For Release ON DELIVERY

Statement of

SHERMAN J. MAISEL

Member
Board of Governors
of the
Federal Reserve System

before the

Subcommittee on Housing and Urban Affairs
Committee on Banking and Currency

United States Senate

March 2, 1970

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Mr. Chairman:

I welcome your invitation to present the views of the Board of Governors of the Federal Reserve System on three bills pending before this Subcommittee on Housing and Urban Affairs.

At the outset, let me say that improvements in the primary and secondary mortgage market, above and beyond the numerous steps already taken, are clearly needed. We need to make residential mortgages more competitive so that they can attract a larger share of the total pool of available money and credit. At the same time, a more efficient mortgage market would help to promote a more efficient allocation of resources in general.

S. 2958

S. 2958 would permit the Federal National Mortgage Association to buy, sell, and hold conventional residential mortgages in addition to its present authority to handle government-underwritten loans. Some difficult policy and technical questions would be posed if FNMA's ability to deal in mortgages were broadened to include authority to purchase, service, sell, lend on the security of, or otherwise deal in conventional residential loans, as S. 2958 would permit. To date, FNMA's activities have been confined to residential mortgages that adhere to public policies and safeguards as expressed in the underwriting of loans by the Federal Housing Administration, the Veterans Administration, and the Farmers Home Administration. Conventional mortgages, on the other hand, are not

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

standardized as to quality of construction, borrower characteristics, loan terms, and origination practices generally.

Both FNMA's costs and risks would be increased if FNMA were authorized to deal in conventional mortgages which lack the protective features of government-underwritten loans. Conventional mortgages, by definition, lack any assurance available from a Federal agency, backed by the U.S. Treasury, against loss of principal and interest. Hence, additions of conventional mortgages to FNMA's assets would broaden FNMA's exposure to potential losses considerably beyond present minimal limits. FNMA might well have to expand its capital base in order to shore up the volume of its resources available to meet its liabilities.

To allow FNMA to deal in conventional mortgages would also raise questions about the liquidity of the portfolio that FNMA might come to hold, and therefore about FNMA's ability to finance itself by issuing debt in the private market. To the extent that FNMA debt became a less attractive instrument, FNMA's ability to raise funds and to sustain Federal housing credit programs would be impaired.

Only a part of FNMA's increased risk exposure could be offset by the provisions of S. 2958 that would limit FNMA's conventional loan acquisitions to mortgages bearing loan-to-value ratios no higher than 80 per cent or those for which, to quote the language of the bill, ". . . that portion of the unpaid principal balance which is in excess of such 80 per centum is guaranteed or insured by an institution, and under a contract, determined by the corporation [FNMA] to be generally acceptable to other institutional mortgage investors."

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The problem of much secondary mortgage lending is that of "adverse selection" against the secondary lender. Given the imprecise art of real estate appraisal and the declines that could occur from time to time in prices of individual houses or even of groups of dwellings, a margin of one-fifth between the price of the collateral and the amount of the loan would provide no assurance of investment liquidity or of capital safety comparable to that inherent in federally underwritten mortgages.

Even conventional loans bearing private insurance can offer no certain guarantee to the lender of liquidity or against loss in case of default and foreclosure. Most contracts of private insurance reserve to the insurer the option of meeting his limited liability by paying either a stated percentage (often 20 per cent) of the outstanding debt or 80 per cent of the total loss ultimately experienced after the lender has disposed of the property, whichever amount is the lesser. In this connection, nearly two out of every three claims settled by one large private mortgage insurance company during a recent period were based on the 20 per cent option. That is, they represented claims involving net losses in excess of one-fifth.

Other serious questions arise as to whether entry by the housing agencies into the conventional mortgage markets might not occur largely at the cost of lessened support available for the Federal housing credit programs. These programs are charged with a special public

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

interest in part because they have helped facilitate mortgage borrowing by low- and middle-income groups under regulations that provide various forms of protection to the home buyer.

