

HOUSING FINANCE: FEDERAL PROGRAMS AND ISSUES

Staff Working Paper

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PREFACE

This report is one of a continuing series of reports on housing issued by the Congressional Budget Office. It describes and analyzes current **problems** related to mortgage credit and the financing of housing **investment**, describes current federal housing finance programs and the way they are reflected in the budget context together with policy options with which Congress might deal with these concerns.

In keeping with the mandate of the Congressional Budget Office (CBO) to provide **nonpartisan** analysis, this paper contains no recommendations. It was prepared by Neil Mayer and Carl **McCarden** of the Congressional Budget Office, Human Resources and Community Development Division with the assistance of Roger Faxon, Budget Analysis Division, and Joel **Bergsman**, formerly of CBO. Katharine **Bateman** provided editorial assistance. Jill Bury provided secretarial assistance for this project. It is intended primarily for Members of Congress and Congressional staff who are not experts in housing finance, but who want to know what the federal government is doing, what the budget impacts **are**, and how and why that might be **changed**. It is responsive in part to some of the questions raised by members of the Task Force on Capital Needs and Monetary Policy of the Senate Committee on the Budget at a housing briefing presented by CBO staff members on May 27, 1976.

Alice M. Rivlin
Director

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SUMMARY

Problems

During recent years, the availability and cost of **mortgage** credit have fluctuated widely. Interest rates have changed by as much as 50 percent in a single economic cycle and have risen in nominal terms over the longer **term--from** under 5 percent for single-family homes two decades ago to 9 percent at present. Availability of mortgage money for housing of certain types and in certain locations has changed substantially.

Since housing is a major purchase which may be deferred when interest rates appear to be unusually high or loans difficult to **obtain**, demand for housing is **particular** sensitive to variations in credit availability and costs. As a result, changes in mortgage credit supply have caused problems for housing consumers and **producers**, as well as lenders.

Cyclical declines in credit supply (increased interest **rates**, decreased loan availability, more restrictive down payment and maturity terms) have been the prime cause of recurrent sharp drops in residential **construction.1.** **These** drops have produced serious unemployment and business losses in housing and related sectors, and very probably have led to reduced efficiency in housing production and resulting higher costs to consumers. Credit downturns also result in high housing costs to those who must move to new or existing homes while interest costs are high (provided they can obtain loans at **all**).

long-run increases in the average level of nominal mortgage interest rates in the past decade have contributed substantially to the total increase in housing costs, although other cost elements have also risen and interest rates have not risen faster for housing than for other investments. Housing cost **increases**, particularly costs of **homeownership**, have outstripped rises in total consumer costs and income in recent years, and interest rate increases might well have forced housing costs even higher were it not for federal assistance to the mortgage sector. Mortgage rates for rental **prop-**erty have climbed faster than for **owner-occupied** housing, making provision of housing for low- and moderate-income tenants difficult. Furthermore in a growing number of urban neighborhoods and some rural areas, unavailability of housing finance at any reasonable price has discouraged home buying and **repair.**

1. **Noncredit** factors affecting housing demand are primarily demographic **changes**, cost trends, and long-run household incomes, not given to cyclical changes. Overbuilding in certain periods has helped produce later downturns, but most analysts agree this effect is not as important as credit changes.

(IX)

Federal Programs

The most important federal influences on housing credit cycles have been the recurring periods of monetary restraint; in inflationary periods, the money supply is **restrained**, interest rates rise, and housing construction drops. Other federal policies have been aimed at softening this effect. An important example during the recent housing **construciton** downturn has been the use of "Tandem Plans," in which the Government National Mortgage **Associ-**ation (**GNMA**) agrees in advance to purchase at full face value mortgages made by private lenders at below market interest rates. But in the clash **between** **macroeconomic** policy goals and short-run housing credit costs the former have generally prevailed.

Federal influences on long-term availability of credit for housing have been more diffuse and their net effects are less clear. Probably the most important programs have been mortgage insurance and guarantees made primarily by the Federal Housing Administration and Veterans Administration, which have almost certainly reduced costs and increased the supply of housing for the nation in the aggregate and over the long run by making mortgages less **risky** and more liquid as investments. Other substantial but more limited programs have included interest subsidies to **homebuyers** through HUD's Section 235 program and direct loans to rural homebuyers from the **Farmers'** Home Administration (**FmHA**) Section 502 Loan Fund. Benefits of activities such as these, however, have not been distributed equally over the population.

Options

The large number and wide variety of policies actually proposed or implemented attest to the ingenuity of those concerned with housing finance. Six major types of housing finance **instruments—interest** subsidies, direct loans, insurance and guarantees, secondary **lending**, tax expenditures, and regulation of lending institutions have all been used in the past, and changes in all of them are being discussed for the future. Their likely impacts on the various aspects of housing finance problems differ **widely.**^{2/}

Interest rate subsidies such as those available in HUD's Section 235 program ordinarily involve the federal government in paying to private lenders the difference between housing payments at the market rate of interest and a lower rate paid by the borrower. Generally they do increase the supply of lower-cost credit and widen its availability to people who perhaps

2. The summary of finance options and their likely impacts described below necessarily neglects substantial differences amongst particular program options. Individual evaluations of each **option's** effects are provided in Chapter III of the report.

otherwise could not afford to borrow. Most have little effect on cyclical variations, although the **GNMA** Tandem Plan was designed to provide the equivalent of an interest subsidy as a countercyclical measure and might be redesigned for greater cyclical impact. Programs of **direct** loans of federal funds such as **FmHA's** Section 502, **HUD's** Section 202 loans for construction of housing for the elderly, and Section 312 housing rehabilitation **loans**, serve mainly to broaden the availability of mortgage credit and, depending on design, can also have positive effects on cyclical and long-run credit supply. Current insurance and guarantee programs work primarily to increase long-run supply and broaden credit availability, but some proposed **options**—such as that to insure savings and loans against losses due to increased short-term interest **rates**—are directed primarily toward assisting mortgage lending institutions and moderating cyclical variations in credit supply.

Secondary market activities in support of housing credit involve the government in **borrowing** funds to be used to purchase mortgages from mortgage lenders in hopes of increasing their total lending. Tax expenditures directed to lending institutions **benefit** mainly those institutions and have some favorable effect in lowering long-run credit costs. Tax expenditures directed to homeowners (namely **deductability** of mortgage interest in the housing **finance** context) lower their long-run financing costs and thereby broaden access to credit, but various proposed changes increase these benefits for some and decrease them for others. The broad array of proposed changes in regulation of mortgage lending institutions would, in **general**, have positive **effects** for the institutions but very uncertain impacts on housing **finance problems**.

A table summarizing the impacts of housing finance options is presented below, with page references to more complete discussion of each later in the paper. Notes explaining terms and concepts used in the table follow the table itself.

TABLE 1: SUMMARY OF PROBABLE IMPACTS OF HOUSING FINANCE OPTIONS

| Housing Finance Options (Page of discussion referenced) | Cyclical Variations | Long-Run Supply | Mortgage Lending Institutions | Broad Availability |
|--|---------------------------------------|--|-------------------------------------|-----------------------|
| A. <u>INTEREST RATE SUBSIDIES</u> | | | | |
| 1. Target countercyclical tandem plan activities more closely on marginal borrowers (p.27) | Positive (relative to present tandem) | Positive | Positive | Positive |
| 2. Expand tandem plan activities to focus on long-run credit assistance (p.28) | Neutral | Positive | Neutral | Positive |
| 3. Expand Section 235 and Section 236 interest subsidy (p.29) | Neutral | Positive | Neutral (small earnings increase) | Positive |
| 4. Provide interest sub- sidies on taxable state and local bonds to finance residential housing investment (p.30) | Neutral | Positive | Neutral or negative | Neutral |
| B. <u>DIRECT LOANS</u> | | | | |
| 1. Provide direct loans through FHA, FmHA, and VA , perhaps at the FHA/VA rate (p.31) | Positive (if so designed) | Positive or neutral | Negative or neutral | Positive |
| 2. Provide nonfederal direct loans through local governments (p.32) | Neutral | Neutral or positive (depending on fund source) | Neutral | Positive |
| 3. Continue the Section 312 program of direct loans for substantial rehabilitation (p.33) | Neutral | Neutral | Neutral | Positive |

TABLE i (Continued)

III

| Housing Finance Options (Page of discussion referenced) | Cyclical Variations | Long-Run Supply | Mortgage Lending Institutions | Broad Availability |
|--|------------------------|--|-------------------------------------|--|
| C. <u>INSURANCES & GUARANTEES</u> | | | | |
| 1. Provide federal coinsurance of long-term, single- and multifamily mortgage loans (p.33) | Neutral | Positive relative to no insurance; negative relative to full insurance | Positive | Positive relative to no insurance ; negative relative to full insurance |
| 2. Provide federal insurance to cover potential income losses to lenders whenever shorter term interest rates increase above mortgage rates (p.34) | Positive | Positive | Positive | Neutral |
| 3. Provide federal insurance coverage for secondary market investors (p.34) | Positive | Positive | Positive | Neutral |
| D. <u>SECONDARY MAE LENT SUPPORT ACTIVITIES</u> | | | | |
| 1. Provide long-term FHLBB loans in tight money periods (p.35) | Neutral or Positive | Neutral | Positive | Positive or neutral |
| 2. Increase secondary-market countercyclical operations by FNMA, FHLMC, & GNMA (p.36) | Positive | Positive or neutral (depending on portfolio behavior) | Positive | Positive |
| 3. Increase secondary-market operations by FNMA, FHLMC, & GNMA over the full credit cycle (p.37) | Neutral | Positive | Neutral | Neutral |

TABLE 1 (Continued)

| Housing Finance Options (Page of discussion referenced) | Cyclical Variations | Long-Run Supply | Mortgage Lending Institutions | Broad Availability |
|---|--|--|-------------------------------------|----------------------------------|
| E. <u>TAX EXPENDITURES</u> | | | | |
| 1. Adopt a tax credit against a portion of interest earned on residential mort- gages (p.38) | Positive, neutral or negative | Positive | Positive | Neutral |
| 2. Amend the homeowners deduction of mortgage interest from taxable income (p.39) | | | | |
| (a) limit | N.A. | N.A. | N.A. | Negative |
| (b) change to tax credit | N.A. | N.A. | N.A. | Positive |
| F. <u>REGULATION OF MORTGAGE LENDING INSTITUTIONS</u> | | | | |
| 1. End regulation of maxi- mum savings deposit interest rates paid (p.40) | Positive, neutral, or negative | Positive, neu- tral or nega- tive | Positive | Neutral |
| 2. Expand lending powers of thrift institutions (p.41) | Positive, neutral or negative | Positive, neu- tral or nega- tive | Positive | Neutral |
| 3. Expand services thrifts are allowed to provide (p.42) | Approximately* neutral | Positive | Positive | Neutral |
| 4. Allow variable payment mortgages (p.43) | Positive,** but at cost to borrower in variability | Positive in availability. Uncertain in cost | Positive | Positive, neutral or negative |

*Excepting asset side effects of consumer loans.

**Particularly assuming elimination of deposit interest regulation.

TABLE 1 (Continued)

| Housing Finance Options (Page of discussion referenced) | Cyclical Variations | Long-Run Supply | Mortgage Lending Institutions | Broad Availability |
|--|--------------------------------------|------------------------|-------------------------------------|-----------------------|
| 5. Eliminate interest- rate ceilings on FHA-insured (p.46) | Neutral | Neutral | Neutral | Positive |
| 6. Modify state usury laws (p.47) | Positive (within affected states) | Neutral or positive | Positive | Positive |
| 7. Regulate geographic distribution of mortgage lend- ing by thrift institutions and commercial banks and strongly enforce antidiscrim- ination regulations (p.48) | Neutral | Neutral | Neutral or positive | Positive |

^X

EXPLANATORY NOTES FOR TABLE 1: Summary of Probable Impacts of Housing Finance Options

Actual federal credit policy directed towards the housing sector is so **complex**, and the options so **numerous**, that we inevitably cover only some of the possibilities here. The reader will also be aware that in many cases, the actual net effects of certain policies and programs are only poorly **understood**, and thus that evaluation is necessarily only tentative and incomplete. Subsequently, the impacts identified in the summary table are defined **as**:

1. **Positive:** *i.e.*, the option provides some benefit in **ameliorating** the problems represented by the criteria;
2. **Negative:** *i.e.*, the option exacerbates the problems represented by the criteria; and
3. **Neutral:** *i.e.*, the option has little, if any impact, either from lack of effect or from approximately offsetting effect.

Options are evaluated according to their impacts on cyclical variations in housing credit, long-run credit supply, the difficulties of mortgage lending institutions in providing credit, and the availability of credit to people and places short of credit in the past.

As examples, an option with positive impact on cyclical variations means a reduction in the severity of cyclical swings in the availability and cost of mortgage credit (and **resultingly** a reduction in severity of variations in housing construction levels and other housing market activity and **costs**).^{*} An option with positive impact on long-run credit supply lowers the long-run trend in mortgage interest rates (increasing funds available at any given interest **rate**). An option with positive impact on mortgage lending institutions increases the flow of savings to them, reduces the **cyclicity** of those flows, and/or increases their net **revenues**.^{**} An option with positive impact on the broad availability of credit obviously extends credit to a greater number of borrowers in underfunded areas. Extensions to neutral and negative impacts are **straightforward**.

The options are numbered and grouped into six **categories**—A through F. Budget impacts for options A through E depend on **specific** programming and financing provisions as discussed in the text. Regulatory options in Section F have no direct budget cost to the government except for administrative costs of **F.9**.

^{*}It is, of course, the case that the existence of housing cycles has in the past had value in moderating cycles in overall economic activity.

^{**}It is important to note that an option which assists mortgage lending institutions may or may not have any positive effect on mortgage credit.

CHAPTER I

ACTUAL AND POTENTIAL PROBLEMS IN HOUSING FINANCE

The three problems discussed in this section are:

Cycles in the supply of mortgage credit and their costs.

The long-run trend in mortgage interest rates.

Unavailability of mortgage credit at any reasonable cost in some central city and rural areas.

Cycles In Mortgage Credit

Mortgage lending has declined sharply and mortgage interest costs have **risen** sharply in three different periods since 1965. The frequency and magnitude of these cycles has not been decreasing despite active intervention by the federal government (see Figure 1).

