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THE AVAILABILITY OF MORTGAGE FUNDS

Remarks of

SHERMAN J. MAISEL

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I welcome the opportunity to address you this afternoon so that I can make one of my periodic attempts to bridge what has too frequently been a major communications gap. That is the lack of understanding between those concerned that the flow of money and credit be consistent with the needs of the economy as a whole and those concerned that there be an adequate flow of credit into a specific segment of the economy, namely, housing.

While I will maintain Federal Reserve tradition and avoid a forecast, it probably is fair to say that I will not be surprised if much of this year is filled with a great deal of discussion, debate, and recriminations over the problems of the mortgage market. All this will be enlivened by statements calling attention to shortages of mortgage money, anger about rates, and demands for reform.

I think it vital that we not simply shrug our shoulders and close our ears because we have heard these problems stated in much the same terms so many times in the past. Rather, we must recognize that the frequent difficulty experienced by residential borrowers in getting adequate funds is a real, major, and recurring problem. We must try to understand why this problem arises so often. In the light of that understanding, we must try to reform the institutional arrangements that underlie the difficulties.

While I am pessimistic over the short run, I am optimistic that we can, over a longer period, make the necessary institutional changes. I think those concerned have a much better understanding of the basic problems than they did in the past. We have made some major improvements which should help ameliorate this year's difficulties. With a concentrated effort, further progress should be possible.

What has caused this communications gap?

Mortgage market difficulties have occurred when demand for output in the overall economy has risen faster than the ability to produce. When such excess demand threatened inflationary price rises, monetary authorities felt it necessary to slow down the increases in demand created by an expansion of money and credit. As a rule, they have believed it proper and necessary simply to limit the pool of funds available and to avoid going beneath the surface to see which specific demands were most affected by the credit slowdown. In some cases they may even have welcomed the fact that certain demands such as that for construction would fall as credit became more difficult to obtain.

On the other hand, those concerned with mortgage lending and housing have paid primary attention to the credit changes in their own markets. They have not been concerned with general inflation or excess demand. They have seen interest rates rise and the credit available to themselves fall. They have emphasized the decrease in national welfare which occurs as fewer houses are produced, rents and costs rise, slums get worse.

The gap between these viewpoints has narrowed. Those concerned with overall demand have become far more aware of the vastly differential impacts of credit restraint in individual markets. They have recognized the costs to the national welfare of housing shortages and of delays in correcting our urban problems. They understand that housing shortages may cause sharp increases in the price indexes as rents and house prices are forced up. They no longer look upon the complaints of mortgage and housing people as arising primarily from self-interest. Far fewer than in the past would welcome a cutback in housing construction. Most, I believe, would agree that changes which could spread the effects of credit restraint more evenly over all markets would be welcome.

At the same time, those primarily interested in the mortgage market now recognize general inflation as a more critical problem. They see that a steady creation of money and credit does not guarantee low interest rates. They recognize the threat of rising prices to financial (particularly thrift) institutions. They sense the danger from inflation to the mortgage system as we have known it.

While such progress is helpful, far more is required. We need action in addition to understanding. Let me summarize the problem as I see it and then briefly expand the major points.

*** Our present overall mortgage system has built-in weaknesses. These cause the availability of funds to fluctuate far more than is desirable.

*** These weaknesses arise from the manner in which mortgages compete or fail to compete for their share of the general credit supply.

*** The ability to compete can be improved through institutional change.

*** In a free market, such competition is likely to mean higher rates. This means a larger share of the population will not be able to afford mortgages or decent housing. They should be aided by a reshaping of the tax incentives now used to aid housing.

The Supply of Mortgage Money

The system through which mortgage money is supplied is closely tied to our financial, particularly thrift, institutions. In recent years, excluding U.S. Government agencies, the four types of financial institutions--savings and loans, commercial banks, mutual savings banks, and life insurance companies--have furnished close to 95 per cent of the net increase in residential mortgage money. This was divided: 48 per cent for S&L's, 22 per cent for commercial banks, 18 per cent for mutual savings banks, and 12 per cent for life insurance companies.

