market could regulate better than a regulator] he was offended by it.” Nocera, 208-10, 212.

of consumers and others for equity."[23] Rather than balancing competing concerns, Comptroller of the Currency John Heimann and Connell argued that the committee should always err on the side of deregulating. Connell concluded, "the sooner we get way from managing the earnings of depository institutions, the sooner we're going to achieve deregulation and the better the market is going to work."[24]

The DIDC settled on a 5¼% ceiling on NOW accounts for commercial banks with a ¼% differential for the thrifts. The committee left the ceiling on passbook accounts unchanged. The DIDC's actions again drew ire, this time from bankers. The ABA protested that the move "would be, we believe, a serious mistake," that "will unnecessarily increase bank costs, and that it might have lasting effects on the makeup of bank liability portfolios."[25] The ABA, along with several state bankers associations also objected to the continuation of the housing differential on passbook accounts. C.N. Cushing of the Kansas Bankers Association wrote that the differential "is so discriminatory, so contrary to the intent of Congress, and its effect will be so one-sided, we find it difficult to believe!"[26] The DIDC took no action at its final 1980 meeting to address the concerns of the commercial bankers. Just months earlier, the DIDC had been

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[23] Volcker, "Report of Activities of the DIDC," 22; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[24] Minutes of May 28, 1980 Meeting, 57; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[25] Gerald Lowrie, Executive Director, Government Relations, ABA, to Normand Bernard, Executive Secretary, DIDC, November 10, 1980; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[26] C.N. Cushing, to Normand Bernard, Exec. Secretary, DIDC, September 19, 1980; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

sued by the U.S. League of Savings Associations for violating the intent of Congress in eliminating the differential on some accounts, and now it faced the charge of ignoring a Congressional mandate to "level the playing field" between banks and thrifts by maintaining the differential on another class of accounts. Both the commercial banking and thrift industries accused the DIDC of being beholden to the other, but the committee's record of offending all parties demonstrates its independence from both. None of the many competing interest groups that petitioned the DIDC could count on being able to influence the group in their favor. The various interests were continually deadlocked, with a swing vote cast most often on the basis of current economic conditions rather than any longer-standing deregulatory agenda or particular interest.

The first year of DIDC activity was characterized by equivocation as it attempted to reconcile the competing imperatives of market rates for savers and the safety and soundness of depository institutions. The DIDC staff opened its March 1981 strategy memo with a brief moral, "in considering deposit rate deregulation, the Committee might find some guidance from the following:"

> In Eastern European ghettos, the local rabbi was called upon to adjudicate disagreements within his community. After hearing the views of one party, to such a disagreement, one such rabbi responded, 'You're right!' The other party said, 'But Rabbi, you haven't heard my side.' After listening to the second argument, the rabbi said, 'You're right!' The rabbi's wife, hearing all of the discussion, could not contain herself and exclaimed, 'rabbi, they can't both be right,' to which the rabbi responded, 'You're right, too!'[27]

That the staff would relate to this story indicates their utter frustration at what they viewed as an impossible task. The only way to get around the earnings problems

[27] Edward Ettin, et al., "Strategies for Deregulating Deposit Rate Ceilings," March 18, 1981, 1; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

presented by rate deregulation seemed to be to impose minimum denominations of $2,000, $5,000, or more, but those limits "would not be consistent with the objective of the DIDMCA to provide a market rate-of-return for all savers."[28] Though some, namely representatives of the thrift industry, believed that the DIDC was deregulating too fast, compressing a six-year phase-out into a matter of weeks, others viewed DIDC actions as moving in the opposite direction, issuing new regulation. The proposal to ban premiums and the early withdrawal penalties even seemed to many to be anti-consumer regulation, while the controversial May 28 rate ceiling restructuring with its minimum ceilings confused lawmakers and consumers alike. Yet the DIDC's apparent equivocation stemmed from the difficulty of negotiating the contradictory elements of the DIDC's congressional mandate, not an inherent distaste for deregulation among the Carter-era DIDC members. The deregulatory rhetoric of Heimann and Connell matched that of the most ardent supporters of broad deregulation, and Bill Miller had been a key supporter of the deregulation agenda of the DIDMCA. Janis, too, favored deregulation in principle, but sought a slow pace of rate deregulation and the continuation of the differential in order to allow thrift institutions to adjust. Even Volcker indicated a desire to move toward deregulation of interest rate ceilings as soon as possible; it was his concern for the viability of depository institutions and continued flow of credit to housing, agriculture, and small business that made him so hesitant. Volcker, in particular, maintained the traditional view of regulation serving the public interest. The key difference in the newer brand of deregulation, that endorsed and espoused by the incoming Reagan

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[28] Ibid.

administration, was their contention that the public interest would be best served not by regulation, but by the unobstructed operation of markets.

Regan Revolution?

The arrival of the Reagan regime in early 1981 portended a breakthrough in the equivocation and caution that had characterized the DIDC's approach to implementing deregulation. Ideologically committed to the superiority of free markets, it seemed the Reagan administration would precipitate the elimination of interest rate ceilings and other restrictive banking regulations and perhaps also the expansion of depository institutions' investment powers. Yet, I argue here, the government of the "Reagan revolution" including incoming Treasury Secretary and DIDC member Don Regan, despite an even stronger rhetorical and ideological commitment to deregulation, found it politically impossible to hasten the pace of liability deregulation and resolve the contradictory charges to the DIDC to achieve market rates for savers and ensure the safety and soundness of depository institutions.

Regan, the newly appointed Treasury Secretary, had spent the previous 35 years at Merrill Lynch, the last eight of which as the company's CEO. In his confirmation hearing, Regan described himself as "a free competitive man, myself, a capitalist, by nature,"[29] and noted, "I think one of the key elements of the [Reagan] economic package is getting a handle on Federal regulations and in fact getting into deregulation."[30] In a November 1978 article in *Financier*, Regan had revealed his deregulatory propensities.

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[29] Senate Committee on Finance, *Nomination of Donald T. Regan: Hearing before the Committee on Finance, 97th Cong., 1st sess., January 6, 1981* (Washington, DC: GPO, 1981), 20.

[30] Ibid., 18.

Commenting on regulation of international credit markets, he wrote, "controls are, I think, demonstrably counterproductive. In addition to trying to prevent something from happening that would otherwise occur, restrictions also often cause something to happen which otherwise would not have happened."[31] This was precisely the argument that scholars like Edward Kane had leveled at Regulation Q. Regan further exposed his thoughts on regulation in a review of a report on Government Regulation and Business Relations for the Reagan campaign that concluded, among other things, "economic regulations almost always impose greater consumer costs than would the operations of a free market."[32] Regan endorsed the report to the campaign with but one caveat, expressing skepticism of a survey finding that "'executives overwhelmingly accept the need for virtually every existing regulatory body,'" which he certainly did not.[33]

Perhaps more than most deregulation proponents, Regan had a fully developed vision of what a deregulated financial marketplace might look like. He expressed this vision in an unpublished manuscript titled "The Changing Market Place." Written for a popular audience, Regan used the metaphor of a supermarket to describe a financial services company that could meet all of a customer's needs under one roof. This one-stop-shop would include depository, lending, and investment functions. The winner, he touted, would be the consumer. His vision included a democratization of the financial

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[31] Reagan, "Commentary: Absence of Controls Permits Fine Capital Markets Performance," *Financier* (Nov. 1978) ; Box 219; Folder 7; Personal; Merrill Lynch and Co., 1978-79; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[32] John W. Hanley, "Draft Report on Government Regulation and Business Relations," October 6, 1980; Box 222; Folder 6; Personal; Political Activities; Reagan, Ronald, Campaign, Business Advisory Panel, Sept.–Nov. 1980; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[33] Regan, to John W. Hanley, October 21, 1980; Box 222; Folder 6; Personal; Political Activities; Reagan, Ronald, Campaign, Business Advisory Panel, Sept.–Nov. 1980; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

marketplace; “those who work daily on Wall Street or other centers shouldn’t be the only ones able to take advantage of either tax changes, or modes of investment. Lawyers, doctors, dentists, businessmen, [and] retired people all over the nation, should have the same opportunities.”[34] Regan had also considered the future of housing finance in a world without specialized housing lenders. He lauded FNMA for “set[ing] up a whole new method of mortgage financing [because of which] the system no longer depends just on deposits in savings and loan associations, or mutual savings banks.”[35] He was especially excited, however, by GNMA’s pass-through securities, which offered “the safety, the cash flow, the good yields, the ease of management, and the liquidity,” to meet the needs of conservative investors.[36] Regan noted “real estate, of course, is a huge market,” that would be increasingly accessible to investors through secondary markets.[37] In other words, Regan could easily imagine a system of housing finance that did not rely on savings institutions but rather various types of financial institutions that pooled investment dollars to fund housing through secondary markets. Under Regan’s leadership, Merrill Lynch was already moving in the direction of a financial services

[34] Regan, “The Changing Market Place,” unpublished manuscript; Box 223; Folder 4; Personal; Speeches and Writings; Books; The Changing Market Place (unpublished) draft, Ch. 1-6; Papers of Donald T. Regan; Library of Congress; Manuscript Division. Of the financial supermarket concept Henry Schechter of the AFL-CIO would say, “the proponents of financial institutions deregulation claim that consumers place great value on the ability of institutions to offer a broad range of services. Yet, they have little evidence to support this position…. None of the 14 million AFL-CIO members have petitioned our headquarters to look into the availability of a financial services supermarket.” House Committee on Banking, Finance and Urban Affairs, *How the Financial System Can Best Be Shaped to Meet the Needs of the American People: Financial Deregulation: Hearings before the Committee on Banking, Finance and Urban Affairs,* 98th Cong., 2d sess., April 11, 12; May 2, 3, 9, 10, 16, 23, 24; June 7, 12, and 19, 1984 (Washington, DC: GPO, 1984), 1827.

[35] Regan, “The Changing Market Place.”

[36] Ibid.

[37] Ibid.

supermarket. *Wall Street Letter* reported in April 1979 that Merrill Lynch planned to take a large role in residential real estate, offering mortgage default insurance to thrifts, and assembling GNMA securities that could be sold through the securities arm of Merrill Lynch.[38]

This perspective informed Regan's approach to his role as Treasury Secretary. A 1981 memo laid out four main objectives of Regan's Treasury "Deregulation Program" as expanding depository institutions' asset and liability powers, broadening product powers then restricted by Glass-Steagall, geographic expansion, and regulatory consolidation, but how it would influence the DIDC was not yet clear.[39] Observing that Secretary Miller had employed his committee vote to do whatever would keep things moving, Regan's staffers reassessed the relationship of the office of the Secretary and the DIDC. Assistant Secretary Roger Mehle presented Secretary Regan with three options; he could, seek to be the chair of the committee and lead the charge on deregulation, follow Miller's example and just take a seat as a regular member of the committee, or push a legislative alternative that would achieve deregulation but not directly involve the Secretary. After weighing the potential downside of strengthening the public's association of the Reagan Administration with the already controversial DIDC against the opportunity to "lead the deregulation of depository institutions to the benefit of the Administration's program," Mehle recommended that Regan seek the DIDC

[38] "Merrill Lynch's Game Plan Could Cause a Revolution in Real Estate," *Wall Street Letter*, Vol. XI, No. 18 (April 30, 1979); Box 219; Folder 7; Personal; Merrill Lynch and Co., 1978-79; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[39] Roger Mehle, "Your Deregulation Program," memo to Regan, October 2, 1981; Box 148; Folder 4; Treasury Department; Subject File; Financial Deregulation, Miscellaneous; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

Chairmanship.[40] As the only DIDC member without a regulatory constituency, Mehle suggested, Regan would be uniquely positioned to lead the committee. Regan agreed and sought the Chairmanship,[41] to which the committee readily elected him. The Treasury staff's take on the previous work of the DIDC was that "the regulators have found it impossible to resist the pressures from trade associations, particular institutions, and other interest groups for case-by-case, one-time, emergency, or 'special-interest' rate ceiling changes."[42] Instead, Gordon Eastburn urged Regan to take a systematic approach to deregulation, and while cautioning that the Secretary should take Volcker's temperature first, he suggested that a strident, organized strategy would "enhance the efforts and image of the Administration as a deregulator."[43] President Reagan had already signaled that deregulation would figure prominently in the Administration's agenda. Immediately upon entering office, Reagan ordered a postponement and review of the "last minute" regulations made by the outgoing Carter Administration, and had heralded "among my priorities as President is the establishment of a new regulatory oversight process that will lead to less burdensome and more rational Federal regulation."[44]

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[40] Roger Mehle, "Secretary's Role in the DIDC," memo to Donald Regan, March 4, 1981; Box 147; Folder 5; Treasury Department; Subject File; Financial Deregulation, Depository Institutions Deregulation Committee, April 28, 1980–May 21, 1981; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[41] Ibid.

[42] Gordon Eastburn, "Proposed Treasury Strategy for the DIDC," memo to Donald Regan, March 16, 1981; Box 147; Folder 5; Treasury Department; Subject File; Financial Deregulation, Depository Institutions Deregulation Committee, April 28, 1980–May 21, 1981; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[43] Ibid.

[44] Ronald Reagan, "Postponement of Pending Regulations," memo to Cabinet, January 29, 1981; Box 165; Folder 1; Treasury Department; Subject File; Regulatory Reform, Jan.–Jun. 1981; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

What had held back deregulation of interest rate ceilings thus far had been the DIDC's, primarily Volcker's, concern for thrift earnings (and, by extension, their solvency). If Regan were to speed up the pace to deregulation, as all signs indicated he would prefer, he would have to offer some resolution to the thrift earnings problem. The Treasury department staff's diagnosis of the plight of the thrifts included what they viewed as dogged resistance of thrift regulators to liberalization of rate ceilings that in turn stemmed from the problems inherent to having regulators with a homogeneous constituency.[45] A Treasury Department memo called for the Administration to hold the line on its policies, "we have the correct policy prescriptions already in place," which would alleviate the problems of the thrifts as the economy improved as a whole.[46]

The Administration's appointee to head the FHLBB, Richard Pratt, disagreed, arguing that the thrifts required special attention. He walked a fine line in testimony before the Senate Committee on Banking, Housing, and Urban Affairs, stating both that the thrift industry was "in its worst state since World War II," and that "the industry does have a collective net worth cushion of $32.4 billion, which should see it through this current adverse phase of the economic cycle."[47] Despite his confidence in the net worth "cushion," Pratt nonetheless requested an increase in FHLBB's line of credit with

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[45] Gordon Eastburn, "Consolidation of the Federal Deposit Insurance Agencies," memo to Donald Regan, May 21, 1981; Box 147; Folder 6; Treasury Department; Subject File; Financial Deregulation, Depository Institutions Deregulation Committee, May 22–August 7, 1981; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[46] Department of the Treasury, "Economic Briefing Book," prepared December 4-11, 1981; Box 139; Folder 1; Treasury Department; Subject File; Economic Situation, Briefing Books, Economic Briefing Book; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[47] Richard T. Pratt, "Statement of Richard T. Pratt, Chairman Federal Home Loan Bank Board, before the Committee on Banking, Housing, and Urban Affairs of the United States Senate: Hearings on Financial Institutions Oversight, April 28, 1981."; Testimony/Transcript HR 2591; Legislative Files, 1944-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

Treasury, a lowering of the threshold to qualify for FSLIC assistance, and "extraordinary power to arrange for insured institutions or their holding companies, notwithstanding current Federal or State geographic or other limitations."[48] But Regan and the Treasury Department staff ran with the idea that the thrifts could rely on net worth to weather their current crisis. To some, this attitude seemed too cavalier. In March, St. Germain wrote to Regan, "many believe the magnitude of the problems within the thrift industry and their possible ripple effects are underestimated by some within the Administration. I tend to agree there is validity to this observation."[49] Regan responded that the Administration took the issues facing the thrift industry very seriously and that the President's economic program remained the best approach to helping the thrifts.[50]

Regan's propensity for deregulation, coupled with his confidence that the thrift industry could survive short-term earnings difficulties, portended more aggressive action by the DIDC to deregulate interest rate ceilings. In a press release following his first DIDC meeting on March 25, 1981, Regan reaffirmed the committee's commitment to enable depository institutions to compete for funds and to offer higher returns to small savers, and he announced his intention to lead the DIDC to "make a significant contribution to financial market stability by better indicating what the future pace and

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[48] Ibid.

[49] St. Germain, to Regan, March 26, 1981; Box 181; Folder 4; Treasury Department Subject File; Thrift Industry Savings and Loan Industry Investigation, Various Background Materials, 1981-91, n.d.; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[50] Regan, to St. Germain, March 26, 1981; Box 181; Ibid.

nature of deregulation will be, thereby reducing individual and institutional uncertainties."[51]

At the March meeting, the DIDC had reviewed five petitions regarding interest rates ceilings reflecting the range of competing concerns and agendas of various types and sizes of institutions. The ABA pressed for an instrument that would allow banks to better compete with MMMFs, as did the large S&L Western Savings Bank. Citibank asked the DIDC to speed up the elimination of ceilings beginning with the immediate removal of caps on deposits of three year maturities and higher, while the National Savings and Loan League sought a more moderate course, urging an indexing of ceilings beginning with deposits with 8 year maturities. Even supporters of deregulation such as Senator Alan Cranston recommended the re-imposition of the differential on MMCs as a "short term remedy" to assist the thrift institutions.[52]

In weighing the competing claims, DIDC staffer Edward Ettin wrote, "the theoretical arguments concerning the impact of deposit rate ceilings provide little guidance on the appropriate pace of deregulation. Reasonable conceptual arguments can be made on both sides, but their resolution depends on the interest elasticity of the public's demand for deposits."[53] In other words, depositors would signal when ceilings would *have* to be relaxed. Otherwise, there was evidence to suggest that ceilings should

[51] Donald Regan, "Press Release," March 26, 1981, 28; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[52] Senator Alan Cranston, to Paul Volcker, March 25, 1981 (copy); Congressional Correspondence; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[53] Edward Ettin, "Petitions for Ceiling Rate Adjustments and Strategies for Deregulation," March 18, 1981; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

be retained to protect thrifts, including the "market" indicator that falling S&L stock prices reflected the assumption that ceiling liberalization would negatively impact earnings, and the experience of New England thrifts that increased asset powers (NOW accounts) did not necessarily increase the ability of the institutions to compete for funds.[54]

Despite the concerns cited by Ettin, Regan continued to hold that the thrifts did not need special protections. Instead, as Regan argued in Senate testimony, a level playing field for all financial services institutions offered the best solution to the thrifts' problems.[55] Volcker attempted to persuade Regan that the dire condition of the thrifts could not be ignored.[56] April 1981 indeed proved to be an especially trying month for the thrifts, which lost $6.6 billion in deposits.[57]

Yet, as of late May 1981, Regan remained steadfast that the thrift industry's earnings and net worth problems were only temporary and that they had sufficient cash flow to ride out the hard times. Better times, he reasoned, would come soon enough, as "the President's economic program with its balanced tax, budgetary, and monetary policy features [worked] in concert to reduce inflation [and] also reduce short-term interest

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[54] Ibid.

[55] Nancy L. Ross, "Regan Says Give No Aid to Thrifts," *The Washington Post*, April 29, 1981. *ProQuest Historical Newspapers* (accessed February 25, 2012).

[56] Volcker to Donald Regan, April 9, 1981; Box 147; Folder 5; Treasury Department; Subject File; Financial Deregulation, Depository Institutions Deregulation Committee, April 28, 1980–May 21, 1981; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[57] Nancy L. Ross, "$6.6 Billion Loss Blamed on Money Market Mutuals," *The Washington Post*, May 27, 1981. *ProQuest Historical Newspapers* (accessed February 25, 2012).

rates."[58] Regan was especially emphatic that current concerns should not impede the progress of interest rate deregulation. "In any event," Regan assured St. Germain, "the most important element of enabling thrift institutions to retain their deposit funds is a removal of restrictive limits on the amount of interest they can pay on their deposit liabilities."[59] Meanwhile, Fed regulators scrambled to draft legislation to provide emergency aid to the thrifts. Yet without support from the Administration, including Pratt, who wanted broader powers in addition to emergency aid, St. Germain and other concerned lawmakers elected not to take up the proposed legislation, instead seeking a more comprehensive approach.

Seeking alternative ways to bolster the thrift industry, Treasury staffers actively pursued what they called the "demand note" concept by which a distressed institution could make a claim on FDIC or FSLIC insurance as way to bolster the net worth of the institution. Pratt liked the idea and agreed that it could be implemented without additional Congressional authorization. This could buy time for ailing thrifts while Pratt and the FHLBB drew up legislation to expand thrift asset powers. Roger Mehle suggested to Regan that these developments should be cited to Pratt to signal that "the groundwork for an accelerated phase-out [of Regulation Q] has been laid."[60]

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[58] Donald T. Regan to Fernand St. Germain, May 29, 1981; Box 147; Folder 6; Treasury Department; Subject File; Financial Deregulation, Depository Institutions Deregulation Committee, May 22–August 7, 1981; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[59] Donald T. Regan to Fernand St. Germain, May 29, 1981; Box 147; Folder 6; Treasury Department; Subject File; Financial Deregulation, Depository Institutions Deregulation Committee, May 22–August 7, 1981; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[60] Roger Mehle, memo to Regan and the Cabinet Council on Economic Affairs, June 3, 1981; Box 147; Folder 6; Treasury Department; Subject File; Financial Deregulation, Depository Institutions Deregulation Committee, May 22–August 7, 1981; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

The moment for Regan to take the lead on deregulation had arrived, or so he thought. Regan opened the June 25, 1981 meeting of the DIDC, announcing, "I should like to take this opportunity to reiterate the problems of the thrift institutions are temporary and manageable, and should not be of concern to the general public."[61] Making good on his March promise to reduce uncertainty, Regan unveiled a schedule for deregulation of rate ceilings, beginning with longer maturities, and working toward complete removal of rate caps by August 1, 1985. The plan also included a two-year phase-out of the differential. Consistent with his prior steering of the committee, Volcker responded to the proposal cautioning, "it might be an awful big step… I think four years is certainly as short as we could go on deregulation at the moment…remember, we can only go so fast."[62]

This meeting was also the first attended by FHLBB Chairman Richard Pratt. Pratt, who would later become known as the man most responsible for thrift deregulation, too called for a slower pace, arguing, "while the committee is charged with the concept of deregulation, [it] has similarly been charged a number of times with taking into account the effect of this deregulation on viability and soundness of the institutions which are regulated."[63] Pratt suggested that the DIDC did not have the legal authority to phase-out the differential as dictated by Regan's proposal. DIDC General Counsel Peter Wallison countered that even if the DIDC could not remove the differential on accounts established prior to December 1975 without Congressional approval, it did have the power to create

[61] DIDC, "Open Meeting of the Depository Institutions Deregulation Committee," June 25, 1981; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP. Quoted in Nocera, 217.

[62] Ibid., 25-6.

[63] Ibid., 3.

accounts of the same maturity without ceilings.[64] Pratt was not satisfied, and abstained from the committee's vote approving the schedule for public comment. The real problem, Pratt argued, was that "the charge which this committee has is really inadequate, that while this committee was charged by Congress with the task of deregulating the liability side, that to do so in a vacuum is inappropriate and not in the public interest."[65] Without greater deregulation of thrift assets, Pratt would go against his deregulatory leanings to slow liberalization of rate ceilings, and especially the differential. Revealingly, Pratt argued that the thrift's obligation to housing left them "charged with paying open market competitive rates for their savings while being precluded from many of the most profitable markets existing in this country."[66]

Despite Regan's reassurances regarding the status of the thrifts, Pratt reported that at the end of May, 70% of S&Ls were experiencing operating losses, and argued, "the differential is a small price to pay to maintain long-run competitive viability of this important sector and to see that flows to housing finance are maintained."[67] Finding little sympathy from Sprague and Lord, who noted that the DIDMCA had granted S&Ls NOW account authority, Pratt insisted, "listening to the comments of my colleagues here, I hope that they will wholeheartedly endorse whatever legislation we might bring forward to make thrift institutions fully competitive with other financial intermediaries, in all regards."[68] Pratt thereby previewed his strategy to leverage concessions on rate ceilings

[64] Ibid., 27-9.

