FEDERAL HOUSING AGENCIES AND THE RESIDENTIAL MORTGAGE MARKET

For many years the expansion of home ownership has been a policy goal of the Federal Government. Because the restrictive impact of rising interest rates is felt disproportionately by the residential mortgage market, the Government has undertaken to cushion this impact through the activities of certain Agencies, principally, the Federal Home Loan Banks, the Federal National Mortgage Association, and the Government National Mortgage Association. With the mortgage market and homebuilding industry currently reeling from the second dose of tight money in four years, the policies of the Agencies have become of increasing importance. While the present period of credit restraint is, by several measures, more stringent than the 1966 episode, the effects on the residential mortgage market thus far have been more moderate. One reason has been the improved quality of assistance offered by the Housing Agencies.

Why the Residential Mortgage Market Needs Help The peculiar vulnerability of the residential mortgage market to tight money conditions derives in part from its dependence on an inflow of individuals' savings into financial intermediaries. The principal intermediaries are savings and loan associations and mutual savings banks which together supply about 70% of total residential mortgage credit, followed in order of importance by commercial banks and life insurance companies. During periods of rapidly rising interest rates, savers are tempted to bypass these intermediaries in order to realize higher rates of return through direct investment in the money and capital markets. This process is known as disintermediation. Rates paid by these intermediaries tend to lag behind a general increase in market rates because of ceilings established by regulatory bodies, and also because such institutions may have predominately long-term portfolios which produce only slowly rising income. Thrift institutions (savings and loans and mutual savings banks) are particularly exposed to this problem as mortgages comprise about 75% to 85% of their assets. When savings inflows stall, thrift institutions are forced to curtail their investments, thereby directly reducing the flow of funds into the residential mortgage market.

A second factor explaining the vulnerability of the residential mortgage market is the tendency for mortgage rates to become relatively less attractive during periods of tight money compared to those on other securities, such as corporate bonds. Mortgage rates tend to rise more slowly than market rates due in part to usury laws imposed in certain states, and to regulated ceilings on Government-backed mortgages. As a result, diversified investors such as life insurance companies tend to switch out of residential mortgages.

Principal Agencies and Their Programs The twelve Federal Home Loan Banks constitute a credit reserve system for member savings and loan associations. Qualified members are eligible to receive secured and unsecured advances from the regional Banks. The Banks are wholly owned by their members, but their policies are supervised by the Federal Home Loan Bank Board in Washington. The Federal Home Loan Bank System obtains funds for lending through the sale of capital stock to members, from members' deposits, and from the sale of its own obligations in the money and capital markets.

The Federal National Mortgage Association (known as Fannie Mae) attempts to provide increased liquidity to the mortgage market by purchasing Government-backed mortgages in the secondary market from eligible institutions such as mutual savings banks, savings and loans, and, most importantly, mortgage companies. Many mortgage companies originate mortgages exclusively for resale to Fannie Mae. Since September 1968, Fannie Mae has been wholly privately-owned, although its policies are subject to Government control. Its investment funds are obtained from sales of capital stock, commitment fees, and sales of notes and bonds in the open market.