For the past two years savings and loans, on the average, put 79 per cent of their asset gain into residential mortgages. The ratio for mutual savings banks was 43 per cent; for life insurance companies and commercial banks it was between 7 and 9 per cent. All of these percentages are much lower than in the early 1960's when thrift institutions placed nearly 85 per cent; life insurance companies about 17 per cent; and commercial banks about 12 per cent of their net change in assets into residential mortgages.

Under our present system, the availability of mortgage money is primarily determined by the flow of money into financial institutions and the share of their inflow that these institutions place in residential mortgages. Neither flow has been stable.

American households and corporations have become increasingly sophisticated in the choice of savings media. While convenience and liquidity remain important, their significance has diminished. As the gap between rates paid in money markets and those at institutions alters, and as equities vary in favor, the share of savings that flows through financial institutions expands and contracts widely.

Available mortgage funds fluctuate even more since, depending upon relative rates and profitability, institutions shift the percentage of their funds they place in the mortgage market. The joint impact of these forces is only too evident. In 1963-65, financial institutions increased their residential mortgage holdings by over $18 billion per year. The amount fell by over 45 per cent in 1966 and still was down by more than a quarter in the expanded economy of the past two years. The fall in purchases of mortgages on single-family houses was even greater. In 1966, savings and loans' net purchases of residential mortgages fell by more than 60 per cent from their previous three-year average. In the past two years, life insurance companies' average net purchases of residential mortgages were less than one-third of their level in the previous three years. Mutual savings banks have averaged about two-thirds of their previous rate. Commercial banks' net purchases have fluctuated widely, but in 1968 they apparently set a new high.

Sticky Rates

The fact that the availability of mortgage credit shifts far more rapidly and drastically than that of other funds apparently is caused by sticky rates. Both the rates paid by financial institutions for their funds and the rates paid to the institutions by mortgage borrowers fail to follow the market closely. As adverse gaps arise between these rates and the market, the available funds fall sharply. The reverse is also true, of course. In some periods, too much money flowed into mortgages because rates fell more slowly than other market rates.

The special character of thrift institutions has contributed to their sticky rates. Most of their deposits in effect have been payable on demand. If such institutions raised the rates offered in order to maintain their flow of current funds, similarly increased rates would have to be paid on all their accounts both existing and new. On the other hand, the maturities on mortgage portfolios are long. Because an increase in income could be expected not on their outstanding portfolios but only on new acquisitions, inevitably a minor share of the total, an earnings squeeze would result.

The stickiness of mortgage rates has a different cause. Part has been owing to legal constraints. In recent years statutory ceilings on rates in many States were below the market. The special case of the

FHA-VA rate ceiling is familiar to all. Considered more broadly, however, mortgage rates are really just one example of the use of administered prices in a diverse market. A characteristic of administered prices is that they are hard to change frequently or rapidly. Their movements tend to be discrete, in larger jumps, and less frequent than rates set more freely by the market. As an example, while most mutual savings banks in recent years probably have not changed their mortgage rates more than a few times, the rate offered them on bonds changes daily or more often.

Improved Mortgage Flows

There seem to be two major types of solutions to the problem of sticky rates and sharp shifts in available mortgage funds. The first is to attack the problem directly by making more frequent changes in rates feasible. The second is to try an end-run around the problem by making it possible for mortgage lenders and borrowers to obtain the funds they desire directly from capital markets at the going rate.

Both of these possible solutions run into a type of difficulty which has rarely been well expressed or analyzed. National policy attempts to insure each American family a decent home in which to live. Strongly implied in policy is the view that home ownership is a preferable way of meeting this goal. A myriad of governmental programs have been established in an attempt to meet these goals. They include subsidies, tax incentives, insurance, guarantees, special rules for thrift institutions, and many other forms of assistance. One aspect of these operations, rarely spelled out, is an attempt to earmark funds flowing into certain segments of the savings market for mortgage borrowers. If institutions can lend only on homes, prospective house buyers may be able to obtain funds at lower rates. This will be particularly true if the rates charged can be limited by law or regulation. As a quid pro quo, the institutions may be given tax or other subsidies.

