FOR RELEASE

April 14, 1967
9 A.M., EST

CAN THE MORTGAGE MARKET BE MADE MORE EFFECTIVE?

Remarks of

SHERMAN J. MAISEL

Member
Board of Governors
of the
Federal Reserve System

at the

Annual Convention
of the
California Mortgage Bankers Association

Palm Springs, California

April 14, 1967

CAN THE MORTGAGE MARKET BE MADE MORE EFFECTIVE?

I am pleased to address this meeting of the California Mortgage Bankers. We have a great deal in common. Willingly or unwillingly, we share the fact that this past year mortgages, the Federal Reserve Board, and their mutual relationships have been at the forefront of everyone's lips and minds.

Both of us would probably prefer a return to the quieter conditions of two years ago. Then, when I, as a Californian, was appointed to the Federal Reserve Board, I had to explain the functioning of the Federal Reserve to the majority of people I met. Most of them had either never heard of the Federal Reserve or, if they had, they assumed its primary function was to engrave our money.

Let me summarize briefly what I want to say today.

Last year underscored three well-known weaknesses of the mortgage market. All could be reduced or removed if we had a sound, well-operating secondary mortgage market. I conclude that each one involved in the mortgage, housing, and real estate fields should now increase his determination to help develop the practices and institutions necessary if mortgages are to compete more successfully with other investment securities.

The problems are clear.

*** We would like mortgages to cost less to borrowers. The costs which are primarily at issue are relative costs--the spread of mortgage yields above the Government bond rate. This is the problem of operating an efficient mortgage market and industry.

*** We must be concerned over whether or not there is and will be sufficient mortgage money to finance the growing and tremendous housing and related needs of the future. This is the secular problem.

*** We have experienced another period when the mortgage market followed feast by famine. The availability of mortgage financing oscillates too much above and below real needs. This is the problem of fluctuations in the mortgage market.

Finally, as an aside, I might note another matter of temporary or immediate concern--when in modern terminology is known as a "mini-problem." Haven't interest rates on mortgages fallen less rapidly than we might have expected, given the tremendous inflow of funds to financial institutions in the past four months? Mortgage interest rates must decline sharply, if the spread and relationship of these Government-insured loans to Government bond yields is to return to that experienced in 1964 and 1965.

There are as always even more answers than questions. However, I find four ideas that have been discussed recently attractive on an initial examination. They seem worthy of development and debate. If they can be worked out, they seem to offer hopes for considerable improvement in each problem area.

An improved secondary market--in which existing mortgages are traded without prior commitments--should increase the efficiency of the mortgage market and decrease its costs.

--- The existence of a true secondary market with traders and dealers should cut marketing expenses. The Federal National Mortgage Association (FNMA) should investigate the feasibility of establishing a real trading desk making a market in accordance with current demand and supply.

--- The Federal Housing Administration (FHA) should re-examine the possibilities of making the FHA mortgage completely insured to the ultimate investor (not an originator). The objective would be to have mortgages trade more like bonds with their far smaller costs and spreads.

--- For the secular problem, securities should be developed based on mortgages but tailored more closely to the experiences and needs of traditional bond investors. Further developments of participation certificates and debentures backed by mortgages seem to hold promise.

--- The fluctuations problem of feast and famine would be aided by each of the above steps. More importantly, however, progress in this sphere requires some hard further thought and decisions as to the proper relationship of the Government to the mortgage and housing market. Are the tremendous pleas to expand Government aid to most purchasers of houses legitimate or not? At what point do--and at what point should--various programs become subsidies to families regardless of income or need? If such programs are expanded, how should the public make certain that governmental programs reflect the needs and desires of all?

The careful re-examination I have suggested in the past of the Federal programs of loans, guarantees, and agency issues may shed some light in this sphere.

Trading in Secondary Markets Cuts Costs and Improves the Supply of Funds

In talking about the advantages of a secondary mortgage market to this audience, I feel like Moliere's gentleman who suddenly discovered he was speaking and writing prose. Most things I can say you know almost as a second nature. Perhaps, however, there is some point in expressing them in a somewhat different perspective.