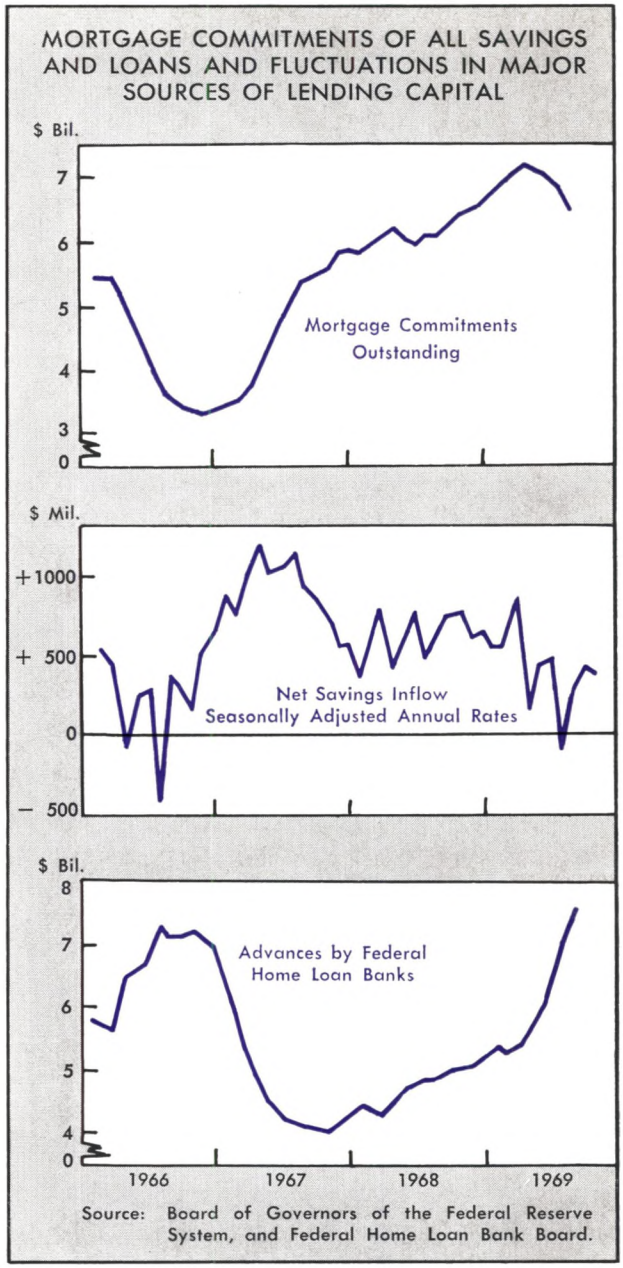
Prior to the passage of the Housing Act of 1968, Fannie Mae had three functions: (a) the Secondary Market Operations Function; (b) the Special Assistance Function; and (c) the Management and Liquidating Function. This legislation, however, provided for the establishment of the Secondary Market Operations Function as a separate privately owned corporation retaining the name Fannie Mae. The remaining two functions became the Government National Mortgage Association or Ginnie Mae. This wholly Government-owned agency provides mortgage funds for special areas of Government interest, such as housing for the aged, and also manages a portfolio of mortgages acquired from various other Government agencies.

The Mortgage Market and Housing Agencies in 1966 The net inflow of funds into savings and

loans in 1966 was the lowest in thirteen years; at mutual savings banks, the net inflow reached a five-year low. Net acquisitions of mortgages by savings institutions declined from $13.1 billion in 1965 to only $6.6 billion. Net investment by life insurance companies in 1-4 family mortgages dropped from $1.2 billion to $0.5 billion, initiating a downward trend still in evidence. For various reasons, the housing agencies were unable to offset this decline to any great extent.

Much of the Federal Home Loan Banks' difficulty in bolstering the declining fortunes of savings and loans in 1966 resulted from policies pursued earlier in the 1960's both by member associations and by the Federal Home Loan Bank Board. During these years savings and loans aggressively increased their mortgage portfolios, sharply lowering liquidity levels in the process. Member savings and loans also borrowed heavily from the Home Loan Banks to finance portfolio acquisitions, with the result that advances outstanding totaled $6.0 billion in December 1965, having doubled in four years. In order to finance these advances the Home Loan Bank System had borrowed extensively in the capital market. Of the $5.2 billion of debt outstanding in December 1965, virtually all was short-term and required refinancing yearly. In the face of tightening credit and uncertain capital market conditions, the Home Loan Banks were unable to tap the market for large sums of new money in addition to rolling over outstanding debt. In fact, unprecedented borrowing by Federal Agencies and sizable sales of participation certificates contributed to the demoralization of the market in late summer of 1966. At this crucial stage, heavy borrowing coincided with the virtual withdrawal from the market by large institutional investors, particularly commercial banks and life insurance companies. All told, the Home Loan Banks borrowed only about $1.6 billion of new money in 1966. In view of these financing difficulties, the Home Loan Banks adopted a policy during the spring of lending only to cover savings withdrawals, not for new mortgage investments. Moreover, savings and loans were required by the Home Loan Bank System to draw down their own liquid assets where possible prior to applying for advances. Thus, restricted recourse to the Home Loan Banks coupled with the virtual disappearance of new saving inflows led to the lowest level of mortgage commitments by savings and loans in over eight years.

As mortgage funds dried up in 1966, Fannie Mae's purchases of Government-backed mortgages rose to 27% of total FHA-VA mortgages issued, compared



to the 3% to 10% level of previous years. At this level, Fannie Mae played a significant role in the willingness of mortgagors to originate Government-backed mortgages. Fannie Mae could not have sustained this level, however, had not Congress passed emergency legislation in September increasing the Agency's authorized debt limit from ten to fifteen times capital and surplus.

