

HOUSING FINANCE AND THE ECONOMIC RECOVERY

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The increase in mortgage interest rates recorded since mid-1983 has raised doubts about the ability of the housing sector to contribute to an economy moving from recovery to expansion. Although rates have drifted down in recent weeks, the effect of interest rate levels on housing activity is still an understandable concern. Housing has played its classical role in the recovery period, leading the upturn and having positive effects upon building materials and consumer durables. The sensitivity of housing to interest rate changes was once again demonstrated in the timing of its recovery, following the substantial decreases in rates on both fixed- and adjustable-rate mortgage contracts that occurred throughout 1982. It would be a mistake, however, to expect an iteration of past housing cycle patterns and old relationships between interest rates, housing starts, and home sales.

The Changing Housing Finance System

Institutions which finance housing are different this time. In one respect, housing is even more interest sensitive today, because of the much closer tie between yields demanded by institutional investment managers considering mortgage-backed securities and the variations in interest rates evident in the capital markets. Aggressive and innovative managements at the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation are helping to bring additional sources of capital to bear upon housing.

On the other hand, many thrift institutions, particularly savings and loan associations--some using their new title of "bank"--are aggressively marketing adjustable-rate mortgages so that consumers have the opportunity to qualify for loans at initially attractive rates

despite the firming of market returns on fixed-rate mortgages. The shift to adjustable-rate mortgages is nationwide, with some regional exceptions, and represents a substantial move by the thrift industry to restructure the asset side of its collective balance sheet while remaining specialized in the financing of housing.

An important thrust in continued housing expansion comes from the unusually large number of first-time homebuyers, and their acceptance of adjustable-rate mortgage contracts is noteworthy. Thus, analyses of the probability and extent of a continued housing contribution to economic expansion must rely more than in the past on the acceptability and rates on the new types of mortgages, rather than on the stated or nominal rates which are fixed and can be interpreted as cutting off housing expansion to an unrealistic degree.

The housing expansion may also be influenced by other sweeping changes taking place in our financial system, changes away from restrictive laws and regulations and toward a system in which financial institutions largely pay market rates for their savings or deposits. Associated with these changes on the liability side are the new empowerments for thrift institutions which went on the books about a year ago permitting thrift managements to consider the development of commercial loan capabilities and to shift portions of their assets into many new lines of activity, some of which have little to do with housing.

Indeed, some observers have begun to view the financial industry as though the thrift institutions already have transformed themselves magically into commercial banks. This may be part of the tendency many of us have to regard the passage of legislation as producing instant, structural effects.

The factual situation is somewhat different. Certainly a small number of thrift institutions have convinced their respective boards of the merit of asset shifts and have actively recruited executives and staff with commercial banking experience. And, of course, New England thrift institutions, mainly savings banks, have had some statutory authority in this regard for a number of years and, in many cases, hold a small percentage of commercial non-real estate loans on their books. Yet in the vast majority of cases, the shift away from mortgage assets which occurred in 1981 and 1982 apparently has been largely completed, and mortgage loans, participations in mortgage loans, and mortgage-backed securities represent the preponderance of new assets being placed on the books.

Prior to the late 1970s, large cyclical movements in mortgage and housing activity partly reflected the impact of various artificial constraints on the "availability" of mortgage credit. When short- and long-term market rates rose, the flexibility of depository institutions to respond was constricted by state laws imposing ceilings on the mortgage rates and federal laws establishing ceilings on the interest rates which could be paid savers. When market rates fell, the inflows of savings tended to produce the upswing and recovery for which the housing sector was well known. As we witnessed, intermediation succeeded disintermediation which succeeded reintermediation.

The jungle of laws and regulations at both state and federal levels--artificial constraints on credit availability--are no longer a significant force limiting the markets. Indeed, on October 1, all ceiling restraints on time accounts of over 31 days will disappear.

Under the prompting of the Depository Institutions Deregulation Committee, numerous new deposit instruments with varying degrees of transactions and savings characteristics have taken shape. Today's financial institution is capable of raising funds in its community and in the capital markets by a variety of means. Thus, in large part, rate considerations and borrower qualifications have succeeded funds availability as primary management concerns.

Though the broader powers provided thrift institutions in the Garn-St Germain Act of a year ago have not transformed mortgage lenders into commercial bankers, the potential utilization of these powers has been attractive to the Wall Street investment community. The transformation which has occurred has been the conversion of many large mutual institutions into stockholder-owned ventures which in the process of conversion have accumulated substantially larger equities. A fair number of institutions have augmented their equity positions by \$100 million or more--a phenomenon of massive capital infusions that has not before characterized the mortgage industry with the exception of the period of experimentation with the real estate investment trusts; in the latter situation, however, the thrust of the REITs was toward commercial real estate and less toward housing. The deepened equity base and the pressure for earnings upon a management whose skills are concentrated in the financing of housing are factors that should be taken into account in evaluating the continued contributions of housing in the expansion phase of this cycle.

The secondary market for mortgages and mortgage-backed securities and the effectiveness of two quasi-governmental mortgage companies,

FNMA and FHLMC, are also factors to be reckoned with. The mortgage-backed security has come into its own after a 13-year struggle. The "swap" programs of FHLMC and FNMA have contributed to thrift institution presence and strength in the mortgage markets. Both agencies have been innovative in several regards as illustrated by the collateralized mortgage obligations marketed by the FHLMC--securities divided into classes with varying maturities such as 5 years, 12-1/2 years, and 30 years. And other sequential-paying type bonds are beginning to appear, utilizing pools of mortgage-backed securities, in contrast to pooling of the mortgages themselves.

It is obvious that deepening secondary markets and mortgage-backed securities are not simply matters of financial legerdemain. These market processes encourage and stimulate thrift institutions and nonthrifts to stay in the market. Some institutions are originating unprecedented volumes of mortgage loans in this recovery, selling the bulk of them, and retaining participation interests. Thus, some thrift managers have joined their mortgage banker competitors in developing a substantial flow-through of funding which finds its way to the homebuyer.

The current consideration by the Congress of additional private vehicles for the pooling of mortgages and the sale of obligations secured therewith is to be applauded. The President's Housing Commission in 1982 recommended changes in tax laws and other statutes which would greatly expand the issuance of mortgage-backed securities by non-governmental corporations--the so-called trusts for investments in mortgages (TIMs) proposal. This is one of the possibilities now being considered by the Senate.

Monetary and Fiscal Policy

The wide variety of institutional changes which underpins the housing expansion does not, of course, remove housing's unusual vulnerability to rate changes, although this vulnerability has been greatly mitigated. It is still true that interest rate sensitivity is greater in the housing sector than in most other components of our domestic economy largely because housing is a high-priced item that requires financing at long term, often by buyers with limited financing alternatives.

Monetary policy that is designed to facilitate expansion of the economy without regenerating inflationary pressures should lead to lower interest rates over time, with attendant benefits for housing and other credit-dependent private sectors. To get the most out of this, however, there must be complementary fiscal policy. Today, the prospect of federal budget mega-deficits looms ahead even as the economy expands, suggesting a serious imbalance arising from fiscal policy. That concern is widely held in the financial markets and in the public at large, and the prospect of intensified "crowding out" of private demands in 1984 and beyond in competition for the available supply of credit appears at least partly responsible for the maintenance of high "real" interest rates on longer-term instruments. Concerns abound that mega-deficits will not only place heavy demands on the credit markets but that they will thereby create pressures for excessive monetary expansion, causing the battle against inflation to become considerably more difficult.

Clearly, the fundamental outlook for interest rates and housing activity does not lie in the hands of the Federal Reserve alone, because

federal budgetary decisions will have an important effect on both the level of interest rates and the distribution of the available supply of credit among private and governmental sectors. Institutional changes in financial markets and financial institutions soften, but do not deflect the blow. Market confidence in the success of monetary policy must be supported by continued commitments and decisions in both the Congress and the Administration to reduce the large structural federal deficits that threaten to place heavy pressure on our financial resources as the economy grows. Complementary monetary and fiscal policies will foster the easing of inflationary expectations that are essential to sustained expansion in homeownership and its potentially positive effects on productivity itself.