[65] Ibid., 66.

[66] Ibid., 67.

[67] Ibid., 67-8.

[68] Ibid., 74-5.

and the threat they posed to the survival of the thrift industry for expanded thrift asset powers.

The June 25 meeting was notable for one other reason, one that promised to overshadow even Regan's phase-out schedule, a proposal to double the passbook savings rate, to over 10%. The proposal was a parting gift from FDIC Chairman Sprague, attending his last DIDC meeting. Long frustrated by the slow pace of deregulation, Sprague noted, "nobody has said one word about the little fellow's passbook."[69] The earnings problems of the thrifts, and consequent implications for the DIDC's charge to ensure the safety and soundness of depository institutions, had, thus far, eclipsed the DIDC's charge to ensure market rates for savers. Certainly Regan's phase-out schedule moved in the direction of speeding up higher returns to savers, but Sprague felt a more dramatic move was needed to precipitate deregulation. The committee agreed to put the proposal out for comment, but did not raise the passbook rate.

The DIDC staff reported the results of 4,571 comment letters on Sprague's proposed 5% increase to the passbook savings rate. Not surprisingly, retirees and retiree associations overwhelmingly supported such an increase. But almost no depository institutions favored a 5% change, with 94% of commenting thrifts opposing any rate increase, while 53% of commercial bank respondents favored a smaller rate increase.[70] The thrifts continued to plead for greater sensitivity to their earnings crunch, and thus, slower movement on ceiling deregulation. An executive of South Texas Savings, Zac

[69] Ibid., 82.

[70] DIDC Staff Memo, "Increasing Savings Deposit Rate Ceilings," September 16, 1981, 3; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

Lentz, wrote desperately to Senator Lloyd Bentsen (D TX) that while his institution was still in the black, at a time when fewer and fewer S&Ls could claim the same, South Texas Savings could not absorb a 5% increase, and complained, "you cannot change from a highly regulated industry to an almost completely deregulated one in a short period of time."[71] Thrift officials also pointed to the uneven nature of deregulation, which was then focused on liabilities. An S&L executive wrote to the DIDC, "No doubt we could withstand these pressures [resulting from a 5% passbook rate increase] if we had been allowed to build diversified loan portfolios as were the commercial banks. However, due to past regulations, our loan portfolios consist of long term fixed rate mortgages over which we have no control."[72]

Several depository institutions that opposed the passbook increase quoted additional costs that the change would mean for monthly or yearly earnings. J.L. Forrester of First State Savings Association in Sedalia, Missouri claimed that the additional $900,000 costs per year "could well be the difference between our continued existence and failure."[73] Forrester charged that some members of the DIDC intended to "homogenize" the financial industry by first making thrifts insolvent, and then encouraging commercial banks to take them over. The end result, he maintained, would be to "reduce the emphasis on homeownership that our society has experienced for the

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[71] Zac Lentz, South Texas Savings, to Senator Lloyd Bentsen, August 20, 1981 (copy); Congressional Correspondence; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP. Zac Lentz, South Texas Savings, to Senator Lloyd Bentsen, November 3, 1981 (copy); Ibid.

[72] Larry Pipkin, Vice President, Bonne Terre Federal Savings and Loan Association, to Gordon Eastburn, August 10, 1981 (copy); Congressional Correspondence; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[73] J.L. Forrester, First State Savings Association, Sedalia, MO, to Gordon Eastburn, August 7, 1981 (copy); Congressional Correspondence; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

past several decades," due to the commercial banks' "preference for non-residential lending."[74]

Insulated from the challenges that Regan faced within the DIDC and distant from the pressure coming from thrift institutions and allied lawmakers, the Reagan administration kept pushing for quicker deregulation of interest rate ceilings. Vice President George Bush wrote to Regan in July, "Regulation Q makes no sense today, and the action taken [to phase out Regulation Q] is pro-competitive and consistent with the President's program of regulatory relief. I hope we can continue to take actions like this in the future."[75] From Bush's perspective, the goal remained the rapid deregulation of interest rate ceilings to achieve higher returns for savers, a position facilitated by the administration's optimistic view of the thrift situation. The Administration expected that if anything, thrift deposits should increase in the short term, as thrifts introduced "All Savers Certificates" (ASCs). The ASCs were part of the Reagan Administration's signature economic legislation, the "Economic Recovery Tax Act of 1981," which allowed savers to exclude up to $1,000 of interest from the certificates from their taxable income.[76] The Council's memo further urged staying the course of current policies to

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[74] Ibid. S&L Vice President Charles Bates offered a similar assessment of the DIDC, which he said "seems bound and determined to bury the thrift industry and consolidate all financial institutions into a few 'super banks.' If this happens, it will be the American people who will suffer and the few banks who will prosper." Charles Bates, Vice President, United Federal Savings and Loan Association, Dothan, AL, to Gordon Eastburn, July 23, 1981 (copy); Congressional Correspondence; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[75] George Bush, to Regan, July 17, 1981; Box 148; Folder 4; Treasury Department; Subject File; Financial Deregulation, Miscellaneous; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[76] William Jackson, "Tax-Favored Savings: All Savers Certificates and Individual Retirement Accounts," October 1, 1985, CRS Report No. 85-168. *ProQuest Congressional* (accessed February 25, 2012). ASCs were issued only from October 1981 to December 1982.

reduce inflation, interest rates, and regulation, and to support the FHLBB proposed legislation for expanding asset powers.

Meeting again in September, the DIDC continued to be hounded by the contradictions in its mandate, with Regan arguing for higher returns for savers and Volcker cautioning that safety and soundness of the institutions must come first. Regan viewed lost deposits as the thrifts' primary problem, arguing, "something has to be done here from the marketing point of view to indicate to the small saver that all of these high interest rates are not passed on just to the big guy."[77] Thrifts could not expect to keep deposits, he continued, by "hoping that lethargy or sheer inertia will mean that the little guy will be kept there at his disadvantage."[78] Recognizing that the proposed 5% rate hike would indeed be too much for the thrifts to handle, Regan called for a more modest increase in passbook rates to 6.75% for banks and 7% for thrifts, keeping the differential. Volcker responded to Regan's proposal acknowledging the merits of higher returns to savers, but concluding, "in this case I do think our injunction to have due regard for the safety and soundness of the depository institutions is relevant and important because in this case all the analyses that I have does suggest that there would be a very substantial earnings cost to the thrift institutions and commercial banks, for that matter."[79]

Pratt supported Volcker's assessment, citing an estimate that each percentage point increase to the ceiling would eat away $1 billion in thrift earnings per year.[80] He

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[77] DIDC, "Depository Institutions Meeting of the Deregulation Committee," September 22, 1981, 21; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[78] Ibid.

[79] Ibid., 24.

[80] Ibid., 27.

also noted that the inertia that Regan identified *was* keeping money in passbooks despite the higher rates available elsewhere even though the FHLBB estimated that over 40% of passbook accounts held over $10,000. By this reasoning both small and large savers were *choosing* to keep money in passbook accounts despite available alternatives, a fact that Comptroller Charlie Lord called "one of the great mysteries of the moment,"[81] leading Pratt to conclude that any increase in the passbook rate would be "simply an increase in costs and not helpful."[82] When discussion moved to proposals for instruments to compete with MMMFs, all with high minimum denominations, Regan remarked, "I notice the tenor of this discussion here is that for accounts of $10,000 minimum or maybe $5,000 minimum and the like, we should raise interest rates [but not for the passbook accounts] and again I come back to my original premise, that the very small saver–that is, the one, $2,000 saver or even less–I think should get a better break on interest rates."[83] "Your logic is impeccable," Volcker responded, but "it's that billion and a half [estimated lost earnings on the low denomination All Saver's Certificate] sticking out there that sticks in my craw and I can't get around it."[84] The committee voted against Regan's passbook increase proposal 3 to 2, with Isaac joining Pratt and Volcker.[85]

Though he lost the first vote on an immediate increase of 1 ½%, Regan secured a three votes to two approval of a still more modest ½% increase,[86] and continued to pursue

[81] Ibid., 28.

[82] Ibid., 27

[83] Ibid., 46.

[84] Ibid., 48

[85] Ibid., 50

[86] Nocera, 222.

a schedule for the 6-year phase-out, this time ensuring that some ceiling and differential continued to March 31, 1986 (as dictated by DIDMCA). Lord and Isaac indicated enthusiastic support of the new plan while Volcker added, "I am tolerant of it. The reservation I had last time was whether we were going too fast. This, on average, I think, is just about as fast as we were going last time. On that basis, I am tolerant. I prefer to go a little more slowly."[87] FHLBB General Counsel Tom Vartanian, speaking on behalf of Pratt, who had left the meeting, argued, "we think it might be a bit precipitous to look at an overall deregulation package covering the next three or four years at this point when it is the right and obligation of this body to look at deregulation from time to time, and, in fact reassess what the effect is on the economy and the institutions this body regulates."[88]

For the thrift industry, the ½% increase in the passbook savings rate ceiling was not modest enough. S&L officials flooded Congressional offices with letters of protest. Michael Allen, a VP of Long Beach Savings and Loan, for example urged "rescission of the D.I.D.C.'s precipitous and irrational decision[s], arguing "we have witnessed an enormous increase in our costs through the deregulation of a variety of savings accounts which have led to skyrocketing mortgage interest rates."[89] Gerald Kuhn, a commenter with no apparent institutional affiliation characterized the decision to increase the passbook savings rate by one-half of one percent "stupid," and called for the abolition of

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[87] DIDC, "Depository Institutions Meeting of the Deregulation Committee," September 22, 1981, 78.

[88] Ibid., 79

[89] Michael H. Allen, to Congressman Glenn Anderson, November 1981 (copy); Congressional Correspondence; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

the DIDC.[90] Kuhn reasoned that the increase was too small to change savers' behavior, but large enough to pose a crippling earnings problem for the depository institutions. The institutions that could survive the earnings squeeze, he continued, would only raise loan rates.[91] Kuhn's explanation of his own saving behavior flew in the face of most regulators' assumption that savers were solely motivated by interest returns. Kuhn argued that depositors "utilize passbook savings due to its convenience and security," and added, "I do not want to be served by a Merrill Lynch computer hundreds of miles from my house."[92] Kuhn had not (yet, anyway) embraced the "modern" financial environment, instead favoring community institutions, despite differences in interest rate returns. Responding to Rep. John Erlenborn (R IL), who had forwarded Kuhn's letter to the DIDC, Executive Secretary Steve Skancke argued that whether or not savers like Kuhn would be moved by changes in yield, enough savers had demonstrated that they would indeed leave depository institutions all together in order to receive greater returns.[93]

While Regan, Skancke, and others focused on disintermediation as the main threat to the thrifts, most thrift officials remained more troubled by the increased cost of retaining funds. William D. Hoover, an executive of Randolph Savings and Loan Association in North Carolina, complained to Representative Ike Andrews (D NC), "the DIDC is proposing new deposit instruments which will only add to our losses and costs.

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[90] Gerald J. Kuhn, Naperville, IL, to Representative John Erlenborn, September 28, 1981 (copy); Congressional Correspondence; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[91] Ibid.

[92] Ibid.

[93] Steve Skancke, to Representative John Erlenborn, November 10, 1981 (copy); Congressional Correspondence; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

We stand to gain little, if any, new deposits."[94] A Texas S&L official cried that the September authorizations, "confirm our early suspicion that this committee is consumed with the idea of writing off the savings and loan industry."[95] As they pressed their case for a slower pace of deregulation, the S&L officials never ceased to stress their importance to housing finance. S&L Vice President Tobin Grady wrote to his Congressman, "I would like for you to impress upon this committee the fact that the savings and loan industry is a special business with a special purpose. Housing has been and will continue to be the number one financial priority of most Americans. Let's not allow Mr. Regan and the DIDC to continue playing havoc with the American Dream of home ownership."[96] Defending the original September 22 DIDC vote in favor of a ½% increase to the passbook savings rate ceiling, Skancke explained that the DIDMCA required a vote on the issue within 18 months, that the majority of the comment letters received on the issue requested a 5% increase (most of those from savers, not depository institutions), and that the DIDC intended that the much more modest increase would at least signal to depositors that the rate would eventually be going up, and thus stem the tide of disintermediation.[97] But lawmakers such as Senator Dale Bumpers (D AR) suggested that the ½% passbook rate increase alone could jeopardize the viability of the thrift industry, and to underscore the stakes added, "without these institutions millions of

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[94] William D. Hoover, Executive Vice President, Randolph Savings and Loan, to Representative Ike Andrews, October 28, 1981; Ibid.

[95] Ray Williams, Vice President Mineola Federal Savings and Loan Association, to Senator Lloyd Bentsen, November 24, 1981 (copy); Ibid.

[96] Tobin B. Grady, Vice President, Home Savings and Loan Association, Chapel Hill, NC, to Representative Ike Andrews, October 29, 1981 (copy); Ibid.

[97] Steven Skancke, to Senator Lloyd Bentsen, November 23, 1981 (copy); Ibid.

young persons in this country may never be able to buy a home,"[98] while Senator Lloyd Bentsen (D TX) protested to Secretary Regan in early September 1981 that an increase on the passbook savings rate would offset any gains made through the ASC.[99]

The outcry from the S&L industry and pressure from Congress led the DIDC to rescind the September 22 authorization of a ½% increase to the passbook ceiling. Regan appeared especially persuaded by Senator Bentsen's line of argument. Skancke circulated a notation ballot to the DIDC members under the following memo:

> Preliminary information regarding All Savers Certificates indicates that they are drawing funds from passbook savings accounts more heavily than was anticipated. At the same time, money market fund assets have continued to increase. In light of the apparent magnitude of this outflow from savings accounts and the small movement from MMFs to All Savers Certificates, the scheduled increase in the passbook savings rate ceilings adopted at the DIDC's September meeting appear likely to have much less of an impact stemming the savings outflow than was anticipated at the time. Chairman Regan, therefore, has proposed postponement of the scheduled one-half percentage point increase pending review of more definitive information regarding the outflows from passbook savings accounts.[100]

Predictably, Pratt and Volcker joined Regan in voting to postpone the increase. Isaac, Conover, and non-voting member, Charlie Lord disagreed with the postponement. Volcker added a handwritten note to his ballot saying, "however, I disagree with analytic reasoning above. My view in December is not likely to depend on ASC flows. I would continue to oppose December consideration."[101] For his part, Lord added his dissent from

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[98] Senator Dale Bumpers, to Donald Regan, October 16, 1981 (copy); Ibid.

[99] Senator Lloyd Bentsen, to Secretary Regan, September 4, 1981 (copy); Ibid.

[100] Steven Skancke, "Postponing the November 1, 1981 One-Half Percentage Point Increase in Passbook Savings Rate Ceilings," October 19, 1981; Notation Ballots May 6, 1980–March 1986; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[101] Paul Volcker; Postponing the November 1, 1981 One-Half Percentage Point Increase in Passbook Savings Rate Ceilings, October 19, 1981; Notation Ballots May 6, 1980–March 1986; Records of the

Regan's analysis, but from the other side, writing "evidence is far from clear that passbook funds are flooding into ASCs. Nevertheless, [the] basic purpose of [a] 50 b.p. [½%] increase was to recognize the existence of small saver and combine to move to close the gap. 150 b.p. [1 ½%] would have been better than 50 [½%]."[102]

Regan continued to seek liability deregulation, always in the name of the small saver, at each turn, but was repeatedly forced to retreat as thrift institutions struggled to bear the increasing cost of deposits. The Regan-led DIDC proved no better able than the preceding committee membership in reconciling the fundamental contradiction underlying its dual charge to deregulate interest rate ceilings and protect the solvency of banks and thrifts. Some saw deregulation of thrift asset and investment powers as a possible solution, but advocates of such deregulation were struggling to secure majority support in Congress as the banking and thrift lobbies tussled over proposed legislation and some lawmakers remained skeptical of asset deregulation altogether. As long as this logjam persisted, the DIDC would continue to strain to implement its mandate to loosen and eventually eliminate interest rate ceilings.

Leveraging Liability Deregulation into Asset Deregulation

It was becoming increasingly clear that the DIDC could make little progress in deregulating interest rate ceilings without first, or at least also, expanding thrift asset powers. Roger Mehle wrote to Regan in October that S&L earnings problems continued

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Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[102] Charlie Lord; Postponing the November 1, 1981 One-Half Percentage Point Increase in Passbook Savings Rate Ceilings, October 19, 1981; Notation Ballots May 6, 1980–March 1986; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

because rate ceiling deregulation outpaced asset deregulation, leading the S&Ls asking for short-term aid such as the All Savers Certificate and noted "Congress is all too willing to oblige."[103] Two pending asset-power reform initiatives, a Pratt/FHLBB bill and a bill sponsored by Senator Garn, promised a more permanent intervention, but passage of neither bill appeared imminent. Slowly the members of the DIDC came to the conclusion that they might be able to force Congress to act on asset deregulation by withholding action to deregulate interest rate ceilings until thrifts were granted more flexible investment powers.

The various proposals for expanded thrift and bank asset powers caused some to fear that thrifts might abandon their traditional role as specialized housing lenders. To dispel such concerns, Regan testified before the Senate that "providing thrift institutions with new asset powers need not diminish their contribution to housing finance. Real estate lending is their area of greatest expertise and they are likely to continue expanding this activity….moreover we expect the new alternative mortgage instruments to make real estate lending more attractive to many financial institutions."[104] Senator Proxmire remained skeptical, "I wonder if this legislation that is before us wouldn't, in effect, just walk away from that special function that thrifts have performed very well over the last many years and create a situation in which home buyers and homebuilders just wouldn't have a financial institution which would provide the kind of service that thrifts have in the past at the price they have in the past with the expertise they have in the past."[105]

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[103] Roger Mehle, "Your Deregulation Program."

[104] Senate Committee on Banking, Housing and Urban Affairs, *Financial Institutions Restructuring and Services Act of 1981, Part I: Hearings before the Committee on Banking, Housing and Urban Affairs, 97th Cong., 1st sess., October 19-22, 1981* (Washington, DC: GPO, 1981), 5.

[105] Ibid., 31.

Edwin Brooks of the U.S. League of Savings Associations testified that the Garn bill contained important improvements to the bill designed by Pratt in its preemption of state prohibitions of due on sale clauses and raising the insurance limit for IRA-Keogh accounts. Still leveraging, however, Brooks argued, "the more flexible asset and liability powers are welcome, but… no one should be misled into thinking that the grant of new powers can solve our immediate problems of high-interest rates, asset-liability imbalance, and negative earnings. They cannot. Many of these new authorities will take years before the benefits are realized."[106] In other words, thrifts needed new asset powers, but they also wanted Regulation Q protection, and the differential, for as long as they could get it.

As Congress considered thrift asset legislation, the DIDC's December 16 agenda had promised consideration of four short-term accounts with liberalized interest rates. For the second time in four months, the DIDC elicited a furry of letters pleading for a slow-down in the pace of deregulation. Again, S&L officials wrote to their Congressional representatives and the DIDC, and Congress leaned heavily on the DIDC to postpone consideration of the proposed accounts. The letters came from members of both parties and cited both the dire conditions of the thrifts and the prospect of new legislation concerning the asset structure of the thrift industry as reasons to wait. Within this broad consensus, the tone of the letters varied widely from angry accusations that the DIDC had strayed from its Congressional mandate to those that applauded past DIDC efforts and merely asked for time to allow Congressional action to deregulate thrift assets.

Representative Bill Lowery (R CA) frankly summarized the contending interests:

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[106] Ibid., 444.

> The DIDC faces a very difficult dilemma in implementing the mandate given it by Congress under [DIDMCA]. On one hand, large commercial banks would like the liability side of the ledger deregulated as quickly as possible in order to allow them to compete more effectively with what have come to be called 'near banks,' i.e. money market mutual funds and other non-traditional entities entering the financial services industry. On the other hand, small commercial banks, savings and loans, and mutual savings banks favor a very slow deregulation schedule for obvious reasons.[107]

Representative Stephen Neal (D) of North Carolina cast the drama differently:

> The DIDC members may be pursuing their own vision of a new financial marketplace, but across the country millions of people are worried about the condition of local institutions, where they have invested their savings, and about the lack of affordable houses and mortgages. Let me assure you that ordinary people are more concerned about these things than about regulations and economic theories.[108]

Even Newt Gingrich (R GA), a supporter of deregulation, had been persuaded that a temporary moratorium was necessary, concluding "it won't do us any good to deregulate these institutions if we kill them in the process," and that the proposed accounts "could only further hurt an already wounded savings industry."[109] Similarly, Senator Richard Lugar (R IN) reiterated his general support of deregulation, but qualified that stance, arguing," there is, however, a special responsibility in the instance of financial institutions in light of the overriding public policy requirement for safety and soundness of depository institutions and the compelling fact of federal deposit insurance."[110] Further deregulation at that time, he reasoned, "could exacerbate the current earnings difficulties

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[107] Bill Lowery, to Donald Regan, December 15, 1981; Congressional Letters Urging Postponement of Consideration of DIDC Meeting Agenda December 16, 1981; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[108] Stephen Neal, to Donald Regan, December 12, 1981; Ibid.

[109] Newt Gingrich, to Secretary Regan, December 11, 1981; Ibid.

[110] Richard Lugar, to Donald Regan, December 15, 1981; Ibid.

of thrifts, and delay, if not eliminate, their return to a profitable status."[111] For Neal, however, it was not merely the health of the institutions that was at stake, but also the community-oriented promotion of homeownership that they represented. Prescient though his warning turned out to be, such concern for the traditional model of local savings institutions and lenders at the heart of the New Deal system of housing finance was drowned out in subsequent debate.

Eclipsing Neal were those who argued that while it was imperative that the DIDC slow the pace of deregulation of liabilities, a parallel deregulation of assets was long overdue. A Hawaii Representative, Cecil Heftel, wrote to Regan "while the DIDC has deregulated the assets of financial institutions… it has not deregulated the thirty year low interest liabilities which thrift institutions have incurred over the years."[112] Many, like Senators Daniel Patrick Moynihan (D NY) and Alfonse D'Amato (R NY) specifically referred to pending legislation, S. 1720 (which would become the vehicle bill for the Garn–St. Germain Act) while requesting a temporary moratorium on DIDC action.[113]

Walking a political tightrope between the interests of savers and borrowers, and emblematic of the continuing dilemma of the DIDC, a letter from the Illinois Congressional delegation to Regan argued "while of course we want to see savers achieve the maximum possible interest rate, we also realize that in order to have lower interest rates for borrowers there must be a balance between the rates paid to savers and

[111] Ibid.

[112] Cecil Heftel, to Donald Regan, December 14, 1981; Congressional Letters Urging Postponement of Consideration of DIDC Meeting Agenda December 16,1981; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP. See also Hamilton Fish, to Donald Regan, December 11, 1981; Ibid.

[113] Daniel Patrick Moynihan and Alfonse D'Amato, to Donald Regan, December 11, 1981; Ibid.

the rates charged to borrowers."[114] Extending this logic, the delegation reasoned that the new accounts would further stress the beleaguered housing market. The letter emphasized that the undersigned supported the concept of deregulation, but asserted that the DIDC had eschewed the statutory six-year timetable. Furthermore, the letter alleged that the DIDC had violated the DIDMCA requirement that deregulated interest rates did not exceed market rates, arguing that "rather than being governed by the market rate ceiling, the DIDC is actually making the market rate."[115] For others, like Christopher Dodd (D CT), the deregulated environment meant the possibility of "disorderly bidding," meaning that neither the DIDC nor a rational market would determine interest rates.[116]

The DIDC had finally broached the possibility of higher rates to the smallest of savers, those with only passbook savings, and Congress, at the behest of the thrift industry, immediately sought to reign in the committee. The interests of consumers as savers seemed to be pitted against those of consumers as borrowers, and certainly against those of thrift institutions. "As desirable as it is for consumers to receive a higher rate of interest on their deposits," wrote Senator Slade Gorton (R WA), "it is also important that the thrift industry and housing industry survive the period of adjustment."[117]

Prior to the holiday recess, Regan instructed his staff to send a response letter to the 38 senators and 136 representatives who had requested that the DIDC take no action

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[114]Frank Annunzio, et al., to Secretary Regan, December 11, 1981; Ibid. Another bipartisan group made this connection, "positive action on the items on your agenda for December 16, 1981, could substantially increase the cost of funds to financial institutions and to their borrowing customers." Henry Reuss, et al., to Donald Regan, December 11, 1981; Ibid. See also "this is a matter that not only affects the financial industry but ultimately the consumers as well." Marge Roukema, to Donald Regan, December 11, 1981; Ibid.

