The Changing Environment for Mortgage Lending

Remarks by

Emmett J. Rice

Member

Board of Governors of the Federal Reserve System

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I welcome this opportunity to speak to the Department of Housing and Urban Development's National Conference for Minority Financial Institutions. As mortgage market participants, you play a key role in one of the most interest sensitive sectors of our economy. Because the level of and variations in interest rates are so important for day-to-day operations in your industry, I suspect that you have developed some interest in the relationship between monetary policy and mortgage market activity. Consequently, it might be useful for me to provide some background about the evolution of Federal Reserve policy and its relationship to the cost and availability of credit.

First, I will provide a brief historical review of the way monetary policy has responded to changing economic circumstances in recent years. Then I'll discuss some of the effects that changes in the financial environment may have had on the behavior of mortgage markets participants. Finally, I'll identify some recent innovations in lending and liability management that have been influenced by the demands of the evolving financial environment.

Prior to the early 1970s, the Federal Reserve focused much of its attention on "money market conditions" as guides to monetary policy. This concept of money market conditions encompassed certain short-term rates of interest and free or net borrowed reserve positions of member banks. With stronger growth in aggregate spending in the second half of the 1960s and accompanying inflationary pressures, it became increasingly evident that money market conditions were no longer a very reliable guide, if monetary policy was to restrain inflation while providing for adequate economic growth. As often as not, upward pressures on interest rates were coming from actual
inflation and expectations of more inflation as from restrictive monetary measures.

By the late 1960s, the Federal Reserve had come to watch more closely growth in certain financial aggregates—such as measures of the money supply and bank credit. Growth in these aggregates would, on occasion, influence policy action. In 1970, the money stock and bank credit became important targets for Federal Reserve policy implementation. The federal funds rate emerged as the primary day-to-day operating target of the Federal Reserve; it was adjusted in response to departures of financial aggregates from objectives.

By the early 1970s the economic environment had changed markedly from that of a decade earlier. In particular, inflation had become a more permanent feature of the economic landscape. Anxieties about the inflation outlook mounted. Adding to unease were dislocations associated with the wage and price control program that had been tried as an inflation antidote and the oil price shocks of 1973 and 1974. Against this backdrop, efforts to curb monetary growth led to a steep rise in interest rates in 1973 and 1974, before rates fell sharply during the recession that followed.

As the economy recovered from the recession of the mid-1970s, monetary growth picked up and inflationary pressures intensified. Efforts to restrain monetary expansion and check inflation led once again to steadily rising interest rates. With the inflationary surge of 1974 and 1975 still fresh in everyone's mind, inflation anxieties became more evident than ever and the domestic credit and foreign exchange markets became more volatile. In particular, the markets seemed to be losing confidence in the resolve of policy makers to adequately reign in inflationary forces. The
world economy was hit with a second oil price shock and U.S. inflation showed
dsings of accelerating further. By the late summer and early fall of 1979,
domestic financial markets and foreign exchange markets were in turmoil.

In view of these developments, the Federal Reserve sought to gain
closer control over the money stock and reassure the markets about its resolve
to curb inflation. It abandoned the federal funds rate procedure that had
been used to control the money stock for nearly a decade and adopted a
nonborrowed reserves operating procedure. Interest rates jumped sharply
after these measures were adopted in October 1979, and rates became
significantly more volatile as efforts to keep nonborrowed reserves on path
ruled out the possibility of also stabilizing short-term rates of interest.

Many observers have forgotten that the economic and financial circumstances
of that time were highly unusual, truly of crisis proportions. Some analysts
have tended to attribute the rise and volatility of interest rates solely to
the new operating procedure. While intra-day and day-to-day interest rate
volatility might have been lower under some other procedure, it is hard
to believe that the financial environment would have been fundamentally more
tranquil if these measures had not been taken. Indeed, as inflation slowed
and showed signs of coming under control, market rates declined appreciably
and became less volatile.

More recently, various institutional and market developments have dis-
urbed and altered the relation between money stock measures and the economy,
and required a more flexible approach toward monetary and reserve targeting.
This move toward greater flexibility is most closely associated with measures
taken in October 1982. Since that time, M1, the most narrow aggregate used for
setting money growth targets, has been given less weight in the conduct of policy. Interpretations of all the monetary aggregates have been done in the context of the outlook for the economy, including prospects for inflation and conditions in domestic and international financial markets.