Why does a well-operating secondary market decrease the costs of borrowing while increasing the available supply of funds? It improves the liquidity of each instrument. It lowers marketing costs. It allows more rapid adjustments. It may make a better market possible for forward commitments.

Mortgages are relatively expensive to turn over. No simple market exists where an investor can find a bid or offer for some or all of his portfolio. The spread between bid and asked prices for a mortgage tends to be fairly large. Costs of a transaction may be heavy. Compared to issues of bonds or other securities, mortgages are small in amount and extremely heterogenous. Each mortgage differs according to the borrower, location, and structure. A buyer finds it costly to value each loan. Trading is both more expensive and more personal than in other markets. Most sales depend upon established relationships or/and Government insurance and guarantees.

Clearly, despite the segmented and localized nature of the primary market for mortgages, some secondary marketing does exist. That is why you are here, and also FNMA and the Home Loan Bank system. Still most sales are for permanent additions to a lender's portfolio. If I want to sell a mortgage today, there is no place to call and get a good bid or even estimate of the price a buyer would pay.

These high marketing costs must be paid for by the borrower over and above pure interest. Lenders must also add a risk premium because they cannot be certain that they can turn over a mortgage in time of need. Finally, individuals and pension and retirement funds or small commercial banks or other financial institutions find it costly and difficult to invest in one or a few mortgages. This limits the supply of funds.

Making FNMA an Active Dealer in Mortgages

When FNMA was established, it was seen as a possible prototype for many private secondary market firms. This may still be possible. It is the most likely place for a true secondary operation to develop. If successful, the type of operation could spread.

I am impressed with three suggested experimental operations for FNMA which could probe the feasibility and problems involved in trying to operate a true secondary market. This would be in some contrast to its existing hybrid operations. At the moment, FNMA in its secondary market operations serves to furnish a great deal of market support and also holds loans as they season. On the other hand, its prices adjust to market changes only with long lags. As a result it may be on one side or the other of the market at any one time for considerable periods. Its prices and purchases reflect Government policy as much as the underlying forces in the market.

One idea is for FNMA to establish a separate section or subsidiary that would be ready to make a market on both the buying and selling side at any time for insured and guaranteed mortgages. This unit would operate similar to the trading of bond dealers. It would adjust its prices on a daily or even an hourly basis as the size of its inventory increased or decreased. Such a trading unit would be a constant source of needed information for all mortgage brokers and investors.

A second suggestion would have FNMA buy or sell a share of its commitments through an auction similar to the existing auction of U.S. Treasury bills. Even without daily trading, a monthly auction would still give a better and more rapid adjustment of the market to the current economy.

The final idea is related to the next suggestion and also to developments among mortgage banks and the Farmers Home Administration. This concept would have FNMA sell some mortgages with full recourse against FNMA while making the necessary charges for this service. This would enable lenders to buy mortgages from FNMA secure in the knowledge that they had a security guaranteed by an agency of the U.S. Government. They would not have to check each individual loan.

Improving the Operation of FHA Mortgage Insurance

Many observers have always been concerned about the wide spread between yields on FHA insured mortgages and Government bonds or the certificates of Government agencies such as FNMA. In recent markets, this spread over similar length Governments has been as much as 200 basis points or a full 2 per cent.

There are well-known reasons for the spread. The cost of servicing by the servicing agent and the lender is not minor. The market is not universal. If one wants to liquidate, marketing or turnover costs are high. Finally, an unknown risk exists which may be high on an individual mortgage even though very low on a statistical basis.

If only the first type of cost existed, a spread of 50 to 75 basis points would probably be more than adequate. The other costs arise because the holder of an insured mortgage does not have an 100 per cent ironclad claim against the FHA. He has certain responsibilities which he must fulfill. In addition he may lose money or goodwill (in the event of default) on a loan because of accidents, acts of God, or other factors against which he cannot insure. As a result, the FHA insurance is primarily valuable to larger lenders who can check the servicing agents' performance and also assume the residual risks on an actuarial basis.