[115] Ibid.

[116] Chris Dodd, et al., to Secretary Regan, December 15, 1981; Ibid.

[117] Senator Slade Gorton, et al., to Steven Skancke, December 11, 1981; Ibid.

in December. As Skancke explained to Senator Abdnor, "at the request of several members of Congress, consideration of [short term deposit proposals] was postponed until the March meeting of the DIDC. This delay was to permit the Congress and others more time to become familiar with these important issues…"[118] Of the delay, Comptroller Todd Conover noted, "I am disappointed because we are not going ahead and providing the depository institutions with the liability products that they need to compete effectively with financial services companies."[119] Despite Conover's desire for a more competitive short-term instrument, the DIDC staff remained cautious, "there is a legitimate concern that a new short-term instrument, which imitates many of the features of an MMF share, will also encourage internal shifts from existing low-cost savings deposits and thereby depress earnings," and estimated that institutions would have to attract $4-6 of new savings to offset the costs of every $1 shifted from a low-yielding account.[120]

Yet the Treasury staff kept up its rosy view of thrift conditions, trying to open the door to resumption of a quickened pace of interest rate deregulation. In a memo prepared to brief President Reagan on the status of the thrift industry in January 1982, the Treasury Department sounded a very positive note: "despite fears expressed throughout 1981 that severe disintermediation would subject the industry to an outflow of deposits which, in

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[118] Steven Skancke, to Senator James Abdnor, March 5, 1982; Congressional Correspondence; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[119] DIDC, "Meeting Transcript," December 16, 1981, 16; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[120] DIDC Staff Memo, "Short-term Instrument Proposals," December 10, 1981, 13-14, 18; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

turn, would lead to their insolvency, total S&L deposits grew $13 billion or 2.6%, (including $38 billion of interest credited to accounts, which more than offset a $25 billion decline in new deposits) and a number of accounts paying market returns have proven quite successful in attracting new savings flows."[121] But such assessments failed to account for increased cost to the institutions. The memo conceded that total net worth was down to $27 billion from $32 billion at the end of 1980, and that 23 mergers were required to aid 30 ailing institutions. The memo concluded, "lasting solutions to the problems being experienced by thrift institutions are long term in nature and require a restructuring of the industry's asset and liability powers so that they may profitably compete in all economic environments."[122] Pending legislation offering such a restructuring, however, had been stalled by wrangling between the thrift and commercial banking lobbies.[123] Senate Banking Committee Chairman Garn, however, insisted on consensus between the groups before proceeding with the legislation.

While the thrift industry and supporters in Congress sought to slow the DIDC's efforts to liberalize rate ceilings, others complained that the committee was not moving fast enough. Between the December 16, 1981 and the March 22, 1982 meetings, the DIDC was inundated with pro-deregulation letters, mostly from commercial bankers who were then feeling increased competition from MMMFs, but not the long-term asset concerns of the thrifts. The staff's summary report of the letters indicated that the banks

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[121] Donald T. Regan, "1981 Developments in the Thrift Industry," to Ronald Reagan, undated; Box 180; Folder 1; Treasury Department; Subject File; Thrift Industry, General, 1982; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[122] Ibid.

[123] William O'Connell, to Roger Mehle, February 9, 1982; Box 180; Folder 1; Treasury Department; Subject File; Thrift Industry, General, 1982; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

remained upset about the DIDC's reversal of the passbook rate increase passed at the September meeting. Each of the major trade associations had proposed a new short-term instrument, reflecting the break between the cautions thrifts and small banks and the more eager large commercial banks. The American Bankers Association pled for a ceilingless, $5,000 transaction account, while the U.S. League of Savings Associations recommended a 91-day account tied to the comparable Treasury bill rate and with a differential favoring the thrifts, along with a continued delay in a ceiling increase on savings, and reinstatement of a 12% ceiling on SSCs.[124]

By March, Regan could point to a modest increase in thrift deposits and reassured depositors that "there should be no public concern about the viability of [the thrift] industry. The existing resources of the Federal Deposit Agencies are adequate to deal with any problems of institutions and these resources will be expanded if the need arises."[125] The Chairman of the "Deregulatory Committee" thereby affirmed one of the many lines that deregulation would not cross, that of the regulations providing deposit insurance. In fact, throughout the debate on deregulation, deposit insurance would only be expanded despite the competitive advantage it gave to insured institutions in what policymakers otherwise claimed to be (finally) making into a level playing field.

The committee discussed a possible 3 ½ year account of fixed- or variable-rate that would give maximum flexibility to institutions to design requirements (such as whether to allow additions after the initial purchase of a certificate). Regan argued,

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[124] DIDC Staff Memo, "Profile of Letters Received for March DIDC Meeting," March 22, 1982 DIDC; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[125] "DIDC, "Meeting Transcript," March 22, 1982, 3; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

“we’re leaving it to the marketplace–in which I, at least, believe–to decide that it wants to do. If the marketplace decides against it, that’s up to them.”[126] The DIDC approved the instrument for comment. Yet in attempting to design short-term instruments, DIDC staff member Susan Krause noted, “the committee has before it the difficult task of considering the creation of a new deposit instrument which will enable depository institutions to compete more effectively for short-term funds but would not exacerbate any current earnings difficulties.”[127] Comment letters revealed that a majority of commercial banks supported a new short-term instrument, while the majority of thrifts were opposed.[128] Pratt argued at length that any new short-term instrument should have a differential. Isaac was furious, “it’s philosophically wrong. This committee was appointed to deregulate interest rates and now we’re talking about coming up with a new instrument with a differential on it, trying to direct fund flows… we were supposed to be moving in the other direction.”[129] On a competitive instrument, Volcker reminded, “we have an impossible job when we try to define an instrument that’s going to compete with nondepository institutions more effectively and still not add, importantly, to the cost of the depository institutions and in particular the S&Ls.”[130] He suggested that any short-term instrument should have a $10,000 minimum denomination saying, “I think the risk it too grave to what Chairman Isaac referenced in terms of cannibalizing low cost deposits.

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[126] Ibid., 28.

[127] Ibid., 38.

[128] DIDC, “91-Day Time Deposits of Less than $100,000,” *Federal Register* 47, no. 66 (1982): 14690. *HeinOnline* (accessed February 16, 2012).

[129] DIDC, “Meeting Transcript,” March 22, 1982, 41; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[130] Ibid., 44.

Otherwise, we can always go ahead and change it in the light of experience and make it more liberal, but it's very difficult to make it less liberal."[131] Regan offered a compromise, advocating a $7,500 minimum denomination, 91-day maturity instrument, with a fixed-rate ceiling based on the most recent Treasury bill of the same maturity, and, shockingly, a differential favoring the thrifts. "Somehow or another," he argued, "the thrifts have to be protected at least for the moment while we attempt to get interest rates down. We cannot just sit idly by and do nothing for that industry."[132] He urged that the differential be authorized for one year, after which it could be extended if conditions warranted. Conover agreed to the Regan compromise, as did Pratt, though preferring a one-year review of the differential rather than a default end point. Volcker did not particularly like the instrument, preferring a $10,000 minimum, and asked that the committee commit to revisiting the issue. He said, "I have a fear of doing too much today… I don't like this account much, but go ahead."[133] Regan countered that he was determined to "do something positive today," and pressed for a vote, which approved the proposed account.[134] The committee compromised, moving on deregulation, as desired by commercial banks, but ultimately designing an instrument that most closely resembled the recommendation of the U.S. League. With Regan now siding with protecting thrift earnings, it became clear that the deregulation of interest rate ceilings as mandated by the DIDMCA would be held up until the thrifts' earnings problems could be resolved. Regan's net/worth, mergers, and FSLIC demand note plan would not be enough,

[131] Ibid., 44-45.

[132] Ibid., 48, 50.

[133] Ibid., 54.

[134] Ibid., 55.

Congress would have to further deregulate thrift assets in order to allow the DIDC to proceed at any speed with rate ceiling deregulation.

By June 1982, Regan could see an impending breakthrough in the logjam of competing mandates that had long handcuffed the DIDC. Regan announced, "our long-term plan for the deregulation of the liabilities of depository institutions, coupled with the proposals for restructuring the asset powers of these institutions now pending in Congress, should allow our insured depository institutions to compete fully in the changing financial services market."[135] In the interim, the best the DIDC could do would be a "moderate step in the direction of deregulation by providing institutions with a slightly more competitive short-term account." Then, he continued, "after legislation has passed, and the asset powers for thrifts are expanded further, so these institutions can generate the earnings needed to pay for additional market rate deposits, I'll urge the committee to consider authorizing a truly competitive market rate, transaction type account."[136] Regan thereby positioned the DIDC to leverage progress on the deregulation of interest rate ceilings in exchange for asset deregulation.

Following up on the promise to revisit the issue and seeking a compromise account that could move towards higher returns without too much harm to thrift earnings, the committee discussed new short-term accounts with no rate ceilings, no prescribed maturity, limited check-writing, and, significantly, high initial minimum denominations, as much as $20,000. Both Regan and Isaac argued that the minimums could be

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[135] DIDC, "Meeting Transcript," June 29, 1982, 4; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[136] Ibid.

incrementally lowered, the latter adding, in-step with "actions by Congress to deregulate thrift asset powers which we feel strongly must be done in connection with liability deregulation."[137] Pratt agreed, arguing that the survival of the thrift industry under liability deregulation depended on further asset deregulation. He continued, "the committee should make very clear [to Congress] that it does view that there is a substantial linkage there," and suggested that the DIDC propose an account that would be even more competitive with MMMFs than the current proposal, but to make its approval conditional on congressional passage of expanded thrift assets.[138] The proposed account passed, but Volcker noted that competitiveness with MMMFs would still be hindered by reserve requirements for banks and thrifts that did not apply to the MMMFs. Both he and Isaac argued that Congress should move, not to deregulate reserve requirements for banks and thrifts, but to extend the reserve requirements to MMMFs.[139] Aside from this limitation in competitive equity, the instrument failed to offer any immediate relief to small savers.

Effectively holding rate deregulation for small savers hostage, the DIDC awaited movement by Congress on liberalizing thrift assets. Negotiations proceeded slowly, but Regan remained confident that Congress would have to act on a deregulation bill sooner than later. At its September 17, 1982 meeting, the DIDC denied the petitions of four states (South Dakota, New Jersey, Texas, and Washington) requesting exemptions from rate ceilings both to avoid competitive inequalities that would result and because the DIDC members believed that imminent Congressional action would preempt the states'

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[137] Ibid., 17

[138] Ibid., 23.

[139] Ibid., 35.

concerns with a national policy.[140] Regan noted progress on Senate Resolution 2879, the latest version of the Garn bill, which he believed would clarify the intent of Congress, and "strengthen the safety and soundness of our depository institutions."[141] Finally, at long last, it seemed that the perpetual impasse over the charge to give institutions the means to compete with MMMFs and concern over earnings (especially of the thrifts) would be taken out of their hands and settled by Congress. Interest rates were also falling, from 13% to 8% over the quarter, meaning that the stakes for deregulating deposit ceilings would be lessened though not escaped entirely.[142]

Congress, which had voted two years prior to proceed with liability deregulation, was gradually coming around to the position that asset deregulation was necessary to implement the elimination of deposit rate ceilings. Garn wrote, "DIDC itself has expressed its frustration with being given the task of deregulating liabilities without the authority to expand asset powers. Absent any change in the asset structure of the thrifts and a clear Congressional mandate, it is unlikely that DIDC will produce a competitive instrument in the near future."[143] Expanded asset powers for thrifts finally seemed imminent, but the competing interests of thrifts and banks still had to be negotiated. Garn sought to appease the ABA, assuring them that the primary emphasis of asset deregulation legislation would be to "provide a new, market-sensitive deposit instrument"

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[140] DIDC, "Transcript of DIDC Meeting," September 17, 1982; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[141] Ibid., 4-5.

[142] Ibid.

[143] Jake Garn and Donald Riegle, Jr., to Llewellyn Jenkins, President, American Bankers Association, September 10, 1982 (copy); Box 52; Folder 5; Treasury Department; Memoranda; Legislative Affairs, Sept.–Dec., 1982; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

so that banks could “compete against non-depository financial intermediaries.”[144] Issues involving Glass-Steagall, Garn told ABA President Llewellyn Jenkins, would have to wait for the next Congress.[145] Later that month, Dennis Thomas reported to Secretary Regan that “negotiations between the Senate Banking Committee and the American Bankers Association appear to be progressing satisfactorily.”[146]

Regan stressed administration support for the Garn bill, indicating that “Titles I, II, and III of S. 2879 [had been] endorsed by the Cabinet Council on Economic Affairs and specifically reviewed with the President,” and impressed the necessity of the bill’s passage during the current Congress upon Majority Leader Howard Baker.[147] In a letter to St. Germain, Regan added to his endorsement that Title II “does not require an institution receiving assistance to channel that assistance into new mortgage investment at the very time when flexibility of asset powers and broader investment is the highest priority,” and noted, “clearly the initial and modest liberalization of thrift asset powers in the financial reform legislation of 1980 did not go far enough.”[148] Regan indicated Treasury support of

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[144] Ibid.

[145] Ibid.

[146] Dennis Thomas, memo to Donald Regan, September 15, 1982; Box 52; Folder 5; Treasury Department; Memoranda; Legislative Affairs, Sept.–Dec., 1982; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[147] Donald T. Regan to Howard Baker (copy); Box 52; Folder 5; Treasury Department; Memoranda; Legislative Affairs, Sept.–Dec., 1982; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[148] Regan, to St. Germain, September 24, 1982; Box 181; Folder 4; Treasury Department Subject File; Thrift Industry Savings and Loan Industry Investigation, Various Background Materials, 1981-91, n.d.; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

accounts competitive with money market funds, but only "contingent on the realization of the expanded asset powers for thrifts."[149]

In September, Congress passed the Garn–St. Germain Act. By most accounts, the Act was emergency legislation to save the long-suffering thrift industry.[150] But the DIDC had also played a critical role by holding up rate deregulation on the condition of legislation expanding thrift asset powers. The maneuver also helped bring the commercial banks on board with Garn-St. Germain despite the fact that it fell short of the asset reform that the banks wanted for themselves, and that it gave thrifts some powers that had been exclusive to banks. But because many commercial bankers, especially those representing the largest institutions, so desperately wanted an instrument that could compete with the MMMFs, they backed Garn–St. Germain with only a phase-out of the differential, and the promise of future consideration of further banking deregulation.

The Garn–St. Germain Act of 1982

Congress had finally passed legislation deregulating thrift asset powers. Deregulation proponents, as early as the Hunt Commission report had sought greater freedom for S&Ls to invest in short-term assets such as consumer loans and in investments other than residential mortgages, including commercial real estate. The aim, and the result, was to make thrifts less specialized (as residential mortgage lenders) and more like commercial banks. The majority of thrift managers, who felt trapped by the

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[149] Ibid.

[150] Marianne J. Scholte writes, "In 1982, Congress passed the Garn-St. Germain Depository Institutions Act, principally to prevent the collapse of the thrift industry." Scholte, "The Circumvention and Reform of Banking Legislation: An Institutionalist Case Study of the Years 1960-1982" (PhD diss., University of Notre Dame, 1990), 126.

dead weight of low-yielding 30-year mortgages even as they were rapidly losing Regulation Q protection, too had long pursued added flexibility in composing their asset portfolios. But just as they had been reluctant to warm to or accept variable-rate mortgages, many policymakers had been slow to rally around additional asset deregulation, despite the severe crisis conditions thrifts faced in the early 1980s. What had broken the impasse that had long held up efforts to secure asset deregulation, I argue here, was the ultimatum of the DIDC: there would be no further movement on achieving market rates for savers or authorizing a MMMF-type account for banks and thrifts until Congress expanded thrift asset powers.

The Garn–St. Germain Act offered a broad package of expanded asset and emergency powers for thrifts. The Act explicitly authorized the FDIC and FSLIC to facilitate mergers and otherwise assist failing institutions in order to avoid liquidation, powers that Regan and the Treasury staff had long argued the corporations already possessed, including the purchase of "net worth certificates" to infuse capital into troubled banks and thrifts. Of greatest interest to the thrift industry, however, were the long awaited asset powers that would allow the institutions to diversify their portfolios beyond the traditional preponderance of long-term residential mortgages. The Garn–St. Germain Act allowed thrifts to invest in non-residential real property up to 40% of their assets, deposit instruments of insured institutions, government securities (no more than 10% to any one issuer), commercial lending (up to 5% of assets before Jan. 1, 1984, and 10% thereafter), consumer loans up to 30%, personal property loans up to 10%, education loans, and foreign assistance loans and small business stock up to 1% of assets. The act set a two-year deadline for elimination of the differential, but also allowed thrifts to issue

demand accounts, facilitated conversion to stock as opposed to mutual ownership, and preempted state prohibitions of due-on-sale clauses that had allowed home sellers to pass on their low interest rate mortgages to buyers rather than paying back a loan in full upon sale. Finally, and most significant for savers, the title directed the DIDC to create a "Money Market Deposit Account" for banks and thrifts designed to compete directly with MMMFs.[151]

Seeking to head off charges that the expanded investment powers would reduce the devotion of the thrifts to residential mortgage lending, Title III, the "Thrift Institutions Restructuring Act," declared, "the lending and investment authorities are conferred by this section to provide such institutions the flexibility necessary to maintain their role of providing credit for housing."[152] Yet the powers extended through the title gave thrifts the opportunity to largely abandon their devotion to housing in pursuit of more lucrative and flexible short-term investments.[153] The Realtors® had in fact dubbed the bill "legislation to curb mortgage lending by savings and loans," asking, "how can Congress dismantle the system of locally based financial institutions that provide housing money?"[154] Though thrifts could still opt to specialize in mortgage lending, the new powers meant that they did not have to do so, and under the pressure of an increasing cost of funds due to liability deregulation, many opted to reduce the proportion of their portfolios tied up in long-term, fixed-rate mortgages.

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[151] P.L. 97-320.

[152] Ibid.

[153] Senate, *Garn-St. Germain Depository Institutions Act of 1982*, 97th Cong., 2d sess., 1982, S.Rep. 641, 88.

[154] Realtor-Gram, to United States Senate, folder "Housing Commission (5 of 6)," Martin Anderson Files, Ronald Reagan Library.

For the DIDC, the passage of Garn–St. Germain meant that the committee could proceed with the phase-out of Regulation Q with less concern for the earnings of the thrifts. Though the earnings problems would not disappear overnight, the committee could be more confident that the institutions would be able to adapt to changes in interest rate ceilings. The Garn–St. Germain Act also explicitly directed the DIDC to authorize an account that would directly compete with the MMMFs. Though the law provided some parameters, the DIDC still had some discretion in determining the features of the account. At one extreme, Callahan argued, "to be directly competitive with the money market mutual funds this account has to have the same flexibility that they have. They have absolutely no restrictions…. I really believe that if we try to fashion an account that will be competitive we will most probably fail, but if we let those institutions have the flexibility they need to compete," they will strike a better balance between competitiveness and safety.[155] But even Don Regan was not prepared to give depository institutions free reign. He wanted, for an initial period at least, a $2,500 minimum on the new account. For all he had said since joining the DIDC about achieving market rates for small savers, "having persuaded myself that I was afraid of what would happen to the passbook savings accounts and other things," Regan was still concerned about thrift earnings. To his surprise, Pratt no longer seemed quite so worried. Neither he nor any of the lobbying groups that had commented to the committee had suggested that a minimum denomination was necessary.[156] Pratt, having finally secured the deregulated asset powers

[155] DIDC, "DIDC Meeting," November 15, 1982, 19; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[156] Ibid., 21.

he had sought, no longer felt compelled to slow liability deregulation. Throwing up his hands, Volcker conceded, "if there's no minimum denomination here I think the straight-forward way would be just to eliminate the interest rate ceilings on savings deposits since this account has all the advantages of a savings deposit plus more. I don't know why the Committee would want to go in that direction but that seems to be the logical and equitable thing to do. I think it would have a disastrous effect on the earnings of the institutions but in concept that seems to be what we're doing."[157]

Regan argued, "if we go with no minimum whatsoever and take all restrictions off, you throw the thing wide open. This is the most competitive way to go. There's no doubt about it. My only caution is that I don't want to throw the baby out with the bath water and find that we've created something that we can't control at a later date."[158] From Pratt's perspective, the damage had already been done. Due to incremental relaxation of ceilings, the amount of money still left in savings accounts was no longer enough to pose a substantial threat, in his judgment, to earnings given new asset powers.[159] With Pratt shifting toward favoring brisk deregulation, it seemed that Volcker might find himself alone on the side of caution. But Regan and Isaac came off the fence to join Volcker in a 3 to 2 vote establishing a $2,500 minimum for the new account category.[160] So the congressionally mandated Money Market Deposit Account (MMDA) would have a minimum denomination putting it out of the reach of truly small savers, and it had limited transactions (thus providing an advantage to keeping funds in a passbook account with

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[157] Ibid., 23.

[158] Ibid.

[159] Ibid., 24.

[160] Ibid., 26, 42.

unlimited transactions). But for those who could reach the minimum, money market rates could now be had at a local bank or thrift, with the added benefit of deposit insurance.[161]

MMDAs attracted a staggering $19 billion in their first six days, but, unfortunately for the thrifts, "most of the money came from passbook savings accounts rather than from competing money-market mutual funds."[162] By the following February, banks and S&Ls had gained $254 billion into new accounts, while MMMFs lost $40 billion over the same period.[163] The latter figure indicated that the depository institutions might have finally begun to compete effectively with the MMMFs, but at increased cost. Even with the minimum denomination, Regan and Volcker's fear that funds would pour out of low-yielding (and thus low-cost) passbook accounts into the higher-yielding MMDAs was being realized.

Since savers were moving their money out of passbook accounts anyway, the DIDC staff recommended that the committee might as well grant consumers the benefits of unlimited transactions. Pratt enthusiastically endorsed the move, and argued that the accounts should be available to all entities, individuals, non-profits, and businesses alike, arguing, "whatever makes the market more efficient benefits all of society."[164] This time

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[161] In addition to having a $2,500 minimum denomination, required seven days notice before withdrawal or transfer, and had a limit of six transactions per month, no more than three of which could be checks. When balances met the minimum requirement, the accounts had no ceiling; if they dipped below the minimum they would have the same ceilings as NOW accounts. DIDC, "Money Market Deposit Account," *Federal Register* 47, no. 229 (1982): 53710-1. *HeinOnline* (accessed February 20, 2012).

[162] "Bank, S&L Accounts Attract $19 Billion in their First 6 Days," *Wall Street Journal*, December 22, 1982. *ProQuest Historical Newspapers* (accessed February 21, 2012).

[163] "Money Market Accounts Vs. The Funds: A New World for Savers, Investors, Borrowers," *The Washington Post*, February 20, 1983. *ProQuest Historical Newspapers* (accessed February 24, 2012).