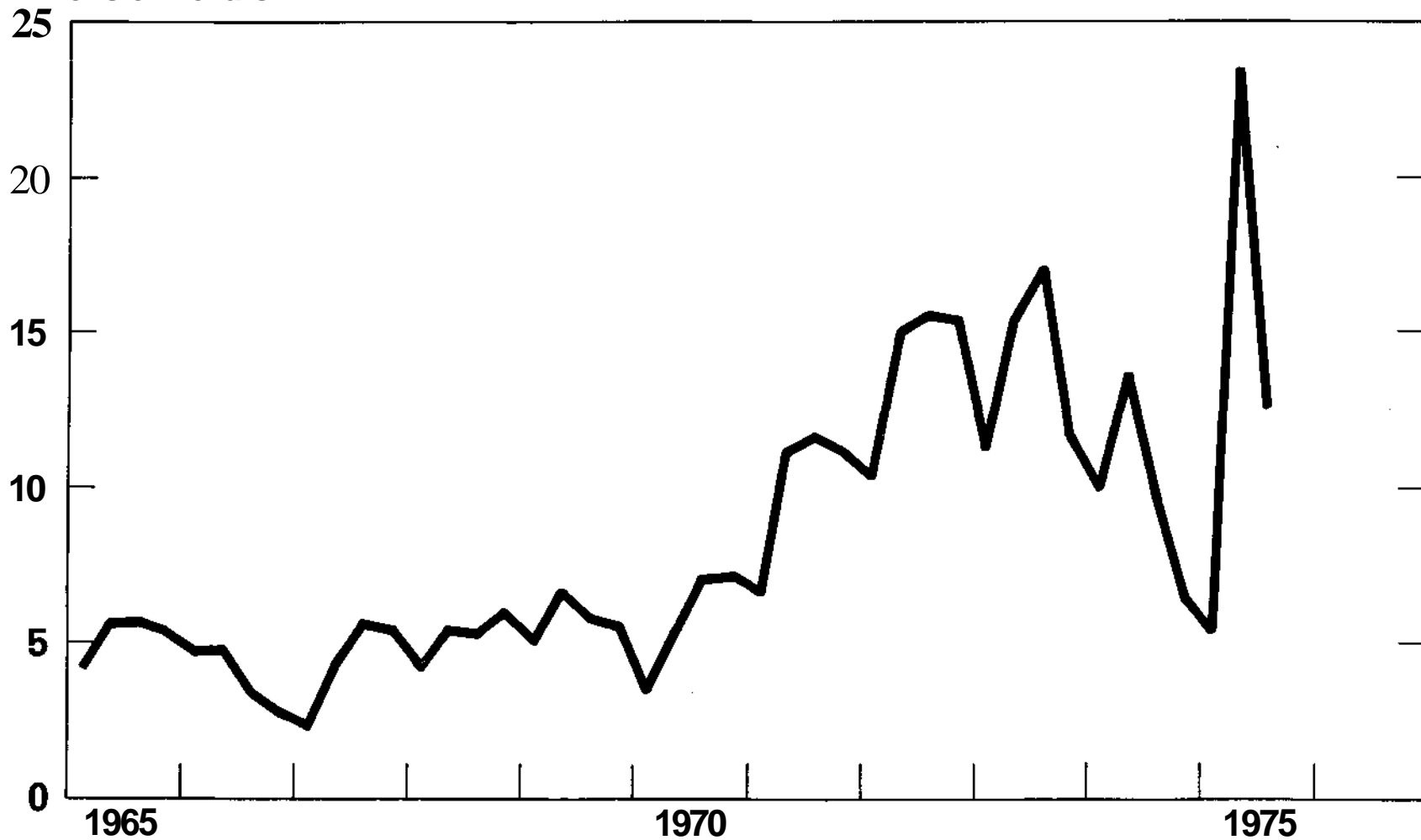
These cyclical declines in mortgage credit flows were the results of tightening of overall monetary policy by the Federal Reserve in pursuit of **aggregate** economic stabilization **goals.1/** But the effects on housing have been more severe than in other sectors. Construction of new housing and purchases of housing react strongly to variations in interest rates and credit availability. The reasons are that most housing purchases are financed by low down-payment long-term borrowing at fixed interest rates, interest is a relatively large part of total housing costs, housing costs in turn are a large part of most **families'** budgets, and therefore housing purchases tend to be postponed when credit terms are **unfavorable--i.e.,** when interest rates or required down-payments are high, length of loan is short.

The strong reaction of buyers of housing to credit cycles is accentuated by the effects of the cycles on thrift institutions (savings and loans and mutual savings banks) and commercial banks. These intermediaries collect (borrow) funds from savers and lend them to buyers of housing. Savings and loan associations (**S&Ls**) are the chief intermediaries through which private

1. Of course, previous rapid expansion of money supply has in some cases been a contributor to the inflation which monetary tightening then attempts to control. And **"easy"** money coupled with inflation may have encouraged speculative investment in housing, which then intensifies the decline in housing activity when credit tightens.

**Figure 1. NEW MORTGAGE LENDING
(NET OF REPAYMENTS) --1965-1975**

Billions of Dollars



Source: Federal Reserve Board

savings flow to mortgage **borrowers**, holding 45.4 percent of outstanding residential mortgages in 1975, and holding 76.3 percent of their total assets in the form of residential **mortgages**.^{2/} Since 1966, the pattern of net savings flows into **S&Is** has been highly cyclical. The reason is that the deposits which are their prime source of funds are largely short-term savings which can be withdrawn at any time. In tight money and/or high inflation periods, interest rates on **savers'** alternative short-term investments, such as **three-month Treasury bills**, rise **steeply**.^{3/} To keep savers from moving their deposits to other investments, S&Is would have to pay greatly increased deposit interest rates. But earnings out of which such higher interest would have to be paid are limited because (1) mortgage (and other) long-term interest rates do not fluctuate as much as do short-term rates and (2) mortgages made in previous years remain in effect at the **original**, and generally lower, fixed interest rates. Thus S&Is cannot compete for savings in periods of high interest **rates**, and their new inflows of potentially loanable funds become small or even negative (called **disintermediation**).

Commercial banks, which held 15.9 percent of outstanding residential mortgages in 1975, but have only 9.5 percent of their total investments in mortgages, substantially reduce their housing lending in tight money **periods**.^{4/} Like S&Is, their deposit inflows also fall as savers seek higher yield investments; however, since commercial banks are far less restricted in their own investments, they lend what funds are available primarily to preferred business customers at the higher short-term interest rates, rather than to mortgage borrowers.

Regulations that put legal limits on allowable deposit interest rates for thrift institutions (thrifts) and commercial banks and limit **thrifts'** choice of lending activities contribute to the **intermediaries'** difficulties in competing for savings in tight money periods. **Whether** the regulations increase or decrease the supply of mortgage credit is however uncertain.

Since 1966, there has been a ceiling on the interest rates that thrifts can pay on deposits, regulated by the Federal Home Loan Bank Board; commercial banks have been similarly restricted over a longer period, with their rate established by the Federal Reserve Board. Regulation Q of the Federal Reserve Board regulations maintains a differential between the rates allowed thrifts and the rates it allows **commercial banks—with** thrift institutions

2. Source: Guide to FNMA, Federal National Mortgage Association, Department of Economics Analysis, May 1975, p. 9.

3. Since inflation makes money worth less in the **future**, savers demand higher returns on bonds in exchange for waiting to use their funds, particularly if alternative investments in assets whose value rises with inflation are available.

4. Source: FNMA Department of Economics Analysis, in Guide to FNMA.

receiving the higher limit. The differential is now **one-quarter** percent on both passbook accounts and certificates of **deposit**, compared to a differential of **three-quarters** percent on passbooks and **one-quarter** percent on certificates in 1966. In addition, thrift institutions are restricted in investments they may make essentially to mortgage loans and to certain government-backed obligations. Construction loans, consumer loans, commercial paper, and other corporate debt are among major investment categories **excluded**.

Clear evidence exists that deposit interest rate regulation has been a substantial factor in producing wide cyclical fluctuations in flows of savings to thrift institutions and commercial banks. Ceilings on rates commercial banks and savings and loans can pay for deposits are infrequently **adjusted**,^{5/} and deposit rates are thus well below yields on other short-term investments in tight money **periods**.^{6/} Empirical evidence shows that net inflows of savings into mortgage lending institutions are heavily dependent on the differentials between deposit and other short-term **rates**.^{7/} More recently, the increase in deposits in the form of medium-term certificates of deposit (also with interest rate ceilings) has made savings flows sensitive to other medium-term rates as well.

The net impact of deposit interest rate ceilings on flows of mortgage credit from thrifts and commercial banks is far less clear, **however**. **Savings and loans**, which put a very high percentage of their funds into **mortgages**, may not have gross earnings large enough to pay deposit rates much above current **ceilings--thus** earnings from their preferred investment, not ceilings, are the more important **constraint**.^{8/} The ceilings on deposit rates may increase the level of mortgage lending because they prevent commercial **banks**, which freely invest in short-term assets rather than mortgages, from bidding away deposits from the thrift institutions. Thus, ceilings may mean less total savings deposits but either more or less mortgage lending.

Regulatory restrictions on **thrifts'** use of their funds clearly limits their ability (in the potential absence of deposit interest rate ceilings) to compete for savings. The restrictions prevent them from making investments

5. Limits on passbook accounts at thrift institutions were **4.75** percent in 1966-69, 5 percent **1970-June** 1973, and 5.25 percent 1973 to date.

6. U.S. Treasury **three-month** bills rose to 8.19 percent in the third quarter of 1974.

7. A simple regression of net savings inflow on the interest rate differential and a linear time trend **explains** 86 percent of the variance in savings inflow from third quarter 1966 through second quarter 1975.

8. **Indeed**, **S&Ls** are active proponents of deposit rate regulation, apparently to protect themselves from competition from commercial banks and new small **S&Ls**.

in the short-term assets which offer high yields in periods of tight money—investments which would increase their earnings and allow them to pay higher deposit interest rates. Whether eliminating the restrictions would moderate decreases in mortgage lending in tight money periods is again **problematical**, depending on how increased savings deposits at thrifts would compare with the magnitude of new **nonmortgage** investment they might **make**.

Potential mortgage lenders other than thrifts and commercial **banks**—particularly life insurance **companies**—**have done little** residential mortgage lending in recent years except for large-scale projects and thus do not help offset mortgage credit cycles.

Restrictions on maximum interest rates allowable on **mortgages**—**particularly** those imposed by state usury laws and by **FHA/VA** loan rate **ceilings**—also discourage the flow of savings into mortgage lending as interest rates rise.

A number of historical changes have intensified the fluctuations in flows of deposits to thrifts and commercial banks which contribute to mortgage credit **cycles**. Increased variations in monetary policy and inflation rates have caused larger changes in short-term interest rates. Average short-term interest rates have risen relative to long-term rates (including mortgage **rates**), so that thrift institutions have greater **difficulty** maintaining earnings adequate to compete for savings when short-term rates move cyclically upward. Deposit rate **ceilings**, first introduced for thrifts in 1966, have limited the competitive ability of even the more profitable institutions. Savers seem to have grown more sophisticated in moving their funds out of deposits into higher yield opportunities such as investment retirement accounts and mutual funds as they arise. Furthermore, commercial **banks**, which lend a far smaller proportion of their deposits for mortgages than do thrifts particularly as interest rates rise, have increased their share of total savings deposits (aided by a reduction in the difference between thrift and commercial bank deposit rate ceilings as set by federal reserve Regulation Q).

The result is that when overall credit tightens, mortgage lenders **supply** of loanable funds falls substantially, mortgage interest rates are bid up until many interest-rate sensitive consumer/investor borrowers decide not to borrow (and thus not purchase **housing**). Many other potential borrowers cannot obtain loans at all or find the down payments too high or terms (length of loan) too short to afford. Both the nature of housing as long-term investment and the structure of the lending industry greatly affect this pattern.

Long-Run Trend In Mortgage Interest Rates

Interest rates on conventional mortgages for single-family homes have risen from 4 percent to 5 percent levels in the 1950s, to 6 percent, 7 percent, and 8 percent levels in the 1960s, and to 7 1/2 percent to 10 percent

levels in the 1970s. While the rise has not been steady, cyclical trough and peak rates have been higher in each new cycle than in previous **ones**, producing a clear upward trend (see Figure 2). Interest rates on multi-family housing **mortgages** followed similar trends in the 1950s and 1960s, but moved relatively higher in the 1970s to 8 1/2 percent to 10 3/4 **percent**.

Recent mortgage interest rate increases have been attributed to inflation, uncertainty about future **inflation**, increased borrowing by government and **business**, and decreased confidence in mortgages as safe **investments**; and concern has been raised about the continued effects of these situations.

The uncertain outlook about future inflation rates could cause mortgage interest rates to rise relative to rates for short-term borrowing, since mortgage lenders might be wary of making long-term, fixed return commitments except at premium interest rates. However, the data do not seem to reflect more concern **than** has been expressed in previous periods. From first quarter 1973 to third quarter 1974, the difference between mortgage rates 9/ and short-term rates 10/ was at or near **20-year** lows. The higher differentials during 1975 and 1976 are little greater than those prevailing in previous periods of cyclical downturn in short-term rates throughout the last two **decades**,^{11/} although the period of high differentials is continuing somewhat longer than in the past. It appears that while recent inflationary patterns have contributed to high nominal interest rates, little unusual disadvantage has been suffered by housing credit relative to short-term credit. Indeed, the decline (in the last ten years compared to the **previous** decade) in mortgage rates relative to average and peak short-term rates has already been seen as a contributor to mortgage credit cycles.

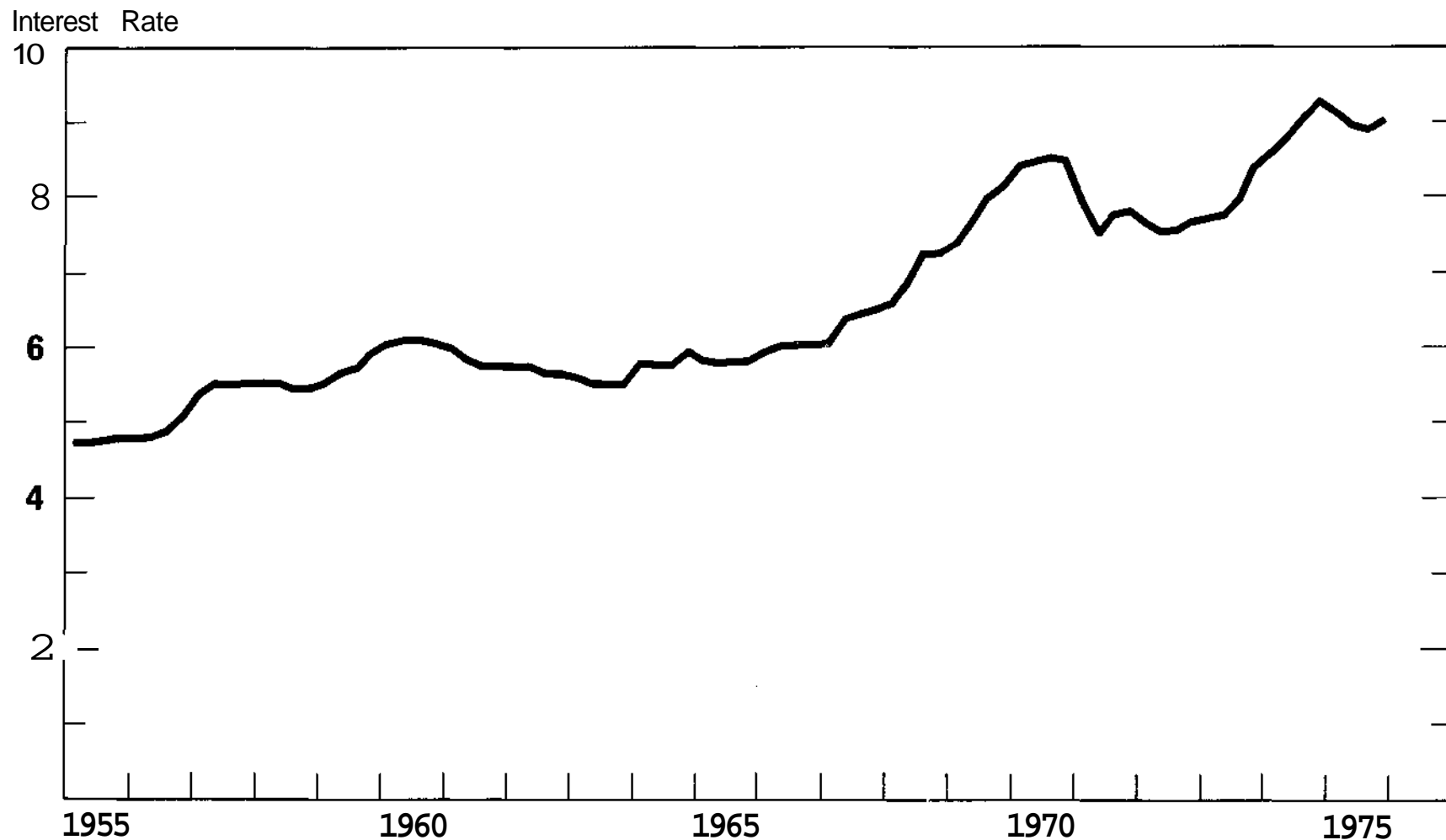
Mortgage credit rates do not appear to be rising relative to risk-free long-term rates, such as might be expected if investors had growing concern about the quality of mortgages as investments. The difference in yields between mortgages and long-term U.S. treasury bonds in most recent quarters is just barely above the median difference for the decade. Nor do mortgage credit rates seem to have suffered relative to other private long-term **rates**, which might be expected if housing lending were an inferior long-run competitor for long-term funds. Mortgage rates have fallen relative to corporate bond rates over the past decade and remained essentially even in the past few years. On the other hand, lenders appear unwilling to finance new multi-family housing at prevailing interest **rates--which** may reflect lowered confidence in the multifamily housing market that overall credit costs fail to measure. Whether the credit availability problem for multifamily housing will become long-run, remains to be seen.

