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Statement by

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before the

Subcommittee on Financial Institutions Supervision, Regulation and Insurance

Committee on Banking, Finance and Urban Affairs

House of Representatives

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Mr. Chairman, I appreciate the opportunity to appear before this subcommittee on behalf of the Federal Reserve to discuss the potential effect of supervisory policies on the level of home and farm loan foreclosures and the need for additional measures to assist financially troubled homeowners. The loss of a home or family farm, or even the potential threat that such a loss could occur, can be a deeply distressing personal experience that can undermine the economic welfare, stability and continuity of family life. Because of the significant economic considerations and important social values at stake, I believe that it is essential that policy-makers be acutely aware at all times of the effect of public policies on the status of real property ownership in this country. Our strong tradition of home ownership and the part that farm owner-operators play in agricultural output are important aspects of our standard of living and the long run performance and productivity of our nation's economy.

Before addressing the specific questions raised by this subcommittee, I would like to make some general observations about the level of mortgage delinquencies and foreclosures.

Delinquency rates on home mortgages typically increase during business cycle contractions as the level of unemployment increases, many full-time workers are forced to accept part time employment, and many families relying upon two wage earners experience the loss of one of their sources of income. Available measures of payment difficulties indicate that the proportion of home loans "seriously" delinquent--that is, with payments 60 days or more past due--has risen substantially since 1979. By late last year, in fact, delinquency rates were well above the levels recorded during and after the 1974-75 economic contraction and the highest of the post-World War II era. As would be expected, mortgage payment problems have been greater in those areas of the country where unemployment has been most serious. Last year, the delinquency rate in the north-central region of the United States was roughly one-third higher than the national average and three-fourths above the rate in the south.

The proportion of home loans placed in foreclosure clearly has risen in the wake of the substantial increase in serious delinquencies, and foreclosures have been most prevalent in areas of the country where unemployment has been both exceptionally high and protracted. Still, by late last year, the quarterly foreclosure rate for all types of home mortgages was less than one-fourth of one percent, and only about six-tenths of one percent of outstanding loans were involved in foreclosure proceedings. This latter figure amounts to approximately one in every 170 mortgage loans. With many delinquent loans, of course, lenders decide to exercise forbearance--even when not required to do so by law or regulation--and arrange various work-out arrangements for normally creditworthy homeowners until their job situations improve. Moreover, households facing foreclosure ordinarily will sell their homes and pay off their debts as long as they have adequate equity to come out ahead. This type of solution, however, is not a happy situation for the distressed homeowner.

The financial problems being experienced by some farmers are mainly a result of the fact that in 1976-77 and again in 1980-82, farm profits dropped substantially below their rising long-term trend. Some farmers who started farming since the mid-1970s or who made significant land purchases or other major investments during the same period have found themselves in a financially-vulnerable position, particularly if they encountered production problems such as drought. Moreover, the difficulties of these farmers have been greatly exacerbated by the sharp rise in interest rates to unexpectedly high levels since 1979. While this situation is of concern, the number of farmers in severe financial stress is a relatively small percentage of all farmers.

Since 1977, many of the financially-stressed farmers have obtained loans from the Farmers Home Administration, under lending programs designed to aid farmers encountering special problems. Many of these FmHA borrowers remain in financial distress, and the FmHA has been directed to exercise forbearance in dealing with their plight. Thus while about one-fourth of the FmHA's 268,000 borrowers are delinquent, and more than half of these are apparently over one year behind in their payments--with some over four years in arrears--only 844 foreclosures are reported to have been completed during 1982.

The shift of many problem borrowers to FmHA programs during 1978-81, coupled with the large increase in Commodity Credit Corporation loans, has undoubtedly reduced the incidence of problem loans at other farm lenders much below what otherwise might have been experienced. Thus the Farm Credit System reports a delinquency rate of about 3 percent, and a mid-1982 survey of commercial banks, conducted by the American Bankers Association, found an average delinquency rate of 4 percent. Liquidations and foreclosures--while up from the near-zero levels of better times--remain a very low percentage of total outstanding loans and borrowers. In most problem cases, the lender as well as the borrower benefits from a restructuring of the debt to reduce current payments, and such actions have been taken far more frequently than the alternative of forcing liquidation.