[164] DIDC, "DIDC Meeting," December 6, 1982, 15; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

it was Isaac who wished to apply the breaks on deregulation, “I don’t see the rush to get this new account…. I think it’s a mistake…. I don’t think most institutions are expecting it. I think most institutions are praying that we don’t do it.”[165] Though insistent on reserve requirements, for the transaction accounts, Volcker had more or less given up on steering the committee away from full deregulation of deposit ceilings. Given the MMDA, he reasoned, “we are well on our way to blurring the distinction irrevocably between transactions and other accounts,” so there was little more harm the new accounts could do.[166] Over Isaac’s objections, the DIDC authorized an account comparable to the MMDA, but with unlimited transactions, called the Super NOW account.[167]

The MMDA, the Super NOW account, and the transfer of funds into those accounts went a long way toward deregulating interest rate ceilings. Only a few limits remained, such as those on passbook accounts. When the DIDC reconvened in March 1983, the committee bowed to the overwhelming comments of financial institutions asking that the remaining ceilings be left unchanged while they adjusted to the challenges of offering market rates on MMDA and Super NOW accounts.[168] The DIDC had also received comments on the possibility of allowing for-profit institutions to use Super Now accounts. Comments from thrifts, who had few business accounts, favored the authorization two-to-one as they could possibly attract new deposits. But the bankers saw only the possibility of paying higher rates on deposits they already held. As the DIDC

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[165] Ibid., 18-25.

[166] Ibid., 15.

[167] Ibid., 24, 36.

[168] DIDC, “Press Release,” March 1, 1983; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

staff reported, nine out of ten bankers opposed the authorization, expressing "the fear that the proposal could ultimately endanger the soundness of the banking system through excessive rate competition for deposits." In other words, bankers suddenly found themselves rearticulating the case for Regulation Q-type ceilings. Pratt could not help himself in noting the irony that the bankers now sought a slow-down in deregulation of the remaining ceilings, precisely the position that he had held on behalf of the thrifts for so much of his time with the DIDC.[169]

Regan heralded the progress of the committee in achieving market rates for depositors, noting that $300 billion were deposited in deregulated accounts as opposed to $20 billion a year prior.[170] But depository institutions were paying the price. In December 1982, MMDAs paid, on average, 2 ½ to 3 % higher than MMMFs to gain market share.[171] Fixed rate ceilings remained only on passbook savings and regular NOW accounts, ironically, the accounts most likely to be held by small savers.[172] DIDC staffer Susan Krause reported "in total, since November 1982, depository institutions have lost $50 billion in savings deposits, $116 billion in small time deposits, and $68 billion in large time deposits…. The declines in time and savings deposits coupled with the success

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[169] DIDC, "DIDC Meeting," March 1, 1983, 17; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[170] Ibid., 2.

[171] Ibid., 11.

[172] DIDC, "Press Release," July 1, 1983; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

of the MMDA have taken their toll on the balance sheets of depository institutions."[173] Yet cause for continued caution on remaining ceilings had largely passed, as DIDC Policy Director Gordon Eastburn reported, deposits had shifted so much into market-linked accounts that there was no real reason not to deregulate the other accounts. Volcker suggested that withdrawal penalties could still help protect institutions from internal shifts of funds into market-rate accounts. Callahan objected, "we have to move sooner or later to let these institutions make these decisions for themselves… I think that would be far more consistent with deregulation than to be doling this out a little bit at a time. I think we are still influencing the marketplace too much."[174] Volcker responded, "I don't really see this as a matter of deregulation philosophy. Presumably there is going to be a certain amount of regulation remaining and this seems to me a safety and soundness consideration basically, and what kind of ground rules do you want to establish perhaps on a permanent basis."[175] Even if an institution wanted to impose its own withdrawal penalties, as Callahan argued an institution could, in a free market, Volcker countered that competition might make that impossible, with the most aggressive competitors moving the market to rates that safety and soundness would dictate that it should not go. Edwin Gray, who had replaced Pratt as FHLBB Chairman, sided with Volcker, arguing that if the DIDC established a target date at which time passbook ceilings would go up, and interest rates indeed went up in the interim, that there could be a severe impact on the thrift industry, just then beginning to show signs of recovery. Again, even as late as June

[173] DIDC, "DIDC Meeting," June 30, 1983, 6-7; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[174] Ibid., 14.

[175] Ibid., 18-19.

1983, the DIDC's thrift representative warned, "this committee ought to proceed with great caution."[176]

Gray remained the most reluctant to proceed with deregulating the last vestiges of Regulation Q ceilings. In September 1983, Regan argued that in order to ensure market rates for "the very small saver, or the saver who wants to utilize these types of [uncapped] savings accounts but is unsophisticated, doesn't know how to of about changing or is frightened of changing, or is afraid of the unknown," that minimum denominations would have to be lowered, and ceilings would have to be removed on passbook accounts.[177] Volcker advocated a phase-out of the minimum ceilings to mitigate the potential negative earnings impact, with Gray arguing to keep the minimums to help "protect the safety and soundness of the Federal Savings and Loan Insurance Corporation," against losses due to thrift insolvency.[178]

At the final DIDC meeting of 1983, Gray reported, "the rapid growth of MMDAs fortunately occurred at the time that interest rates were falling. Even though MMDAs were crucial in reversing deposit outflows at thrifts as I have suggested, the fact is the new deposit flows were costly."[179] Charles Partee, representing the Federal Reserve, argued that the most important accomplishment of rate deregulation had been to redirect funds that had gone to MMMFs back into traditional depository institutions. "It is often

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[176] Ibid., 22.

[177] DIDC, "DIDC Meeting," September 30, 1983, 33; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[178] Ibid., 36.

[179] DIDC, "DIDC Meeting," December 15, 1983, 9; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

asserted." Partee continued, "that the cost of credit is higher as a result of the deregulation and the higher rates paid for funds. I don't know any banker or any savings and loan man that I have talked to that doesn't believe that and doesn't say, well, I have to pay more for my money and so I have to charge more for my money."[180] But Partee said that increased credit availability meant lower rates, and that costs had been overestimated by the press and by Congress. Chairman Isaac argued that while Garn–St. Germain and lower interest rates allowed the DIDC to deregulate liabilities quickly to the benefit of savers and the financial system as a whole, that "Congress has got to deal with the asset side of balance sheets to a greater degree than it has with Garn St. Germain. We must make available new profit opportunities for banks and thrifts to help them cope with the cost of liability-side deregulation."[181] In other words, even with expanded asset powers, liability deregulation had put enormous pressure on the banking and thrift industries to cope with increasing cost of funds.

Regan looked back at the DIDC's tenure, defending both the pace of deregulation, "we had no choice but to move rapidly because the industry itself was and in changing rapidly," and the committee's accomplishments, "we should not forget that the ultimate beneficiary of all of this is the American consumer of financial services [who] want and deserve the best financial services at the best price. They want a reasonable return for their investments. And we want and need a modern, healthy financial services industry which can provide just that. That's what we are all about."[182] Regan cited an estimate of $20 to $40 billion that had been lost to depositors due to Regulation Q, and said that the

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[180] Ibid., 14-15.

[181] Ibid., 20-21.

[182] Ibid., 24.

DIDC had only delayed the creation of an MMDA-like account "in order to spur support for Congressional action to rescue ailing thrift institutions. Passage of the Garn–St. Germain Act satisfied [this] objective."[183] Regan concluded, "the economic perspective of this Administration is based on a faith in the market-place…what we have done here is to take some very important steps to reintroduce the positive power of the market system back into the financial services industry."[184]

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It had been a tumultuous road to "reintroducing" the market system into the financial services industry. In the case of banking and housing finance, the process of deregulation frequently involved re-regulation or attempts to continue certain regulations to protect the safety and soundness of depository institutions and direct credit towards housing. Even the most ardent proponents of deregulation, like Regan, found themselves struggling to reconcile the competing mandates of achieving market returns for savers and due regard for the safety and soundness of depository institutions. The struggle made policymakers abundantly aware of the difficulties that rate deregulation would pose for housing lenders, and yet they forged ahead, cautiously at first, until ultimately reconciling the problem by allowing thrifts to pursue various investment opportunities other than housing. Forcing their hands, policymakers argued, was increased competition from non-bank financial services companies; rate ceilings had to be loosened not only to achieve market returns on (insured) savings, but so that depository institutions could compete for

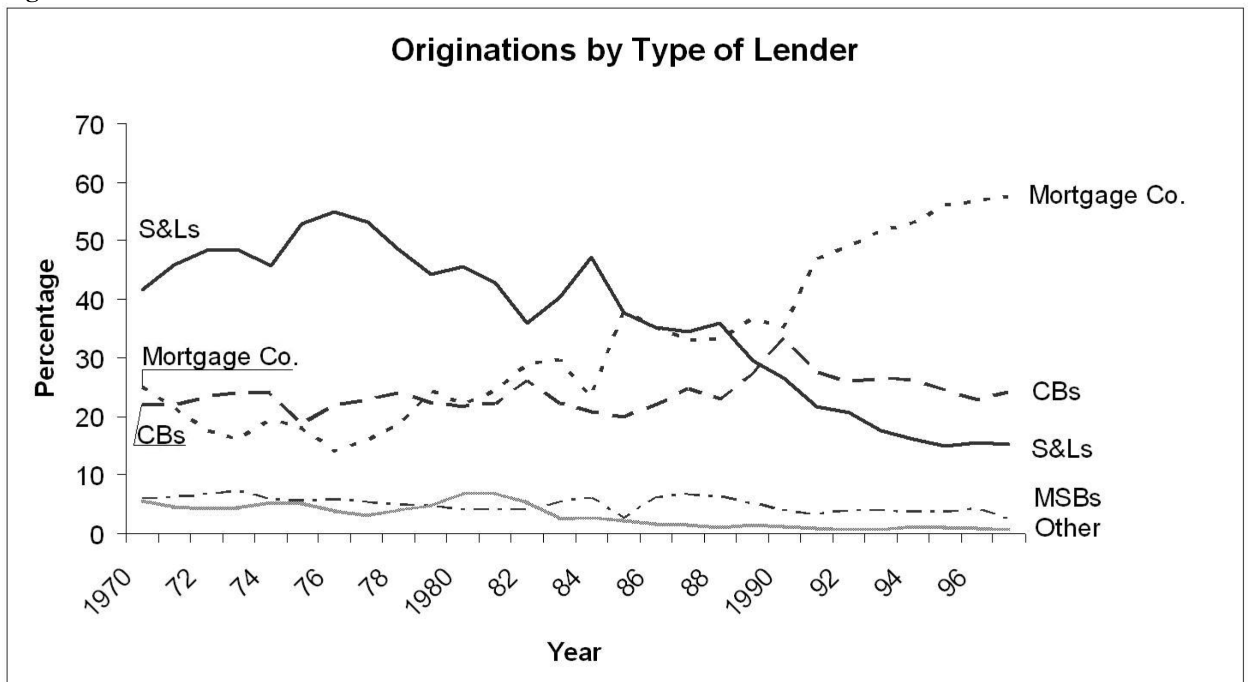
[183] Ibid., 26.

[184] Ibid., 27.

savings against MMMFs. But, as discussed in Chapter Four, it was the same policymakers who had *chosen* not to reign in the MMMFs, arguing that the instruments filled a previously unmet market demand. And so policymakers privileged market rates for savers over protected (lower) rates for prospective homebuyers, leveraging the narrow deregulation of interest rate ceilings into broad deregulation of thrift asset powers.

At the insistence of House conferees, the Garn–St. Germain Act explicitly (and paradoxically) claimed to grant non-housing investment powers so that thrifts could maintain their role as housing lenders. But the share of mortgage originations by thrifts declined considerably through the 1980s. Increased deposit flow following the introduction of MMDAs coupled with falling interest rates contributed to a brief increase in the thrifts' share of mortgage originations immediately following the passage of Garn–St. Germain, but this trend was short-lived despite the fact that interest rates continued to come down from their historic early-1980s highs.

Figure 2



Source: Kenneth A. Snowden, "Originations, Purchases, and Sales of Mortgages, by Type of Institutional Lender: 1970-1997," *Historical Statistics of the Unites States Millennial Edition Online*. Eds. Susan Carter et al. (Cambridge University Press, 2006).

Over the longer-term, the relevant trend was a dramatic reduction of the role of S&Ls in housing finance beginning in 1978, when, through MMCs, thrifts began to pay market rates on an increasing portion of their deposits. As policymakers such as Senator Proxmire had feared, thrifts largely "walked away" from housing finance. Significantly, the dwindling role of thrifts in housing finance largely divorced residential lending from the types of community institutions at the heart of the community reinvestment movement.

It was not yet clear, in 1982, who would fill the void left by the S&Ls, but as the chart above shows, mortgage companies would take the place of thrifts as the primary originators of residential mortgages. Though specialized housing lenders, these mortgage companies would operate much differently than S&Ls. The mortgage companies or mortgage brokers did not collect deposits, nor did they keep mortgage loans in their portfolio, instead, they would raise capital and sell the mortgages they originated through secondary mortgage markets. The rapid growth of secondary mortgage markets in the 1980s, and policymakers' "turn" to those markets as the primary source of capital for housing will be explored in the following chapter.

Chapter 7

More Money for Housing–The Turn to Secondary Markets and Housing Affordability

"Real estate," Don Regan, then CEO of Merrill Lynch, noted, "is a huge market."[1] In the 1970s and into the 1980s, saver/investors had been shifting savings capital from depository institutions into capital markets, threatening to deprive this "huge market" of adequate credit. In addition to the disintermediation of the 1970s (mainly into MMMFs), a longer-term development, the growth of private pension funds over the course of the twentieth century, further diverted savings that otherwise would likely have found its way into depository institutions instead into capital markets.[2] Secondary markets offered a means to reconnect this disintermediated savings-capital with housing, bypassing the depository institutions altogether. To Regan and others on Wall Street, including Lewis Ranieri at Salomon Brothers, residential mortgage finance represented a vast market that had long been beyond the reach of their investment banks. Ranieri, by the late 1970s, was leading Salomon into housing finance via mortgage-backed securities (most of them guaranteed by the federal government). Along with this modest entry into housing finance by a few investment banks, government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, had stepped up their traditional role of supplementing

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[1] Regan, "The Changing Market Place," unpublished manuscript; Box 223; Folder 4; Personal; Speeches and Writings; Books; The Changing Market Place (unpublished) draft, Ch. 1-6; Papers of Donald T. Regan; Library of Congress; Manuscript Division.

[2] Jacob S. Hacker, *The Divided Welfare State: The Battle over Public and Private Social Benefits in the United States* (Cambridge: Cambridge University Press, 2001), 49, 149-150. These pensions had long been supported by federal subsidies. In some cases, policies fostered accounts, such as IRA and Keogh that depository institutions could compete to offer.

mortgage capital through secondary mortgage markets when depository institutions retreated, to take over an increasing share of housing finance. In the early to mid-1980s, with S&Ls struggling to stay solvent, and a growing, though still small, role for secondary markets led by the GSEs, policymakers gradually turned to the secondary markets to replace the thrifts as the primary source of capital for housing.

Though they had become increasingly important over the course of the 1970s, and into the 1980s, secondary mortgage markets took on a fundamentally new role in the mid-1980s. This new role was two-fold. First, in the early to mid-1980s, policymakers identified secondary mortgage markets as *the* primary source of mortgage capital, replacing traditional depository institutions and their collected household savings. Policymakers viewed the growth of the GSEs' secondary market activity as proof that the secondary markets could serve as an alternative source of capital for housing, and moved to facilitate a more permanent reliance on the secondary markets, which they did through both regulatory and legislative changes.[3] Second, the Reagan administration and allies in Congress made a concerted effort to widen *private*[4] participation in secondary markets

[3] Comptroller John Heimann, for example, said, "in effect, what the Congress did is create a third financing system for the housing market. Now, it is our belief that this system has proven itself. Because of the Federal and federally sponsored credit agencies, we can now make the changes to the financial system that many of us feel are correct and equitable." House Subcommittee on Financial Institutions, Supervision, Regulation and Insurance, of the Committee on Banking, Finance and Urban Affairs, *The Consumer Checking Account Equity Act of 1979: Hearings before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance, and Urban Affairs,* 96th Cong., 1st sess., May 15, 16, 17; June 12, 13, and 14, 1979 (Washington, DC, GPO, 1979), 105-6.

[4] Due to the enigmatic relationship between the GSEs (FNMA and FHLMC) and the federal government, in discussions of secondary market participation, "private" is a relative term. Here I differentiate between the GSEs and "fully private" secondary market participants, namely financial services companies of various forms. Secondary market instruments too could be more or less private, ranging from those with a government guarantee or insurance to conventional or privately insured mortgages or instruments. While these distinctions are important for understanding the categories that participants employed in debates over secondary mortgage markets, the pervasive federal role, both explicit and implicit, in market-making and ultimately in socializing risk makes the notion of a "private" secondary market of limited utility.

that had previously been dominated by the GSEs. Some in the Reagan administration sought the full privatization of the GSEs themselves, leaving them to compete in the private market with no explicit or implicit relationship to the federal government. Yet the consensus that ultimately emerged in Congress included both the GSEs and private actors in an expanding secondary market for mortgages.

Congress endorsed and facilitated the emergence of the secondary mortgage market as the primary source of capital for housing finance both by deregulating thrift asset powers, allowing S&Ls to devote less and less of their portfolios to residential mortgages, and by easing regulations governing the sale of mortgage-backed securities. This two-step process shifted the majority share of mortgage originations away from local depository institutions to mortgage companies and brokers. This change in mortgage origination had significant bearing on Fair Housing and Community Reinvestment Act enforcement, as market share transferred from depository institutions that fell under federal regulation and oversight in these areas to mortgage companies and brokers who did not. These consequences, however, were scarcely considered during debate over the turn to secondary markets. In addition to undermining fair housing and community reinvestment enforcement, the restructuring of housing finance perpetuated racial inequality by making credit more costly for all borrowers. Borrowers who were just gaining access on equal terms (to the extent that they did) were accessing less favorable terms than had borrowers under the New Deal system. While this negatively affected all new borrowers, it was especially harsh for those who benefited least from intergenerational transfers of wealth and other advantages accrued through homeownership.

The turn to secondary markets as the principal source of capital for housing marked a fundamental transition in housing finance. Residential mortgages would increasingly be financed by investment capital, as opposed to savings capital, and would increasingly be originated by mortgage companies and brokers rather than thrift institutions. Housing finance would no longer enjoy protected status, as it had when Regulation Q funneled low-cost capital to housing lenders, but would be integrated into the broader capital market and compete with other sectors. But in one important way the turn to secondary markets, because of the preeminence of the GSEs, represented continuity with the New Deal system. The reconfigured system of housing finance remained deeply dependent on the federal government. As economist Robert Van Order has written, the increasing importance of Fannie Mae and Freddie Mac "[did] not represent an increase in government support as much as a change in the nature of support from the depository charter to the GSE charter."[5] Because of the implicit guarantee behind the GSE charter, the federal government increasingly subsidized the investment risk in the housing market, much more so than it ever did through FHA insurance alone. Through FNMA and FHLMC, the federal government drastically escalated its underwriting of the mortgage market in order to support both an increasing homeownership rate in the face of stagnant wages and decreased affordability *and* the profits/dividends to private investors who invested in housing finance through secondary markets.[6]

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[5] Robert Van Order, "The Structure and Evolution of American Secondary Mortgage Markets, with Some Implications for Developing Markets," *Housing Finance International* 26, no. 1 (2001): 16-31, 17.

[6] Michael Stone notes that in 1990 dollars, "federally sponsored housing credit," excluding FHA and VA insurance, rose from less than $0.4 trillion in 1980 to $1.4 trillion in 1990. Stone, *Shelter Poverty: New Ideas on Housing Affordability* (Philadelphia: Temple University Press, 1993), 177.

The Institutional Inheritance: Secondary Markets from the New Deal through the 1970s

Neither secondary mortgage markets nor a federal presence therein were new in the 1980s. Both the inherited institutional structure and the past activity of the government-sponsored enterprises (GSEs), the Federal National Mortgage Association (FNMA, or Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC, or Freddie Mac), and the government agency, the Government National Mortgage Association (GNMA, or Ginnie Mae), informed debate over the ongoing function of secondary markets in housing finance. Here I document the development of secondary mortgage markets and the GSEs through the 1970s in order to provide context for policymakers' decision to rely on both as central components of housing finance beginning in the mid-1980s. I argue that until the early 1980s, policymakers viewed secondary mortgage markets as a countercyclical mechanism, stepping in only when traditional lenders had retreated. Over the course of the 1970s, successive countercyclical interventions demonstrated the capacity of secondary markets to raise capital for housing. In the early 1980s, as policymakers considered the future of housing finance in light of, first, thrifts' struggle to remain profitable during interest rate ceiling deregulation, and second, thrifts' retreat from mortgage lending as they exercised new investment powers granted in Garn–St. Germain, secondary markets appeared to be a ready and viable alternative to the thrifts as the primary source of capital for housing.

Federal policymakers had outlined a role for a secondary market to provide liquidity to the primary market in federally-insured mortgages as early as the 1934 Housing Act (Title III), allowing for the formation of "national mortgage associations" to

buy and sell such loans.[7] After no private-sector investors stepped in to perform this function, Congress established the Federal National Mortgage Association (FNMA, or Fannie Mae) in 1938.[8] Since its inception, FNMA had provided liquidity for FHA-insured, and, later, VA-insured, loans that found no buyers in private markets.[9] As the agency demonstrated that it would buy these loans, eventually even issuing advance contracts, it induced lenders to make mortgages that they would not otherwise have made, thus expanding the mortgage market. Even if FNMA did not purchase a particular loan, the likelihood that it would if needed, encouraged lenders to issue more mortgages. FNMA's market-making influence thereby extended beyond its actual purchases, but the purchases in themselves became an important tool for stimulating mortgage activity when tight credit conditions forced private lenders to retreat. In 1958, 1969-70, 1973-74, and 1978-9, FNMA, in some cases at the express urging and funding of Congress, dramatically increased its purchasing to counteract cyclical downturns due to tightening credit.[10]

Congress reorganized FNMA in 1954, making it partially private, with both government ownership and capital raised from private stockholders, and in 1968, FNMA was further privatized, with its stock publicly traded, and its debts divorced from the

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[7] P.L. 73-479, Title III.

[8] Senate Committee on Banking, Housing and Urban Affairs, *The Role of the Federal National Mortgage Association in the Secondary Mortgage Market* (Washington, DC: GPO, 1976), 4.

[9] FNMA would also purchase mortgages insured by the Veterans Administration under the GI Bill.

[10] For the 1958 intervention, see David M.P. Freund, *Colored Property: State Policy & White Racial Politics in Suburban America* (Chicago: University of Chicago Press, 2007), 193. FNMA purchases jumped from $1.9 billion in 1968 to $4.1 billion in 1969 and $4.7 billion in 1970, from $2.5 billion in 1972 to $4.1 billion in 1973, and from $4.6 billion in 1977 to $12.3 billion in 1978. Congressional Budget Office, "The Housing Finance System and Federal Policy: Recent Changes and Options for the Future," October 1983 (Washington DC: GPO, 1983), 100.

federal budget.[11] Yet FNMA retained its federal charter, and came under direct oversight by the Department of Housing and Urban Development, with five of its board members also appointed by the President.[12] This quasi-private status allowed private ownership of the agency's profits, while its quasi-government status entailed continued obligation to the public interest, the continued benefit of borrowing from the U.S. Treasury, and the competitive borrowing advantage in capital markets due to investors' perception that the U.S. government would not allow the agency to fail.[13] During this transition to a more fully private status, policymakers primed FNMA to take a stake in the conventional (not government-insured) market, while the function of purchasing government-insured mortgages primarily remained public (explicitly so), under the auspices of the newly formed Government National Mortgage Association (GNMA or Ginnie Mae). Rather than holding purchased mortgages, as FNMA did, beginning in 1970, GNMA insured pass-through mortgage-backed securities in which guaranteed payments of interest and principal from federally-insured mortgages "passed-through" to investors. Mortgage brokers and thrifts would pool FHA- and/or VA-insured mortgages, which they would typically continue to service, and then issue the securities, with the GNMA guarantee, to investors.[14] In 1970, as part of the Emergency Home Finance Act, Congress chartered the

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[11] Senate Committee on Banking, Housing and Urban Affairs, *The Role of the Federal National Mortgage Association*, 5. See also, Sarah Lehman Quinn, "Government Policy, Housing, and the Origins of Securitization, 1780-1968," (PhD diss., University of California, Berkeley, 2010).

[12] Viral V. Acharya, Matthew Richardson, Stijn Van Nieuwerburgh, and Lawrence J. White, *Guaranteed to Fail: Fannie Mae, Freddie Mac and the Debacle of Mortgage Finance* (Princeton: Princeton University Press, 2011), 17.