9. Measured by rates on **conventional**, single-family lending.

10. Measured by U.S. Treasury **three-month** bills.

11. This comparison and those in the following paragraph are based on CBO **computations**.

**Figure 2. INTEREST RATES ON CONVENTIONAL MORTGAGES
FOR SINGLE-FAMILY HOMES --1955-1975**
(new and existing combined to 1963; new thereafter)



Source: 1955-64, Jack Guttentag and Morris Beck, *New Series on Home Mortgage Yields Since 1951*, NBER, 1970; 1964, Mortgage Bankers Association of America; 1965-1975, Data Resources, Inc., Data Bank.

While mortgage interest rate increases may not have outstripped other interest rate rises, the substantial upward secular movement has certainly contributed to increases in housing costs. The most current analysis ^{12/} available evaluates changes in **homeownership** costs from 1967 to 1973. By the end of 1973, conventional mortgage interest rates on single-family homes had risen to **8.56** percent for existing and **8.39** percent for new homes (as compared to **6.64** percent and **6.53** percent at the end of 1967 and 9.11 percent and 8.91 percent in third quarter **1975**). In the six-year period between 1967 and 1973, homeownership costs increased 47 percent, faster than the consumer price index as a whole (33 **percent**). The chief source of this increase was the rise in purchase price, accounting for **41.3** percent of the overall cost increase. Maintenance and repairs were the second largest source at 23 **per-**cent. Mortgage credit costs followed as the third cost increase factor as the source of 20 percent of the total increase. Property taxes (11.7 per-cent) and insurance (4.4 percent) were the other contributors. Thus the secular rise in interest rates contributed significantly but by no means overwhelmingly to homeownership cost increases. Comparable cost component figures are not available for **multifamily** housing. The rise in **multifamily** interest rates relative to single-family rates in the 1970s probably means financing was a substantial contributor to cost increases despite sharp rises in operating and construction costs as well.

Long-run increases in mortgage interest rates have probably then been the result of the same forces as the general rise in long-term interest rates and have been no greater in magnitude. However, they have significantly affected the cost of housing.

Unavailability Of Mortgage Credit In Certain Areas

Community organizations in cities and in extremely poor rural areas have documented mortgage **lenders'** practice of systematically denying loans in certain geographic areas, commonly termed "**redlining**." The early stages of this practice are subtle. Higher down payments are required, mortgage loans have higher interest rates, the terms are shorter than the national average, and older houses are excluded altogether. In more advanced stages, loans are openly denied throughout areas considered too risky for long-term **investment**.

The shift of thrift institutions and commercial banks away from local lending in inner-city housing markets in areas of Washington, **D.C.**, Oakland, **St. Louis**, Philadelphia and rural areas in the south and midwest leaves relatively few sources of mortgage credit. In Washington, **D.C.**, for example, studies indicate that of all real estate loans closed by **S&Ls** with city-based

12. See, John C Weicker and John C. **Simonson**, "Recent Trends in Housing Costs," Journal of Economics and Business, Vol. 27 (Winter **1975**), pp. 177-183.

offices between 1972 and 1974, only 7.4 percent went to people in the city buying single-family homes. In fact, only 11.6 percent of all real estate loans were originated on inner-city properties.

One of the principal provisions that indirectly permits redlining is the Federal Home Loan Bank Board (FHLBB) regulation allowing S&Is to lend anywhere within the state where they are located, and up to 15 percent of their assets outside their resident state. In the District of Columbia, for example, S&Is may lend to borrowers within a 100 mile radius from their central office.

Prospective buyers or repairers of homes in redlined areas either are unable to finance their desired actions, or must use FHA, VA and Farmers' Home insured or guaranteed financing. Unfortunately, federally underwritten mortgages in central city areas have been subject to abuse, often resulting in overpayment for poor quality housing and later abandonment (see Chapter III, F, below). Lack of conventional financing thus produces substantial losses for potential buyers and sellers in affected areas, and for their neighbors as neighborhood decline is hastened. Society as a whole also suffers from a waste of capital assets when usable housing falls into disuse or avoidable disrepair.

The Home Mortgage Disclosure Act of 1975, which required public disclosure of the geographic distribution of lending institutions' loans but not deposits, was designed to discourage discrimination and to give government and community organizations information which presumably would allow them to press for more favorable lending practices. Numerous other actions by private groups and all levels of government have been proposed and in some areas implemented.

The rural mortgage credit system is characterized by frequent and severe shortages of loanable funds, marginally efficient secondary markets, conservative loan terms, higher interest rates and fewer government-insured or guaranteed mortgages than the urban credit system. (Only 24 percent of rural mortgages were guaranteed in 1971 vs. 42 percent for urban areas.) Median census data (1971) on existing mortgages comparing rural to urban mortgage credit borrowers illustrate that rural homebuyers paid higher interest rates on conventional mortgages (6.7 percent vs. 6.0 percent), received shorter repayment periods (20.4 vs. 24.6 years), smaller mortgages, and had access to fewer lending sources.^{13/}

The relation of rural credit shortages to the prevalence of substandard and rural housing is not proven. Nonetheless, housing observers frequently point to inadequate rural credit as a primary reason for lower housing

13. For a detailed analysis of rural credit conditions see, "Differences in Housing Credit Terms and Usage Between Metro and Non-Metro Areas in the United States," Agricultural Economic Report No. 305, Economic Research Service, U.S. Department of Agriculture.

quality in rural areas. While **some** evidence seems to indicate that less credit is available in rural **areas**, it is **important** to recognize that **observed** differences between the volume of rural and urban loans may be due to differences in the demand for housing interacting with credit supply. Many rural families have incomes too low to qualify for substantial private mortgages. As an **example**, the median household income of homeowners outside metropolitan areas in 1974 amounted to \$11,700 compared to \$15,900 for homeowners within metropolitan areas. In addition, 22 percent of the **nonmetropolitan** homeowners had incomes below **\$7,000** compared to only 12 percent of the metropolitan **homeowners**.^{14/} When they own **homes**, poorer **families**, like rural residents generally, **also** have low ratios of mortgage debt to income because their earnings tend to be erratic and depend largely on crop production.

Conceivably, insufficient income may partially explain why rural residents carry proportionally less housing (as a percent of their income) than their urban counterparts. **The** lower price of land in rural areas also contributes to the apparent difference.

On balance, rural credit conditions improved during the 1960s through federal direct loans through the **Farmers'** Home Administration and expanded private lending by **S&Ls**. By 1971, **S&Ls** held 35 percent of the first mortgages in rural areas compared to 23 percent in 1960. Nonetheless, severe credit shortages arose during the tight money periods of 1974 and early 1975. Correspondingly, the decline in mortgage investment similar to that in certain urban communities has increased particularly in small southern rural communities. Lower valued properties, lower household **incomes**, and high unemployment contributed to increased lending caution among rural financing institutions during the past credit **shortages**.

Overall, the lack of credit in certain areas is the result of a mixture of economic conditions and discrimination. In either case the effect is a negative impact on the **development, transfer**, and maintenance and rehabilitation of housing in those areas.

14. See Part A (Advance) Annual Housing Survey, 1974, U.S. Department of Commerce, and U.S. Department of Housing and Urban Development.

CHAPTER II

CURRENT FEDERAL CREDIT ACTIVITIES

This chapter describes the current array of federal residential credit **programs**, identifies their chief objectives, and classifies them both by type of activity and by the agency that administers the program.

Federal Residential Credit Policies

Federal residential housing finance programs can be classified broadly under six credit policies. The major policy categories, the method of credit assistance, the initial beneficiary, and the way in which the programs affect the budget are briefly described below.

1. Interest Rate Subsidies

Government National Mortgage Association (GNMA) Tandem Plans, the Farmers' Home Administration (FmHA) Interest Credit, and HUD's Section 235 Homeownership Programs provide **below-market-interest** rate loans. Basically three **methods** apply: the government either pays part of the interest on private loans, makes the direct loans bearing interest rate subsidies, or (under the **so-called "Tandem Plan"**) commits to purchase private **lenders'** below market interest mortgages at prices providing a slightly higher than market return. When the government buys them, it ultimately intends to sell at a price that usually represents a loss, because the selling price on the mortgages purchased at below market interest rates must reflect the current market rate of interest. Interest rate subsidies on **GNMA** programs are typically 1 1/2 percentage points (below market rates) for single-family units, and are expected to average 2 percentage points for **multifamily** housing. FmHA interest credit loans typically carry a subsidy of 6 percentage points. Section 235 subsidies vary with the market interest rate, currently subsidizing the difference between market rates and an **income-related** rate as low as 5 percent on single-family home mortgages.

The major objective of the GNMA programs is to mitigate cycles in housing construction. When interest rates are cyclically high and housing construction is **declining**, GNMA makes commitments to provide funds at below-market-interest rates in order to induce additional construction. According to cyclical patterns in the housing industry, **GNMA-financed** construction should have some effect on housing during tight money periods. **However**, it appears that most **GNMA-financed** construction would have taken place in the absence of the program. Many Tandem loans went to high-income borrowers, who

might well have bought new homes without assistance; other Tandem money was used to fulfill lending commitments already previously agreed to by private lenders. Treasury borrowing to finance the GNMA program attracted some funds that would otherwise have gone into mortgages through private **lending.**^{1/}

However, it is important to distinguish between conventional mortgages and mortgages on properties that are also receiving lower-income subsidies (under Sections 235 and 236 in the past, and Section 8 in the **future**). GNMA programs may be much more necessary in the latter cases than in the former, because primary lenders have not been willing to make loans on subsidized housing if they must then hold them.

The budget impact of these programs is complex. The impact on outlays over the long run is roughly equal to the value of the interest rate **subsidy--i.e.**, the difference between the face value of the mortgages that GNMA buys and the market value of the same mortgages when GNMA sells them. In any particular fiscal year, however, the major determinants of outlays are GNMA portfolio management decisions: outlays will be high if GNMA mortgage purchases exceed mortgage sales; will be low or even highly negative if sales equal or exceed purchases. Outlays also include, of course, operating expenses of various types. In terms of budget authority, new permanent authority plus revolving authority carried over from previous years are required in amounts equal to the total portfolio of mortgages and commitments carried by GNMA, plus operating expenses. Sales of mortgages from the portfolio thus restore budget authority which is then available for additional purchases. GNMA currently has cumulative mortgage purchase authority of **\$20.5** billion, of which about \$12.2 billion is unused (**i.e.**, neither used for mortgages owned nor committed to future purchases, and includes \$2 billion appropriated but not released by the Secretary, **HUD**), as of May 31, 1976.

The Section 235 program, as reconstituted in January 1976, differs from GNMA and **FmHA** interest subsidies. Under Section 235, HUD subsidizes mortgage interest payments by homeowners. HUD payments of part of lower-income **homeowner's** mortgage interest are such that the effective interest rate to the homeowner is as low as 5 percent, and his total payments do not exceed 20 percent of his (adjusted) income. Thus the subsidy may continue over the life of the mortgage.

The objectives of the 235 program are to assist lower-income families to become homeowners, and to increase construction of new housing for such families. Under the original 235 program abandonments of properties and defaults were high, in part due to program abuses and very low down payment requirements. The reconstituted program aims at reducing these problems, in

1. See George M. von **Furstenberg**, "The Economics of the \$16 Billion Tandem Mortgages Committed in the Current Housing Slump," unpublished paper, and Ronald Utt, "A Study of the Impact of the Government National Mortgage Association's Tandem Plan on Housing **Productions**," December 11, 1974 (revised December 1975).

part by increased down-payment requirements and in part by increased minimum interest rates and income **standards--both** aiming the program at higher-income people.

For fiscal year 1976, \$42.5 million was **reserved, 2/** to subsidize an estimated **50,000** units, at an average maximum subsidy of \$850 per **year**. The income range of participating families is expected to be \$9,000 to \$11,000 **per year**, and the average mortgage amount is expected to be **\$23,000**. **Ninety percent** of the units are to be newly constructed, and 10 percent substantially rehabilitated.

The **FmHA** programs, in contrast to **GNMA** and the 235 program, are basically aimed at providing adequate housing in rural **areas--not** in countering construction cycles. The program does appear to expand rural credit provision although the number of beneficiaries is limited.

2. Direct Loans

The federal government makes loans directly to those **specific** kinds of borrowers who are unable to find mortgage credit elsewhere. Direct lending was a preferred approach during the 1950s, a period of **frequent** budget surpluses. The shift away from direct loans to **"tandem plans"** (discussed earlier) occurred primarily to avoid increases in the **budget** deficit. Existing direct loan programs include:

- (a) Section 502 Homeownership loans made from the Rural Housing **Insurance** Fund under the **Farmers'** Home Administration to **low-and-moderate homebuyers** in rural areas. Loans are financed by the sales of guaranteed FmHA notes (**e.g.**, Certificates of Beneficial Ownership) to the public or to the Federal Financing Bank (**FFB**), an off-budget agency. Recently the FFB has been the only **purchaser**. The FFB charges **one-eighth** to one-half percent higher than the interest rate charged by FmHA on the direct loans, depending on FFB costs of borrowing from Treasury.

Budget outlays vary considerably from year to year, because of variations in defaults and foreclosures and the timing of loans and financing. Outlays also represent net interest expense (difference between interest rate charged by FmHA and the interest paid by FmHA to its public and private creditors) and operating expenses. In **fiscal** year 1975, operating losses in this program were \$175 million, on \$9.5 billion of loans outstanding. Nearly \$167 million of

2. Total amount available and obligated is \$264 million pursuant to court order. Official accounting books carry this amount; however only **\$42.5** million is reserved for units approved within fiscal year 1976. As of May 3, fiscal year 1976, HUD had approved 12,017 home loans representing slightly over \$10.2 million.

total operating losses occurred from interest credit and default expenses within the 502 **Homeownership** program. For **example**, the 1975 bi-annual review of interest credit borrowers shows that each 502 borrower receives an interest subsidy of approximately \$684 per year on an average loan amount of **\$18,800**. Median family incomes of 502 loan recipients are around \$7,300 to **\$8,740**.

- (b) VA Direct Loans are made to veterans from the Direct Loan Revolving Fund for new purchases, construction and improvement and for farm **purchases.**^{3/} As of fiscal year 1975, the net cumulative value of direct loans outstanding totalled nearly \$68 billion. Proportionately, the number and value of annually approved loans have decreased substantially in the last decade; only **2,665** loans were closed in fiscal year 1975. **The** average loan was \$18,344, bearing a 9 percent interest rate on a 25-year **life**. Generally, net income is realized by **VA**, since their borrowing costs from Treasury are lower than their direct loan interest rates.
- (c) Section 312 Rehabilitation Loans are available through HUD for **substantially** rehabilitated properties in areas **specifically defined "uninsurable, high-risk, and in serious decline."** The maximum loan is \$12,000 per dwelling unit for residential structures. Loan priority is given to low- and moderate-income families subject to discretionary approval by HUD field offices. Private lending institutions service the loans for which HUD pays the fees. The interest rate is also subsidized, HUD paying the difference between the market rate and 3 percent. The net value of cumulative rehabilitation loans outstanding totalled \$215.6 million in fiscal year 1975.
- (d) Some other smaller loan programs directly provide subsidized mortgages: **e.g.,** elderly and handicapped citizens (**\$508.5 million**); and physical disaster loans (**\$1.3 billion**), administered by the Small Business **Administration.**^{4/}

3. Insurance and Guarantees

Currently, the government provides numerous insurance and guarantee programs. The primary objective is to increase the availability of mortgage credit, possibly on more liberal terms. An insurance or guarantee

3. Farm purchases include residences on farms. No separate budget accounting distinguishes home types within **Subfunction** 704, Direct Loan Revolving Fund.