FNMA's capacity to support the residential mortgage market ultimately rests on its ability to finance its mortgage acquisitions by borrowing in the market for Federal agency issues. Use of government agencies to raise funds in the market can channel some money to housing away from other users. The total credit available in the economy is, however, limited. Thus, attempts to overload the tasks of the agency markets will increase the rates the agencies must pay. Each additional sum raised will increase the cost mortgage borrowers pay. At the same time, a larger and larger share of the money flowing through the agencies will be attracted from lenders who would otherwise, directly or indirectly, have put their funds into mortgages.

Related to this issue of which portions of the mortgage market should have priority for FNMA support is the question of the efficiency with which aid can be allocated. The various Federal housing credit programs are specifically designed to assist low- and moderate-income consumers. On the average, these households require less financing assistance than do borrowers who rely on conventional mortgages which typically finance more expensive homes. To the degree that FNMA purchased conventional mortgages rather than federally underwritten loans, any given amount of FNMA's funds would support fewer dwellings than would otherwise be the case.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

All these considerations aside, it may be argued that enactment of S. 2958 would eventually hasten efforts to standardize the conventional residential mortgage--a desirable step in itself. Conventional mortgages do now lack the degree of homogeneity required for active trading in the secondary market. But many measures can and should be taken to standardize the conventional mortgage independently of granting FNMA authority to deal in this type of instrument. Drafting a uniform mortgage code for adoption by the States, for example, need not--and should not--await the creation of a Federal secondary market facility for conventional mortgages. Nor should we delay efforts to bring greater uniformity in the laws governing mortgage investment standards, as noted below.

S. 3503

S. 3503 would authorize advances by the Federal Home Loan Banks to lenders who will use the proceeds to make mortgage loans for families with incomes of $10,000 or less. The Federal Home Loan Banks would obtain funds for this purpose by borrowing from the Federal Reserve System, which would be required to discount the FHLB obligations at a maximum interest rate of 6 per cent. The sum of such borrowing is unspecified except that it would be limited to $3 billion the first year plus $3 billion for each additional year the act is in force.

Thus the bill would authorize a lending program of $3 billion annually outside the budget. The Board believes, however, that whatever subsidies the Congress determines to be necessary and justified in order

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

to aid housing should be included in the budget, so that the Congress may weigh them against other Federal outlays, and then reduce other outlays that have a lower priority, or increase revenues to cover their cost.

This is the approach the Administration proposes to use in increasing flows of funds from the Federal Home Loan Banks to their member institutions for mortgage loans. The Administration would authorize appropriations to cover part of the cost of borrowing by the Federal Home Loan Banks in the market, so that they may make advances at reduced rates to their member institutions. If the rates on advances to members are not reduced, the members might discontinue mortgage lending in order to repay the amounts they have borrowed from the Federal Home Loan Banks. The Board supports this proposal as a more efficient procedure. Congress will, of course, have to consider whether subsidies for middle-income families are needed in addition to, or in place of, this general housing subsidy. But the Board believes that whatever subsidies are authorized should be identified and subjected to the appropriations process.

If, as provided in S. 3503, the Federal Reserve were directed to increase its holdings of Federal Home Loan Bank obligations by up to $3 billion a year, credit markets would have to absorb a corresponding amount of Treasury obligations over and above what would otherwise be marketed. In order to keep control of the reserve base, the Federal Reserve would have to offset its loans on Federal Home Loan Bank obligations with sales of Treasury securities--or forego purchases of Treasury securities it would otherwise have made. Sales of $3 billion additional

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Treasury obligations in the capital markets would, of course, attract funds away from other uses, including credit that would otherwise finance housing as well as other capital improvements.

Moreover, the Board opposes tapping Federal Reserve credit for special-purpose lending, no matter how worthy, because it could frustrate the objectives of monetary policy. A $3 billion a year program to help middle-income families buy homes could soon lead to proposals for other types of special lending. There are, of course, other purposes--perhaps equally worthy--for which funds are urgently needed. Hearings have just been completed in the House of Representatives on legislation which would authorize use of Federal Reserve credit to rehabilitate urban and rural pockets of poverty. State and local governments generally are having difficulty borrowing for schools and hospitals; they, too, could use 6 per cent loans from the Federal Reserve. To compel the Federal Reserve to meet credit needs of these magnitudes would lead at first to a weakened market position for Treasury securities--as the System made offsetting sales of Treasury issues--and ultimately to inflation, as it became impossible in practice to offset the expansion of Federal Reserve credit in that fashion.