[13] Senate Committee on Banking, Housing and Urban Affairs, *The Role of the Federal National Mortgage Association*, 34. *Deposit Interest Rate Ceilings and Housing Credit: The Report of the President's Inter-Agency Task Force on Regulation Q*. (Washington, DC: GPO, 1979), 112-3.

[14] Charles M. Sivesind, "Mortgage-Backed Securities: The Revolution in Real Estate Finance," *Federal Reserve Bank of New York Quarterly Review* (Autumn 1979): 1-8, 4.

Federal Home Loan Mortgage Corporation (FHLMC) to establish a secondary market for conventional mortgages issued by S&Ls, which owned stock in the new agency and shared a common regulator in the FHLBB (FHLMC stock would not be publicly traded until 1989).[15] In 1971, FHLMC issued its first mortgage-backed security, a "participation certificate" modeled after the GNMA pass-through instrument, and the following year FNMA also entered the conventional market for the first time (though it had the authority to do so since 1970).[16]

The expanded operations of FNMA, FHLMC, and GNMA fueled the impressive growth of secondary markets through the 1970s. GSE participation in secondary markets followed one of two basic models. GNMA and FHLMC largely insured and/or issued mortgage backed-securities, Ginnie's backed by government insured loans, and Freddie's by conventional loans. FNMA, which was not authorized to issue MBSs until 1980,[17] followed the model of the thrift industry, raising funds by issuing debt, purchasing mortgages to be held in portfolio, and profiting on the spread between the cost of funds and the return on the mortgages. In absolute dollars and as a proportion of the overall market mortgages, GSE activity, both in MBSs and outright purchases, increased substantially over the course of the 1970s. This activity, however, was, and was understood by policymakers to be, supplemental to the activity of traditional lenders and

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[15] John M. Quigley, "Federal Credit and Insurance Programs: Housing," *Federal Reserve Bank of St. Louis Review* 88, no. 4 (July 2006): 281-309. *Business Source Complete*, EBSCO*host* (accessed April 10, 2012). Louis Hyman, *Debtor Nation: The History of America in Red Ink* (Princeton: Princeton University Press, 2011), 231.

[16] House Subcommittee on Housing and Community Development, *To Expand and Reorganize the Federal Home Loan Mortgage Corporation: Hearings before the Subcommittee on Housing and Community Development of the Committee on Banking, Finance and Urban Affairs*, 97th Cong., 2d sess., April 21 and June 3, 1982 (Washington, DC: GPO, 1982), 56-7.

[17] FNMA gained this authority through the Housing and Community Development Act of 1980 (P.L. 96-399).

sources of funds, stepping in as a countercyclical check during periods in which those sources dried up.[18]

The privatization of FNMA and the chartering of GNMA and FHLMC represented policymakers' turn to the secondary markets (the GSEs in particular) as an enhanced countercyclical apparatus, but not yet as a permanent and primary conduit of capital for housing.[19] Through the 1970s, the three GSEs acted mainly to assure lenders of the liquidity of FHA- and VA-insured loans, and to counteract periods of tight credit through increased purchases of both insured and conventional mortgages.[20] The first test of the GSEs' capacity to see the housing industry through a period of tight credit occurred in 1970, and by the account of the Hunt Commission, the new apparatus worked as intended. The Commission reported, "for a time during 1970, FNMA became the major mortgage lender. Without FNMA purchases and the expanded role of the Federal Home Loan Banks, the performance of the mortgage market in 1970 almost certainly would have been worse than in 1966."[21] As in 1970, FNMA stepped up its purchases when credit tightened again in 1974, buying up $7 billion in mortgages (including $1

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[18] See Herbert M. Kaufman, "FNMA and the Housing Cycle: Its Recent Contribution and its Future Role in a Deregulated Environment," in *The Federal National Mortgage Association In a Changing Economic Environment; Supplement to a Report by the Comptroller General of the United States* (Washington, DC: GPO, 1985): 41-74. http://gaonet.gov/assets/150/143071.pdf (accessed June 12, 2012).

[19] John C.Weicher, "The New Structure of the Housing Finance System," *Federal Reserve Bank of St. Louis Review* 76, no. 4 (July 1994): 47. *Business Source Complete*, EBSCO*host* (accessed April 10, 2012).

[20] Senate Committee on Banking, Housing and Urban Affairs, *The Role of the Federal National Mortgage Association*, 1-2. The report noted, "throughout its history FNMA has increased its level of commitments during periods of relatively scarce credit, and allowed its commitment level to decline during periods of relative ease [and] … sales of mortgages from FNMA's portfolio have also generally followed a countercyclical pattern, although there does seem to be a marked decline in sales since FNMA became a private corporation in 1968."

[21] President's Commission on Financial Structure and Regulation, *The Report of the President's Commission on Financial Structure & Regulation* (Washington, DC: GPO, 1971), 84.

billion in the conventional market).[22] GNMA likewise intervened during the 1974 crunch through an emergency program that became known as the "Tandem plan" or the Brooke-Cranston program, after the Senators, Edward Brooke (R MA) and Alan Cranston (D CA), who sponsored the enacting legislation. Under the Tandem plan, GNMA agreed to buy below-market rate mortgages issued to low-income buyers, and then sold them to investors, including FNMA, at market rates, subsidizing the difference.[23] FNMA President Oakley Hunter explained the countercyclical role of the GSEs in 1975, "as a general rule, our business volume is up when mortgage money is in short supply from the institutions that traditionally supply the bulk of the money for residential financing in the United States."[24] The GSEs would again assert their influence as the decade came to a close and rising interest rates coupled with bank and thrift liability deregulation (via authorization of market-rate Money Market Certificates) again created a tightening of credit from traditional lenders. In 1978, FNMA purchased over $12 billion in mortgages ($5.6 billion of them conventional) after only $4.6 billion the previous year.[25]

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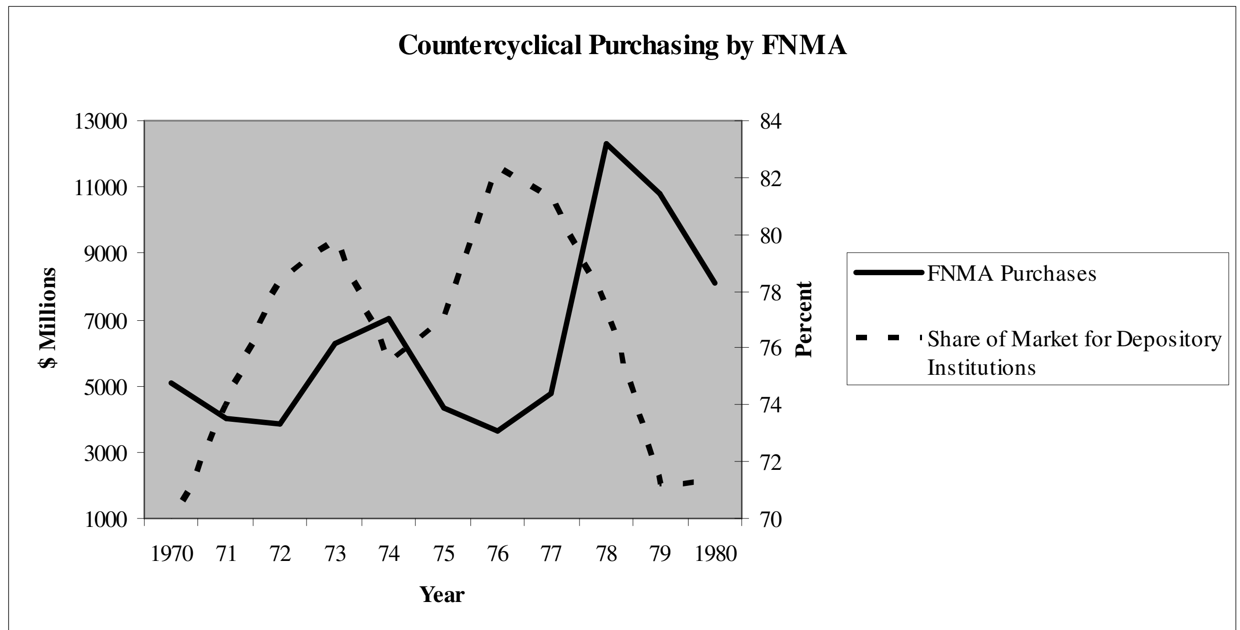
[22] Ibid.

[23] Sivesind, 4.

[24] "Remarks of Oakley Hunter: Before the Economic Club of Detroit," March 17, 1975; Folder "Federal National Mortgage Association (FNMA)," Box 10; F. Lynn May Papers; Gerald R. Ford Library, Ann Arbor, MI.

[25] Congressional Budget Office, "The Housing Finance System and Federal Policy, 100.

Figure 3



Source: Data from Kenneth Snowden, "Secondary Residential Mortgage Market Activity of Federal-Related Agencies: 1970-1999," and Snowden, "Originations, Purchases, and Sales of Mortgages, by Type of Institutional Lender: 1970-1997 [One- to four-family homes]," *Historical Statistics of the Unites States Millennial Edition Online*. Eds. Susan Carter et al. (Cambridge University Press, 2006).

The cumulative countercyclical interventions over the course of the 1970s and especially during the long period of rising interest rates in the late 1970s and early 1980s made for a remarkable expansion of the secondary markets. FNMA enlarged its mortgage holdings from $2.5 billion in 1965 to $37.6 billion in 1978.[26] GSE secondary market purchases increased at a higher rate than originations over the 1970s, indicating their increasing importance to the overall market. While mortgage originations increased 356% over the decade ($44.4 billion in 1970 to $202.3 billion in 1979), secondary market purchases increased 419% (from $14.4 billion in 1970 to $74.9 billion in 1979).[27] In addition to increased purchases and holdings, the GSEs fueled the proliferation of mortgage-backed securities. By 1979, there were over 33,000 mortgage pools and more

[26] *Deposit Interest Rate Ceilings and Housing Credit*, 100.

[27] Department of the Treasury, *The Report of the Interagency Task Force on Thrift Institutions* (Washington, DC: GPO, 1980), 76-7.

than 800 brokers and thrifts actively issuing the securities.[28] Outstanding federally underwritten mortgage-backed securities grew from $0.4 billion in 1970 to $110.8 billion in 1980, representing a jump from 0.1 percent of total residential mortgage debt to 10 percent by the end of the decade.[29] While MBSs remained a small part of the overall outstanding debt, they financed an increasing portion of mortgages each year, as much as 25% in 1978.[30] Consistent with a supplementary role, the 12.5% increase in the share of outstanding residential mortgage debt held in federally-insured mortgage pools or pools backed by federally-insured mortgages offset the 12.3% decline in the share held by thrifts (8.3% of which was in portfolios of mutual savings banks) between 1970 and 1982.[31]

By the late 1970s and early 1980s, during a prolonged period of tight credit, the GSEs had demonstrated a capacity to raise capital for housing at precisely the times that the traditional sources faltered. Furthermore, the GSEs provided relief to those very institutions by buying their low-yielding mortgages, allowing them to take them off their portfolios. Even better than selling newly originated mortgages, the ailing thrifts could "swap" some of the older, low-yielding mortgages on their portfolios in exchange for FNMA and FHLMC participations in MBSs.[32] The ability of traditional lenders to sell off the mortgages they originated became especially important in 1978-9 as thrift liability

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[28] Sivesind, 4.

[29] Congressional Budget Office, "The Housing Finance System and Federal Policy," 46.

[30] Sivesind, 1.

[31] Congressional Budget Office, "The Housing Finance System and Federal Policy," 104.

[32] Robert Furlow, "Securities Swap Proposed to Help S&Ls," *Hartford Courant*, August 18, 1981. *ProQuest Historical Newspapers* (accessed April 10, 2012).

deregulation began in earnest through the advent of MMCs, raising their cost-of-funds precipitously. By 1980, overall secondary market sales had risen to nearly half of the value of all mortgage originations that year (49.2%).[33]

In many ways the increased scale of secondary market activity, the creation of new institutions (GNMA and FHLMC), the changing status of existing institutions (further privatization of FNMA), and innovations in market instruments (the mortgage-backed security) during the 1970s marked a turning point in housing finance. As early as 1979, Federal Reserve Bank of New York economist Charles M. Sivesind heralded a "revolution in real estate finance," through the emergence of mortgage-backed securities.[34] Yet critically, as housing expert Jack Guttentag writes, "while the secondary market underwent substantial transformation during the 1970s, not much happened to affect segmentation of primary markets," that is, they remained local rather than national.[35] The traditional model of banks and savings and loans raising capital and lending locally still predominated. The decline in thrift holdings, offset by increased GSE purchases, had not yet been accompanied by any significant shift in mortgage origination (as would happen in the 1980s, with thrift originations dropping to 30% in 1990 from a high of 61% in 1976), indicating that thrifts had simply been selling off more of their originations. Until Garn–St. Germain, in 1982, thrifts had no choice but to continue their traditional lending role. Had thrift asset powers not been deregulated in 1982, it is

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[33] House Subcommittee on Telecommunications, Consumer Protection, and Finance, *Secondary Mortgage Market Enhancement Act: Hearings before the Subcommittee on Telecommunications, Consumer Protection, and Finance, of the Committee on Energy and Commerce*, 98th Cong., 2d sess., March 14, 1984 (Washington, DC: GPO, 1984), 119.

[34] Sivesind, 1-8.

[35] Jack Guttentag, "Recent Changes in the Primary Home Mortgage Market," *Housing Finance Review Housing Finance Review* 3, no. 3 (July 1984): 221-254, 244.

conceivable that the industry could have continued to serve as the primary mortgage originators, with growing secondary markets allowing the thrifts to move those mortgages off their portfolios, or with some other form of government intervention. However, by deregulating thrift asset powers, policymakers opened the space for new originators to gain market share as thrifts pursued non-housing investments.

In addition to being primarily countercyclical and supplemental, the growth of secondary market activity over the 1970s was almost exclusively government related.[36] The first notable private issues of conventional MBSs, by Bank of America and the First Federal Savings and Loan Association of Chicago, came in 1977. Salomon Brothers trader Lewis Ranieri later called the issue a "total failure" due to the illegality of the instrument in all but fifteen states.[37] Between 1977 and 1981, only $1.6 billion in private issues of MBSs were made to the public, and only $2.2 - $2.8 billion more were privately offered before June 1982.[38] Though private entities had issued mortgage-backed securities and bonds modeled after those issued by their government-sponsored counterparts, the private issues paled in comparison to the federally-related market share. As debate over the role of secondary markets continued into the 1980s, most policymakers agreed that greater private participation should be encouraged *alongside* a continuing GSE presence, while some argued that secondary markets should become wholly private.

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[36] Sivesind, 4.

[37] Lewis S. Ranieri, "The Origins of Securitization, Sources of Growth, and Future Potential," in Leon T. Kendall and Michael J. Fishman, eds., *A Primer On Securitization* (Cambridge: The MIT Press, 1996): 31-44, 33.

[38] Congressional Budget Office, "The Housing Finance System and Federal Policy, 45.

Secondary markets, and especially the GSEs, had been increasingly important during the 1970s, providing critical supplementation when traditional lenders scaled back lending during periods of rising interest rates. But it was not until the early 1980s, after Garn–St. Germain, that policymakers committed to a permanent and preeminent role for secondary markets in housing finance. At that point, relatively minor regulatory and legislative changes could redeploy the inherited institutional structure, including FNMA, FHLMC, and GNMA, to replace the thrifts, and the household deposits they collected, as the primary source of capital for residential mortgage finance. The remainder of this chapter will consider when and how policymakers would turn to the secondary markets to replace the thrifts, and how this change would thoroughly transform housing finance.

Envisioning the Future of Housing Finance, 1978-1983

Given the increasing importance of secondary mortgage markets and the GSEs during the 1970s, policymakers' decision that both would feature centrally in the future of housing finance was almost an easy one. Particularly as thrifts struggled to adapt to interest rate ceiling deregulation, and, after 1982, began to pursue the non-housing investment powers granted by Garn–St. Germain, consensus grew that secondary markets would play a vital role. Yet while the "turn" to secondary markets mainly embraced and accelerated changes already occurring in the marketplace (as a consequence of deregulation of thrift liabilities, and, later, thrift assets), it was early enough in the restructuring that policymakers could still shape the long-term direction and character of secondary markets in housing finance. Two major questions remained. First, what role, if any, would thrifts play in the restructured system of housing finance? If thrifts would not,

and most observers believed they could not,[39] hold long-term, fixed-rate mortgages in their portfolios, someone else would have to, or else the fixed-rate mortgage would disappear. Secondary markets allowed other capital investors, such as pension funds, which like 30-year mortgages had a long-term orientation, to own mortgages. But pension funds and other capital market investors would not be mortgage originators, so thrifts, like mortgage brokers, could have continued in their traditional role as the primary mortgage *originators*, even if they did not keep the mortgages on their own portfolios. The Garn–St. Germain Act, despite its statement claiming that expanded powers were intended to *preserve* the role of thrifts in housing finance, made this course less likely by allowing thrifts to become less devoted to residential mortgage lending. Subsequent policy also facilitated the emergence of mortgage brokers as the foremost mortgage originators, eclipsing the thrifts.

The second remaining question was: how would secondary mortgage market activity be divided between public and private parties? Some in the Reagan administration, especially in the Office of Management and Budget (OMB), wanted the secondary markets to be exclusively private, including full privatization of the GSEs (removing any link, explicit or implicit, between the GSEs and the U.S. Treasury).[40] But

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[39] See, for example, FHLMC President Philip Brinkerhoff, who said, "with the scheduled elimination of regulation Q and the evolving realities of inflation, lending institutions, whether they are thrift institutions or commercial banks, will never again finance on a broad basis long-term fixed rate mortgages with short-term deposit funds." House Subcommittee on Housing and Community Development, *To Expand and Reorganize the Federal Home Loan Mortgage Corporation*, 57.

[40] These critics understood that the U.S. Treasury would have to serve as a backstop to the GSEs if needed, and wished to remove that risk. The long-term goal of full privatization of FNMA and FHLMC was stated in the Administration's 1984 Budget as submitted to Congress. Senate Subcommittee on Housing and Urban Affairs, *Secondary Mortgage Market: Hearings before the Committee on Housing and Urban Affairs of the Committee on Banking, Housing, and Urban Affairs,* 98th Cong., 1st sess., May 5, 1983 (Washington, DC: GPO, 1983), 14, 29. See, for example, the testimony of Steve Bartlett in House Subcommittee on Housing and Community Development, *Secondary Mortgage Market: Hearings before*

this approach was soundly rejected by Congress, including the Republican majority in the Senate. The consensus that emerged from the legislative branch held that while private participation in the secondary markets should be encouraged, it was essential that the GSEs, with both the special advantages and obligations owing to their federal charter and oversight, continue to support housing during good times and bad (they assumed private players would not do the latter). By and large, lawmakers accepted the argument of secondary market proponents that by bringing new investors into housing, the supply of mortgage credit would increase and stabilize, translating into more affordable mortgage rates for borrowers. This presumed benefit, they reasoned, justified the risk borne by the U.S. Treasury in backing the GSEs. Though there is some indication that a Carter Administration Task Force on Housing for the Eighties would have investigated the implications of secondary markets on the cost of credit, that possibility was lost in the 1980 presidential election, and the central premise that secondary markets would benefit borrowers was otherwise generally unquestioned.[41]

The questions regarding the future role of the thrift industry and the appropriate mix of public and private activity in secondary markets were taken up by the Carter and Reagan administrations as well as Congress. Carter's "Interagency Task Force on Thrift Institutions," and short-lived "President's Task Force on Housing for the Eighties," and Reagan's President's Commission on Housing similarly concluded that whatever the continuing role of thrift institutions, secondary markets would play an increasingly

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the Subcommittee on Housing and Community Development, of the Committee on Banking, Finance and Urban Affairs, 98th Cong., 2d sess., February 1, 1984 (Washington, DC: GPO, 1984), 93.

[41] Robert Van Order wrote in 1984, "we now have a system that is well integrated with national and even international markets….Analytically, housing finance has developed to the point where we need not be ashamed to use our classical textbook models of competition." Van Order, "Foreword," *Housing Finance Review* 3, no. 3 (July 1984).

important role in raising capital for housing finance. The Interagency Task Force envisioned thrifts acting more like mortgage brokers, that is, continuing to originate and service mortgages, but selling them to investors through the secondary market rather than holding them in their own portfolios. Citing the "phenomenal growth of the secondary market in the 1970's," the task force expressed confidence that capital market investors would eagerly support an increasing volume of mortgages.[42] The task force made a handful of policy recommendations regarding secondary markets, urging state legislatures to remove any statutory restrictions against thrifts selling mortgages in the secondary market,[43] facilitation of pension fund investment in secondary markets, and relaxation of the requirement that S&Ls have 82% of their portfolios invested in qualifying housing investments in order to receive tax advantages.[44] The latter recommendation linked secondary market expansion to thrift asset deregulation, which the task force also recommended, but in this case with the explicit goal of continuing thrift mortgage origination.

The task force's report represented the fullest effort of the Carter Administration to articulate a vision of the future of housing finance. Had Carter defeated Reagan in the 1980 election, the continuing reassessment of housing finance would have fallen to the "President's Task Force on Housing for the Eighties," a group announced in October 1980. Chaired by former HUD Secretary Robert Weaver, the housing task force was

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[42] John Mingo, "Summary of First Rough Draft Chapters of the Task Force Study," May 19, 1980; DIDC: Rules Conference Report; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[43] Volcker, "Report of Activities of the DIDC," 23; Records of DIDC Meetings, May 6, 1980–Dec. 15, 1983; Records of the Depository Institutions Deregulation Committee; General Records of the Department of the Treasury; RG 56; NACP.

[44] Department of the Treasury, *The Report of the Interagency Task Force*, 84-5.

scheduled to report by June 30, 1981, but the outgoing administration never issued any findings, and it is not clear that the task force ever met. The "fact sheet" announcing the task force, is telling, nonetheless, and suggests a somewhat different approach than that Reagan's Presidential Housing Commission would later take. The fact sheet reaffirmed the deregulation of interest rate ceilings and the limited asset deregulation contained in the DIDMCA, and acknowledged that secondary market activity had brought stability to credit availability, but also noted that the growth of secondary market activity as well as deregulation had affected the cost of credit. Echoing findings of the earlier Interagency Task Force, the fact sheet concluded, "with the development of the secondary market, mortgages are being priced by investors like other capital market instruments and thus must maintain rates competitive with alternative investments."[45] For the "Task Force on Housing for the Eighties," the role of the secondary markets and the GSEs and their impact on credit cost would be the subject of inquiry and debate, as the desirability of expanded secondary market activities remained in question, whereas the Reagan commission viewed the benefits of the secondary markets as a foregone conclusion.

Established by Reagan's executive order on June 16, 1981, the President's Commission on Housing (PCH) was chaired by San Francisco Federal Home Loan Bank Chairman William McKenna. The body informed the administration's stance on the on-going Congressional debates leading to Garn–St. Germain, made recommendations for regulatory changes to enhance pension fund investment in mortgages, and formed the

[45] President's Task Force on Housing for the Eighties, "Fact Sheet," October 8, 1980; Housing–Community Development; Subject Files of Robert E. Moss; Office of the Assistant Secretary for Legislative Affairs; General Records of the Department of the Treasury; RG 56; NACP.

basis of the administration's side of the legislative push resulting in the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA).

Like the Carter housing groups that preceded it, the PCH saw housing finance in transition, with the thrifts reeling, and secondary markets rapidly expanding. The PCH also foresaw thrifts acting more like mortgage brokers in the future, but more so than the previous task forces or the lawmakers who had supported DIDMCA and even those who would support Garn–St. Germain, they explicitly sought a replacement for thrifts as the primary conduit of capital for housing. Reasoning that thrifts would utilize the expanded asset powers then being considered by Congress, the PCH argued in an interim report, "a strong industry that devotes a smaller portion of its portfolio of assets to mortgages could be a better source of housing funds than a weak industry fully committed to mortgage investment."[46] The PCH even asserted that a reduced role for thrifts would directly facilitate secondary market investment, "in properly functioning markets, a reduction in mortgage supply at thrift institutions would place upward pressure on mortgage yields, and investors that operate in both mortgage and other capital markets would move more funds into mortgages."[47] The underlying assumption, one not featured elsewhere in the commission's analysis, was that costs for borrowers, at least temporarily, would go up ("upward pressure on mortgages yields" for investors meant upward pressure on costs for borrowers).