4. These represent cumulative loans made as of fiscal year 1975.

eliminates almost all risk of **default**, generally covering up to 90 percent of any losses. The insurance or guarantee may come at two different points in the lending **process**: mortgage payments by the homeowner to the lender may be insured or guaranteed by a federal agency (as is done by **FHA**), or the agency may guarantee privately-issued securities backed by home mortgages (as in the **GMA** mortgage-backed securities **program**). Federally insured lending has declined as a share of all mortgage lending, giving way to private **insurance**, but remains important in at least three specific **submarkets**: (1) a portion of the conventional market not privately insured, including lower-income families; (2) the **multifamily** market in which **FHA** remains the major insurance force; and (3) primary market lenders that originate loans for their own portfolios and require insurance in order to market or improve the "sales-value" of mortgage backed securities issued by them and guaranteed principally by the Government National Mortgage Association or the Federal Home **Loan** Mortgage Corporation. Federal insurance programs are numerous and only the major ones are described **here.5/**

- (a) The Federal Housing Administration (**FHA**) has 40 major insurance programs administered through four **subaccounts** under the Federal Housing Insurance Fund. Paid-in premium fees are the principal income source and until recently, **FHA** insurance operations yielded net income.

Sizeable budget outlays (\$1.1 billion in fiscal year 1975) have resulted from increasing defaults. In **general**, the traditional **FHA** insurance programs (203 and 207) still yield net incomes. But the high default rates, particularly in subsidized Section 235, 236, and **221(d)(3)** programs, have caused net losses in General and Special Risk Funds. As of fiscal year 1975, the cumulative number of **FHA** insurance contracts outstanding totaled 6.1 million with \$87 billion of insured mortgage balances.

- (b) The Veterans Administration (**VA**) guarantees mortgage loans taken out by eligible veterans. No charge is made to the borrower for the guarantee. Premiums paid by lenders provide revenues to cover the operating expenses of the **VA** Loan Guaranty Revolving **Fund**. Unlike the **FHA** fund, no appropriations have been **required**. At the end of fiscal year 1975, **VA** loans guaranteed numbered 3.8 million with mortgage balances of \$27.9 billion, based on a 50 percent mortgage guaranty.

5. Detailed descriptions are contained in the **President's Annual Housing Goals Report** to the Congress.

- (c) Under the GNMA **mortgage-backed** securities program, GNMA guarantees securities issued by private lending institutions and backed by mortgages insured or guaranteed by **FHA**, **VA**, or **FmHA**. \$5.9 billion worth of such securities were sold in fiscal year 1975, and a total of \$17.7 billion worth was outstanding at the end of that year. GNMA estimates that almost \$10 billion more will be sold in 1976. **However**, the long-run future of the program is limited by the decline in the number of new mortgages now being insured or guaranteed by **FHA**, **VA**, or **FmHA**. The program has been somewhat successful in attracting additional funds into the mortgage **market--for** example, roughly one-third of the securities are purchased by pension funds, which would probably not otherwise invest as much in mortgages. **However**, a large number of securities are held by primary mortgage lenders themselves; to this extent the program does not increase **funds** available for housing but merely adds the GNMA guarantee to the **FHA**, **VA**, or **FmHA** insurance or guarantee on mortgages held by mortgage lending institutions.

FmHA Certificates of Beneficial Ownership perform a similar function, except that here the underlying mortgages are originated and held by **FmHA itself**, rather than by private lenders.

- (d) The Federal Home Loan Mortgage Corporation (**FHLMC**; called "**Freddy Mac**") guarantees securities issued by **S&Ls** that are members of the Federal Home Loan Bank System. The securities are backed principally by government insured or guaranteed mortgages (**i.e., FHA/VA**).

4. Secondary Market Support

Purchases of mortgages from primary lenders and subsequent resale or other **refinancing** of large blocks of these mortgages by federal and federally sponsored credit agencies have expanded greatly in the last ten years. The original purpose of this kind of activity, as performed by the old **FNMA** during the 1930s, was to induce lenders to write the then revolutionary **low-down** payment, long-term, federally insured mortgages. **FNMA's** willingness to purchase these mortgages made them more easily converted into cash (**i.e., liquid**) and thus more attractive. More recently, the expanded level of activities by **FNMA** (now a private federally sponsored **corporation**), **GNMA**, and **FHLMC** and **FHLBB**, have two main objectives: The first, similar to the original concept of **FNMA**, is to induce primary mortgage lenders to continue making mortgage loans, especially on higher risk housing designed for federally subsidized lower-income occupants. The other purpose is to offset cyclical declines in private mortgage credit supplied to residential borrowers.

On the evidence, federal secondary market operations do channel loanable funds into residential mortgages, primarily through thrift **institutions**, and do provide countercyclical assistance. **However**, some or all of these

funds may have found their way to residential mortgages even without the federal activity; whether the net effect of floating federal securities to raise loanable funds that are redirected into thrifts significantly increases the supply of mortgage credit is simply not known.

Analyses of one-shot **FNMA** mortgage purchases and **FHLBB** advances to **S&Ls**, using computer-based simulation **models**, do show some of the hoped-for effects: short-term decreases in home mortgage interest rates and then increases to slightly below the rates in effect prior to the simulated credit assistance. **Overall**, however, the effects of secondary lending by federal and federally sponsored credit agencies are still questions. Analysis of **the agencies'** performance is generally confined to **FNMA's** traditional countercyclical support of government-underwritten mortgage lending and the equally traditional functions of the **FHLBB** system in supplying advances to supplement savings inflows and loan repayments to **S&Ls** to meet **FHLBB** regulated liquidity requirements. **GNMA**, **FmHA**, and **FHLMC** activities are generally ignored because their operations are relatively new or **insufficient** data exists. On balance, secondary lending has been countercyclical since 1965 and a mixed pattern of **procyclical** and countercyclical performance by federal and federally sponsored credit agencies in the pre-1965 **period**.6/

Since the early seventies, federal and federally sponsored credit agencies residential mortgage purchases have increased dramatically. At the end of calendar year 1974, federal and federally sponsored credit agencies held \$65 billion worth of residential mortgages or nearly 13 percent of total residential mortgage debt outstanding in comparison to \$4 billion held in calendar year 1955, or less than 4 percent of the total. Gross acquisitions by federal and federally sponsored credit agencies have fluctuated annually from \$7.9 billion in calendar year 1970 to \$14.9 billion in calendar year 1974, while net acquisitions ranged from \$6.2 billion to \$12.0 billion during the same **period**.7/ These numbers can be compared to total net acquisitions of \$81.6 **billion** worth of residential mortgages in calendar year 1974.

6. For detailed analysis of federal and federally sponsored credit agencies performance see Leo Grebler, "Broadening the Sources of Funds for Residential Mortgages," Federal Reserve Staff Study, Ways to Moderate Fluctuations in Housing Construction," published December 1972, and George M. von Furstenberg, "The Economics of the \$16 Billion Tandem Mortgages Committed in the Current Housing Slump."

7. Net acquisitions equal gross acquisitions less sales. In essence, it measures the net effect of transactions in both primary and secondary mortgage markets. For detailed technical definitions and statistics for mortgage lending see, Arnold H. Diamond "The Supply of Mortgage Credit, 1970-1974," U.S. Department of Housing and Urban Development, October 1975, pp. 311-315.

5. Tax Expenditures

Tax expenditures are, particularly in terms of dollar **value**, a very important part of federal housing policy. Some of these expenditures are directed specifically toward mortgage credit.

Federal income tax deductions of mortgage interest on **owner-occupied** homes lowers **homeowners'** actual borrowing cost significantly, at an expected cost to the Treasury of \$4.7 billion in **1976.8/** Other **housing-credit-directed** tax expenditures include deductions for construction-period interest paid by builders and excess bad debt reserve deductions (larger than expected actual losses) for mutual savings banks and **S&Ls**.

These tax subsidies represent relatively uncontrollable federal expenditures, determined by the level of activity of private individuals and institutions eligible for the deductions.

As an example, in 1969 the tax allowance for excess bad debt reserves allowed deductions of up to 60 percent of taxable income as additions to reserves. The allowable percentage of income is being reduced by law and will be reduced to 40 percent by **1979.9/** Estimated revenue losses are \$570 million in fiscal year 1977. The tax expenditure may have little effect on the amount of investment thrifts held in residential mortgages, since their choice of **investments** is already restricted by **regulation**. Another aspect of the provision is its cyclical nature: the savings to **S&Ls** are lowest when money is tightest.

6. Regulation of Mortgage Lending Institutions

A number of regulations regarding the behavior of major mortgage lending institutions have significant impacts on housing finance. As indicated in the previous chapter the important regulations are:

- Ceilings on deposit interest rates. The Federal Home Loan Bank Board and the Federal Reserve Board respectively limit the interest thrift institutions and commercial banks can pay on

8. See Tax Expenditures, Committee on the **Budget**, United States Senate, March 1976.

9. To use the maximum, S&Ls are required to keep 82 percent and mutual savings banks 72 percent of their assets in residential mortgages and certain liquid assets. Allowable bad debt asset percent less than the maximum 82 percent and 72 percent of assets, down to 60 percent **after** which they special reserve provision no longer applies.

time and savings deposits and certificates of **deposits**, maintaining a higher rate for thrifts than for commercial **banks**.^{10/} **These** limits affect the ability of the lenders to compete for savings with which to make loans particularly in tight money periods as described in Chapter I.

- Limitations on investments by thrift institutions. Thrift institutions are prohibited from making many kinds of loans (such as **consumer**, construction, commercial **paper**, and corporate bond investments) and are limited to mortgage lending and certain liquid **assets**.^{11/} The effects on mortgage credit of these limitations, by concentrating investments in mortgages in the long-run but limiting institution earnings during cycles, were discussed in Chapter I.
- Limitations on **services** by **thrifts**. Thrift institutions are prohibited from offering checking accounts or other forms of payment on demand to potential depositors, as well as from making many types of loans customers might **desire**.^{12/} These prohibitions limit the ability of thrifts to **compete with** commercial banks for deposits with which to invest in mortgages (although thrifts clearly enjoy other compensating advantages) and thus may reduce long-term mortgage credit supply.
- Ceilings on FHA-insured and VA-guaranteed loan interest rates. The HUD Secretary establishes maximum interest rates **lenders can** charge for FHA-insured and **VA-guaranteed** loans and adjusts them periodically. Charges of points (essentially prepayment of additional interest) are not regulated, however, and lenders typically use them to compensate for difference between conventional mortgage rates and federal ceilings.
- State usury laws. Maximum permitted interest rates are regulated by some states for mortgage (and other) **lending**, and some of the states also limit maximum charges of points. In high interest periods such as the most recent credit cycle, these limitations have become operative in a number of states where ceilings stood at 8 percent, 9 percent, and 10 percent levels. States do legislate increases in ceiling rates, often after market rates have risen significantly above the ceiling and caused serious declines in **lending**.

10. Current maximum passbook rates are 5 percent for commercial banks and 5 1/4 for thrifts.

11. Tax provisions, explained in Chapter I, give thrifts incentive to select to put most of their funds in mortgage lending rather than the other permitted assets.

12. Some states presently have temporary permission from the FHLBB to offer NOW accounts.

- Discrimination in lending. Discrimination against individuals in mortgage lending is prohibited by federal law. The Home Mortgage Disclosure Act of 1975 requires lending institutions to indicate the breakdown of mortgage loans they make by census tract, which will provide information on whether discriminatory lending policies are being practiced against whole areas. A suit has been **filed** against federal agencies regulating lending for **nonenforcement** of antidiscrimination **provisions**, but has not yet come to **trial**.

These activities have no major direct impact on the federal budget.

Federal Credit Institutions

The purpose of this section is to regroup the activities just described according to the agencies that administer them. This is shown in Table 2. The agencies responsible for the major activities described above are: the Federal Home Loan Bank Board (**FHLBB**) and Federal National Mortgage Association (**FNMA**), in existence since the **1930s**; the Government National Mortgage Association (**GNMA**) and Federal Home Loan Mortgage Corporation (**FHLMC**), created in 1968 and 1970 respectively; the Federal Housing Administration (**FHA**), and the Direct Loan and **VA** Loan Guaranty Funds created in the early **1940s**, and the Rural Housing Insurance Fund established in 1965 under the **Farmers'** Home Administration. (Regulatory activities are not dealt with in this section.)

The **FHLBB**, **FNMA**, **GNMA** and **FHLMC** channel savings from capital markets into the residential mortgage market largely by selling bonds and other debt instruments to obtain funds which are then used either to purchase mortgages from primary lenders or to provide loans to them. **FHA**, **VA**, and the Rural Housing Insurance Fund operate primarily by insuring or guaranteeing mortgages in order to encourage lending to types of borrowers or under terms which might otherwise be considered too risky by lenders.

TABLE 2: MAJOR RESIDENTIAL MORTGAGE MARKET ACTIVITIES OF THE FEDERAL AND FEDERALLY SPONSORED CREDIT AGENCIES (FSCAs) *

| Agency and Budget Classification | Major Residential Credit Programs | Market Operation | Program Level (Dollars in Millions) | FY 1975 (Actual) | FY 1976 Estimate | FY 1977 Estimate |
|---|---|--|--|------------------|------------------|------------------|
| FARMERS HOME ADMINISTRATION | | | | | | |
| Rural Housing Insurance Fund (RHIF) (400) | (1) Section 502 Homeownership Loans (non-interest credit program) | Lends to specific residential credit borrowers in rural areas of 10,000 maximum population, if private credit is unavailable | • Value of FmHA 502 loans made during the year for single-family purchases | \$1,927 | \$2,343 | \$2,292 |
| | | | • Value of FmHA 504 loans made during the year for single-family home repair | 5.0 | 20.0 | 20.0 |
| | (2) Section 502 Homeownership Loans (interest credit program) | Subsidizes interest rate to as low as 1 percent on FmHA homeownership loans to lower-income rural area borrowers | • Total value of FmHA single-family loans made during year | 1,932 | 2,363 | 2,312 |
| | | | • Value of single-family loans sold during the year | -3,547 | -2,870 | -4,010 |
| | | | • Total value of portfolio, end of year | 9,400 | | |
| | | | • Value represented by single-family loans | 8,898 | | |
| | | | • Number of borrowers (in thousands) | 648,269 | | |
| | | | BUDGET IMPACT | | | |
| | | | Direct loan authorization | 2,252 | 3,220 | 2,720 |
| | | | Budget Authority | .13 | .12 | .18 |
| | | | Total Outlays for RHIF | -.9 | -.3 | -.5 |
| | | | Amount of total outlays represented by 502 single-family operations | -.8 | -.2 | -.4 |

*Only the major programs and financing activities are identified here and therefore the table does not include all the programs within an agency.