The ability to maintain lower than market rates consistent with an adequate flow of funds to mortgages depends on the type of regulation used, the degree to which savers and lenders are locked into particular channels, and the amount of competition for funds within a channel. Past fluctuations in mortgage flows are a result of the difficulties with these arrangements when they attempt to keep rates below the market. Another problem with this system is the lack of relationship between the need for funds and the way they are distributed. Given past difficulties, the question obviously arises whether the objectives of the present system could not be achieved in a more realistic and less contradictory or self-defeating manner.

Institutional Changes

I and others have over the years advocated many changes in the way thrift institutions bid for and invest funds. We have also made many suggestions as to how the operations of the mortgage market might be improved. Enough of these changes have already been incorporated to provide some amelioration of this year's mortgage difficulties. Far more are required, however.

In bidding for funds, thrift institutions should be allowed to offer an even greater range of savings instruments at different rates. With a variety of instruments, consideration of amount, convenience, rights to liquidity, and rates could be shaped individually to the needs of separate segments of the savings market. An institution would be able to borrow as much as it deemed worthwhile in each market. Some progress along these lines has been made, but it has been small compared to the needs.

The mortgage needs improvement as an investment instrument. Some but not much action has been taken by States to improve the mechanics of mortgage lending. The ceilings on mortgages--particularly FHA-VA insured or guaranteed--have been made more flexible. Some mortgages have been written with variable interest rates. This has clearly been significant in making loans more available for apartment houses. The ability to write loans with "kickers" is, however, limited. Most thrift institutions cannot do so. Increased use of variable rates over a broader range, including mortgages on individual houses, appears desirable.

There have been suggestions that thrift institutions be allowed to invest in a larger variety of assets. While studies of these proposals are still in progress, many of these studies seem to show that this idea conflicts with the concept of giving mortgage borrowers a more or less protected channel to certain types of savings.

Finally, slightly anticipating the next topic, the mortgage market information gap has been closed somewhat. As you know, FNMA last year through its new auction procedure helped improve pricing practices for mortgages. We now have a better idea of what changes are taking place on a week-to-week basis in at least one segment of the market.

Access to the Market

Because of the recognized uncertainties in the flow of mortgages from financial institutions, the Government has increasingly attempted to make it possible for more mortgage money to be raised in the general capital market. Since these funds have been raised through U.S. agency issues, they may have served to lower mortgage rates slightly. However, the differences in rates are a rather minor factor compared with the contribution of these systems to insuring a greater availability of funds in times of need.

Major funds have been raised through the operations of FNMA and the Home Loan Bank Board, but the FHA and VA plus other minor agencies have also put some funds directly into the market. The magnitude of this support has been impressive. In 1964, a year of more than adequate mortgage funds, the government agencies properly operated at a low level. They furnished less than 2 per cent of the net increase in residential mortgages. On the other hand, in 1966, when the need was great, these agencies furnished about 28 per cent of the net increase in total funds. In dollars the amount grew from under 0.4 billion in

1964 to nearly 3.8 billion in 1966, or a growth of 950 per cent. In 1968, under far less critical mortgage market conditions, the amount stayed close to the level of 1966, but it was, of course, a smaller percentage of the total.

Last year Congress created a new channel which I believe can open a major new source for funds. This involves the authority of the newly created GNMA to insure or guarantee bonds backed by FHA or VA mortgages. I am glad to see that your session this afternoon is devoted to this topic. If this approach can be made to work, it should make it still more possible for mortgage borrowers to compete on a basis of greater equality with other long-term borrowers of funds.

Problems may still arise related to the general availability of savings or because of imbalances between the overall demand and supply for financial funds. However, relatively direct access to the capital markets for mortgage borrowers should reduce the difficulty experienced so often in the past when flows to financial institutions decreased or institutions shifted their lending away from the mortgage market.