In light of these circumstances, one can appreciate this subcommittee's concern with the recent upward trend of mortgage loan foreclosures and its desire to consider ways to assist financially-pressed homeowners. In the letter announcing these hearings, this subcommittee requested the Board's views on the effect of supervisory and examination procedures on financial institutions' decisions to institute foreclosure proceedings and whether or not new supervisory procedures are needed to encourage institutions to exercise greater forbearance. This subcommittee has also requested that the Board give consideration to ways in which the resources of the discount window could be utilized to assist distressed borrowers in making timely interest payments on their mortgage loans until their economic circumstances improve.

Supervisory Procedures

With respect to the foreclosure practices of financial institutions, the Board does not believe that supervisory or examination procedures employed by Federal agencies encourage financial institutions to take premature or imprudent action to foreclose on delinquent mortgage loans to the detriment of hard-pressed borrowers. Further, we do not believe that supervisory procedures discourage institutions from exercising an appropriate degree of forbearance so long as such a course is consistent with an institution's safety and soundness and banking laws and regulations, and holds a reasonable prospect in the long run of enabling a borrower to strengthen his financial position and resume timely loan repayments. In making this statement, I should point out that the commercial banking system, over which the Federal Reserve shares jurisdiction with the other banking agencies, holds only about 17 percent of all one-to-four family residential mortgages and approximately 9 percent of farm real estate debt. Our supervisory experience with commercial banks indicates that institutions generally view foreclosure as a last resort to be employed only when other reasonable steps to assist the borrower have failed.

In evaluating the quality of residential and farm mortgage loans, supervisory examiners consider underlying collateral values and the borrower's long-term prospects for repayment, as well as the borrower's current performance. Examiners also take into account the borrower's present economic and financial circumstances, his future prospects, and the effect of local or regional economic conditions. These procedures are designed to ensure that transitory economic difficulties or temporary interruptions in loan repayments do not result in unduly harsh supervisory criticism. In addition, I should point out that the recently-implemented supervisory reporting guidelines for commercial banks, while requiring information on the past due status of residential mortgage loans, do not require banks to place such loans in a nonaccrual or renegotiated "troubled" debt status. Consistent with safety and soundness considerations, financial institutions are encouraged to work with borrowers who are delinquent in order to return their loans to a current status since such efforts are obviously in the interest of both lender and borrower. For example, a prudent program to counsel an individual borrower, modify or extend repayment terms, or grant a reasonable grace period would not be criticized so long as the program is designed to improve the borrower's ability to service his obligation and does not result in the bank's failure to recognize and take action to address its problem loans.

In practice, foreclosure is an expensive and time-consuming process that is subject to numerous uncertainties. Moreover, foreclosure during periods of economic recession can be a particularly uncertain process since it is far from clear that a financial institution will benefit from taking possession of or attempting to sell property when real estate markets are depressed. Consequently, financial institutions have an incentive to take reasonable steps and establish prudent work-out plans that assist borrowers whose financial problems are temporary and whose long-term prospects are favorable. Supervisory procedures do not discourage such programs as long as they are sound, well thought out and consistent with an institution's financial condition and overall safety and soundness.

In the past, Federal agencies have cooperated with Congressional actions to encourage forbearance in foreclosure proceedings in order to assist financially-pressed homeowners. For example, in passing the Emergency Housing Act of 1975, Congress instructed the Federal financial institutions supervisory agencies to take action, consistent with safety and soundness considerations, to relax supervisory criticisms pertaining to mortgage delinquencies and to encourage forbearance in residential mortgage loan foreclosures. In response to this legislation, the banking agencies informed mortgage lenders of the critical importance of considering a borrower's long-term prospects and of the need to exercise forbearance in mortgage foreclosures. Specifically, the Federal Reserve instructed its field examiners to refrain from criticizing forbearance in residential mortgage foreclosures as long as the institution's efforts did not threaten its safety and soundness or violate banking statutes. Nonetheless, in light of the passage of time and the continuing hardship associated with high unemployment and loss of income, we believe that it may be useful to reiterate to supervisory examiners that workout plans and forbearance programs that assist homeowners will not be subject to supervisory criticism so long as they are not inconsistent with banking statutes and an institution's overall safety and soundness.