TABLE 2: MAJOR **RESIDENTIAL** MORTGAGE MARKET ACTIVITIES OF THE FEDERAL AND **FEDERALLY** SPONSORED CREDIT AGENCIES (**FSCAs**) (Continued)

| Agency and Budget Classification | Major Residential Credit Programs | Market Operation | Program Level (Dollars in Millions) | FY 1975 (Actual) | FY 1976 Estimate | FY 1977 Estimate |
|---|--|--|---|---|-------------------------|-------------------------|
| FEDERAL HOME LOAN BANK BOARD (FHLBB) | | | | | | |
| Federal Home Loan Bank System Advances (off-budget) | Advances to eligible lending institutions | Supplies loans to member thrifts via <u>advances</u> through 12 FHL Banks to meet liquidity & credit expansion requirements especially during tight credit periods of net savings outflows (dis-intermediation) | <ul style="list-style-type: none"> Value of advances outstanding | \$16,800 | \$18,300 | \$22,000 |
| | | | BUDGET IMPACT: None | | | |
| Federal Home Loan Bank Board Revolving Fund (401) | Special Forward Commitment Program | Normally, no loans are advanced to the FHLB System through the revolving fund. Beginning in FY 1975, the fund loaned nearly \$1.6 billion to the FHLB System which in turn loaned it to FHLMC primarily for counter-cyclical purchases of conventional mortgages. The temporary budget authority expired in March 1976. | <ul style="list-style-type: none"> <u>Program Level:</u> the outstanding principal balance on the loan to FHLMC totalled \$1.5 billion, with a 30-year repayment term. | | | |
| | | | BUDGET IMPACT | | | |
| | | | B.A. (Special Forward Commitment Program) | \$2,000 | — | — |
| | | | Outlays | \$1,237 | 303 | -52 |
| Federal Home Loan Mortgage Corporation (off-budget) | Special Market Support, principally for conventional mortgages held by member thrifts in FHLB System. | Buys and sells FHA/VA and conventional mortgages originated in the FHLB System. Primary legislative intent is to provide a secondary market for <u>conventional</u> mortgages. | <ul style="list-style-type: none"> Total mortgage commitments* Total mortgage purchases** Participation Certificates sales (i.e., mortgage-backed securities)*** Borrowings to finance increase in portfolio of \$2,156 million Outlays | \$3,400 2,455 527.0 2,229 2,048 | — 2,646 2,346 | — 3,751 3,156 |
| | | | BUDGET IMPACT: None | | | |

*Excludes \$2,380 million of **GNMA** Mortgage Commitments held by **FHLMC** for **GNMA** mortgages.**Excludes \$936 million of **GNMA** Mortgage Purchases under **GNMA/FHLMC** Tandem Plan.***Excludes \$287.1 million worth of **GNMA** mortgages repurchased by primary originators.

TABLE 2: MAJOR RESIDENTIAL MORTGAGE MARKET ACTIVITIES OF THE FEDERALLY-SPONSORED CREDIT AGENCIES (FSCAs) (Continued)

| Agency and Budget Classification | Major Residential Credit Programs | Market Operation | Program Level (Dollars in Millions) | FY 1975 (Actual) | FY 1976 Estimate | FY 1977 Estimate |
|--------------------------------------|---|--|---|------------------|------------------|------------------|
| FEDERAL HOUSING ADMINISTRATION (401) | <u>Single-Family Mortgage and Loan Insurance Program</u> | | <u>Single-Family Insurance Activity (Units)</u> | | | |
| | ● Section 203(b), basic home mortgage insurance | ● Constitutes the bulk of all FHA-insured loans through private lenders on one-to-four family units. | • Number of mortgage insurance applications | 478,261 | 560,000 | 654,000 |
| | | | • Number of insured units | 241,120 | 249,477 | 165,245 |
| | ● Section 235, homeownership assistance | • Insures federally-subsidized single-family loans made to lower-income borrowers through private lenders. | • Value of insurance in force | \$65,681 | | |
| | ● Section 221(d)(2) home mortgage insurance | | | | | |
| | <u>Multifamily Mortgage and Loan Insurance Program</u> | | <u>Multifamily Insurance Activity (Units)</u> | | | |
| | ● Section 221(d)(3), non-profit rental housing | ● Insures federally-subsidized multifamily loans made to sponsors/developers through private lenders. | • Number of mortgage insurance applications | 65,319 | 84,500 | 170,000 |
| | ● Section 221(d)(4), profit-oriented rental housing | | • Value of insurance written | \$51,141 | \$46,029 | \$32,976 |
| | ● Section 236 rental housing assistance | | | | | |
| | ● Sections 213 and 234 co-operative and condominium housing | ● Similar to Section 203(b) program except Section 213 applies insurance to an entire property that is collectively owned. | | | | |
| | | | <u>Cumulative Number of Mortgage Insurance Contracts in Force</u> | | | |
| | | | • Homes | 5,026,494 | 4,878,367 | 4,567,399 |
| | | | • Multifamily | 14,072 | 13,729 | 12,962 |
| | | | TOTAL | 5,040,566 | 4,892,096 | 4,580,361 |
| | | | BUDGET IMPACT | | | |
| | | | • Budget Authority | \$1,294 | \$1,272 | \$975 |
| | | | • Outlays | 1,088 | 1,161 | 830 |

TABLE 2: MAJOR RESIDENTIAL MORTGAGE MARKET ACTIVITIES OF THE FEDERAL AND FEDERALLY SPONSORED CREDIT AGENCIES (FSCAs) (Continued)

| Agency and Budget Classification | Major Residential Credit Programs | Market Operation | Program Level (Dollars in Millions) | FY 1975 (Actual) | FY 1976 Estimate | FY 1977 Estimate |
|--|---|--|--|---------------------|---------------------|---------------------|
| FEDERAL NATIONAL MORTGAGE ASSOCI- ATION (FNMA) | 1. <u>FHA-Insured, VA-Guaranteed & Conventional Mortgages and Loans</u> | | | | | |
| | • "Fannie Mae" provides major secondary market support by buying mortgages from private lenders—supplying a degree of liquidity for mortgage investments, and improving the geographical distribution of residential mortgage credit. | • Overwhelmingly FHA/VA mortgages constitute the bulk of FNMA's purchases amounting to 93% of total portfolio, at the end of CY 1974. | • Value of mortgage purchases* and loans made during year | \$5,024 | \$4,190 | \$6,170 |
| | | | • Value of mortgages sold during the year | 3.0 | — | — |
| | | | • Value of net mortgage and** loan portfolio, mid-year FY 1975 | 28,645 | | |
| | 2. <u>Federally-Subsidized Mortgages</u> | • Provides a secondary market for mortgages on subsidized housing for lower-income families at the discretionary authority of HUD Secretary. FNMA does not incur a higher degree of risk since the mortgages are federally-insured/guaranteed. | • Total assets | 29,671 | | |
| | | | <u>Summary of Outstanding Debt—mid year, FY 1975</u> | | | |
| | | | Discount Notes | 3,470 | | |
| | | | Debentures | 23,971 | | |
| | | | Mortgage-backed bonds | 727 | | |
| | | | Bank credit used | none | | |
| | 3. <u>Construction Loan Participation</u> | | Treasury borrowing authority used | none | | |
| | • Makes loans jointly with other lenders to finance FHA-insured multifamily housing, nursing homes and hospitals. | | Total Debt | \$28,168 | | |

*Data Source: Appendix, U.S. Budget Fiscal Year 1977, p. 925.

**Data Source: "A Guide to Fannie Mae," Annual Publication by Federal National Mortgage Association, pp. 14 and 20.

TABLE 2: MAJOR RESIDENTIAL MORTGAGE MARKET ACTIVITIES OF THE FEDERAL AND FEDERALLY SPONSORED CREDIT AGENCIES (FSCAs) (Continued)

| Agency and Budget Classification | Major Residential Credit Programs | Market Operation | Program Level* (Dollars in Millions) | FY 1975 (Actual) | FY 1976 Estimate | FY 1977 Estimate |
|---|--|---|---|---------------------|---------------------|---------------------|
| GOVERNMENT NATIONAL MORTGAGE ASSOCI- ATION (GNMA) | | | | | | |
| Special Assistance Functions Fund (SAF) (401) | 1. <u>Traditional SAF Programs</u> | | | | | |
| | • Special purpose programs #16-20, for FHA/VA mortgages on single- and multifamily units. | • Provide direct purchase of tandem support of FHA/VA mortgages whenever private mortgage funds are unavailable. | • Value of SAF commitments outstanding | 5,840 | \$610.0 | — |
| | | | • Value of mortgage purchases made during the year | 3,100 | 2,234 | 467.0 |
| | • Special purpose programs #21 and 22, FHA multi- and single-family units | • Provide market support similar to the above except used primarily for countercyclical programs. | • Value of mortgages sold | 1,300 | 3,900 | 467.0 |
| | | | • Value of SAF portfolio, with- out emergency purchase programs | 4,500 | 2,700 | 2,500 |
| | 2. <u>Emergency SAF Programs</u> | | | | | |
| | • Program #23 FHA multi-family (initiated January FY 1976). | • Provides tandem plans for FHA-insured below market mortgages. Interest rate of 7-1/2% on commitments and purchases is statu- torily established. | • Total value of SAF portfolio, including emergency purchase programs | 5,151 | 4,946 | 4,749 |
| | | | BUDGET IMPACT | | | |
| | • Program #24 FHA single-family (initiated June, FY 1975). | • Provides tandem plans similar to all the pro- grams except the mort- gage interest rate of 7-3/4% is statutorily established. | Cumulative mortgage pur- chase authority | \$20,500 | \$20,500 | — |
| | | | Budget authority | 6,000 | 4,750 | — |
| | • Conventional home mortgage programs — GNMA/FNMA — GNMA/FHLMC —Repurchase option | • Provides the major tandem plans that attempt to vary new housing production for countercyclical purposes. | SAF outlays | 2,180 | 512 | 186 |
| Guarantees of Mortgage Backed Securities | 1. Bond-type securities | • GNMA guarantees securities issued by private insti- tutions which originate and service mortgages. The securities are long-term bonds or pass-through type that are backed by pools of FHA/VA/FmHA mort- gages sold at a favorable effective return since the issuer retains the serv- icing contracts. | • Securities guaranteed outstanding, end of year | 17,723 | 27,000 | 37,500 |
| | 2. Pass-through type securities | | BUDGET IMPACT Outlays (\$ in thousands) | | | |
| | | | | -9,700 | -11,600 | -16,810 |

*Data Source: Summary document "Justification for 1977 Estimates," Department of Housing and Urban Development, pp. T-1 through T-4; V-1 through V-3.

TABLE 2: MAJOR RESIDENTIAL MORTGAGE MARKET ACTIVITIES OF THE FEDERAL AND FEDERALLY SPONSORED CREDIT AGENCIES (FSCAs) (Continued)

| Agency and Budget Classification | Major Residential Credit Programs | Market Operation | Program Level* (Dollars in Millions) | FY 1975 (Actual) | FY 1976 Estimate | FY 1977 Estimate |
|---|---|--|---|---------------------------------|---------------------|---------------------|
| VETERANS ADMINISTRATION | | | | | | |
| Direct Loan Revolving Fund (704) | Direct loans to eligible veterans | Lends to eligible veterans in rural areas, small cities and towns where private credit for guaranteed loans is generally unavailable. The maximum loan is \$25,000 with a 30-year term at the current FHA interest rate for single-family homes. | <ul style="list-style-type: none"> • Value of loans made during the year • Value of loans sold during the year • Total value of portfolio, end of year | \$50 - .3 703 | \$49 - .4 615 | \$51 - .1 383 |
| BUDGET IMPACT | | | | | | |
| Budget authority** | | | | — | — | — |
| Outlays*** | | | | 41.4 | -101 | -210 |
| Loan Guaranty Revolv- ing Fund (704) | Loan guarantees to eligible veterans | Substitutes the federal government's guaranty to private lenders against financial loss on loans to veterans for the investment protection provided by sub- stantial down payments and relatively shorter, conven- tional loan terms. | <ul style="list-style-type: none"> • Value of guarantees made during year • Value of property acquisi- tions during the year • Value of loans and property sold • Total value of portfolio, including vendee loans, end of year | \$8,254 257 -192 1,252 | — 300 -352 | — 305 -538 |
| BUDGET IMPACT | | | | | | |
| Budget authority | | | | 2.0 | — | — |
| Outlays | | | | 71 | 5 | -161 |

*Data obtained from Roger Faxon, Budget Analysis Division, Congressional Budget Office.

**Under existing legislation, direct lending authority and veterans eligibility are open-ended until their entitlement is used. Thus, there is no terminal date on the authority to make direct loans.

***Negative outlays result from greater loan repayments than direct loans made during the year.

CHAPTER III

OPTIONS

A variety of options currently under discussion are described and evaluated in this section. The issues outlined in Chapter I suggest the following criteria or objectives against which to evaluate options:

1. Reduction of cyclical variations in mortgage credit, or reduction of the social cost of such variations.
2. Assurance or improvement of the long-run supply of funds for housing investment.
3. Assistance to thrift and other mortgage lending institutions to operate effectively and efficiently.
4. Broadening of the availability of housing finance to cover locations and households where it is currently not available at reasonable costs.

In **addition, the** budget impact of the options are identified qualitatively. Precise budget impacts cannot be stated because they vary according to exact program **specifications** and scales of operation.

Actual federal credit policy is so complex, and the options so numerous, that only some of the possibilities can be covered here. The reader should also be aware that in many cases the actual net effects of certain policies and programs are poorly understood, and thus that evaluation is necessarily only tentative and **incomplete**. Expected impacts of options are summarized in Table 3 at the end of this chapter (a repeat of Table 1 in the summary for **convenience**). If an **option's** expected impact on a given criterion is negligible, there is no narrative impact **description** and the impact is listed as neutral in the table.

Interest Rate Subsidies

1. Target countercyclical tandem plan activities more closely on marginal borrowers. As noted above in Chapter II, studies suggest that **much tandem** plan activity does not bring net additional mortgage credit to borrowers unable to obtain mortgage money elsewhere, but merely substitutes for funds available through **normal** channels. To increase the effectiveness of the program, some or all tandem-plan mortgages could be restricted to **low- and moderate-income borrowers**, and/or to neighborhoods in danger of decay. Such loans would be less likely to occur without the tandem plan subsidy.

Cyclical effect; This change would probably improve the **counter-**cyclical **effects** of the program, by extending loans to people who who would not be able to purchase housing otherwise. The extent of that improvement depends on the impacts of federal borrowing (to finance the GNMA program) on the supply of funds available for private mortgage lending activities.

Long-run effect; Such loans are probably marginal in all periods, and therefore the change would probably increase housing **finance** availability in the long run.

Operations of thrift institutions; Extended tandem purchase commitments and actual mortgage purchases may be of substantial **benefit** to lenders during periods of reduced savings inflows and other income. Lenders may feel that their loan commitments exceed expected cash flow and thus tandem commitments insure their ability to meet future loan obligations at cheaper costs than borrowing from the Federal Home Loan Bank System or selling mortgages through the **FNMA** auction system. For example, during fiscal year 1975 average **FHLBB** advances and average yields on accepted offers to sell conventional mortgages to FNMA were frequently higher than the costs of obtaining tandem commitments from GNMA.

Broaden availability of credit; This option could significantly increase credit availability for the targeted households and neighborhoods.

Budget impact; The minimum budget impact would be similar to present tandem programs as to cost per unit **subsidized—on** the order of \$3,000 per housing unit. Larger subsidies per unit might be necessary to get funds to the marginal borrowers. Moreover, since these mortgages would be more risky than those currently **subsidized**, the cost to the Treasury could be considerably **higher**, either through reduced resale value when GNMA resells the mortgages or through defaults on mortgages in **GNMA's** portfolio.

Other effects; Past experience with federal subsidies for home **pur-**chasing for lower-income households has not always been **good—in** some instances program abuses have led to high cost to the government and little or no benefit to intended recipients. This option would face the same potential dangers.

2. Expand tandem plan activities to focus on long-run credit assistance, perhaps only to specific **subsectors (e.g., single-family or multi-family; government financed, government insured, or conventional)**. This option would put the federal government in a long-run effort to assist selected owners of housing by reducing interest costs.

Cyclical effect; small or zero.