S. 3442

S. 3442 would implement certain recommendations of the Commission on Mortgage Interest Rates, as set forth in its report of August 1969. The Board supports the proposed experimental dual-market system of setting contract interest rates on new FHA and VA mortgages, as authorized by Section 1 of the bill. The trial period to last until January 1, 1972--during which

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

contract interest rates could be established either by regulation, as at present, or by the market--will offer the opportunity for determining how far it is appropriate to move toward more flexible rates. Whatever greater flexibility can be achieved, of course, will allow standardized FHA and VA mortgages to compete more readily with conventional mortgages as well as with other capital market instruments. And it will broaden the potential scope of the secondary market for government-underwritten mortgages.

The Board of Governors is also in accord with the principles of Section 2 of S. 3442, which would explore ways and means of reducing and, where possible, standardizing charges for attorneys' fees, property surveys, title insurance, and other settlement costs on FHA and VA mortgages. Appropriate guidelines in this area could help to lessen the costs of transactions and thereby improve the efficiency with which the real estate market operates.

The Special Advisory Commission on Housing authorized by Section 3 of the bill would be required to submit broad recommendations about the next fiscal year's housing output, Federal costs of meeting this goal, needed legislative and administrative actions, and ". . . the fiscal and monetary policies, both long- and short-range, which are necessary to achieve recommended levels of housing production. . . ."

In this connection, it should be pointed out that the Commission's annual report would have to be submitted well before the Administration's proposed budget has been completed for the next fiscal year; according to

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the bill, the report should be submitted by November 1. While one purpose of the Commission's report is to help guide prospective fiscal as well as monetary actions, fiscal and monetary policies must take account of the broadest aspects of the economy, with housing being only one--though an important one--of many competing demands for the nation's resources. There is the danger, therefore, that the Commission's early recommendations may not be consistent with, or attainable within, the general framework of public economic policy as it ultimately evolves.

Incidentally, the limit established by Section 3(d)(2) of the bill on the rate that the Commission could pay for temporary and intermittent services in seeking guidance about its recommendations appears low. A $50-a-day ceiling on consultant fees for individuals would hardly seem likely to strengthen the Commission's hands in obtaining the most qualified sources of advice.

Sections 4 and 5 of S. 3442 would liberalize certain restrictions on the mortgage lending powers of Federal savings and loan associations and national banks, and would permit a Federal savings and loan association to act as a trustee for certain trusts. With respect to mortgages, there is a pressing need to standardize, as far as possible, the authority of all types of financial institutions to invest in these assets.

Section 5 of S. 3442 would liberalize the authority of national banks to make real estate loans. For conventional mortgage loans, the loan-to-value limit would be raised from 80 to 90 per cent, and the maximum maturity from 25 to 30 years; for loans on construction projects,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the maximum maturity would be extended from three years to five years. The Board continues to support this change as a means of stimulating increased mortgage lending by banks.

The bill does re-emphasize the need for broad and equitable standards that would be applicable to investment in mortgages by all federally chartered financial institutions. Moving toward greater uniformity in mortgage investment standards at the Federal level would then provide a basis for similar action among the more numerous and heterogeneous State-chartered lenders. Such standardization, in turn, would promote a more effective primary and secondary market for all the different types of lenders that place funds in the mortgage instrument.

Legislation is needed to improve the working of the mortgage market. Similarly the burden of monetary restraint on the mortgage market should be lightened, and the Board is studying ways and means to accomplish this without impairing the use of monetary policy in achieving national economic objectives. But it should be kept in mind that the problems of the housing industry are not related solely to credit. Rising costs of construction and land have been major impediments.

However efficient the mortgage market becomes, and however successful the Federal Reserve is in achieving a more uniform impact of monetary restraint, another step is needed to ensure that sufficient funds will be available to reach the national housing goals. We must enlarge the total pool of credit. We probably cannot achieve our nation's housing goals merely by enabling housing to attract a larger share of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the available pool of capital. It seems to me that the most feasible way to expand the pool of housing credit is to reduce the demands that the Federal Government is making on the private capital markets. This is a major reason that we must examine with caution proposals which increase rather than diminish the total credit demands of the Government and its agencies.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis