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Statement by

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before the

Subcommittee on Financial Institutions Supervision, Regulation and Insurance

of the

House Committee on Banking, Currency and Housing

U.S. House of Representatives

January 22, 1976

Thank you for the opportunity to appear on behalf of the Board of Governors to take part in the hearings on your Committee's consideration of possible reforms in the structure and performance of the nation's financial institutions. Our comments on the implications for the residential mortgage and real estate markets of Title II of the FINE "Discussion Principles" will build on the testimony presented earlier today by Governor Holland on Title I dealing with depository institutions.

Before going into the details of the Discussion Principles, I would like to make two general points. The first is that inflation continues to be the chief enemy of the mortgage and housing markets in our country. Inflation not only increases the cost of financing, but it also disrupts the supply of funds. It not only escalates the price of homes, but it may also reduce the income, after allowing for other necessary expenses, which consumers have available to acquire new or better housing accommodations. Unless the forces of inflation can be contained, it is doubtful that any financial restructuring could produce a mortgage market which will appropriately meet the housing needs of the American public.

The second general point is that in recent years the private sources of home mortgage credit have become concentrated in the nonbank thrift institutions. These particular lenders traditionally borrow short and lend long and thus are highly vulnerable to the effects of inflation and variations in general credit conditions. In 1960 thrift institutions held approximately 52 percent of home mortgages outstanding. By June 30, 1975, this proportion had grown to 60 percent. In contrast, life insurance companies dropped during this same period from 18 percent to 5 percent. Commercial banks, on the other hand, increased their share from 14 percent to 18 percent. Federal credit agencies and mortgage pools grew from 5 percent in 1960 to 12 percent in mid-1975.

This trend was confirmed in 1975 by the volume of new home loans extended. Over the first three quarters of last year, savings and loan associations and mutual savings banks together accounted for 61 percent of total long-term home mortgage acquisitions. In comparison, commercial banks supplied 15 percent, with Federal credit agencies and related mortgage pools accounting for nearly all of the balance. No other source of savings capital made a significant contribution to the home mortgage market.

When we consider the problem of inflation as well as the concentration of housing credit in institutions with volatile inflows of funds, it is small wonder that home buyers have been plagued not only by volatility in the price of mortgage money, but also by a periodic scarcity of money at any price. There are two overriding considerations, then, that should be kept in mind insofar as housing finance is concerned. One is the need to further dampen the inflationary forces in our economy that contribute to such erratic fluctuations in both the demand for and the supply of housing credit. The other is to broaden and strengthen the sources of funds available to finance housing at a variety of investment outlets.

The expansion of investment powers of the nonbank thrift institutions and the removal of ceilings on deposit rates -- as proposed in Title I of the Discussion Principles -- would make for greater stability in the operations of savings and loan associations and savings banks, and produce a more even flow of mortgage funds from them. Even though the proposed expansion of deposit powers at thrift institutions may well encourage a larger share of total savings to be funneled through them, it is uncertain whether there might be some decline over the longer run in the supply of mortgage funds at institutions which become more diversified. The result may be that the cost of mortgage credit would rise relative to yields on other investments. In that event, other types of lenders would be encouraged to move more funds into mortgages. This shift would lessen upward mortgage rate pressures to some degree and help to reduce short-run fluctuations in the cost and availability of mortgage credit in the future.

Some of the FINE Study proposals in Title II are designed primarily to moderate the possible impact of more competitive pricing on mortgage borrowers. As these proposals are considered, it is well to remember that similar measures are already in effect in other forms. Of these, the principal one is our system of Government mortgage insurance and guaranty through HUD's Federal Housing Administration and the Veterans Administration. Such programs make mortgage terms more advantageous for borrowers by pledging the faith and credit of the government in addition to that of the home buyer who is seeking funds.

The Federal Home Loan Bank Board loan proposal in Title II is similar to the GNMA tandem plan now in operation. To this extent, the proposal would essentially duplicate an existing program which provides below-market interest rates to home buyers and utilizes a government-related source of funds. It is not clear from the Discussion Principles whether the proposed new role for the Federal Home Loan Bank Board would eliminate the authority of the Federal Home Loan Banks to make advances to thrift institutions in order to cover either takedowns of earlier mortgage commitments, or deposit withdrawals, in the event of unexpected reversals in their overall flows of funds. In our view, such advances would still be needed, at least on a transitional basis, so as to provide necessary flexibility to this class of depository institutions. Although the FINE Discussion Principles would allow depository institutions access to the Federal Reserve discount window, discount borrowings have traditionally taken the form of very short-term credit designed primarily to cover temporary reserve deficiencies. Thus the discount window operation would not duplicate the FHLBB medium-term advance program now in effect.

The proposed mortgage-interest tax credit and the mortgage reserve credit features of the Discussion Principles would undoubtedly be of some help in ameliorating any adverse impacts on consumers of more competitive pricing of mortgage money. Yet the degree to which they might do so in unclear. A progressive mortgage-interest tax credit would probably offer only a relatively modest investment incentive for commercial banks and insurance companies. Neither type of credit would encourage pension funds to invest in mortgages.