Long-run effect: **Tandem-type** activity will draw more borrowers and more savings into the mortgage market to the extent that it goes to borrowers who would not have borrowed without the interest rate subsidy. Otherwise, if the subsidized mortgages are available to those who would have borrowed at the market **rate**, some borrowers receive a subsidy but the total amount of home purchasing is essentially unchanged. The effect also depends on the responsiveness of investors (persons or **institutions**), especially their **receptiveness** to whatever **financial** instruments are used to finance the tandem plan purchases. Added mortgage funds again flow only to the extent that the purchasers of these instruments would not otherwise have directly or indirectly been investors in mortgages.

Broaden availability of credit; Again, to the extent that the **subsidies** are targeted on marginal borrowers, the program will bring net additional **homebuyers** into the market. The targeting could be aimed at specific **disadvantaged** groups or neighborhoods.

Budget impact: Would depend on timing of purchases and resale or refinancing of mortgages. Cost per unit could be either more, less, or about the same as current programs. If the program **were** operated so as to have a neutral cyclical effect, the unit cost would be somewhat higher than for the present (countercyclical) programs.

3. Expand Section 235 Homeownership and Section 236 Rental Housing Programs. **These** programs provide interest subsidies on **FHA** and **VA mortgages** for lower-income families and for single- and **multifamily** dwellings. Other than the income restrictions on eligibility, their impacts on the availability and costs of mortgage credit are similar to those of tandem plan activities. Moreover, the funding of programs 235 and 236, like tandem, must be rationed, since subsidies cannot be given to all who are eligible.

Long-run effect; Since the program provides subsidized mortgage credit directly to lower-income borrowers and builders of lower-income rental housing who probably would not be in the residential mortgage market without a **subsidy**,^{1/} a net increase in home purchasing as well as in lower-income rental housing will result if the **program** is implemented successfully. **However**, to the extent that the recipients are borrowers who would not have received conventional **loans**, then funds may be drawn away from market-rate mortgages.

Broaden availability of credit; The option is **specifically** designed to make **lower-cost** credit available to lower-income homebuyers.

1. The builders might, of course, operate in the **non-low-income** part of the market.

Budget impact: The cost per unit may be higher than tandem **programs**, for two reasons. First, the subsidy is **deeper**—the differences between market and subsidized interest rates are greater for 235 and 236 programs than for tandem plans (original 235 and 236 subsidized rates were as low as 1 percent, revised 235 rates may be as low as 5 percent, while tandem rates have been no less than 7 1/2 **percent**). Second, interest payments are provided over the life of the 235/236 loans and thus the terms may be longer than the anticipated average life of tandem plan mortgages (12 **years**). In fiscal year 1975, the average subsidy on 235 mortgages amounted to \$630 annually; the current average is \$903 per **year**. In addition, for those 235 loan recipients whose shares of mortgage payments are calculated on 20 percent of adjusted gross incomes there is no incentive to avoid higher priced **housing**, and therefore the higher mortgage amount, since they do not pay the additional costs themselves. Existing limitations on maximum loan values restrict this effect, **however**.

4. Provide interest subsidies on taxable state and local bonds to finance residential housing investment (as under Section 802 of the Housing Act of 1974). **There** are now 30 states with housing **finance** and/or **development agencies**; only 15 have actually initiated housing **development** and of the 15, approximately 11 have issued bonds or notes. These have all been **tax-exempt**; the interest rates have been 2 to 2 1/2 percentage points lower than the rates on conventional mortgages. Section 802 provides authority for the federal government to subsidize interest rates, should these agencies choose to issue taxable bonds. The subsidy can be up to one-third of the interest costs, which would approximately equate the net interest cost to the state agencies and allow them to tap the larger taxable-bond market. HUD is only now preparing to implement this authority, and the Administration has requested a **recission** which has not been approved.

Long-run effect: This option would tend to increase the long-run availability of funds to state housing finance agencies, provided that the **one-third** subsidy proves adequate to compensate state agencies for the higher taxable rates. However, even this option may be insufficient in light of current market reluctance to acquire a large amount of state and local obligations regardless of the yields. Federal insurance or guarantees of the state agency obligations, also authorized under Section 802, would probably solve the **agencies'** financing problems but would involve additional risks to the federal government. HUD is currently working on a co-insurance formula for mortgages held in housing finance **agencies'** portfolios, under existing authority.

Broaden availability of credit: This option would have no **affect** on availability of credit for **disadvantaged** groups if the funds are used in traditional ways. **However**, the availability of lower-income rental housing could increase significantly (under the Section 8 **program**).

Budget impact: The existing appropriations of \$15 **million**, for one **year's** subsidy payments on **40-year bonds**, would support 15,000 to **20,000**, of the total number of 125,000 new units proposed in the President's 1977 budget, under the Section 8 program. The President's budget anticipated that **20,000** units would be constructed by state housing finance agencies in fiscal year 1977.

If the guarantee provisions of Section 802 were implemented, additional budget costs due to defaults might be expected. Co-insurance is favored by HDD precisely because it is expected to reduce this risk.

Direct Loans

1. Provide direct loans through **FHA, FmHA and VA**, perhaps at the **FHA/VA** rate. All three agencies could provide direct loans either at subsidized or at market interest rates, for single-family homes. The funds could be borrowed from Treasury or the Federal Financing Bank.

Cyclical effect: The program could be designed to operate **counter-cyclically**. To be **effective**, it would have to bring net additional borrowers into the market. Treasury borrowing to finance such a program would tend to raise interest rates, resulting in reducing funds available to **S&Ls**, and hence negating part or all of the countercyclical effect. The extent of this negative effect (comparable to that of **GNMA** tandem programs) depends on the scale of borrowing and the responsiveness of investors in the various securities markets. The negative effect would be reduced longer-term borrowing by the Treasury.

Long-run effect: As mentioned earlier, the program might divert savings from thrifts and commercial banks into the government securities that are marketed to finance direct loans. Hence, the total supply of mortgage funds may not increase very much.

Operations of **thrift institutions**: The loans provided in this option would compete with loans provided by these institutions unless tightly targeted on borrowers who are unable to obtain loans through normal channels.

Broaden availability of credit: Direct loans could alleviate shortage of mortgage credit in **specific "redlined"** and other credit scarce

areas. Loans can be given to specific income classes of borrowers, and thus eliminate the effects of higher mortgage interest rates and other forms of credit rationing on certain borrowers.

Budget impact: Direct loans, unless made **off-budget**, have much higher immediate budget impacts than interest-rate subsidies since the entire amount of direct loans are recorded as budget expenditures. Later repayments would reduce the long-run impact. Of **course**, this option would make the government the only screener of mortgage applications, and expose the Treasury to risk of default based on government lending practices, in contrast to the joint **private/public** approval process under **FHA** insurance.

Other effects: Treasury borrowings to provide direct loans may increase the **government's** borrowing costs to finance the public debt, by raising all government rates because of the additional government demand for funds to finance direct loans.

2. Nonfederal direct loans through local governments. This option is discussed here as an alternative to option 1 **above**, and because federal funds (community development block grants and tax expenditures on **tax-exempt** bonds) are used to finance the lending.

These **loans**, to purchase and/or rehabilitate substantially housing in redlined areas, can be designed to attempt to induce further investment from private lenders for the preservation and upgrading of housing in declining areas. Currently, a number of direct loan experiments have been undertaken by some city governments and local lenders.

Broaden availability of credit: These programs are designed to **provide** housing **financing** for **specific** classes of borrowers in redlined **areas**. Local governments are in the best position to identify neighborhoods where such a program might be most effective. Thus, **nonfederal** direct loans or some combination of federal **and/or** state insurances or guarantees of **locally-financed** direct loans could alleviate prolonged credit shortages in redlined or other credit-short areas.

Budget impact: To the extent that federal funds used for such **programs** are used to leverage other funds, the impact on the federal budget per housing unit assisted will be less than for direct **unleveraged** **lending**. Moreover, any defaults will not increase federal outlays.

To the extent that municipal bonds are used to **finance** the programs, a federal tax expenditure is involved.

3. Continue or discontinue the Section 312 program of direct federal loans for substantial rehabilitation. Under Section 312 of the Housing Act of 1964, the government **makes** rehabilitation loans at subsidized interest rates to owners and tenants in specially designated neighborhoods. President Nixon impounded the appropriation for this **program**, and President Ford has proposed that it be discontinued on the ground that local governments may use community development block grant funds for this program.

Broaden availability of credit; The program has resulted in **rehabilitation** that otherwise may well have not occurred, in neighborhoods where normal credit channels are not readily available.

Insurances and Guarantees

1. Provides federal coinsurance of long-term loans for single- and multifamily dwellings. Considerable attention has been given to limited experimental design of coinsurance programs in which the public or private lender shares the risk of loss from serious defaults and foreclosures with the federal government. The concept underlying this approach is that the basic processing and underwriting decisions will be delegated to the lender who also assumes a small percentage share of the potential costs. The federal government and the lender would share (say in 80:20 proportions) net losses from default in contrast to more traditional private and public mortgage insurance programs in which the insurer takes full responsibility for losses up to a set percentage of the mortgage amount.

Long-run effect; The coinsurance option would clearly be less **attractive** to lenders than full federal assumption of **risk**, and thus might discourage some mortgage lending relative to the present FHA insurance approach. Secondary mortgage market purchases, traditionally largely of more fully federally insured mortgages, might also be hindered. **On** the other hand, if recent large losses in the special assistance type FHA operations produced unwillingness to fund such **programs**, coinsurance would be expected to produce somewhat greater lending than no insurance at all. Furthermore, transferring underwriting responsibilities from FHA to private lenders may overcome some of the time delays which have discouraged insured lending.

Broaden availability of credit; Availability of credit to lower-income people and buyers or residents in some older neighborhoods is heavily dependent on FHA insurance. Thus the long-run supply effects described above will have by far their major effect on these groups.

Budget impact; Since coinsurance involves a shared risk, the federal **government's** cost for a given amount of insured lending will be smaller than with full insurance. This saving would be partly

offset by a sharing of insurance premiums. Additional savings should come **from** the **government's** reduced administrative activity, and particularly from more careful underwriting by private lenders who share the default risk.

Other effects; Full federal insurance has helped to create abuses in some **redlined** areas, with lenders willing to finance home purchases at prices far above the value of poorly repaired homes since they bear no risk. Coinsurance could serve to discourage such abuses, but, of course, with some cost (possibly great) in the availability of any credit in such areas.

2. Provide federal insurance to cover potential income losses to lenders whenever shorter-term interest rates increase above mortgage rates.

The government would protect lenders when short-term interest rates **rise** above mortgage **rates**, either by insuring payment of the difference in exchange for a premium, or by offering lenders, at the time they made mortgages, the **option** of exchanging them for obligations of the same **principal** but paying current short-term **rates**. In the latter **case**, the government would pay or receive the difference between short-term rates and long-term rates. In both cases lenders would retain responsibility for servicing and defaults.

Cyclical effects; This option would improve availability of mortgage credit **in** tight money periods by giving thrifts higher earnings without raising rates to borrowers. The earnings would enable thrifts to compete for savings deposits if deposit rate ceilings were lifted, or to pay for other fund sources.

Long-run effects: Long-run supply should be improved somewhat by lenders' increased willingness to make mortgage loans because of the protection from interest rate risk.

Operations of thrift institutions; Would be eased by reducing risk of losses and improving ability to retain loanable funds.

Budget impact; The federal government would bear some budget costs or earn some net return. The net impact is difficult to evaluate. Estimates show that the government would have earned a profit on the obligations exchange program for the period 1950-1973 because long-term rates usually exceeded the average of short-term, and only in 1974 would the cost become positive. Estimated 1950-1974 total cost would have been \$3 billion, assuming all mortgages made by thrifts were entered into the program. Costs under the insurance premium plan would obviously depend on premium levels.

3. Provide federal insurance coverage for secondary market investors. **Traditionally**, federal insurance programs have concentrated entirely on the

primary mortgage market. However, given the declining volume of **FHA** activity in this market and the continuing concern of secondary mortgage investors about purchasing conventional **mortgages**, the federal government could provide specific secondary market **insurance**, insuring loans initially made with private or no insurance when they are sold in the secondary market. There are a number of alternative concepts the federal government can employ to support the secondary market. Federal reinsurance of privately insured mortgages is one possible approach. Additionally, the coinsurance concept already introduced by **FHA** in the primary market can be extended to uninsured or privately insured mortgages or to the entire portfolio of a secondary market investor.

Cyclical effects: This option would help to moderate credit cycles by increasing the ability of primary lenders to obtain funds by selling mortgages in secondary markets when tight money conditions restricted their ability to attract deposits.

Long-run effects: The option would also increase the long-run supply and decrease the cost of mortgages to the extent that it helped to expand the secondary market to investors previously unwilling to purchase conventional mortgages.

Operations of thrift institutions: Thrift operations would be made more efficient by the added ability to sell conventional mortgages to obtain funds as desired.

Budget impacts: The implied expansion of government **(co) insurance** would have budget costs to the extent that losses on defaults exceeded premiums. The cost level obviously depends on the premium charged and riskiness of the insured loans.

4. Guarantee of state housing finance agency bonds. This option was discussed above in the context of Section 802 interest **subsidies**.

Secondary Market Support Activities

1. Provide long-term Federal Home Loan Bank loans in tight money periods. The Financial Reform Act of 1976, as proposed in the House of Representatives, provided for loans of up to 30 years from the **FHLBB** to savings and loans, mutual savings banks, credit unions, and commercial banks in periods when credit is not readily available for residential mortgage loans. This differs from current programs limited to five-year maturity "advances" to savings and loans. The loans are to be financed by borrowing from the Treasury or through the Federal Financing Bank (**FFB**). The loans would be made to primary lenders at the cost of borrowing plus operations costs. Lenders would be allowed to loan the funds only for homes with sales price

less than 150 percent of the median price in its geographic area or rental buildings with unit rents less than 150 percent of median area rental, and lending rates would be limited to the borrowing cost plus a reasonable profit. (The program is, of course, not a secondary market program in the traditional mortgage-purchase **sense**.)

Cyclical effect; This option may help moderate cyclical shortages in mortgage credit somewhat, by providing a source of long-term fund funds to lenders in tight money periods. If Treasury (or **FFB**) borrowing for this purpose is relatively long term as is apparently intended but not **required** in the bill, there will be less pressure on short-term rates than under the current advances **program** and thus less likelihood of the program being partially **self-defeating** by causing further deposit **withdrawals**. The long-term nature of the funds might limit the current practice of rapid repayment of **FHLBB** advances when deposits begin to flow back into savings and loans, which tends to lengthen periods of mortgage credit **shortage**. On the other hand, long-term borrowing in tight money periods, though initially cheaper than short-term **borrowing**, may not greatly appeal to mortgage-lending institutions if they expect interest rates to return to lower levels. It does not solve the basic long-term loan, short-term deposit problem of lenders locked into low yield mortgages when interest rates rise.

Long-run effect: To the extent that the option is **financed** through funds from such institutions as pension funds and insurance companies beyond their usual participation in mortgage financing, it should add to the long-run supply of credit (despite its intended **primary** countercyclical **focus**).

Broaden availability of credit; Because the option limits lending to non-luxury housing, it may result in some increase in credit availability to relatively lower-income people who are less attractive customers for lenders in periods of credit shortage.

Budget impact; The long-run direct cost to the government should be zero, **since** funds are to be loaned at interest adequate to cover borrowing and operating cost. Since the initial borrowing **options** are **on-budget**, the short-run budget impact could be **substantial**. There could be an impact on federal borrowing cost (interest) generally due to the increased borrowing.

2. Increase secondary-market countercyclical operations by **FNMA**, **FHLMC**, and **GNMA**. These government sponsored agencies could operate countercyclically on a larger scale than at present particularly by increasing purchases of conventional mortgages and limiting resales in tight money periods.