It has been suggested that the FHA, FNMA, or private firms could assume these residual risks for a much smaller fee than now exists in the spread between FHA mortgages and other Government-secured issues. They could guarantee payment of 100 per cent of the unpaid principal balance of VA and FHA underwritten mortgages alike. With full recourse, the final lender could buy an FHA mortgage without concern as to the underlying property, borrower, or uninsurable risk. Some such arrangement seems necessary if there is to be real trading in mortgages or sales to smaller investors.

The idea of complete insurance has been questioned on the assumption that it might encourage laxity in lending or servicing standards. To avoid this possibility the existing co-insurance feature could be retained but the responsibility be placed on the originator and the servicer of the loan rather than the final lender. This seems more logical and more efficient. It would serve to improve marketability and increase the number of possible lenders on mortgages.

Various methods can be envisaged for maintaining responsibility. There could be direct recourse, or the holding of partial credits in a pool to be released according to certain schedules and underwriting results. Arrangements of this type, which are common in instalment lending, may make sense in the mortgage field. From the FHA's point of view the originator and servicer would continue to have a financial interest in improving their operations, but the second and following holders would have a loan with a much improved Government guarantee.

This idea of partial or full recourse against the originator or servicer is extremely important if we try to imagine a true secondary market for conventional mortgages let alone the Government-underwritten types. No efficient small-lot trading of conventional mortgages is likely because of the high additional cost to each purchaser in turn of rechecking the appraisal, the property, the papers, etc. Such trading would be far more likely if the holder could claim against the originator of the loan. We could imagine a situation where mortgages traded at different prices depending on the credit rating of the guarantors, just as bonds now trade at different prices depending on the credit-worthiness of their issuer.

Mortgage Bonds and Participation Certificates

A third suggestion with great appeal is that more effort be given to the development of securities using pools of mortgages as collateral but aimed at smaller investors and those who purchase traditional types of bonds. Again the operations of the FHLBB and savings and loans in issuing longer term bonds and the issuance by FNMA of participation certificates are cases in point. Both types of operation could be expanded. Similar operations are also theoretically possible for well-financed private firms.

These proposals aim at separating the function of servicing and handling the mortgage from the function of furnishing the funds. Trusteed participation certificates or mortgage debentures can be based upon both the pledge of mortgages and the security of the issuing organization. They can be tailored in their terms, forms, and payments to the needs of individual investors and the need for marketability. In many European countries such certificates and debentures dominate the long-term credit market.

The Cause of Fluctuations in the Supply of Mortgage Money

You probably feel at this point like those watching Hamlet without the Prince of Denmark. Why have I said so little about the problem of getting a greater supply of mortgage money in periods when over-all credit demands are intense? After recent experiences you probably feel that is the most critical problem. In actuality, everything I have said is related to this topic. A well-organized, properly functioning secondary market for mortgage funds is one of the industry's best chances of avoiding similar fund shortages in the primary market in the future.

What did happen last year? The answer is simple. A tremendous surge occurred in the over-all demand for credit. Credit's growth was restrained in line with the growth in real resources. In a fully-employed economy, money and credit growing faster than the ability to produce goods means higher bidding for the limited supply. As a result prices rise and we have inflation.

With people and firms bidding hard for credit, its price (the interest rate) rose. Those willing to pay the most got a larger share. Typically in such periods, the supply increases as new lenders enter the market, but some old borrowers may get squeezed out.

The problem for potential mortgage borrowers is that mortgages have not remained competitive in periods of rising interest rates. Partly from choice, but more so because of institutional rigidities, mortgage borrowers' share of credit falls in boom periods.

Rigidities are of two types. In the first place most mortgages come from financial and particularly thrift institutions. As rates rise, these groups tend not to stay competitive with the money and bond markets. As a result their share of new savings falls as do their mortgage loans. Secondly, the mortgage market does not adjust very rapidly to changing situations. Because marketing is expensive, time-consuming, and personal, it tends to be cushioned against short-term interest rate movements. When interest rates move rapidly, these lags mean lenders prefer to seek the higher rates being offered elsewhere.