Moreover, it is uncertain how much of the benefits from these plans would be passed through to lower-income consumers. If applied retroactively, the tax credit and reserve credit plans would obviously provide windfall gains to lenders on mortgages already held in their portfolios -- benefits that would apparently not be transmitted to any lower-income households that had borrowed prior to the inception of the programs.

The proposals in Title I would encourage more diversification by financial institutions which are now specialized. In contrast, the incentive programs in Title II would encourage specialization in one type of asset, typically with long maturity and limited marketability. It is even possible that the progressive tax credit proposal might lead to a concentration of low- and moderate-income mortgages in a relatively small number of lending institutions.

The proposed mortgage reserve credit plan to aid low- and moderate-income housing raises a number of important additional issues which I would like to summarize:

> The institution of a reserve credit plan would set an unwise precedent for extending similar preferential treatment to holdings of other types of assets deemed to be of pressing social merit. The list of favored credit instruments of this type could become longer as time passed, thus diluting the initial advantage enjoyed by qualifying mortgages, and tending to segment private credit markets even further.

A reserve credit on one type of instrument -- such as a mortgage -- would encourage financial institutions to change the form of their lending simply to take advantage of this kind of subsidy. To that extent, the mortgage reserve credit would not stimulate more housing investment. Lenders would have an incentive, for example, to offer loans secured by real estate in lieu of consumer loans to be used for non-housing purposes.

The mortgage reserve credit plan would affect the pricing of qualifying mortgage assets, and could accordingly limit their marketability. On a given mortgage loan, a reserve credit -- particularly when accompanied by a mortgage-interest tax credit -- would produce a different effective yield at depository institutions holding different proportions of assets in qualifying mortgages relative to their deposits. A yield distinction would also exist between institutions qualifying for the credits and those, such as pension funds, which do not. To the extent that these yield differentials would prevail, depository instituions would either have to take lower profits or larger losses than they otherwise would be obliged to absorb on the sale of loans to nondepository purchasers, and would thus be discouraged from broadening the secondary market for such loans.

The mortgage reserve credit plan would require lenders to identify loans on "low- and moderate-income housing" held in their portfolios. This ongoing identification process would be difficult, particularly since qualifying characteristics of borrowers, properties, and even neighborhoods can change either up or down over the life of a given loan.

Of even greater importance, a mortgage reserve credit would pose a more fundamental problem for the monetary authorities. The mortgage reserve credit plan would weaken the capacity of the Federal Reserve to control the growth of reserves at depository institutions in order to maintain a rate of expansion in the monetary aggregates consistent with the needs of our economy. Federal Reserve decisions would be complicated by the addition of a new element to the already complex relationship between the reserve base and the money stock. This new element -- stemming from the asset side of lender balance sheets rather than the liability side --

would require the Federal Reserve for the first time to predict changes in holdings of qualifying mortgage assets by a large number of diverse types of commercial banks, savings banks, savings and loan associations, and credit unions.

To the degree that the proposed financial market reorganization resulted in higher average mortgage borrowing costs over the long run, low- and moderate-income households would be affected the most. For these consumers, the cost of shelter, along with other basic necessities, usually absorbs a relatively large portion of their income. In that case, considering the imperfections of both the mortgage-interest tax credit and the mortgage reserve credit approaches, one or more alternative methods of housing assistance may be regarded as desirable for low- and moderate-income groups.

In addition to the FHA, VA, and GNMA mortgage credit programs, an elaborate system of other Federal housing aids is currently in place. Many of these plans already provide some support, directly or indirectly, to lower-income households. Altogether, Federal aid to housing takes such varied forms as tax incentives to homeowners, landlords, and builders; cash subsidy programs to produce new and substantially rehabilitated housing; secondary mortgage market support; and direct lending. Given the complexities of the present system, now may be an appropriate time for the Congress to evaluate its overall cost and benefits, and the interrelationships among the various forms of subsidy, before proposing any further significant change.

Even in the absence of a comprehensive review of this sort, there are several ways in which Federal assistance to homeownership could be directed at the lower-income portion of our population where the need is greatest. Unfortunately, portions of our present system now apply the largest subsidy to consumers most able to pay without public assistance.

One possibility would be to revise the present system of income tax deduction for mortgage interest and real property taxes so as to allocate tax benefits more heavily toward the lower end of the income scale. Another possibility would be to provide periodic supplements to the income of lower-income households. Both of these approaches have the advantage of directly assisting those least able to pay, rather than doing so indirectly through incentives to financial institutions.

In conclusion, the Board of Governors believes that the restructuring of depository institutions proposed in Title I of the FINE Discussion Principles may well hold the possibility of greater stability for our specialized depository institutions, and ultimately for the mortgage and housing markets. If the Congress should decide that additional support is necessary for low- and moderate-income housing over the longer run, the Board believes that direct aid to qualified home buyers and renters is a more efficient use of public resources than programs designed to reduce the cost of housing credit through subsidies to lenders.