Paying Market Interest Rates

As I indicated earlier, one major problem in this whole institutional structure seems to me to have been sadly neglected. We have rarely articulated the theory of what supports the Government now gives, should give, or might give to mortgage borrowers. I think such a theory badly needs development. Our existing system of incentives with related ceilings on rates has created too much instability in the mortgage and housing market. At the same time, there is little evidence that benefits are being distributed in accordance with needs.

Particularly if we want to develop a system which assures the availability of funds through the payment of going market rates, a careful re-examination of our existing system is necessary. We all recognize that as rates rise, more and more families are forced out of the market. Could the existing system be reshaped better to meet these needs?

I won't spend any time on direct subsidies or the general concepts of the various financing packages contained in the almost-annual housing acts. I will restrict my remarks to our general scheme of tax incentives to real estate, housing, and home ownership, asking whether the country is getting its money's worth. I do this even though I recognize that the field of tax incentives is a can of worms. A regulation or law that is a tax incentive to one observer, is a subsidy to another, and simply a necessary and legitimate exemption or deduction to a third.

There are three general types of tax exemptions or deductions in the housing sphere. First come the provisions for rapid depreciation plus related capital gains and other special features for rental properties. The Treasury states the cost of these incentives as over $250 million per year. Second comes the special income tax treatment of thrift institutions primarily related to their special function as mortgage lenders. Tax savings in this sphere have been estimated at $200 to $350 million a year or more. Finally, there are deductions allowed owner-occupiers for mortgage interest and real estate taxes from their taxable income. These total over $3.5 billion.

Thus, it can be conservatively estimated that existing incentives now cost over $4.0 billion in tax receipts and some estimates even go as high as $6.0 billion a year. There is as little agreement on what is obtained by the Government for these sums as there is over whether they should be considered as forgivenesses, subsidies, or simply not proper areas for taxation.

The Treasury's tax reform studies argue that the incentives to owners of rental property in many cases have had a negative impact. They tended to decrease the quality of our housing stock. Bankers have attacked the tax status of other financial institutions--particularly those specializing in home finance--as unfair competition. More significantly, the criteria which determine the actual beneficiaries of these aids are unclear. Are they the owners of the institutions (the majority are mutuals)? Are they the management and staff? If they are the mortgage lenders, how significant in determining their lending rates is the forgiveness and the related lending restrictions on the institutions compared to market pressures? How many borrowers are aided who need the help to make possible their housing purchases? How do these compare with others who are pleased simply to find their after-tax income increased?

The same problem arises with respect to the deductions granted to homeowners. If mortgage interest rates rise, as an example, the share of the increased interest paid for through a reduced liability for income taxes will be higher the wealthier is the family. There are probably few for whom this incentive is crucial in enabling them to borrow. This will be even more true if the liberalized standard deduction suggested in the Treasury tax studies is passed. The potential owner who would seem most in need of aid--he who is on the line between being able to afford a house or not--will probably receive no benefit at all. The Treasury suggests that with the proposed change, 80 per cent of taxpayers would find it to their advantage to use the standard deduction. This means that the tax advantage for housing would be useful only to those with the highest incomes. These clearly are the ones who can best afford to pay any increase in market mortgage rates even without this additional subsidy.

Conclusion

I don't propose to suggest today how our tax incentives should be reshaped. Obviously though it is a multi-billion dollar problem, one worth a great deal more thought than it has been given in the past if our goals for housing and the general welfare are to be realized in a meaningful way.

I do suggest that we press forward with our reforms of the mortgage market. The country will be better off if the burden of a general decline in credit expansion, which unfortunately seems to be facing us, can be spread among more spending groups. The improved access of mortgage borrowers to the capital markets which results from the operations of FNMA and the HLBB can be expanded. Such access should be promoted even though it may involve a higher level of capital market rates than would result from simply rationing potential mortgage borrowers out of the market.

The same statements apply to the new GNMA-guaranteed bonds. The fact that credit may be tight and government bond rates at record levels should not be used as an excuse to halt their development. Potential mortgage borrowers should at least be given the chance to compete for all the credit for which they can and are willing to pay.