Cyclical effect; Studies show these operations to have had some **countercyclical** impact 2/ in the past, which presumably would be increased by expanded operations. **However**, even more than in the tandem plans there is the likelihood of secondary market funds being substitutes for rather than additions to total mortgage funds (since there is no interest subsidy to attract additional **borrowers**). The agencies do encourage mortgage lending by bringing in some funds from **nontraditional** mortgage lenders and by decreasing the risk of **illiquidity** for primary lenders.

Long-run effect; Net long-run effects depend on whether the agencies resell the mortgages in easy money periods (little long-run effect) or continually increase portfolios (greater **effect**).

Operations of thrift institutions; Secondary market purchases provide a hedge against illiquidity for thrifts, which can sell mortgages they hold to meet deposit withdrawals or advance mortgage commitments.

Broaden availability of credit; Countercyclical activity improves availability for the poorer risks and smaller scale borrowers who cannot obtain credit in severe shortages.

Budget impact; Among the secondary market **operations**, only **GNMA's** are **on-budget**. **GNMA's** budget impacts have been discussed above.

3. Increase secondary market operations by **FNMA**, **FHLMC**, and **GNMA** over the full credit cycle, by greater purchases of mortgages without resale (greater net purchasing).

Long-run effect; Expanded secondary operations over the long-run would increase the total supply and lower the cost of mortgage credit to the extent that the saver-investors in obligations sold to **finance** these activities spent funds which would not otherwise have gone into mortgages.

2. See, for example, Barry **Bosworth** and James **Duesenberry**, "Policy Implications of a Flow of Funds **Model**," Journal of Finance Papers and Proceedings, 1974.

Tax Expenditures

1. A tax credit against a portion of interest earned on residential mortgages was included in Financial Institutions Act-related legislation in the Senate Finance Committee (but not in the House Financial Reform Act **legislation**). The Senate bill provided for a tax credit of $3 \frac{5}{6}$ percent of earned interest on qualifying loans for institutions with at least 80 percent of their assets in residential **mortgages**, with the percentage credit reduced one-thirtieth of 1 percent for each percent of assets below 80 percent down to $1 \frac{1}{2}$ percent of credit for 10 percent of assets. The credit would be available to lending institutions of all types except **FNMA** (and to individuals at the $1 \frac{1}{2}$ percent **level**), but in the case of thrift institutions would substitute for presently allowed bad debt reserve deductions in excess of actual **experience**.

Cyclical effect: Cyclically, the tax credit has effects which offset each **other**. The credit is more valuable in periods of higher interest rates (since it is a percentage of **yield**), increasing the incentive it provides to invest in mortgages rather than other taxable assets. On the other hand, the increase in **thrifts**" marginal tax rates from substitution for the excess bad debt reserve makes increases in interest rates on **tax-exempt** bonds of more value relative to mortgage rate increases than **before**, inducing greater shifting from mortgages to bonds in tight money periods. There is no empirical study to evaluate the net effects.

Long-run effect: The tax credit should be expected to lower mortgage interest rates over the long **run**, by increasing the flow of funds into mortgages from all lenders combined. Thrifts could be expected in general to continue to keep nearly 80 percent of their assets in mortgages, because the sliding scale of the tax credit gives marginal additions to residential lending very high after-tax yields up to the 80 percent of assets **level**.^{3/} Commercial banks and other discretionary investors with less but not much less than 10 percent of assets in mortgages would have a very

3. For example, if a thrift currently had 79 percent of assets in **mortgages**, the current mortgage interest rate is 9 percent, and average yield on mortgages held is 8 percent, the after-tax yield on putting the next 1 percent of assets in residential mortgages is as high as that for investment in other assets yielding 10.38 percent. The 1.38 percent gross yield differential comes as **0.59** percent from the tax credit directly on the additional mortgages and another **0.79** percent from the increase in tax credit on mortgages already held as a result of increasing percent of assets held in mortgages.

strong incentive to move to 10 percent **holdings**, since that minimum allows a jump from 0 to 1 1/2 percent tax credit on interest on eligible **loans**.^{4/} An off-setting factor is that savings and loans with greater than 80 percent of assets in residential mortgages would have substantial incentive to switch some assets to **tax-exempt** bonds, since their marginal tax rates would be significantly increased by loss of the excess bad debt provision. An empirical study of the impact of the mortgage tax credit ^{5/} assumed portfolio switches of the types described and **finds** a modest lowering of mortgage interest rates, varying from 5 to 15 basis points (**hundredths** of a percentage **point**), depending on other assumptions about **institutions'** behavior under additional **FIA provisions**.^{6/}

Budget impact: The mortgage interest tax credit does involve **substantial** tax expenditure costs to the federal government, even after netting out the gains due to substituting it for the excess bad debt reserve provisions for thrifts. The increase in cost goes partly to thrift **institutions**, whose tax savings are greater under the tax credit than under excess bad debt reserve provisions, and partly to commercial banks and other institutions and individuals who qualify for the credit but not the reserve. The Treasury has estimated this cost at \$264 million in **fiscal** year 1977, rising to \$824 million in fiscal year 1980.

2. Proposed changes in the tax treatment of mortgage interest on owner-occupied homes **have** taken a number of forms, generally focusing on equity **considerations**. The current unlimited deduction is more valuable to higher-income people, because their higher tax rate means a greater saving for each dollar of deduction. They own more expensive houses with larger mortgages and interest costs, and they are more likely to itemize

4. For **example**, banks that already have 8 percent of their assets in mortgages would increase after-tax earnings by raising their investment to 10 percent even if alternative assets yield a full percentage point more than mortgages. See **Patric H. Hendershott**, "The Impact of the Financial Institutions Act of 1975," Appendix A (typewritten paper, August 1975).

5. See **Patric H. Hendershott**, "The Impact of the Financial Institutions Act of 1975," (typewritten paper, August 1975).

6. Those estimates should be expected to understate the reduction, since they are based on an earlier FIA provision of a maximum 3 1/2 percent tax credit with 70 percent of assets in residential mortgages which suggested reduction in **S&Ls** share of assets in mortgages.

deductions.^{7/} Renters, more often lower-income people, of course gain no benefit at all from the deduction.

One **proposal**, to convert the deduction to a tax credit, would make each dollar of interest paid produce the same tax saving regardless of taxpayer income. The tax saving would then be approximately proportional or perhaps somewhat progressive among those who are **homeowners**,^{8/} and would be available even if deductions were not large enough to be itemized. **Another**, to limit the maximum size of the deduction or credit, would remove the large **benefits** to high-income people which are really not useful in widening homeownership.

Broaden availability of credit; Such changes would spread the tax **expenditure benefit** more evenly to lower-income homeowners with resultant broadening of lower net interest costs.

Budget impact: The net cost or saving to the Treasury obviously **depends** on the size and structure of tax benefits provided.

Regulation Of Mortgage Lending Institutions

1. Proposals to end regulation of maximum savings deposit interest rates paid by commercial banks and thrift institutions (after five and one-half years and subject to further evaluation) have received recent consideration in the **Congress.**^{9/}

Cyclical effect: The effect of elimination of the ceiling on deposit interest rates on cyclical fluctuations in mortgage credit **supply** is uncertain. A factor that would reduce the severity of cycles is that loss of savings to thrifts and commercial banks together when short-term interest rates rise should be reduced by the expanded freedom to compete for them. But elimination of ceilings could cause more severe cycles by encouraging a

7. According to the Treasury an estimated 27 percent of all tax returns will claim these deductions in fiscal year 1976, with an average tax savings of \$325. However, of taxpayers claiming income over \$100,000, 87 percent claim **homeowners'** deductions with an average **\$2,289** saving.

8. Depending on the ratio of mortgage debt to income.

9. The Senate Financial Institutions Act (**FIA**) of 1975 (S. 1267) passed the Senate with this provision; and the Financial Institutions Subcommittee of the House Banking, Currency and Housing Committee considered the Financial Reform Act of 1976 containing a comparable measure.

flow of savings from thrifts to banks which make far more non-mortgage investments, resulting in greater reductions in mortgage **lending**. The reason is that thrifts are investors mainly in long-term mortgage assets and might be unable to pay rates as high as those of commercial banks in tight **money**, high short-term interest periods. Even if cyclical credit availability were increased, credit costs might still rise because of the higher rates institutions were paying for deposits. Unfortunately, no empirical or simulation analysis is available on the cyclical questions.

Long-run effect: The results of such a change for long-run mortgage credit supplies are also uncertain. Tending to increase long-run supply is the fact that increases in deposit rates should raise total deposits in banks and thrifts. **Working** to discourage mortgage lending is the likelihood that the existing regulated differential between thrift and commercial bank rates would **disappear**, again resulting in shifts from thrifts to commercial banks. Available analyses suggest that impacts on both mortgage flows and interest rates could be either positive or negative but would be small in either direction. A possibility neglected by the analyses but viewed as reasonably likely by some economists and thrift institution **officials** is that commercial banks might be able to significantly outbid thrifts for savings, especially in high interest rate periods, given the shorter-term maturity and greater flexibility in their asset portfolios. The outcome in that case could be substantial increases in mortgage credit costs and decreases in flow.

Operations of **thrift institutions**: The substantial effects for thrifts are discussed above under cyclical and long-run effects.

2. The Senate and House (early version) financial acts provide for expansion of thrift institution lending powers to allow investment in **consumer** construction (without permanent **take-out financing**), **nonresidential** real estate, education, and community development loans, and commercial paper and (Senate only) other corporate **debt**.^{10/}

The effect of expanded powers on mortgage credit supply both cyclically and in the long run would be the result of two factors acting in opposite directions. It is uncertain whether the net outcomes would be more or less mortgage lending at lower or higher interest rates.

10. The Senate limits these to a total of 30 percent of assets. The proposed House bill required that savings and loans retain 80 percent of assets in residential mortgage loans and related investments to be allowed the expanded powers.

Cyclical effect; Helping to moderate **cycles** would be the fact that, in tight money periods of credit cycles with high short-term interest **rates**, the new investment powers would allow thrifts to earn higher yields and thus better retain loanable savings (assuming deposit rate ceilings were raised or **eliminated**). On the other **hand**, thrifts would accomplish this by investing what new savings inflows and repayments on existing mortgages they received in the higher-yield **nonmortgage** investments rather than mortgages. Thus the severity of cyclical declines in mortgage credit availability could increase or decrease. Even if availability increased, mortgage credit cost might still rise since deposits were being attracted at higher cost, and high alternative yields were available. Unfortunately, no empirical evidence exists to indicate the likely outcome.

Long-run effect; In the long run, ability to put money in higher yield investments would presumably raise deposit rates thrifts could pay (again assuming ceilings were **lifted**), thus drawing in more savings and making possible more mortgage lending. But some part of these funds, and perhaps more than the total addition, would be put into the newly allowed nonmortgage investments, so that mortgage credit supply could **decline**. Simulation analyses indicate that the net effect on the long-run cost of mortgage credit could be positive, negative, or **neutral**, depending on assumptions about the response of lenders to new investment choices and of savers to increased deposit rates. Under most assumptions, the predicted magnitude of net effect on interest rates is again not great. (Within the range of 20 basis points, but assumption of greater shifting tested at Senate Banking Committee request yields estimates of long-run mortgage rate increases of 50 basis points.)

Operations of thrift institutions; The expanded powers, while either **helpful** or harmful for mortgage **lending**, are definitely advantageous to thrifts since they expand available options for increasing earnings.

3. Provision of expanded services by thrift institutions, in the form of demand deposits (checking accounts) and consumer loans, was also proposed by Senate **FIA** and House **FRA**.

Cyclical effect; Demand deposit services should have little effect on cyclical credit flows and interest rates. Some reduced cyclicity might result from demand deposits being less subject than savings deposits to interest rate-connected outflow.

Long-run effect; The added checking account services should attract a greater supply of funds into thrifts and thus increase the flow

of funds into mortgages. Magnitudes are difficult to estimate since there is little directly relevant evidence on either how much additional business the services would attract or what share of demand deposits thrifts would put into mortgages. (Simulations using alternative assumptions indicate eventual long-run decline in the mortgage interest rate of 5 to 50 basis **points**, which is further estimated to produce a maximum of 2 percent additional mortgage stocks and 1 percent additional increase in the housing stock over ten **years**.)

Operations of thrift institutions; Allowing thrifts to attract **additional** funds obviously may improve their profitability though not necessarily their efficiency.

The uncertain effects of allowing lenders to make consumer loans have been discussed in option 2 above.

4. Allowing lenders to use housing finance lending instruments that differ substantially **from** the current standard **mortgage** has been suggested as a solution to several housing finance **problems**: **high** initial costs to **homebuyers** lowering long-run demand, uneven savings flows to lending institutions with resulting cycles in mortgage credit supply, and high risks to mortgage lenders. A number of alternative instruments have been proposed, varying in their ability to deal with each of the problems.

The standard mortgage is characterized by its long-term, fixed-interest rate and equal monthly payments. As has been discussed in previous **chap-**ters, the first two characteristics help create difficulties for lenders which are then reflected in the supply of mortgage credit: with earnings on outstanding mortgages fixed, thrift institutions cannot afford to pay the interest rates necessary to compete for savings in high-interest periods (even if rate ceilings were **lifted**) .

Further, these mortgage characteristics combined with fluctuations in interest rates may make institutions wary of lending funds for long-term mortgages except at rates including a substantial risk premium, since they may otherwise later be caught paying high rates for their funds relative to their **earnings**.^{11/}

On the credit demand side, equal monthly payments under the standard mortgage may mean high initial housing costs relative to income for many borrowers, especially in inflationary periods. The reason is that mortgage interest **rates**, reflecting expected inflation, determine monthly payments

11. Even with deposit-rate ceilings in operation the risk premium may still be sought, because deposit outflows can force thrifts to obtain other funds at high cost (e.g., **FHLBB** advances, or sales of mortgages at discounts).

immediately while higher money incomes which inflation might be expected to bring are not earned until future years. In **addition**, fixed long-term interest rates on mortgages may well encourage borrowers to defer home purchases in periods of high interest **rates**, exacerbating cyclical swings in the housing market.

However, the standard mortgage has proved an attractive way for many people to invest in their own homes, building equity as inflation increased values without raising debt, and gradually decreasing the real cost of fixed monthly payments. It remains to be seen how popular alternative mortgage forms will be with **homebuyers**.

One proposed new instrument is the variable rate mortgage (VRM), a long-term mortgage carrying periodically adjusted interest rates. Adjustment is based on some measure of current short, medium, or long-term rates (a "reference" rate agreed to in **advance**). Mortgage payments are recomputed each **time** the interest rate is adjusted, to cover principal and interest if the new interest rate were to apply for the full terms of the **mortgage**.^{12/}

Cyclical effect; Cyclical decreases in mortgage credit supply would clearly be moderated by introduction of **VRMs**, if deposit rate ceilings were **eliminated**, because of thrift **institutions'** added ability to compete for deposits to then loan out. And potential housing purchasers would have less incentive to defer borrowing in high interest rate periods, because their mortgage rates would not be fixed at temporarily high levels. Borrowers, however, are made to suffer uncertain and possibly very substantial cyclical variations in their payments over the lives of their loans. Cyclical variations in mortgage borrowing/lending and housing purchasing might thus be moderated but at a cost to borrowers that has raised great opposition to VRMs from consumer and labor groups.

Long-run effect; Long-run credit supply impacts of VRMs are much less **certain**. The risk reduction for lenders might be expected to result in lower average interest charged on mortgages. But many factors affect the relative future interest rates on short- and long-term lending which are the actual determinants of relative VRM and standard mortgage borrowing costs.