Use of the Discount Window

In considering the proposal to implement a mortgage workout program by the provision of credit from the Federal Reserve discount window, a vital point must be kept in mind: a special type of money is provided through discount window loans, a money which serves as the reserve base for a multiple expansion of money and credit in our economy. Consequently, Federal Reserve lending is critically important to the conduct of monetary policy, and the volume of reserves available to depository institutions must be kept under disciplined control if we are to avoid a resurgence of the inflationary pressures which have recently shown signs of abating. In the Board's view, a special assistance program which utilizes the resources of the discount window would erode the Federal Reserve's ability to exercise control over the reserve base and the money supply.

The Federal Reserve, in its traditional lending activities, has been able to keep the volume of reserves provided through Reserve bank discount windows within manageable bounds, in part because discount officers have enforced rules which limit the purposes and conditions under which Federal Reserve credit is made available. With the level of borrowed reserves thus generally held under effective constraint, it has been possible for the Federal Reserve to respond to an unexpected increase in borrowed reserves that seemed inconsistent with the general requirements of monetary policy by making offsetting sales of government securities in the open market to absorb reserves.

Adoption of a mortgage workout program that would likely involve a relatively large increase in discount window credit would obviously tend to complicate the reserve management task of the Federal Reserve and undermine its ability to control growth in the money supply. But, while the complications that might be created by this program alone are of concern, I am much more worried about the precedent that would be set. If Federal Reserve credit were to be made available to assist in handling this special problem, there would soon be many other economic groups--all with credit needs which they sincerely believe to be as pressing as those of distressed homeowners--submitting requests to the Federal Reserve and the Congress for access to the discount window. As a result, the Federal Reserve's ability to control the general availability of reserves and the money supply would be threatened. I would emphasize that my reading of central bank experience in other countries suggests that where central banks have been given the dual assignment of carrying out monetary policy and of providing credit assistance--either to special economic groups or for special economic purposes--political pressures have inevitably tended to arise which worked to undercut effective discipline over money and credit growth, leading ultimately to higher inflation.

I should point out that mortgage loans may be used as collateral by depository institutions borrowing from the discount window. Such credit is available for temporary adjustment purposes or for seasonal needs when warranted by the liquidity circumstances of the institution. But in such situations the risk remains with the original lender, as it should, and the discount window does not become an open tap for special assistance that could adversely effect the discount window's critical central banking function.

There is another important matter raised by proposals to have the Federal Reserve extend credit to special economic groups. In its efforts to exert control over the volume of total credit being extended through the discount window, the Federal Reserve would be placed in the position of having to decide how resources are to be allocated among competing economic groups. I believe all would agree that, in line with our social values and our economic and political system, decisions on resource allocation should normally be left to individuals and consumers operating within a free market system. However, when decisions are to be made concerning the allocation and use of public resources, such decisions should be made by the people's elected representatives in the Congress.

Finally, I would note that credit extended by the Federal Reserve is reflected in neither the unified nor the credit budgets of the federal government. Thus, directing the Federal Reserve to provide credit assistance would constitute yet another program involving the government in the economy without having this involvement reflected in the budget. This is a practice which the Congress has for some time recognized to be counterproductive to the long-run health of our economy and our society in general.

Congress may wish, of course, to consider special risk-oriented programs to aid homeowners and farmers who are having a difficult time making their mortgage payments. In considering such plans, Congress must weigh the costs and benefits of special measures to subsidize or assist borrowers and evaluate the need for such programs in light of competing social demands and budgetary imperatives. As I have stated, the Board does not believe that it would be appropriate to utilize the discount window to provide direct financial assistance to individuals or to mix the provision of special risk-oriented assistance with the central banking function. If such assistance is deemed necessary, we believe that Congress should consider programs in the context of the budgetary review and approval process. Adoption of special subsidies or other forms of aid would, however, add to budgetary and/or Federal credit program outlays and would logically necessitate offsetting cutbacks in other areas if the discipline of tight Federal expenditure constraints is to be maintained in the effort to lower deficits and further reduce inflation and interest rates. If such programs were to be financed through additional Federal borrowing, the end result could very likely be greater upward pressure on interest rates.