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[46] The President's Commission on Housing, *Financing the Housing Needs of the 1980s: A Preliminary Report on Housing Finance* (January 1982), 6, folder "Housing Commission (6 of 6)," Martin Anderson Files, Ronald Reagan Library.

[47] Ibid., 54.

The overall emphasis of the PCH, however, remained that thrifts would no longer be singularly committed to housing finance. The commission had posited an alternative centered on a wider set of mortgage originators and investors, connected through secondary markets:

> In the future, housing will not be as dependent as it has been on this limited sector of the capital market; housing will draw more funds from a wide range of private institutions, including pension funds, insurance companies, and commercial banks. To encourage greater participation in housing finance by such institutions, the commission recommends the removal of various tax, legal, and regulatory impediments to widespread private investment in mortgages and mortgage-backed securities. Secondary markets dealing in new types of mortgage-related securities will help attract these new participants to housing finance.[48]

The commission envisioned a system of housing finance in which capital would come to the housing market not in the form of deposits, but in the form of investments, including, but not limited to, pensions. According to the principles outlined by the PCH, this increased investment would ideally be *private* investment, facilitated by *private* intermediaries, but at the time the dominant players in secondary mortgage markets were the "quasi-private" government chartered FNMA and FHLMC. "The government should create," the commission reported, somewhat paradoxically, "the economic and market environment necessary for a shift of certain government housing credit programs to the private sector and should carefully manage and monitor the changeover."[49]

The commission's members, which included industry representatives, regulators, and former lawmakers, had been carefully selected to reflect Reagan's free market and

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[48] *The Report of the President's Commission on Housing* (Washington, DC: GPO, 1982), xxix.

[49] Ibid., 157.

limited government orientation.[50] The PCH was indeed unapologetic in its ideological orientation, reporting, "the genius of the market economy, freed of the distortions forced by government housing policies and regulations that swung erratically from loving to hostile, can provide for housing far better than Federal programs."[51] The group's avowed faith in "the market economy" to provide the best housing outcomes may explain why it, unlike Carter's "Housing for the Eighties" Task Force, seemed unconcerned about the implications of increased secondary market activity for the cost of credit. Where the Carter group noted that as secondary markets more closely linked housing to capital markets, "mortgages … must maintain rates competitive with alternative instruments," the PCH either assumed that increased supply of capital through secondary markets would (eventually, if not immediately) lead to lower cost of credit, or that ensuring the availability of credit was more important than ensuring the affordability of credit.[52] In a free market, the commission argued, investors would participate in the secondary market "because financing the housing market is profitable, not because of regulation or indirect

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[50] The members of the Commission were: William McKenna (chair), Carla Hills (vice chair), Herbert Barness, Robert Boucher, Edward Brooke, Garry Brown, Bernard Carl, Richard Carver, Stuart Davis, G. Richard Dunnells, Richard Fore, Myra Goldwater, Lee Goodwin, Robert Hatch, Jasper Hawkins, Richard Helmbrecht, Peter Herder, Samuel Jackson, Charles Klumb, Sherman Lewis, Gordon Luce, Maurice Mann, Preston Martin, Robert Mathison, Martin Mayer, Richard Muth, George Shafran, Bernard Siegan, Kenneth Thygerson, and Charles Urstadt. Kent Colton served as staff director over a group that included John Weicher, David Seiders, Andrew Carron, and John Tuccillo. Of a group of possible members, Deputy Assistant for Policy Development Ed Gray advised, "it is absolutely essential that we know they are solid Reagan people who support the President and his economic policies and who will directly reflect that support in the work of the Commission." Memo, Ed Gray to Pendleton James, November 18, 1981, folder "Housing Commission (5 of 6)," Martin Anderson Files, Ronald Reagan Library.

[51] *The Report of the President's Commission on Housing*, xv-xvii.

[52] President's Task Force on Housing for the Eighties, "Fact Sheet," October 8, 1980; Housing–Community Development; Subject Files of Robert E. Moss; Office of the Assistant Secretary for Legislative Affairs; General Records of the Department of the Treasury; RG 56; NACP.

credit allocation."[53] Credit would be available, then, for those who could compete to get it.

President Reagan endorsed the Commission's recommendations, most concretely by instructing the Department of Labor to enable pension funds to invest in housing.[54] As of May 1982, pension funds were authorized to invest widely in mortgage-related securities, and, after January 1983, in securities backed by second mortgages.[55] But except for these changes, the PCH's policy recommendations would rely on action by Congress. For its part, the Congress proved much more ambivalent about the division of public and private secondary market activity than the PCH. There was, after all, no small amount of confusion over what was public or private activity given the ambiguous status of the GSEs. In hearings on secondary mortgage markets, for example, Democratic Congressman Tim Wirth (CO) noted recent buzz about private sector involvement in the secondary mortgage market, specifically citing a report that such activity had become "the largest, single profit sector for Salomon Bros."[56] "The mortgage-backed security in the Ginnie May form is, sir," witness Preston Martin, then a Fed Vice Chairman, clarified, "but not the kind of issue we are talking about here, that a private company, privately insured with conventional loans–I bet they can't even find the volume at

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[53] The President's Commission on Housing, *Financing the Housing Needs of the 1980s*, 7.

[54] Manuel H. Johnson, "Current Action and Recommended Changes that Aid the Housing Industry," memo to Regan, March 19, 1982; "United States Housing Policy," undated; Box 151; Folder 4; Treasury Department; Subject File; Housing: Working Group on Housing Policy, 1982; Papers of Donald T. Regan; Library of Congress; Manuscript Division. As of May 1982, pension funds were authorized to invest widely in mortgage-related securities, and, after January 1983, in securities backed by second mortgages. Congressional Budget Office, "The Housing Finance System and Federal Policy," 37-8.

[55] Ibid.

[56] House Subcommittee on Telecommunications, Consumer Protection, and Finance, *Secondary Mortgage Market Enhancement Act*, 102.

Salomon Bros. for that one. [Private sector growth had occurred only] if it is guaranteed or passed through Freddie Mac or some other of the other three agencies. Not if it is private, private, private, no sir."[57] The private sector was participating and profiting from the secondary mortgage market, but only by trading publicly guaranteed securities. The purely private market envisioned by the PCH did not then exist, and not everyone agreed that it could. Lewis Ranieri, the Salomon Brothers broker often credited as a pioneer in mortgage securitization, testified, "I agree with the potential growth of the [private] market. It is also true, however, that that additional growth cannot be expected, were not some relief to the private sector to be forthcoming. It would be my contention that the system would collapse in and of itself without that [government] relief. As to the agencies, I do not think anybody believes that the agencies do not have a vital role to play in this process, certainly in the near term, until a larger private sector exists."[58] While the ideological orientation of the PCH led to the conclusion that the agencies should get out of the market immediately, Ranieri, the practitioner, knew that the highly profitable arraignment he was perfecting for Salomon Brothers relied heavily on the guarantees offered by GNMA.

The GSE heads, whose corporate titles distinguished them from agency directors and cabinet secretaries, offered little help in clarifying the murky status of the FNMA and FHLMC. Their own descriptions belied the ambiguous nature of the GSE. David O. Maxwell, Chairman and CEO of FNMA, proudly asserted, "Fannie Mae is entirely self-supporting. We do not use the resources of the United States to carry out our business."

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[57] Ibid.

[58] House Subcommittee on Housing and Community Development, *Secondary Mortgage Market*, 304.

And yet, moments later, Maxwell identified and defended exactly how the resources of the United States helped FNMA to carry out its business, “Fannie Mae’s agency status, which enables us to borrow at favorable rates in the capital markets, is a very valuable tool for middle-income home buyers in this country, and a creative and magnificent tool that has saved the American taxpayers billions of dollars since Fannie Mae became a private company in 1970.”[59] Maxwell’s counterpart, Kenneth J. Thygerson, President of the FHLMC, sounded a similar tone, though more directly acknowledging the debt and responsibility of the GSE, “no Federal appropriations or outlays support the operations of Freddie Mac. The Corporation’s congressional charter and ties to the Federal home loan bank system do nevertheless provide it significant advantages to fulfill its congressional mandate. Consequently, Mac believes that these advantages bring with them commensurate duties and responsibilities to the Congress and to the public.”[60]

As Congress reassessed the role of the GSEs and secondary markets within the rapidly evolving structure of housing finance, many of its members showed a reluctance to let go of the potential influence that could be wielded through the GSEs if they remained obligated to the public interest. It was Lew Ranieri, of all people, who pointed out during Congressional testimony, “to view the capital market in the context of housing without the agencies is to leave the Congress without the very valuable tool of public policy that the agencies represent by their sheer girth.”[61] The more the secondary markets were turned over to private entities (if that was even possible), the less effective that

[59] Ibid., 80.

[60] Ibid., 94.

[61] Ibid., 304.

"valuable tool of public policy" would become. Representative of many lawmakers, who saw continuing utility of holding the GSEs to public account, New York Republican George Wortley reminded Maxwell, "You may be a private company. Nevertheless, your charter comes from the Government. And you have to come back to us."[62] As policymakers embraced and sought to facilitate the greater role of the secondary markets in housing finance, the consensus that emerged aligned with Wortley's view rather than that advocating the complete privatization of the GSEs. Congress would move to increase private participation in the secondary markets, but would maintain a prominent role for the GSEs while holding them accountable to their federal charters.

The Secondary Mortgage Market Enhancement Act–No Turning Back

The policy initiative to facilitate the shift to secondary markets as the primary source of mortgage capital eventually took the form of the Secondary Mortgage Market Enhancement Act of 1984 (SMMEA), as a majority in Congress came to agree that "as the demand for housing rises throughout this decade, the sale of mortgage backed securities to provide housing credit will become increasingly important."[63] The emerging consensus that secondary markets would replace the thrifts crystallized in SMMEA as lawmakers sought to remove any impediments to their continuing growth. In addition to endorsing secondary markets as the main source of capital for housing, the SMMEA attempted to facilitate participation of private (meaning other than the quasi-private GSEs) entities in secondary market activities, through "procedural deregulation" to

[62] Ibid., 81.

[63] House Report 98-994, 7.

facilitate purchase and exchange of MBSs, by opening MBSs to institutional investors, and by limiting the competitive advantage of the GSEs. The Act also preserved the market for securities backed by mortgages of over $108,300 to the (fully) private sector, while recognizing, "the continuing and important role [Fannie Mae and Freddie Mac] will play especially to the market serving lower and middle income homebuyers."[64] The Act's emphasis on MBSs indicated policymakers' preference for that model, as opposed to FNMA's portfolio approach. The bill authorized "updates" to existing regulation to extend registration exemptions to include securities backed by manufactured and cooperative home loans as well as second mortgages, those backed by other mortgage pools, and by any HUD-approved mortgages so as to include those issued by mortgage bankers as well as by depository institutions. It also facilitated investment in MBSs by depository institutions, arguing that such investments would not jeopardize the safety and soundness of the institutions given that the MBSs "are backed by a pool of many mortgages with relatively low default risk as well as mortgage insurance on both the individual mortgages and the pool."[65]

SMMEA emerged from the policymakers' attempt to reconcile their desire for a robust mortgage market and the rapid withdrawal of thrifts from residential mortgage lending. By 1983-4, as S&Ls exercised their new asset powers it became commonplace to attribute the need for expanded secondary markets to deregulation.[66] Congressman

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[64] Senate Committee on Banking, Housing and Urban Affairs, *The Secondary Mortgage Market Enhancement Act of 1983,* 98th Cong., 1st sess., S. Rep. 293 (Washington DC: GPO, 1983), 3.

[65] Ibid., 6.

[66] The Senate Report accompanying the bill that would become the Secondary Mortgage Market Enhancement Act summarized, "deregulation of the financial services industry and the memory of the experiences of the 1981-1982 recession are combining to further erode the role of the portfolio lender of mortgage capital." Ibid., 2.

Wirth summarized the evolving role of the secondary markets in the context of deregulation:

> Government-sponsored agencies have been called upon to support mortgage originators and have turned to the capital markets as a source of funds for housing. Private participants have entered the arena, and [the Secondary Mortgage Market Enhancement Act] seeks to further encourage their participation. The rapid growth of the secondary mortgage market is a response to a major regulatory change–the lifting of regulation Q ceilings on short-term deposits. Because of this change, banks and thrifts must now pay market rates of interest on deposits and many no longer want to accept the risk of using short-term, variable-rate funds to make long-term fixed rate mortgage loans. Many experts argue that depository institutions will no longer be able to provide sufficient credit for housing. New sources of long-term funds are said to be required to meet the rising needs for mortgage credit.[67]

To the extent that depository institutions, particularly thrifts, would continue to contribute to housing finance, FNMA CEO Maxwell suggested that they "are going to function more like mortgage bankers."[68] Thrifts could continue to lend, but increasingly would raise funds from secondary market investors rather than depositors.

Consistent with arguments made in favor of deregulation in other arenas, proponents argued that new rules to broaden participation in secondary markets would benefit consumers, in this case explicitly consumer-borrowers. Lawmakers were generally less likely to tout the benefits to consumer-investors though their interests were certainly at stake, and who, arguably, were even more likely to benefit. Senator John Tower, declared, "it is the hope of this [Senate Banking] committee to support a properly

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[67] House Subcommittee on Telecommunications, Consumer Protection, and Finance, Committee on Energy and Commerce, *Secondary Mortgage Market Enhancement Act*, 1-2. See also the testimony of John Teutsch, Jr. of the Mortgage Bankers Association legislative committee. Teutsch testified, "deregulation of depository institutions has dramatically accelerated the development of the secondary mortgage market. During the 1970s, annual secondary market loan sales to investors averaged 35 percent of the volume of loans originated. Since then, the secondary market has become even more important. In 1982, secondary market loan sales of new mortgage loans reached 73 percent of the volume of mortgages originated." House Subcommittee on Housing and Community Development, *Secondary Mortgage Market*, 190.

[68] Ibid., 78.

functioning market in which funds can flow freely to meet demands, not unduly influenced by any one sector of the industry or any one organization, but subject to healthy competition which creates the lowest price and fairest terms to the home buyer."[69] The Committee's report, recommending the bill's passage, added that "as population shifts and home building demand moved cross country to the west and southwest, the demand for mortgage capital and its sources became separated," arguing that efficient national secondary markets would get capital where it was needed, erasing regional differences.[70]

Opening housing investment more fully to private investors in the capital market, argued Ralph Horn of the Dealer Bank Association, was essential to maximizing competitive forces to the benefit of consumers. "Without full participation by all financial institutions in the capital market system," Horn testified, "potential homeowners will be unduly penalized because the market will not work as efficiently as it can. A highly-efficient secondary mortgage market should not only make it easier for families to buy their own homes by keeping mortgage interest rates down, but should also increase demand for housing, and thereby increase jobs in the construction and other related businesses."[71] Horn's primary objective, of course, was to make sure that banks could underwrite and deal mortgage securities, and the argument that such powers would benefit homeowners could only help. Ranieri upped the ante, claiming that the future of the fixed-rate mortgage, still held dear by most policymakers despite the recent

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[69] Senate Subcommittee on Housing and Urban Affairs, *Secondary Mortgage Market*, 1.

[70] Senate Committee on Banking, Housing and Urban Affairs, *The Secondary Mortgage Market Enhancement Act of 1983,* 2.

[71] House Subcommittee on Housing and Community Development, *Secondary Mortgage Market*, 119.

authorization of ARMs, depended on the secondary market, and thus for borrowers over the price limits for FNMA and FHLMC, on *private* participation in the secondary market.[72] Ranieri explained that MBSs would result in lower mortgage rates for borrowers by increasing the supply of credit, moving capital from areas of surplus to areas of demand, and by reaching a wider range of investors through collateralized mortgage obligations.[73] Senators Riegle, Cranston, Sarbanes, Dodd, Dixon, Sasser, and Lautenberg agreed on the benefits of secondary markets, underscoring the need for increased credit for housing as the so-called "baby boomers" reached the age that many of their parents had become homeowners, citing that "leading housing analysts suggest that mortgage-backed securities will have to supply over 75% of all housing credit by 1990."[74] But the group was less convinced about fully private participants, calling GNMA, FNMA, and FHLMC "the foundation of our country's housing finance system."[75]

Indeed, while the bill aimed to facilitate private participation in the secondary markets, the debate occasioned a hearty defense of a continuing role for the GSEs. While some in the Reagan administration, especially in the OMB, favored the complete privatization of the secondary markets, many in Congress insisted that the GSEs played

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[72] Ibid., 258.

[73] Ibid., 273.

[74] Senate Committee on Banking, Housing and Urban Affairs, *The Secondary Mortgage Market Enhancement Act of 1983*, 18. For a different, but still sizable estimate, see David Maxwell, President of FNMA, testified, "I think it is recognized by every one involved in the housing finance business that the secondary mortgage market is going to become more and more important…. We estimate that at least 50 percent of [the estimated $1.6 trillion in financing for housing during the 1980s] will have to come from the secondary mortgage market." House Subcommittee on Housing and Community Development, *Secondary Mortgage Market*, 68.

[75] Senate Committee on Banking, Housing and Urban Affairs, *The Secondary Mortgage Market Enhancement Act of 1983,* 18.

an indispensable role in housing finance. Texas Democrat Henry Gonzalez argued, “I feel that the primary mission of these institutions [Fannie and Freddie] is to serve the great middle segment of the housing market….Let it be recorded that these institutions–more than any other force–kept the housing industry alive during the deepest part of the recession. These institutions were active in the market when no one else was; they remain the biggest and most vital force in stabilizing and strengthening the homebuilding industry.”[76] The main contention of the privatization proponents, such as the PCH, was that government should not do anything that private enterprise could do. Gonzalez countered that government intervention was necessary precisely to do what private enterprise would not do. Others, like FHLBB Chairman turned Merrill Lynch executive, Richard Pratt, acknowledged the pioneering role that the GSEs had played in the innovation of the mortgage-backed security and the collateralized mortgage obligation, and in developing the secondary markets more generally, but argued that private entities could now take over the bulk of secondary market activity.[77] Ultimately, the SMMEA struck a compromise, seeking to stimulate private participation, but not by scaling-back the GSEs. The Senate report on SMMEA defended the continuing role of the quasi-private entities, “We want to point out, in particular, that this bill rejects the radical suggestion of some members of the Administration who want to quickly terminate or greatly reduce the Federal Government’s role in housing finance.”[78] The GSEs, the report

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[76] House Subcommittee on Housing and Community Development, *Secondary Mortgage Market*, 23.

[77] Ibid., 277.

[78] Senate Committee on Banking, Housing and Urban Affairs, *The Secondary Mortgage Market Enhancement Act of 1983,* 18.

argued, would support the secondary markets in good times as well as continuing their countercyclical role when private investors might retreat.

Republican Congressman Bill McCollum (FL) called for further study of the secondary mortgage markets and the role that the GSEs should play within them, suggesting that the Congress did not yet have a handle on the dramatic changes taking place in housing finance.[79] Except for this reservation, the bill received enthusiastic bipartisan support and passed by voice vote in both houses. President Reagan signed the bill into law on October 3, 1984. To facilitate institutional investment in MBSs, the Act authorized that in cases in which state or federal law limited investment options to U.S. Treasury obligations, that "securities issued or guaranteed by the Federal Home Loan Mortgage Corporation or the Federal National Mortgage Association, shall be considered to be obligations issued by the United States for purposes of the limitation."[80] The Act allowed the GSEs to purchase loans on manufactured homes and second mortgages, and, crucially, it included mortgages issued by any HUD-approved mortgagee (mortgage brokers and companies) as qualified for mortgage related securities for the purposes of the Act.

The Secondary Mortgage Market Enhancement Act of 1984 put a Congressional stamp on and further facilitated the rapid growth of the secondary markets as the primary source of capital for residential mortgages. While commercial banks continued to originate mortgages at roughly the same share of the market as they had through the postwar era, the traditional leaders in origination, the thrifts, quickly became marginal

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[79] *Congressional Record,* 98th Cong., 2d sess., 1984, 130: 24855. *ProQuest Congressional* (accessed August 14, 2012).

[80] PL 98-440, Sec. 106.

players. By the mid-1980s, three of the most central aspects of the New Deal system of housing finance, interest rate ceilings, the fixed-rate mortgage, and finally, the thrift industry, had been, respectively, ended, challenged, and diminished. Thereafter, instead of a protected source of low-cost deposit funds, investment capital raised in secondary markets would finance the majority of residential mortgages, fixed-rate mortgages would compete with adjustable-rate alternatives, and mortgage companies would become the primary mortgage originators. Like the New Deal system before it, the newly reconfigured system of housing finance would shape opportunity for homeownership. The assumption of most policymakers who had supported SMMEA and the turn to the secondary markets was that by bringing in more investors, the secondary markets would increase the supply and stability of credit, leading to more affordable credit for borrowers.

Implications for Fair Housing and Community Reinvestment

Debate over the secondary mortgage enhancement bill provided on-going opportunity to examine the consequences of the changing institutional and structural landscape of housing finance, but unlike for the PCH, this debate occurred after Garn–St. Germain. Like the PCH, however, the relevant congressional committees largely passed on taking a closer look at the implications of secondary markets for the cost of credit. But in view of the precipitation of thrifts' withdrawal from residential mortgage lending as they exercised their widened investment powers, those same committees did discuss the consequences of the increasing importance of mortgage companies or brokers. One of the central arguments of this study is that deregulation and the restructuring of housing

finance undermined fair housing and community reinvestment policies by reducing the share of mortgage origination by the institutions targeted by those policies. Remarkably, policymakers largely failed to anticipate or even consider the implications of such a fundamental change. Yet because policymakers recognized that secondary markets would facilitate mortgage origination by mortgage brokers, debate over the SMMEA presented a ripe opportunity for just such a consideration. Indeed, critics raised concern over the (comparatively) unregulated status of mortgage brokers during SMMEA hearings, but it was not over the interests of consumer-borrowers, much less those borrowers that fair housing and community reinvestment policies were intended to protect, rather, it was over the interests of investors that critics called for caution. Gale Cincotta, who led the push for the CRA in 1977, alone raised the issue of a lack of fair housing and reinvestment accountability for unregulated originators, but her call for extension of the CRA to all financial institutions, especially new entrants to housing finance as well as mortgage brokers, went unheeded.

Concern over investor protection arose over the "procedural deregulation" in SMMEA, which included provisions to loosen the requirements governing registration of mortgage-backed securities. MBSs pooled mortgages over time, most of them *after* investors had first committed to purchase the security. Instead of requiring individual registration of each security, beginning in 1981, SEC regulators allowed for continuous registration, by which, as long as the underlying mortgages remained essentially similar, subsequent securities could be issued under the previous registration. SMMEA added to the SEC's loosening of registration regulations by exempting registration of MBSs sold

to institutional investors in amounts of $250,000 and higher, and, crucially, made this exemption applicable to securities backed by mortgages issued by mortgage brokers.

Critics of these loosened regulations raised two main objections. First, the registration exemptions would require less disclosure to investors. While policymakers intended the $250,000 threshold to separate “sophisticated,” from “unsophisticated” investors (the former needing less protection), Henry Schechter of the AFL-CIO suggested that large pension funds, for example, might be managed by inexperienced investors but still meet the $250,000 minimum. Schechter additionally pointed to the higher default rates of second mortgages, which would also qualify for exemption under the bill.[81] Fed Vice Chairman Preston Martin too expressed misgivings about the registration exemptions and the more fundamental problem of lacking sufficient knowledge about the pools of mortgages behind the securities. Martin raised further objection to SMMEA’s loosened regulations, questioning the extension of exemptions to securities backed by mortgages issued by mortgage brokers. Martin argued, “I have some trouble with extending the SEC exemption to all HUD-approved mortgagees, including mortgage companies not subject to the levels of supervision, and regulation and examination that depository institutions have. It raises questions of the quality of the mortgages in the underlying pool, and they can vary very greatly….”[82] Martin suggested that some minimal “parameters” might be advisable, including registration of the loan to

[81] House Subcommittee on Telecommunications, Consumer Protection, and Finance, *Secondary Mortgage Market Enhancement Act*, 282.