Operations of thrift institutions: The advantages of VRMs to mortgage credit lending institutions are substantial, particularly if short-term interest rates are used for reference. Institutions are protected from the risk of being **locked-in** at earnings below costs

12. In another variant, the term of the mortgage is adjusted on the same basis with monthly payments kept constant. However, this alternative is of limited feasibility because the term becomes infinite for quite moderate rate fluctuations.

because interest received rises as interest paid does. If deposit rate ceilings are retained, they are **protected** from having to offset savings out-flows at costs above their earnings. If ceilings are lifted, **they** can compete effectively for savings without threat to net **earnings**.

Budget impact; **VRMs** have no direct costs to the government, but indirect costs might result if VRMs were insured by **FHA** and payment variations resulted in defaults.

Other effects: Another disadvantage to the government is the **political** pressure homeowners might place on the authorities whose monetary and fiscal actions determine interest rates.

Related approaches; Another alternative lending instrument is the graduate payment mortgage (GP), made at a fixed interest rate like the standard mortgage but with payments set at some smaller level in earlier years and growing larger **later**. The GP has none of the VRMs cyclical effects for borrowers or lenders because of the fixed interest rate. It may encourage **homeownership** in the long-run by lowering initial payments and allowing them to rise as **borrowers'** money incomes rise, but this effect could be **offset** by higher down payments needed to compensate for the risk of low early equity build-up.

More complex instruments, constant-payment-factor-variable-rate mortgages and price-level-adjusted mortgages, attempt to combine the advantages of VRMs and GPs. Payments are computed based on a **fixed** real interest rate (agreed to by borrower and **lender**), outstanding principal and remaining loan **life**; but principal owed is adjusted according to interest owed at short-term rates or real interest plus inflation rate respectively, so that payments rise gradually approximately in line with inflation.

Lenders receive interest which follows short-term interest rates (interest **rates**, of course, need not move exactly with inflation), with the advantages to them explained above under VRMs. Cyclical credit supply problems would be reduced as with **VRMs** (again assuming lifting deposit rate **ceilings**), and **borrowers'** incentive to defer purchases in high interest periods is removed without subjecting them to **VRMs'** wide fluctuations in payments. Long-run home investment might be encouraged, as with GPs, by the lower initial payment level. But there are the serious disadvantages in that **individuals'** incomes may not rise in line with inflation so that the large later payments become highly burdensome, or that some home values may not rise with inflation so that little or no equity is developed in early years. And borrowers, who have generally **benefited** from inflation in home values greater than

that anticipated by long-term interest **rates**, would lose that advantage as mortgage balances were adjusted upward. Costs to the government might arise as defaults on such loans if they were insured.

5. The Senate Financial Institutions Act proposes elimination of interest rate ceilings on **FHA-insured** and **VA-guaranteed loans**, along with prohibition on the charging of **points**.^{13/}

The proposal is intended to increase the flow of such **loans**, on the assumption that this flow is hampered by ceiling rates below market rates particularly in tight money periods of credit cycles. Proponents of ceilings argue that they result in lower effective interest costs to borrowers and thus both assist **homebuyers** and thereby stimulate the housing industry.

Cyclical effect: Available evidence suggests that ceiling rates have little effect on cyclical mortgage flows and **homebuying**, and that therefore removing ceilings would also make little **difference**.^{14/} Apparently housing buyers and sellers absorb points charged by lenders in some combination, with little effect except to encourage some switching from federally insured to conventional borrowing.

Long-run effect: Long-run impacts are similarly negligible.

Broaden availability of credit: Particular **borrowers--those** with limited resources for **downpayments** and/or living in areas in which conventional mortgage lending is not **available--may** suffer negative results from ceilings. To the extent points charged to compensate for low ceiling rates are paid by buyers, they amount to an addition to the cash (**unborrowed**) payment buyers must make at the time of purchase. This hurts people with low savings and may

13. A point is one percent of the face value of a mortgage, paid by the seller of a home to the lender as a fee for making a loan to the buyer. When ceilings are lower than market rates, charging of points is used by lenders to make effective yields on the government-backed loans the same as for conventional mortgages. Since the points are paid immediately, the lender in effect loans out less than the full value of the mortgage but collects the **below-market** ceiling rate of interest on the full **value**. Fully offsetting charges are typically two discount points for each quarter percent the interest ceiling is below the conventional market interest rate.

14. See, for example, Eugene A. Brady, "An Econometric Analysis of the U.S. Residential Housing Market," and John **Kalchbrenner**, "A Summary of the Current Financial Intermediary, Mortgage, and Housing Sectors of the **FRB-MIT-PENN Econometric Model**," in National Housing Models, Bruce R. Ricks, **editor**, Lexington Books, 1973.

put home purchase beyond their reach. Those living in redlined neighborhoods do not have the option of switching to conventional lending. In **addition**, the combination of payment of points and regulated lower interest rates seems to have encouraged hurried foreclosures by lenders in such areas (to reap the profits of the points payment and then collect the insurance, rather than hold or resell the **loan**).^{15/} Thus the availability of mortgage credit on reasonable terms might be broadened by elimination of ceilings.

6. Consideration has been given by Congress to federal override of state usury laws, which limit maximum interest rates **charged by lenders**, often including mortgage **lenders**.^{16/}

Cyclical effect; While the presumed purpose of usury statutes is to maintain lower interest rates than would prevail in the market, and particularly to protect unsophisticated borrowers from **substantial overcharges**, the main result seems to **be** to intensify credit and housing cycles in affected states. When market interest rates rise above usury limits, total mortgage lending decreases in affected states as lenders seek higher yields **elsewhere**.^{17/} Lenders buy more mortgages and make more other investments out of **state**;^{18/} **out-of-state** lenders reduce activity in affected **states**; and in-state lenders lose deposits to **out-of-state** institutions which, unregulated on their loan yields, can better compete for savings. The resulting credit shortage has serious effects on new housing construction, as well as on financing of sales of existing homes. A study of 77 metropolitan areas indicates that, other conditions being equal, areas in states with ceilings below market rates had on average a 28 percent lower rate of building than those without effective **ceilings**.^{19/} The greater the **differential**, the

15. Brian D. **Boyer**, Cities Destroyed for Cash, (Follett, 1973), pp. 94-112.

16. For example, S. 3817 which pertained to corporate borrowing but gave rise to discussion of mortgage credit as well.

17. In states where points are not also limited or prohibited, they are used as compensation by some lenders. But lenders are reluctant to make loans inflated to higher percentages of loan value by points without accompanying mortgage insurance.

18. Norman N. **Bowsher**, "Usury Laws: Harmful When Effective," Federal Reserve Bank of St. Louis Review, August 1974, pp. 19-22.

19. Philip K. Robins, "The Effects of State Usury Ceilings on Single-Family Homebuilding," Journal of Finance, March 1974, pp. 232-234.

the greater was the construction **decrease** — a 1 percent increase in ceiling corresponding to a 16 percent increase in **starts**.^{20/}

Broaden availability of credit; Relatively **uninformed, poor-risk borrowers**, rather than being protected from paying **exorbitant** interest **rates**, more likely are made unable to obtain credit at all in tight money **periods**. The reason is that when interest rates are limited and funds are flowing elsewhere, credit tends to be rationed to borrowers of low risk and on more restrictive down payment and short-term **bases**.^{21/}

Nonetheless, rather than eliminating ceilings Congress could continue to leave usury regulation to states, on the substantial basis that most **disbenefits** accrue within the regulating state. States do in fact adjust their ceilings quite often when harmful effects **occur**. Another option is limited federal **override**, by creating automatically adjustable ceilings tied to regional market interest rates plus some margin (for poor risk **borrowers**) . This last possibility has the advantage of avoiding most negative effects while still affording some protection against loans at extreme interest rates to unwary borrowers.

7. Direct regulation of the geographic distribution of mortgage lending by thrifts and commercial banks and stricter enforcement of anti-discrimination regulations have been advocated as means to overcome lack of conventional mortgage credit availability in some urban neighborhoods.

Broaden availability of credit: The approach is most appropriate in areas where lenders have made decisions to deny loans based on race or other criteria other than actual economic risk of default and resale loss (actual risk would suggest risk-reducing approaches rather than requirements to face real future **losses**). There is substantial evidence of such discrimination in some **cases**.^{22/}

Problems exist, however, in determining which individual loans involve discrimination and which genuinely high risk, and how much lending should be **required**, to whom, and at what price. Some neighborhood citizen groups have expressed concern that regulatory mechanisms would never provide more than limited credit

20. Ibid.

21. **Maurice Goudzwaard**, "Price Ceilings and Credit **Rationing**," Journal of Finance, March 1968, pp. 179-183.

22. See, for example, Financial Institutions and Neighborhood Decline, Joint Center for Urban Studies for **FHLBB**, November 1974.

in their areas and suggest instead a **"greenlining" approach--**
"regulation" by local depositors agreeing to withdraw savings
from institutions practicing redlining. **This** would attach a cost
to redlining for lenders and might discourage it where the basis
was discrimination rather than **well-defined** expected financial
loss.

Budget impact; Direct regulation or mortgage distribution and stricter
enforcement of antidiscrimination regulations have administrative
costs for the government which are difficult to estimate.

EXPLANATORY NOTES FOR TABLE 3
Summary of Probable Impacts of Housing Finance Options

Actual federal credit policy directed towards the housing sector is so **complex**, and the options so **numerous**, that inevitably only some of the possibilities are covered here. The reader will also be aware that in many cases, the actual net effects of certain policies and programs are only poorly understood, and thus that evaluation is necessarily only tentative and incomplete. Subsequently, the impacts identified in the summary table are defined as:

1. **Positive:** i.e., the option provides some benefit in ameliorating the problems represented by the criteria;
2. **Negative:** i.e., the option exacerbates the problems represented by the criteria; and
3. **Neutral:** i.e., the option has little, if any impact, either from lack of effect or from approximately offsetting effect.

Options are evaluated according to their impacts on cyclical variations in housing **credit**, long-run credit supply, the difficulties of mortgage lending institutions in providing credit, and the availability of credit to people and places short of credit in the past.

As **examples**, an option with positive impact on cyclical variations means a reduction in the severity of cyclical swings in the availability and cost of mortgage credit (and **resultingly** a reduction in severity of variations in housing construction levels and other housing market activity and **costs**).^{23/} An option with positive impact on long-run credit supply lowers the long-run trend in mortgage interest rates (increasing funds available at any given interest **rate**). An option with positive impact on mortgage lending institutions increases the flow of savings to them, reduces the **cyclical**ity of those **flows**, and/or increases their net **revenues**.^{24/} An option with positive impact on the broad availability of credit obviously extends credit to a greater number of borrowers in underfunded areas. Extensions to neutral and negative impacts are straightforward.

The options are numbered and grouped into six **categories—A** through **F**. Budget impacts for options A through E depend on **specific** programming and financing provisions as discussed in the text. Regulatory options in Section F have no direct budget cost to the government except for the administrative costs of **F.9**.

23. It is, of course, the case that the existence of housing cycles has in the past had value in moderating cycles in overall economic activity.

24. It is important to note that an option which assists mortgage lending institutions may or may not have any positive effect on mortgage credit.

TABLE 3: SUMMARY OF PROBABLE IMPACTS OF HOUSING FINANCE OPTIONS

| Housing Finance Options (Page of discussion referenced) | Cyclical Variations | Long-Run Supply | Mortgage Lending Institutions | Broad Availability |
|--|---------------------------------------|--|-------------------------------------|-----------------------|
| A. <u>INTEREST RATE SUBSIDIES</u> | | | | |
| 1. Target countercyclical tandem plan activities more closely on marginal borrowers (p.27) | Positive (relative to present tandem) | Positive | Positive | Positive |
| 2. Expand tandem plan activities to focus on long-run credit assistance (p.28) | Neutral | Positive | Neutral | Positive |
| 3. Expand Section 235 and Section 236 interest subsidy (p.29) | Neutral | Positive | Neutral (small earnings increase) | Positive |
| 4. Provide interest sub- sides on taxable state and local bonds to finance residential housing investment (p.30) | Neutral | Positive | Neutral or negative | Neutral |
| B. <u>DIRECT LOANS</u> | | | | |
| 1. Provide direct loans through FHA, FmHA, and VA , perhaps at the FHA/VA rate (p.31) | Positive (if so designed) | Positive or neutral | Negative or neutral | Positive |
| 2. Provide nonfederal direct loans through local governments (p.32) | Neutral | Neutral or positive (depending on fund source) | Neutral | Positive |
| 3. Continue the Section 312 program of direct loans for substantial rehabilitation (p.33) | Neutral | Neutral | Neutral | Positive |

TABLE 3 (Continued)

| Housing Finance Options (Page of discussion referenced) | cyclical Variations | Long-Run Supply | Mortgage Lending Institutions | Broad Availability |
|--|------------------------|--|-------------------------------------|--|
| C. <u>INSURANCES & GUARANTEES</u> | | | | |
| 1. Provide federal coinsurance of long-term , single- and multifamily mortgage loans (p.33) | Neutral | Positive relative to no insurance; negative relative to full insurance | Positive | Positive relative to no insurance; negative relative to full insurance |
| 2. Provide federal insurance to cover potential income losses to lenders whenever shorter term interest rates increase above mortgage rates (p.34) | Positive | Positive | Positive | Neutral |
| 3. Provide federal insurance coverage for secondary market investors (p.34) | Positive | Positive | Positive | Neutral |
| D. <u>SECONDARY MARKET SUPPORT ACTIVITIES</u> | | | | |
| 1. Provide long-term FHLBB loans in tight money periods (p.35) | Neutral or Positive | Neutral | Positive | Positive or neutral |
| 2. Increase secondary-market countercyclical operations by FNMA , FHLMC , & GNMA (p.36) | Positive | Positive or neutral (depending on portfolio behavior) | Positive | Positive |
| 3. Increase secondary-market operations by FNMA , FHLMC , & GNMA over the full credit cycle (p.37) | Neutral | Positive | Neutral | Neutral |

TABLE 3 (Continued)

| Housing Finance Options (Page of discussion referenced) | Cyclical Variations | Long-Run Supply | Mortgage Lending Institutions | Broad Availability |
|--|--|---|-------------------------------------|-------------------------------|
| E. <u>TAX EXPENDITURES</u> | | | | |
| 1. Adopt a tax credit against a portion of interest earned on residential mortgages (p.38) | Positive, neutral or negative | Positive | Positive | Neutral |
| 2. Amend the homeowners deduction of mortgage interest from taxable income (p.39) | | | | |
| (a) limit | N.A. | N.A. | N.A. | Negative |
| (b) change to tax credit | N.A. | N.A. | N.A. | Positive |
| F. <u>REGULATION OF MORTGAGE LENDING INSTITUTIONS</u> | | | | |
| 1. End regulation of maximum savings deposit interest rates paid (p.40) | Positive, neutral, or negative | Positive, neutral or negative | Positive | Neutral |
| 2. Expand lending powers of thrift institutions (p.41) | Positive, neutral or negative | Positive, neutral or negative | Positive | Neutral |
| 3. Expand services thrifts are allowed to provide (p.42) | Approximately* neutral | Positive | Positive | Neutral |
| 4. Allow variable payment mortgages (p.43) | Positive,** but at cost to borrower in variability | Positive in availability. Uncertain in cost | Positive | Positive, neutral or negative |

*Excepting asset side effects of consumer loans.

**Particularly assuming elimination of deposit interest regulation.

TABLE 3 (Continued)

| Housing Finance Options (Page of discussion referenced) | Cyclical Variations | Long-Run Supply | Mortgage Lending Institutions | Broad Availability |
|---|--------------------------------------|------------------------|-------------------------------------|-----------------------|
| 5. Eliminate interest- rate ceilings on FHA-insured (p.46) | Neutral | Neutral | Neutral | Positive |
| 6. Modify state usury laws (p.47) | Positive (within affected states) | Neutral or positive | Positive | Positive |
| 7. Regulate geographic distribution of mortgage lend- ing by thrift institutions and commercial banks and strongly enforce antidiscrim- ination regulations (p.48) | Neutral | Neutral | Neutral or positive | Positive |