Improved Markets Functioning as a Source of Cyclical Funds

Developments of this type show why the suggestions to achieve a more efficient secondary market also constitute a partial solution of the fluctuations problem. A well-operating market would decrease the lag between money market rates and those on mortgages. Lenders would not need to shift so large a proportion of their funds to other borrowers. As an aside, if the techniques for marketing mortgages improve, the mortgage banking business would become far more interesting and more productive while demanding a higher level of analytical ability and skills.

More important, if these advances are achieved, the channels through which mortgages can draw on the money and capital markets in times of need will be improved. These channels have been developing. Both the Federal Home Loan Banks and FNMA made a tremendous contribution to housing this past year. They increased their advances and mortgage holdings by $3.3 billions. They furnished 27 per cent of the net additional money in the market for 1-4 family homes, or 22 per cent for all residential mortgages, including multi-family.

These instruments require still further development. These agencies have tended to stress shorter term borrowing and a somewhat narrower market among lenders. With more channels, and entry to more sources of funds, mortgages could retain a higher share of lenders' money in periods of less ebullient credit.

Some Difficult Problems Still Ahead

It would be wrong to make it appear that the problems of fluctuations in credit terms can be solved simply. As last year made clear, when the demand for credit grows too rapidly, all sectors will eventually feel squeezed and all will find themselves faced with high rates. Only a more flexible fiscal policy adjusting demand for resources more directly is likely to be a real solution to this particular problem. Drastic changes in demand flowing into the credit sphere are bound to create major problems for mortgages.

Three factors influence house building's instability: (a) Real demand fluctuates. (b) For technical reasons, inventory fluctuations in new and used houses cause major swings in production. (At times a decrease in building coming from this source may not be unwelcome.) (c) Finally, the purchase of houses is sensitive to movements in interest rates simply because credit inevitably plays a much larger role in housing than in most other industries.

This relationship of credit to production is, of course, one of the reasons so much stress has been placed on Government-aided interest rates for housing. Last year tremendous pressures built up for increased Government aid. I heard surprisingly few demands that the mortgage and building industries be freed of both Government aid and interference and be allowed to stand on their own feet.

In the course of last year's debates, it became apparent that support for at least four different interest rate levels in the secondary market could be found among the building and real estate groups. These included: (1) The rate set entirely by the money market with no Government aid. (2) The current Government agency rates paid by the FHLBB and FNMA. Such rates depend on the Government's name and implied guarantee and result in a rate between the private market and that of the Government's own issues. Under last year's stresses, this rate came close to the private market rate. (3) A third rate is the Government's own borrowing rate. (4) During the year many people urged that borrowers on houses be given a special subsidy to bring their rate below even the Government rate. Frequently these suggestions called for the Federal Reserve to pay the subsidies with funds that otherwise are turned over to the Treausry to increase Government revenues.

In attempting to think through means of improving the secondary mortgage market, the question of rate is important. Should the amounts paid by the Government to aid average or wealthy borrowers be increased? What will the benefits and cost of more Government aid be both with respect to your industry and our over-all economic life?

I have suggested previously that the question of Government and Government agency guarantees and borrowing ought to be re-examined carefully. I hope the President's Budget Commission will be able to perform this task. Clearly, ideas as to how to improve the secondary mortgage market must be closely related to the sources of financing available at different rates.

Concluding Remarks

Obviously, no simple solutions exist to the mortgage industry's complex problems. Recently the mortgage market has turned sharply around. More money is available. Interest rates have come down and by past patterns should fall further. We should not, however, forget recent experiences. Now is the time to reshape some of the institutional functioning of the mortgage market in order to reduce future fluctuations. Well-considered improvements in the secondary market should increase future stability, lower costs, and obtain more funds from a broader base of lenders. Such potential improvements are worth searching for and adopting, both from the point of view of your industry and the economy as a whole.