Fannie Mae's financing problems were aggravated by its method of purchasing mortgages. Prior to May 1968, Fannie Mae announced a series of prices presumably within the going market range which it would pay for qualified Government-backed mort-

gages. The Agency stood ready to buy all eligible mortgages offered at its announced prices, either on an immediate or a commitment basis. As credit tightened and sources of lending capital dried up, mortgage lenders turned more and more to Fannie Mae. Attempts by the Agency to reduce the flood of mortgages offered to it by such methods as stiffening qualifications and raising fees and charges were unsuccessful partly because private mortgage buyers tended to scale their offering prices slightly below Fannie Mae's. As a result, Fannie Mae's resources were nearly exhausted by September.

Agency Assistance and Financing in 1969 While the net inflow of funds into thrift institutions has been weakening since July, and mortgage commitments have trended steadily lower, the level of commitments as of September was almost one and two-thirds higher than in the fall of 1966. The more moderate impact of restrictive credit policies on mortgage funds thus far in 1969, compared to three years ago, may be attributed to several factors. For example, regulatory agencies have curtailed competition among intermediaries. In another instance, the statutory 6% ceiling on Government-backed mortgages has been replaced by an administrative ceiling, currently at 7½%. Along the same lines, several states have raised or abolished interest rate ceilings established by usury laws. Finally, support from the Federal Home Loan Banks and Fannie Mae has been both enlarged and more effective.

Having reduced their debt outstanding by nearly one half from peak 1966 levels, the Federal Home Loan Banks were in a much stronger position to obtain funds for loans to members in 1969. In addition, the level of outstanding advances to members was substantially lower than at the start of 1966. Through October of this year, the Home Loan Banks raised almost $3 billion of new money for relending to members. While the majority of the new issues carried one-year maturities, a $201 million five-year issue was sold in August, the first long-term issue in a decade. This departure from tradition was in line with the Agency's decision in July to extend five-year loans to members in addition to the usual one-year variety. Recently, loan extensions up to ten years have been authorized. In addition, the Agency on two occasions has lowered savings and loans' liquidity requirements to free more funds for mortgage loans.

Fannie Mae increased its total mortgage holdings fairly steadily after 1966 through persistent borrowing in the capital market. Since that year, combined Fannie Mae-Ginnie Mae purchases have averaged between 20% and 30% of total FHA-VA loans made. In August of this year, such purchases leaped to 49% of the total, with Fannie Mae alone accounting for about 42%.

Fannie Mae's ability to render such assistance on a continuing basis reflects in part a change in the method of purchasing mortgages. Under the "reverse auction" system adopted May 1968, the Agency announces weekly the total amount of mortgages it will commit itself to purchase in 3, 6, or 12-18 months. Private holders of Government-backed mortgages then submit "bids" specifying the amount, price, and commitment period desired. Unlike 1966 when Fannie Mae purchased only new mortgages in an attempt to staunch the flood of offerings, certain seasoned offerings are also eligible for resale to Fannie Mae. The Agency accepts bids starting with the lowest priced until the preannounced volume of funds is committed. In this way Fannie Mae can control its volume of purchases and gear them to available resources, while market forces set the price. As the supply of mortgage funds has come under increasing pressure, Fannie Mae has gradually raised its level of weekly purchase commitments from the $30-$60 million range prevailing in 1968, to a $140-$150 million range.

Conclusion At current levels of activity, the Federal Housing Agencies undoubtedly provide valuable support to the residential mortgage market by providing channels through which investment funds may flow into mortgages to augment savings flows. Of course, the Agencies cannot halt, much less reverse, the general shrinkage of credit available to residential mortgages. Debate relating to Federal assistance centers on the cost and effectiveness of providing this assistance. Critics contend that the rising tide of Agency borrowing is an important factor in forcing up rates on short- and medium- term instruments. These high rates increase the attraction of disintermediation. Thus, funds which might have gone directly into mortgage institutions go instead into market instruments, possibly Agency issues, and may be returned to the mortgage market at greatly increased cost to the ultimate borrower. In times of stringent credit conditions, however, it seems unlikely that the absence of Agency borrowing would reduce disintermediation appreciably. As long as mortgage lenders have no direct access to the capital market due to the unsuitability of mortgages as capital market instruments, it seems that the Housing Agencies fill an important role in being able to bid for a share of available investment funds.

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