[82] Ibid., 87-8. Michael Wise, of the U.S. League of Savings Associations, added, “as closely supervised institutions specializing in mortgage lending, we are concerned about any open invitation to unregulated entities to provide mortgage credit through these new securities products.” House Subcommittee on Housing and Community Development, *Secondary Mortgage Market*, 121.

value ratios, geographic distribution, and insurance status of mortgages and/or the pool, and, favored exempting only the top two ratings categories.[83]

Richard Malmgren of the North American Securities Administrators Association even warned that lax regulation, particularly preemption of state regulations, could create openings for questionable or even illegal lending practices, though not mentioning discrimination in particular. “As a deregulatory mode or concept permeates Federal regulation,” he argued, “that increases the opportunity for certain segments of our society to come into a particular State jurisdiction and involve themselves in illegal activity.”[84] In other words, the exemptions created a regulatory blind-spot, in which mortgage origination would take place outside of the purview of the federal financial regulators.

These warnings, drawing attention to the comparative lack of oversight over mortgage brokers and the problem of questionable quality of mortgages underlying MBSs, were quickly dismissed by key regulators and other witnesses. SEC Chairman Charles Cox indicated that concerns over investor protection had been resolved to the Commission’s satisfaction. Former FHLBB Chairman Richard Pratt and MBS trader Lewis Ranieri too assured the committee that the ratings agencies offered adequate protection to consumers. At the time, Moody’s had been the only ratings agency to develop a presence with mortgage related securities. But faith in the ratings agencies was not universal. Malmgren had noted in testimony that Moody’s fourth category included “securities where ‘certain protective elements may be lacking or may be characteristically

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[83] House Subcommittee on Telecommunications, Consumer Protection, and Finance, *Secondary Mortgage Market Enhancement Act*, 87.

[84] Ibid., 48.

unreliable over any great length of time.'"[85] Subcommittee Chairman Tim Wirth (D CO), similarly pressed Cox on the role of the ratings agencies, citing an SEC report that had found that Moody's ratings of New York City securities had misled investors in the mid-1970s. But Cox replied that the fact that the exemption applied only to purchases over $250,000 meant that such protections were not necessary.[86]

A second critique of the turn to secondary markets emerged out of concern over concentration of financial power among a few financial firms. This line of argumentation also had clear implications for community reinvestment. Keith Willoughby of the National Council of Savings Institutions warned, "if the terms of … mortgages [originated for sale in secondary markets] are dictated by investment bankers, we believe it will change the nature of capital markets in this country dramatically… the lack of participation of local financial institutions in the marketing of such securities will lead to the concentration of capital flows [that] would be undesirable for this country."[87] Representing the S&Ls, Michael Wise, of the U.S. League of Savings Associations, cautioned that while thrifts could originate and buy securities, "the intervening steps, issuance, underwriting, and distribution, would be left to others, especially to the Wall Street firms. We do not understand why Congress would want to concentrate the capital for home finance in this way."[88] The ABA too opposed concentration of benefits to "four or five dominant securities firms," but ultimately endorsed the concept of secondary market enhancement so long as commercial banks could underwrite and deal all types of

[85] Ibid., 73.

[86] Ibid., 73, 78.

[87] Ibid., 188.

[88] Ibid., 145.

mortgage-backed securities.[89] All self-interested defenses of local depository institutions, these critiques nonetheless spoke to a public interest concern, the concentration of capital. The same system that promised to deliver credit more efficiently throughout the nation also had the potential to channel capital predominately through a few money-center financial services firms, including, as it turned out, the quasi-private Fannie and Freddie. Though capital might flow more freely, it would flow to whoever could compete to pay for it. Credit would be allocated by market demand, which could be vastly different from allocation based on the local obligations of depository institutions. Markets would measure demand by ability/willingness to pay, not by need, likely leaving the credit-starved locations championed by CRA activists wanting.

The lone voice calling attention to the implications of secondary market growth for the CRA, Gale Cincotta argued that the concentration of capital threatened the mechanisms for securing credit for underserved neighborhoods. "If American Express, J.C. Penney, Sears, Equitable Life, Dreyfus, Beneficial, Parker Pen, and Western Family, a chain of furniture stores, want to play in the financial game," Cincotta said of the financial services firms that would increase their involvement with housing via secondary markets, "they all must play by the same rules and meet the credit and service needs of the communities where they are doing business. This is what we call a level playing field…. If Merrill Lynch is bullish on America, why aren't they bullish on our communities?"[90] Seeking greater accountability for the mortgage brokers and other non-bank entities that did not fall under the authority of the CRA, Cincotta requested an

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[89] Ibid., 201.

[90] Ibid., 417.

extension of the act to cover "the entire national financial services industry."[91] But of Wirth's "traditional concerns" only investor protection found a place in an agenda primarily concerned with market efficiency. The CRA's efficacy in assuring fair and equal access to credit and capital and related concerns about concentration of financial power were drowned out by promises of more efficient allocation of capital.

The Cost of Credit

A final critique of the secondary markets raised during Congressional hearings questioned the most fundamental claim of secondary market proponents, that they would benefit consumer borrowers. It was Michael Wise, who, like the Carter Task Force on Housing for the Eighties before him, raised doubts about the implications of secondary markets on consumer cost:

> As mentioned, we are somewhat skeptical about claims that the efficiencies made possible by mortgage securities will result in significantly lower mortgage rates for homebuyers. That is an untested proposition. It is entirely possible that the addition of new middlemen could diminish the alleged rate savings. In addition, there are obviously winners and losers in local markets when mortgage rates are dominated by national securities products which tend to even out rates throughout the country…. We don't really know if the mortgage-backed securities products enhanced by this legislation will deliver more affordable home loans.[92]

But claims about competition and efficiency ruled the day. The majority of policymakers bought into the assertion of the free market thinkers of the PCH that secondary market efficiencies would benefit consumers. As secondary markets attracted new investors to housing finance, they reasoned, the supply of credit would increase, assuring both the availability and affordability of residential mortgages.

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[91] Ibid., 416-7.

[92] Ibid., 145.

Congressman Wirth, who had chaired the House Telecommunications, Consumer Protection, and Finance Subcommittee's hearings on the Act, however, felt the issue needed to be revisited. In hearings held in April 1984, titled "Financial Restructuring: The Road Ahead," Wirth cautioned, "given the rapidity of change outside the existing legal framework," he argued, "a new financial system could emerge that fails to balance concerns for competition and efficiency against our traditional and equally valid concerns for safety and soundness; for the protection of investors, depositors and policy holders; for the fairness and equity of access to capital and credit; and for the prevention of conflicts of interest and financial concentration. These principles have been ignored in the rush to deregulate."[93] Wirth saw in the recommendations of the PCH, the SMMEA, and the changing marketplace itself, the elevation of "competition and efficiency" over goals that had been, for much of the twentieth century, sought through regulation.

The consequences of the turn to the secondary markets, instead of unmitigated benefit to borrowers, have been greater costs and risks for borrowers, a shift to a majority of originations by under-regulated mortgage companies and brokers, and greater systemic risk. Both the increase in borrower cost and the shift in mortgage origination undermined fair housing and community reinvestment policies. Increasing borrower cost under the deregulated system of housing finance meant that fair housing and community reinvestment policies opened up access to credit to previously excluded borrowers on less favorable terms than those available to borrowers who had accessed credit under the New Deal system. This historic inequity perpetuated racial inequality, as well as imposing

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[93] House Subcommittee on Telecommunications, Consumer Protection, and Finance, *Financial Restructuring: The Road Ahead: Hearings before the Subcommittee on Telecommunications, Consumer Protection, and Finance, of the Committee on Energy and Commerce*, 98th Cong., 2d sess., April 4, 5, and May 17, 1984 (Washington, DC: GPO, 1984), 1-2.

comparative hardships on all borrowers under the new system. But fair housing and community reinvestment policies themselves became less effective under the new system as more and more mortgage origination shifted away from the depository institutions that fell under the hard-won fair housing and reinvestment regulations and to the comparatively less regulated mortgage companies and brokers. Secondary markets brought more investors to housing finance, creating an incredible amount of residential mortgage credit, but the cost and quality of that credit detracted from the advantage of increased credit availability.

Several complementary pieces of evidence support the claim that the deregulated system of housing finance increased cost to borrowers. The logic of the operation of the secondary markets, with increased intermediaries and a shift from reliance on savings-capital to investment-capital, suggests higher costs compared to the New Deal system.[94] Capital raised in secondary markets differed in character from that traditionally raised by depository institutions. Secondary market capital was investment capital, speculative by nature, with varying expectations regarding risk and correspondingly variable compensation for such risk (with some investors taking on higher risk for the chance of higher returns). In an integrated capital market, housing finance competed with other investment options, meaning that capital went to housing when it offered comparative

[94] Ann Meyerson, Greta Krippner, and Michael Stone all argue that the deregulated system, without interest rate ceilings to control the cost of funds, would lead to higher borrowing costs. Meyerson and Krippner point to increased cost due to fees as well as interest rates. Countless bank and thrift officials repeatedly insisted that as they paid more for funds that they would charge higher rates to borrowers. Under the new system, however, fewer residential mortgage borrowers received loans from depository institutions, and thus, the dynamics of the secondary markets were especially important in affecting cost. Key in that regard was the addition of intermediaries and the yield expected by investors. Ann Meyerson, "The Changing Structure of Housing Finance in the United States," *International Journal of Urban and Regional Research* 10, no. 4 (1986): 465-497. Greta R. Krippner, *Capitalizing on Crisis: The Political Origins of the Rise of Finance* (Cambridge: Harvard University Press, 2011). Stone.

benefits to investors in return and security. By comparison, depositors had placed household savings in banks and thrifts at no risk (after the advent of deposit insurance) and with little speculation over future returns. These depositors valued safety, convenience and liquidity in addition to a modest rate of return. This vast pool of deposit capital supplied lenders with low-cost capital that they could lend profitably at relatively low rates.

Secondary market capital was also more mobile than that deposited in local institutions. Though deregulation and technological changes were reducing barriers, the Community Reinvestment Act continued to restrict the mobility of deposit-capital, that is, it had to be invested locally. Secondary market proponents argued that the comparatively mobile investment-capital would more efficiently match supply and demand. In theory, this quality could benefit capital-short communities, but demand would be measured not by need, but by the profitability of lending in a particular area. In other words, capital could be more available, as long as borrowers could compete to pay for it. Capital-deprived communities, of course, were least able to bear such costs.

Reliance on secondary markets meant additional intermediaries in housing finance. Rather than a thrift originating and holding a mortgage, a lender would originate a mortgage; the lender or another party would then service the mortgage; then another party might insure the mortgage; another party would bundle the mortgage with others and create a security (mortgage-backed security); a ratings agency would assess the quality of the pool. Each of these intermediaries would be compensated for their services, and then an investor, expecting a return, of course, would buy the security. Indeed, the turn to secondary markets was as much about giving new investors and financial

institutions access to housing, recall, as Don Regan noted "real estate, of course, is a huge market," as it was about giving homebuyers access to new investors and capital.[95] Supporting the profits of all of these intermediaries and the return to investors meant that credit raised in secondary markets would cost more than that raised in depository institutions under interest rate ceilings.

Several indicators of housing affordability point to increasing costs through the 1980s despite subsiding inflation.[96] The rate of homeownership began to stagnate after decades of increase,[97] foreclosures increased,[98] and housing scholars, in response to changing costs, adjusted the "rule of thumb" from 25% to 30% as the amount of income that households should be expected to devote to housing.[99] Frank S. Levy and Richard C. Michel write in their 1991 study, "the percentage of a young family's income necessary to pay the principal and interest on a new home rose from 15-16 percent in the 1950s and 1960s to 28 percent in the 1980s."[100] This affordability crunch was not exclusively attributable to changes in housing finance, rising construction costs and stagnant wage growth also played a role, but higher mortgage interest rates indicate that the new system

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[95] Regan, "The Changing Market Place."

[96] Using constant 1986 dollars, William C. Apgar and H. James Brown found in 1988, "the after-tax cash cost of homeownership, although down from its recent peak, remains high by historical standards." Though the amounts (in 1986 dollars) vary by region, they follow the same general pattern indicated above. Apgar and Brown, *The State of the Nation's Housing, 1988* (Cambridge: Joint Center for Housing Studies of Harvard University, 1988), 1.

[97] Kenneth A. Snowden, "Housing Units, by Occupancy and Ownership: 1890-1997." *Historical Statistics of the Unites States Millennial Edition Online*. Eds. Susan Carter et al. (Cambridge University Press, 2006).

[98] Kenneth A. Snowden, "Mortgage Foreclosures and Delinquencies: 1926-1979." Ibid. Kenneth A. Snowden, "Delinquency and Foreclosure Rates for Single-family Home Mortgages: 1979-1999." Ibid.

[99] Alex F. Schwartz, *Housing Policy in the United States: An Introduction* (New York: Routledge, 2006), 23.

[100] Frank S. Levy and Richard C. Michel, *The Economic Future of American Families: Income and Wealth Trends* (Washington, DC: Urban Institute press, 1991), 87.

increased costs for borrowers. Data presented by Michael Stone on the inflation-adjusted mortgage interest rate on single family conventional mortgages show that while coming down from an early 1980s peak, rates remained higher into the 1990s than they had been at any time between 1967 and 1981.[101] While some academic studies have shown modest benefit to borrowers attributable to either secondary markets or GSE participation, in particular, others have found no indication of benefits to borrowers. Taken together, the logic of the new system, the lack of scholarly consensus on benefits to borrowers, and evidence of higher mortgage interest rates, make a compelling case that borrowing costs were in fact higher under the deregulated system of housing finance.

A number of studies have sought to quantify the benefit gained by secondary market activity as promised by secondary market proponents, public, private, and quasi.[102] A 1989 study of California loans closed in 1978 and 1986 by Patric Hendershott and James Shilling found that conforming loans (those meeting Fannie Mae and Freddie Mac qualifications, less than $153,000 in 1986) had rates of 15 to 30 basis points lower than nonconforming loans.[103] A series of further studies found similarly modest benefits to homebuyers, finding between 16 to 21 basis points in lowered rates attributable to securitization or other secondary market activity. Other studies, notably those by Steven Todd and by Andreas Lehnert, Wayne Passmore, and Shane M. Sherlund, reported no relationship between mortgage rates and securitization. Todd, accounting for different risk associated with adjustable- and fixed-rate mortgages, found no gains to homebuyers

[101] Stone, 169-183.

[102] For a review of this literature, see John J. McConnell and Stephen A. Buser, "The Origins and Evolution of the Market for Mortgage-Backed Securities," *Annual Review of Financial Economics* 3 (2011): 173-92.

[103] Patric H. Hendershott and James D. Shilling, "The Impact of the Agencies on Conventional Fixed-Rate Mortgage Yields," *Journal of Real Estate Finance and Economics*, 2, no. 2 (1989): 101-115, 101.

in terms of interest rates from passthrough securities or CMOs, but did conclude that securitization correlated with reduced fees (which may have been attributable to institutional changes in origination, rather than securitization per se).[104] Lehnert, et al., focusing on the GSEs, and on purchases rather than MBSs, find "that GSE portfolio purchases have no significant effects on either primary or secondary mortgage rate spreads."[105] Quigley likewise argues "there is little or no evidence [that GSE purchases] stabilize cyclical swings in home purchases or reduce interest rates to home purchasers."[106] In sum, there is no scholarly consensus that secondary mortgage activity reduced interest rates for borrowers, and those studies that do find benefits for home buyers calculate gains that fall short of what secondary market proponents predicted in the early 1980s. Into the 1990s, inflation-adjusted mortgage rates remained higher than they had been at any point between 1967 and 1981, indicating that the newly reconfigured system of mortgage finance was in fact more costly than the New Deal system.

As costs increased, credit quality also declined. "In the opinion of most informed observers," Jack Guttentag wrote in 1984, "residential mortgage-loan quality deteriorated markedly during 1980-84… heavily driven by parties who profit from transactions, but do not take any significant risk."[107] As secondary market investors purchased loans, they, or the insurers of those loans, assumed the risk from the originator. Unlike the depository

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[104] Steven Todd, "The Effects of Securitization on Consumer Mortgage Costs," *Real Estate Economics* 29, no. 1 (2001): 29-54.

[105] Andreas Lehnert, Wayne Passmore, and Shane M. Sherlund, "GSEs, Mortgage Rates, and Secondary Market Activities, "*Journal of Real Estate Finance and Economics* 36 (2008): 343-363.

[106] Quigley, 281-309.

[107] Guttentag, 250.

institutions that had held the mortgages they originated in their own portfolio, the mortgage brokers that became the primary originators retained no such risk once they sold a mortgage in the secondary market. This moral hazard, coupled with comparatively less regulatory oversight, created opportunity for a host of predatory lending practices. Secondary markets also facilitated issuance of the risk-shifting adjustable-rate mortgages. In 1981, the year that ARMs were federally authorized, FNMA purchased over $100 million of the new instruments. FNMA, according to President David Maxwell, brought "standardization to the ARM market [that was] essential for attracting mortgage capital, especially from non-traditional lenders–and to reduce buyer confusion."[108] The shift of risk associated with ARMs and the deterioration of credit quality in the 1980s was only exacerbated in the 1990s as a subprime mortgage market developed.

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The turn to secondary markets accelerated and then completed the transformation of housing finance. By the mid-1980s, central elements of the New Deal system had been significantly altered or altogether dismantled. Interest rate ceilings, which had enabled the growth of the thrift industry in the 1930s and 1940s and provided a protected source of low-cost funds to housing lenders throughout the post-war decades, were fully deregulated. This first step in deregulation, carried out in the name of "small savers," initiated crisis conditions for thrifts, which, in turn, justified further asset deregulation

[108] Senate Subcommittee on Financial Institutions and Consumer Affairs and the Subcommittee on Housing and Urban Affairs of the Committee on Housing, Banking and Urban Affairs, *Adjustable Rate Mortgages: Hearings before the Subcommittee on Financial Institutions and Consumer Affairs and the Subcommittee on Housing and Urban Affairs of the Committee on Housing, Banking and Urban Affairs,* 99th Cong., 1st sess., (Washington, DC: GPO, 1985), 39.

and the growth of the secondary mortgage market. Among the new asset powers, which extended not just to the thrifts, but to all mortgage originators, were adjustable-rate mortgages. The fixture of the New Deal system, the fixed-rate mortgage would no longer be the exclusive mortgage instrument. Further asset powers allowed thrifts to invest less and less in residential mortgages, and secondary markets facilitated greater competition from non-depository originators. In sum, the deregulation to save the thrifts ultimately destroyed them. As Lewis Ranieri put it, "the federal government started the process in the late 1970s by deregulating financial institutions. The removal of Regulation Q and the ceilings on savings deposits in the late 1970s left thrifts with mismatched thirty-year, fixed-rate loans. Wall Street, though securitization, finished the job by taking away the thrifts' primary business of home lending."[109]

With the thrift industry out of the way, mortgage companies and mortgage brokers, including new entrants to real estate, filled the void, originating mortgages to be sold in the secondary market. Typically bundled and backed by securities, these mortgages found ready investors, institutional and individual. Housing finance had shifted from household savings capital plus federal subsidy to household and industry investment capital plus federal subsidy. The nature of the capital financing homeownership had changed from being primarily savings capital, deposited by households with little to no speculation on the rate of return, to investment capital, on which investors expected a significant yield. The key to this shift was the growing wealth of middle-class households that increasingly turned their savings (especially after paying off a mortgage) into capital markets through stocks, mutual funds, and pensions.

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[109] Ranieri, 42.

Secondary markets reconnected that savings-turned-investment to housing finance. The nature of federal subsidy had changed somewhat too, as the bulk of that subsidy came through the implicit guarantee behind the behemoth GSEs. The profits from that backing remained private while the risk was public until the implicit became explicit and both became public when FNMA and FHLMC came under federal conservatorship in 2008.

Deregulation and the turn to secondary markets ended an era of relatively cheap credit for housing and of expanding rates of homeownership.[110] The stated commitment to equal access to homeownership and the "American Dream" for all and an imperative that the profitability of housing finance be competitive with and integrated into all other capital markets, created contradictory policy goals. Policymakers were asking the new system to produce yields for investors and profits for a host of intermediaries while reducing costs for borrowers. Instead, borrowers bore higher costs while borrowers, investors (to some extent), and the federal government shared increased risk. In the short-term, this contributed to constrained opportunity for homeownership, as through the 1980s, the homeownership rate plateaued at 64%.[111] Over the long term, into the 1990s and 2000s, the contradiction in goals created a market for new and often risky credit instruments in order to restart an expansion of homeownership rates and new-home construction in the face of an affordability gap. Those risky instruments, often forms of adjustable-rate mortgages, flourished in the regulatory blind-spot created by the shift in mortgage origination from depository institutions to mortgage brokers, and

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[110] This development paralleled the pattern of racial minorities achieving political power in city governments just as those cities faced debilitating challenges related to eroding tax bases resulting from capital mobility including suburbanization.

[111] Kenneth A. Snowden, "Housing Units, by Occupancy and Ownership: 1890-1997."

disproportionately coincided with discriminatory and predatory lending practices. The risk in this burgeoning subprime market spread throughout the newly integrated financial markets, and when the risky loans proved unsustainable, the deregulated system of housing finance came crashing down.

Conclusion:

The Transformation of Housing Finance: From Three Revolutions to Three Crises

The dismantling of the New Deal system of housing finance played a central role in three economic crises in the late twentieth and early twenty-first centuries: the S&L crisis of the late 1980s, the subprime crisis of the mid to late 2000s, and a more enduring crisis of racial inequality that raises questions about the relationship between opportunity and democracy. The transformation of federal housing policy in the late 1970s and early 1980s–the deregulation of interest rate ceilings and thrift asset powers, combined with the turn to the secondary markets–fundamentally restructured the way that residential mortgage credit was created and allocated. The newly reconfigured system of housing finance proved remarkably capable of raising vast amounts of capital for housing–making residential credit abundantly available. But that credit came at higher cost and risk for borrowers compared to those under the New Deal system. Systemic risk increased too, as secondary markets integrated housing finance into broader capital markets, pulling in more and more investors and institutions–both sharing and spreading risk.

The S&L Crisis

Throughout the 1970s, as deregulation proponents and then champions of "small savers" argued for an end to Regulation Q, S&L officials repeatedly insisted that they could not continue as the leaders in residential lending, or even survive as an industry, without the protection of interest rate ceilings. They were right. Beginning in 1978, when

regulators authorized high-ceiling Money Market Certificates, the S&Ls' cost of funds began to rise precipitously. Policymakers continued to push depository institutions to provide higher returns to savers, ultimately committing to the elimination of Regulation Q ceilings. Implementing the phase-out of Regulation Q proved difficult, however, as S&Ls, their portfolios still dominated by long-term mortgages earnings rates far lower than their inflated cost of funds, suffered a severe pinch in earnings each time ceilings were liberalized. The profitability of the thrifts plummeted, eating away at the net worth of many institutions. Creative accounting (encouraged by federal regulators) papered over the effective insolvency of much of the industry, buying time to search for a long-term solution.[1] What thrift officials and their regulators asked for (and eventually got) was more deregulation, but deregulation of a different kind. While most thrift officials had fought against interest rate deregulation, they claimed that deregulation of investment powers, including both the authorization of adjustable rate mortgages and freedom to invest outside of residential mortgages, would return the industry to profitability.

