

Comment on Douglas B. Diamond, Jr., and Michael J. Lea's "The Decline of Special Circuits in Developed Country Housing Finance"

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Introduction

Diamond and Lea review recent developments in housing finance practices in the United States and four European Community (EC) countries: Denmark, France, Germany, and the United Kingdom. They observe that each country entered the 1980s with a different housing finance arrangement; nevertheless, all were dominated by specialized credit circuits. That dominance eroded over the decade, as a result of diversification by intermediaries and reduced government regulation and support. The decline of special circuits exemplifies those changes in national financial systems in the 1980s that enhanced the allocative roles of interest rates relative to direct techniques.

The reduced importance of credit availability effects

The importance of credit availability effects as a means of transmitting monetary policy has greatly diminished over the last decade. For example, Mauskopf found that, during the 1980s, expenditures on residential construction in the United States became less interest-sensitive because of the absence of episodes of credit rationing (Mauskopf 1990, 985–1008). This is consistent with the general proposition that monetary policy has over time become less sector-specific.

The reduced importance of credit availability effects can be traced to the interaction of regulatory changes, such as the phasing out of interest-rate ceiling on deposits, and financial innovations. Many economic sectors, most prominently housing, once had only limited sources and types of credit. They have now gained access at low cost to a wide range of close credit substitutes available through financial transactions in both regulated domestic and unregulated Euromarkets. In addition, as Diamond and Lea document, governments have become increasingly less inclined to encourage specific

channels of financial intermediation through favorable tax rules.¹ Counterbalancing the integration trend has been the reduced identification of any one sector's financing requirements with specific organizations and contracts, for example, the reduced role of bank loan markets in short-term corporate finance because of the development of commercial paper markets.

Increasing scrutiny of government credit guarantees

Diamond and Lea foresee a continuing role for government as a source of guarantees against credit risk. This is indeed a likely outcome for housing finance, but one that will no doubt occur in an environment in which the scarcity value of such guarantees will be stressed. For example, in the United States, a statutory limit has been recently placed on the reach of the governmental protection afforded by "too big to fail" policy. The Federal Deposit Insurance Corporation (FDIC) Improvement Act of 1991 prohibits the FDIC from taking any action that would increase loss to the fund by protecting uninsured depositors and creditors of failed depository institutions unless the FDIC, the Federal Reserve, and the Treasury (in consultation with the president) determine that such action would have "serious adverse effects on economic conditions of financial stability."

There are strong reasons also to expect greater European attention to controlling the use of governmental credit guarantees. The Maastricht Treaty contains a "no bailout" clause which provides that, after economic and monetary union, no member country shall be liable for or assume commitments made by public entities of any other member country. Kenen has argued that the Maastricht Treaty stresses the need for surveillance over national policies with respect to direct and indirect issuance of debt (Kenen 1992).

Factors limiting convergence of financing practices

Diamond and Lea describe a scenario for increasing convergence of housing finance systems among countries in the 1990s. As they

¹The Tax Reform Act of 1986 removed a number of tax rules that had influenced U.S. banks' portfolio choices. One area of change involved the reduced availability of tax credits associated with crossborder bank lending. For a discussion, see Allen B. Frankel (1984).

note, the reduced role of special housing finance circuits accommodates more diversity in offerings, because no source of finance is afforded the advantages previously accorded the sponsored arrangement. New financial technologies have greatly expanded the capacity of intermediaries to combine individual credit transactions (including transactions involving multiple countries) into marketable assets. Market participants can thus exploit diversification benefits that emanate from the law of large numbers. These may be particularly important in Europe, where unification could result in reduced differentiation among credit recipients on the basis of nationality.

On the other hand, one might ask: What factors are operating to limit convergence? I would argue that national differences in governance of information transfer could limit convergence. Some countries, for example, impose few legal and regulatory barriers to extensive cross-selling by financial organizations of financial services, including insurance, permitting the free exploitation of information gained from customer relationships. This encourages financial firms to transact “over the counter” with customers rather than through public markets, even though such transactions may be costly.²

In other countries, law and regulation will continue to constrain the structuring of financial service firms. In some cases, this will involve prohibitions against affiliations between, for example, life insurance and commercial banking firms. In other cases, restrictions on the tying of financial product sales to individual customers will remain. Both types of restrictions encourage financial firms to use standardized transactions to create business positions which can, in turn, be transferred through the market.

Finally, there are strong reasons to be skeptical of the capacity of crossborder initiatives to force the pace of convergence. Mortgage credit institutions (MCIs), seeking entry in foreign markets, are likely to encounter selection problems, because the most creditworthy borrowers in those markets are those most likely to have established relationships with a domestic firm. MCIs are also more

² Recent research has focused on reconciling the existence of banks with the assumption of frictionless markets. An explanation has evolved that maintains the existence of intermediaries derives from capital market frictions between firms and investors. In this framework, banks and other financial intermediaries are institutions that overcome information problems. See Gilchrist and Sharpe (1992).

likely to be asked to extend credit against individual properties for which a market valuation is costly to establish. Furthermore, the barriers to entry are likely to be heightened if only a few firms dominate the national market, because it is then easier to coordinate those firms' responses to the new product offerings.

Conclusion

The reduced role of special housing financing circuits constitutes a major structural change in the financial systems of many developed countries. It is symptomatic of many initiatives associated with the removal of government sponsorship of techniques or channels of financial intermediation. As a result, national financial markets have moved from relatively static to more fluid environments. Nonetheless, important differences remain in national legal and regulatory environments; these will influence the nature and the importance of the roles to be played vis à vis customers by depositories and other financial service firms both within and among national financial systems.

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