The efforts to deregulate thrifts out of insolvency failed miserably. Allan Sloan and Allan Dodds Frank wrote in *Forbes* in December 1984, "politicians started out to save the S&Ls, intending to help housing, and ended up encouraging, among other things, corporate greenmail[takeovers]," with S&L money increasingly flowing to financiers like T. Boone Pickens and Saul Steinberg. Sloan and Frank concluded, "the theory was that expanding the power of S&Ls would help homeowners, because profits from new businesses would allow S&Ls to subsidize their sickly mortgage portfolios. But markets are perverse. Instead of acting the way politicians hoped they would, many

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[1] Kitty Calavita, Henry N. Pontell, and Robert H. Tillman, *Big Money Crime: Fraud and Politics in the Savings and Loan Crisis* (Berkeley: University of California Press, 1997), 57.

savings and loans are using their new freedom to lend money where it will earn the highest return …. Just what you would expect…..”[2] In other words, thrift officials were doing precisely what Regulation Q ceilings originally had been designed to prevent: competing for deposits by offering higher returns, and then pursuing high-risk, high-return investments to cover the costs and make a profit.[3] The deregulation of interest rate ceilings led to crippling competition and then the deregulation of thrift asset powers widened the range of investment options.

But S&L officials had been specialized mortgage lenders for decades.[4] They were ill qualified to successfully expand into commercial real estate or consumer lending. Too many of the high risk-investments, including junk bonds, office buildings, commercial real estate, “barbeque stands [and] ski resorts,” failed to pan out.[5] As economist Robert Samuelson put it, “the gamble backfired. S&Ls–not experienced in these areas–made

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[2] Allan Sloan and Allan Dodds Frank, “An Idea Whose Times Has Gone,” *Forbes* (December 31, 1984), in Testimony, Small Savers Equity; Legislative Files, 1949-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

[3] Henry Schechter, of the AFL-CIO, who unwaveringly supported Regulation Q even as consumer advocates turned against it, noted in Congressional testimony, “As history demonstrates, increased money costs lead to increased risks as higher yields are sought to cover the increased costs.” House Committee on Banking, Finance and Urban Affairs, *How the Financial System Can Best Be Shaped to Meet the Needs of the American People: Financial Deregulation: Hearings before the Committee on Banking, Finance and Urban Affairs,* 98th Cong., 2d sess., April 11, 12; May 2, 3, 9, 10, 16, 23, 24; June 7, 12, and 19, 1984 (Washington, DC: GPO, 1984), 1827.

[4] Martin Lowy points out that commercial banks had exercised comparable lending powers for years without the problems the thrifts would soon encounter, pointing to the inexperience of both thrift officials and regulators in dealing with non-housing investments. Lowy, *High Rollers: Inside the Savings and Loan Debacle* (New York: Praeger, 1991), 50.

[5] Paul Zane Pilzer, with Robert Deitz, *Other People’s Money: The Inside Story of the S&L Mess* (New York: Simon and Schuster, 1989), 15. Martin Mayer writes, “Probably the single most damaging provision in the [Garn–St. Germain] law was the elimination of all regulation of the ratio between what an S&L could lend to a developer and the appraised value of the project for which the loan was made.” In other words, S&Ls could get greater leverage on their capital, increasing the risk to the firm and the federal insurance program. Mayer, *The Greatest Ever Bank Robbery: The Collapse of the Savings and Loan Industry* (New York: Macmillan, 1990), 97.

billions of dollars of lousy loans. A bad situation became worse."[6] The S&Ls never dug their way out of the earnings crunch precipitated by the combination of high inflation and interest rate ceiling deregulation in the late 1970s and early 1980s. Many institutions, at the urging of federal regulators, employed dubious accounting methods to stave off bankruptcy for years, but by the late 1980s the industry had effectively collapsed.[7]

Long before the S&Ls went out of business, they had ceased to be the leaders of the business of residential mortgage lending. The collapse of the thrift industry had little impact on the flow of credit to housing, as secondary markets and mortgage companies substituted for the thrifts' capital raising and mortgage originating roles. The magnitude of the S&L crisis is instead typically measured by the cost to taxpayers to cover for the S&Ls' losses that went far beyond exhausting the industry's federal insurance fund, the Federal Savings and Loan Insurance Corporation, which insured deposits (up to $100,000 per account) held by S&Ls. Estimates of the total cost vary, and range as high as $500 billion, leading to characterizations such as "one of the worst financial disasters of the twentieth century."[8] But a cost was borne too when local depository institutions ceased to be at the center of housing finance. The local obligations of lenders and capital investors would be significantly eroded, contributing to an immeasurable, but no less critical, crisis in housing finance. S&Ls, and to a lesser extent, commercial banks, had been the key lever for community reinvestment. Under the Community Reinvestment Act, only depository institutions could be compelled to loan in the community in which they were

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[6] Robert J. Samuelson, "S&Ls: Much More Than Sleaze," *The Washington Post,* July 7, 1993.

[7] Kitty Calavita, Henry N. Pontell, and Robert H. Tillman, *Big Money Crime: Fraud and Politics in the Savings and Loan Crisis* (Berkeley: University of California Press, 1997), 57. Lowy, 28-34.

[8] Calavita, 1.

chartered, rather than simply pursuing the most profitable investments. As the S&Ls retreated from housing finance, the community reinvestment movement became less able to encourage lending to historically underserved neighborhoods.

The Subprime Crisis

With a longer incubation period, the transformation of housing finance that was completed by the mid-1980s also laid the structural foundation of the so-called "Great Recession," of 2007-2009. While the financial deregulation of the early 1980s and the turn to the secondary markets as the primary source of capital for housing might not have *inevitably* led to the subprime and broader financial crises, and intervening developments such as the repeal of Glass–Steagall among others also played a role, several critical policy changes in the late 1970s and early 1980s combined to make a crisis both more likely and more severe. Regulators' authorization of adjustable rate mortgages in 1981 made possible many of the complex, confusing, and risky mortgage instruments that enticed borrowers with low initial "teaser-rates" that later escalated out of their reach and induced default. Federal preemption of state consumer protection laws such as usury ceilings in the 1980 DIDMCA allowed those rates to go even higher than they could have otherwise. The thrift asset deregulation contained in the 1982 Garn–St. Germain Act, coupled with the turn to secondary markets, facilitated the shift in mortgage origination from heavily regulated depository institutions to comparatively unsupervised mortgage brokers. Finally, moving from depository institutions to secondary markets as the primary source of capital for housing made the development of exotic investment instruments

more likely, and spread the risks associated with housing finance throughout the global economy.

Deregulation of mortgage instruments during the late 1970s and early 1980s, the authorization of alternatives to the traditional 30-year, fixed-rate mortgage, without strident consumer safeguards, allowed lenders to issue mortgages that were riskier for borrowers and harder for them to understand. During debate over alternative mortgage instruments in the 1970s, all parties conceded that flexible-rate mortgages shifted risk to borrowers. Successive authorizations of increasingly liberal flexible-rate mortgage instruments in the late 1970s and early 1980s and then the passage of the Alternative Mortgage Transaction Parity Act as part of the Garn–St. Germain Act opened the door to the wide range of often complicated and risky mortgage instruments that dominated the subprime market. Policymakers eschewed long-standing consumer protections such as limits on rate hikes (both incremental and overall), and the DIDMCA had already preempted state usury ceilings, which would have limited the maximum rate of interest that could be charged to borrowers.[9] The market, regulators such as Richard Pratt argued, would provide all the safeguards that consumers would need. Under these wide-open conditions, various alternatives to the traditional fixed-rate mortgage proliferated,

[9] Patricia McCoy and Elizabeth Renuart write, "by liberalizing the permissible features of loan products and facilitating differential pricing according to risk, the DIDMCA and AMTPA set the legal stage for the emergence of the subprime mortgage market a decade later." Patricia A. McCoy and Elizabeth Renuart, "The Legal Infrastructure of Subprime and Nontraditional Home Mortgages," in Nicolas P. Retsinas, Eric S. Belsky, eds., *Borrowing to Live: Consumer and Mortgage Credit Revisited*, Joint Center for Housing Studies, Harvard University, James A. Johnson Metro Series, Brookings Institution Press, November 2008. Available at SSRN: http://ssrn.com/abstract=1471306 or http://dx.doi.org/10.2139/ssrn.1471306.

increasing from 32% in 1998 to 55% in 2004, and those loans, according to McCoy and Renuart, carried a foreclosure risk 62% to 123% higher than a fixed-rate alternative.[10]

A market for such risky mortgage instruments emerged in large part because the deregulation of thrift asset powers and the turn to secondary markets facilitated the emergence of mortgage originators outside the highly regulated depository institutions who operated with comparatively little oversight. In addition to being less closely monitored, these originators, by and large, did not keep the mortgages they issued on their own portfolios, instead selling them to investors through the secondary market. This created moral hazard. That is, these originators had nothing to lose if borrowers could not repay, and profited from high upfront fees.

The subprime market and subsequent subprime crisis also emerged out of a particular reconciliation of the transformation of housing finance in the 1980s with the civil rights revolution in housing finance that opened access to racial minorities. As Gary Dymski argues, minority borrowers achieved access to mortgage credit, but "under terms far more adverse than were offered to non-minority borrowers."[11] All else being equal, these adverse terms, by definition, would have been harder to repay. But minority borrowers were not on equal footing, both due to continuing discrimination and inequity in income and historic inequalities in wealth.

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[10] Patricia A. McCoy and Elizabeth Renuart, "The Legal Infrastructure of Subprime and Nontraditional Home Mortgages," in Nicolas P. Retsinas, Eric S. Belsky, eds., *Borrowing to Live: Consumer and Mortgage Credit Revisited*, Joint Center for Housing Studies, Harvard University, James A. Johnson Metro Series, Brookings Institution Press, November 2008. Available at SSRN: http://ssrn.com/abstract=1471306 or http://dx.doi.org/10.2139/ssrn.1471306, 21-22.

[11] Gary A. Dymski, "Racial Exclusion and the Political Economy of the Subprime Crisis," *Historical Materialism* 17 (2009): 149-179, 150. The timing of the transition from racial exclusion to inclusion at adverse terms is difficult to pinpoint. While it is fully evident in the subprime markets of the 1990s and 2000s, evidence such as the fair housing complaints regarding terms suggests that inclusion in the mainstream mortgage market on higher terms may date back to the Fair Housing Act. Minorities' access to credit at exorbitant or predatory rates outside the mainstream market has an even longer history.

The new system of housing finance held in tension contradictory goals of providing equal access to homeownership to all and conforming to the imperative that mortgage financing be competitive with and integrated into global capital markets. Policymakers, homeowners, would-be homeowners, financial institutions, the construction and real estate industries, and investors simply asked too much of housing finance, especially in the context of stagnating wages. The New Deal system had worked, and worked well, in large part because it did not have to produce profitable returns to investors and layer upon layer of intermediaries. The New Deal system had buckled precisely when savers demanded higher returns and policymakers forced lenders to provide them. The new system too reached a breaking point when it had extracted all it could out of borrowers. Because housing finance had been so thoroughly integrated into the global economy, when the subprime market crashed, it produced a much broader financial crisis.

A Crisis of Inequality

The subprime crisis, with its disproportionate impact on racial minorities, continued and exacerbated racial inequality in wealth and housing. A recent study published by Brandies University's Institute on Assets & Social Policy finds that the gap in wealth between white and black households *tripled* between 1984 and 2009. The authors of the study argue that 27% of the difference in wealth growth between white and black households over this period can be explained by the number of years of homeownership (by far the largest single factor). The gap in homeownership rates between white and black households remains high, near 30%, and those black households

that have achieved homeownership have done so later than white households and often on costlier terms. Among the reasons for earlier homeownership for white households are the greater likelihood of inheritance and financial assistance from family, both related to the historical disparities in homeownership over the course of the twentieth century.[12]

How has a racial wealth gap, largely rooted in unequal access to homeownership, persisted and even widened, now four decades after the passage of the Fair Housing Act and three decades after the passage of the Community Reinvestment Act? The answer provided here is that the deregulation of housing finance in the late 1970s and early 1980s undermined the capacity of fair housing and community reinvestment policies to promote equality in two important ways. First, deregulation facilitated a shift in mortgage origination away from the highly regulated and supervised depository institutions that the Fair Housing and Community Reinvestment Acts had been designed to affect to the comparatively less regulated mortgage brokers who were not beholden to the Community Reinvestment Act and not subject to the same fair housing inspection and supervision. Fair housing and community reinvestment policies affected less and less of the overall share of mortgage originations, and as discussed above, subprime and predatory lending flourished beyond their reach. While this shift opened access to mortgage credit for some minority borrowers, that access came on discriminatory terms that made homeownership more attainable, but less sustainable.

[12] Thomas Shapiro, Tatjana Meschede, and Sam Osoro, "The Roots of the Widening Racial Wealth Gap: Explaining the Black-White Economic Divide," *Institute on Assets and Social Policy: Research and Policy Brief* (February 2013), http://iasp.brandeis.edu/pdfs/Author/shapiro-thomas-m/racialwealthgapbrief.pdf (accessed March 3, 2013). This study is just the latest to document the longstanding and fluctuating disparities in wealth by race. See also Melvin L. Oliver and Thomas M. Shapiro, *Black Wealth/White Wealth: A New Perspective on Racial Inequality* (New York: Routledge, 1995).

Second, deregulation ended an era of protected status for housing finance. Borrowing would become more risky and more costly for all homebuyers compared to borrowing under the New Deal system of housing finance (not just for subprime borrowers). In other words, just as women borrowers and racial minorities ostensibly attained equal access to housing finance, the system itself became less generous and expansive than it had been during the previous four decades. Though all borrowers were affected by the increasing risk and costs of the new system of housing finance, racial minorities were more likely to be victims of predatory lending,[13] and largely because of previous exclusion from the mortgage market, were less likely to benefit from inter-generational transfers of wealth to mitigate the increasing costs of homeownership.[14]

While I do not argue that policymakers deliberately set out to undermine fair housing and community reinvestment policies via deregulation, characterizing this development as a case of unintended consequences risks obscuring unheeded warnings and accepted risks. When policymakers elected to pursue higher returns for consumer-savers via interest rate ceiling deregulation, they may have reasoned that they would also be ensuring the availability of credit to borrowers because depository institutions could better compete for deposits. They might have hoped that an increasing supply of deposits could lower the cost of credit. But they did so over countless assurances from bankers and S&L officials that borrowers would pay the cost of higher returns to savers through higher rates and fees. Many, but not all, consumer groups likewise ignored the warnings of higher costs to borrowers to secure higher yields for savers. One consumer advocate

[13] See Dymski.

[14] See Shapiro, et al.

who had always been wary of the implications of rate ceiling deregulation, Gale Cincotta, observed in 1984, "many Americans bought a bill of goods back in 1979, when Congress passed the Depository Institution Deregulation and Monetary Control Act. The sponsors and press at the time justified this major move toward deregulation of banks as necessary in order to extend to the small saver the higher interest privileges of the big savers. We opposed this bill. Now, 5 years later, the small saver is in worse trouble than ever."[15]

Lawmakers too had considered the potential dangers of adjustable-rate mortgages for borrowers. Knowing that the instruments shifted risk from lenders to borrowers and that borrowers were least equipped to judge such risks, lawmakers and even most ARM proponents had advocated for strict consumer safeguards (and recall that as late as 1975, Congress emphatically rejected ARMs altogether). But in the early 1980s, regulators abandoned most of the traditionally accepted consumer safeguards and Congress mounted no formal response to reverse the move, and eventually endorsed it. For policymakers like FHLBB Chairman Richard Pratt, the absence of safeguards was necessary to allow S&Ls to survive and further justified by the rationale that "the market"

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[15] House Subcommittee on Telecommunications, Consumer Protection, and Finance, *Financial Restructuring: The Road Ahead: Hearings before the Subcommittee on Telecommunications, Consumer Protection, and Finance, of the Committee on Energy and Commerce*, 98th Cong., 2d sess., April 4, 5, and May 17, 1984 (Washington, DC: GPO, 1984), 415. Glenn Nishimura, Consumer Federation of America, "The record under deregulation is dubious… we see, thus far, in the name of convenience and to the benefit of the more affluent, deregulation has shifted costs onto lower and middle income consumers." Ibid., 478. Jonathan Brown of PIRG conceded that his group had indeed backed the phase out of Regulation Q, but also stated, "we made efforts to try to raise the issue of credit allocation and credit controls and affordability of housing with little success." House Committee on Banking, Finance and Urban Affairs, *How the Financial System Can Best Be Shaped to Meet the Needs of the American People: Financial Deregulation: Hearings before the Committee on Banking, Finance and Urban Affairs,* 98th Cong., 2d sess., April 11, 12; May 2, 3, 9, 10, 16, 23, 24; June 7, 12, and 19, 1984 (Washington, DC: GPO, 1984), 1901. Allen J. Fishbein, Director of Neighborhood Revitalization Project of the Center for Community Change, said, "the benefits that are most often touted by deregulation enthusiasts is that fierce competition will ensue between banks, insurance, and retail chains offering consumers the best possible deal. The argument falls flat, however, with small depositors and low and moderate income consumers who have yet to see any benefits from deregulation." Ibid., 1840-1.

would provided its own consumer protections. And for policymakers such as Senator William Proxmire, the authorization of ARMs with minimal safeguards was tolerable (only) as a trade-off for increased returns to savers. Surely neither intended the abuses of ARMs that would emerge in the subprime market, but both knowingly accepted the possibility.[16]

Finally, lawmakers had been warned of the possible dangers of secondary markets facilitating mortgage origination by unregulated mortgage originators. Federal Reserve Vice Chairman Preston Martin, among others, had suggested that investors would have little assurance of the quality of the loans issued by mortgage brokers. Though most observers had raised this concern in respect to secondary market investors, consumer advocates such as Cincotta added that these unregulated mortgage brokers would not be obligated to the Community Reinvestment Act. Lawmakers could not have claimed they were unaware of the potential for the growing share of mortgage origination by mortgage brokers to reduce the effectiveness of the Community Reinvestment Act. Rather, they declined to take up Cincotta's urging to extend the reach of the CRA to cover all mortgage-issuing financial institutions.

Policymakers were well aware that they were witnessing and shaping a fundamental transformation in the system of housing finance. By and large, they neglected to consider the implications of that transformation for fair housing and community reinvestment. Trumping such concerns, and driving the transformation of

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[16] Regulators also largely ignored the early sign of abuses. In 1983, the FHLBB Office of Community Investment received its highest volume of written consumer complaints since the record began in 1978. Complaints over alternative mortgage instruments had increased 160% over the previous year. An industry insider, the Chairman of 1st Nationwide Savings in California "expressed concern that lending institutions were advertising initial low rates on alternative mortgage instruments without adequately disclosing that the rates would increase in six to twelve months." Richard Tucker, Director, Office of Community Investment, FHLBB, "Consumer Complaint System Briefing Memorandum," February 16, 1984; Legislative Files, 1944-1988; Records of the Federal Home Loan Bank Board; RG 195; NACP.

housing finance, was a populist politics on behalf of consumer-saver/investors. The fact that a broader swath of Americans, including anyone with a pension, had a real stake in high-yield investment outlets, the stock market, in rising home values, etc. made for a formidable majority coalition to favor policies that ultimately led to a deregulated system of housing finance.

The New Deal system of housing finance helped to expand homeownership to a majority of American households, thereby changing their relationship to a system of regulations that asked savers to subsidize borrowers. Once a borrower had a home loan, locked in at a fixed-interest rate, they had nothing more to gain from interest rate ceilings, but rather stood to lose as savers. During the 1970s, enough of those consumer-savers opted out of the New Deal system, moving their money to other intermediaries, pressuring lawmakers to eliminate interest rate ceilings, and preventing policymakers from extending rate ceilings to cover investment alternatives, to create sufficient support to pass the DIDMCA. As Henry Schechter of the AFL-CIO put it, "It goes back to the growth, over a number of years, of a large number of economically literate and affluent households who began a couple of decades ago to deploy their funds, themselves, instead of leaving it in depository institutions."[17] It is worth noting that the legislation that inaugurated the phase-out of interest rate ceilings passed after a decade and a half of rate ceiling extensions and the support of the S&L industry and only after it was paired with an urgent reauthorization of widely popular consumer-friendly bank accounts. Further deregulation of thrift asset powers, both the authorization of adjustable-rate mortgages

[17] House Subcommittee on Telecommunications, Consumer Protection, and Finance, *Financial Restructuring: The Road Ahead: Hearings before the Subcommittee on Telecommunications, Consumer Protection, and Finance, of the Committee on Energy and Commerce*, 98th Cong., 2d sess., April 4, 5, and May 17, 1984 (Washington, DC: GPO, 1984), 455.

and the ability to invest outside of residential mortgages, turned on the implementation of interest rate ceiling deregulation. Regulators authorized ARMs to enable them to better adjust to the rising cost of funds due to interest rate ceiling deregulation, and Congress, including ARM opponents such as Senator Proxmire acceded to the bargain. Similarly, the Garn–St. Germain Act was largely seen as necessary for the thrifts to adjust to the phase-out of Regulation Q, and its passage was directly precipitated by the DIDC's refusal to continue with liability deregulation until Congress acted on asset deregulation. The turn to the secondary markets followed as a necessary response to the thrifts' retreat from housing finance as they exercised their new asset powers.

The populist politics of the consumer-saver/investor tipped the balance towards deregulation and capital flowing to the highest returns and away from efforts direct a protected source of capital to housing, and particularly, to traditionally underserved areas. This was never more evident than in the debates over the proposed regulation of Money Market Mutual Funds. In a battle over the very soul of the New Deal system of housing finance, FHLBB staffers argued over whether savings capital should freely flow to market-determined returns wherever they might be found, or if a source of low-cost capital should be preserved for locally-oriented depository institutions and lenders. Only the latter seemed to fit the model of the newly won Community Reinvestment Act. As reinvestment advocate Gale Cincotta pleaded "All we are asking for is a fair return on our savings into our communities."[18] But by the 1980s, Cincotta's vision of a fair return on savings–abundant and affordable home loans to underserved areas–lost out to the

[18] Cincotta, in Senate Committee on Banking, Housing and Urban Affairs, *Home Mortgage Disclosure Act of 1975: Hearings before the Committee on Banking, Housing, and Urban Affairs, 94th Cong., 1st sess.* (Washington, DC: GPO, 1975), 171.

prevailing vision of fair return on savings–market yields. In order to reconcile changing interests of the new majority of homeowning consumer-saver/investors, policymakers restructured housing finance in a way that restricted opportunity for the minority.

Any victory for the middling majority, however, was short-lived. Scholars have pointed to the disproportionate accrual of wealth to the elite under the workings of a financialized, deregulated, neoliberal regime, and, correspondingly, increasing insecurity for the working and middle classes, of which the transformation of housing finance was a significant part.[19] Certainly the reconfigured system of housing finance opened up opportunities for the financial elite to prosper from new ways to invest in residential mortgages. But, while many working and middle class households benefited from increased access to mortgage credit, they did so on terms more costly and risky than had borrowers under the New Deal system. Given essentially stagnant income growth for lower- and middle-income households,[20] access on such terms, taking on large sums of debt, proved unsustainable for many. The momentary victory for middle-class homeowner-saver/investors ultimately ushered in an era of increasing inequality between an elite wealthy few and a low- to middle-income many, and continued and exacerbated racial inequality.

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[19] While the literature on the neoliberal turn accurately describes the inequitable outcomes of the new regime, few studies make any effort to historicize the processes by which neoliberal policies were implemented. Too often the election of Ronald Reagan and the policies of Fed Chairman Paul Volcker stand in for more complex and contingent processes. David Harvey, in his *Brief History of Neoliberalism* raises the question of the "construction of consent," or, in other words, why would the many consent to a government that primarily serves the interests of the few? Looking closely at when and how deregulatory policies gained the support or implicit consent of Congress offers considerable insight into the construction of consent. Harvey *A Brief History of Neoliberalism* (Oxford: Oxford University Press, 2005), 39.

[20] On income trends since the 1970s, see Jacob S. Hacker and Paul Pierson, *Winner-Take-All Politics: How Washington Made the Rich Richer–And Turned Its Back on the Middle Class* (New York: Simon & Schuster, 2010), 21-28. Household incomes for these groups rose modestly since 1979, but largely due to more family members entering the paid workforce, and more working hours per worker.

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