This brief account of the evolution of Federal Reserve policy and operating procedures has identified several important themes. The Federal Reserve in recent decades has placed greater weight on financial aggregates in its formulation and conduct of monetary policy. This greater attention to monetary and credit aggregates accompanied rising national concern about the debilitating effects of inflation on the economy. Mounting evidence of the linkage between inflation and growth in the financial aggregates, along with the deficiencies of money market conditions as a guide under such circumstances, contributed to the shift in emphasis. The most dramatic event in this evolution was the October 1979 policy action that sought tighter control over the money stock through a shift in operating procedures toward nonborrowed reserves. Nonborrowed reserves replaced the federal funds rate as the instrument for controlling the money stock, as the funds rate in practice had proven slow to adjust to new developments and had become rather undependable in achieving monetary control. More recently, the Federal Reserve has pursued its objectives for monetary growth more flexibly, in view of new uncertainties about the relation between measures of the money stock and output and price performance.

Even though conditions in financial markets have stabilized considerably in recent years from those of the late 1970s and the very early 1980s, there remains more scope for interest rate variations and market volatility than most of us would like. Substantial progress on inflation notwithstanding,
the markets remain very sensitive to inflation prospects. The financial outlook is also linked closely to the massive federal deficits which place strains on financial markets both here and abroad.

Recent events have made market participants more concerned about the fragility of our financial system and the vulnerability of some sectors to unexpected events. The inflation-disinflation process of recent years along with the strong dollar and heavy debt servicing burdens faced by domestic and foreign borrowers has eroded the quality of many asset portfolios and weakened numerous financial institutions and it will take time for them to rebuild their balance sheets. In the meantime, they will be exposed to untoward developments affecting funding costs or asset returns.

The changing climate in money and capital markets has inevitably affected all types of entities that borrow, invest, or lend money, but nowhere has a transformation been more evident than in the mortgage market where many of you participate as originators, brokers, servicers, or investors. As many of you know first hand, the changing financial environment required dramatic modifications in the management of both assets and liabilities. The need for sweeping adjustments in the structure and the operation of the mortgage market had become acute by the late 1970s as double-digit inflation was reflected in unusually high interest rates.

Thrift institutions—long a key source of mortgage funding—had always been sensitive to fluctuations in market interest rates that directly or indirectly affected the willingness or ability of these lenders to accommodate the credit needs of housing. At times during the 1960s and the 1970s, market interest rates had climbed well above levels that S&Ls and savings banks were able (or allowed) to pay on their deposit accounts. Under such circumstances,
deposits were squeezed as many savers shifted their funds to higher-yielding investments available in the market. As a result, the mortgage market—and the housing market that it serves—have been buffeted by successive waves of ease and tightness in the availability of credit. These cycles, in turn, triggered large swings in patterns of residential construction and housing sales.

Occasional periods of disintermediation at thrift institutions were marked mainly by reductions in thrift liquidity, and by weakness in thrift earnings. Faced with the potential threat of a further squeeze on their resources, thrifts typically slashed their new mortgage lending commitment volume as they scrambled to fund takedowns from the backlog of outstanding commitments accumulated earlier when financial prospects seemed brighter. The opposite sequence of events ordinarily unfolded during periods of declining market rates; as deposit flows surged, thrifts would compete aggressively for market share in their traditional business of mortgage lending.

The feast-or-famine character of the mortgage market has been a matter of concern to the Federal Reserve for some time. As far back as 1970, the Board instructed its staff to undertake a fullscale study of housing and housing finance. The Board recognized that supplies of mortgage credit to home buyers had been heavily curtailed at times of rising interest rates. These were typically occasions when demands for credit of all types expanded in the face of limits on the aggregate supply of loanable funds, and various impediments tended to divert funds from housing. The study accordingly was aimed mainly at devising possible ways of moderating short-term swings in the availability of housing credit.
One major conclusion of the study was that public policy should consider ways of encouraging lenders to offer what are now known as adjustable-rate mortgages (ARM's). Unfortunately, a decade was to elapse before the adjustable-rate mortgage concept became widely authorized in the United States as a technique for managing interest rate risk and encouraging mortgage lending.

Throughout the 1970s and into the early 1980s, swings in the mortgage market from ease to tightness had been intensified by familiar legislative and regulatory constraints. Usury ceilings in many states held down interest rates that could be charged on nongovernment-insured mortgages, which thus became less attractive investments during periods of general credit stringency. Administered ceilings for interest rates on FHA/VA-underwritten mortgages also discouraged investment in this type of financing instrument. And until quite recently, interest rates were capped on core deposits of banks and thrifts, severely limiting their ability to raise funds for mortgage lending. In recognition of the disruptive effect of such restrictions on thrifts and housing, nearly all of these direct and indirect constraints on new mortgage lending—-and on the ability of would-be borrowers to compete for mortgage credit—-have now been removed.

The weakening in earnings of thrift institutions that began after 1978 deteriorated further to widespread losses in 1981, and funds for new mortgages became scarcer and more costly. As a result of higher interest rates in the market place, combined with the progressive deregulation of deposit liabilities, the cost of deposit funds to thrifts rose sharply.
Although most market interest rates began backing down in 1982, the costs of funds for thrifts continued upward as many depositors shifted to accounts that were not subject to rate ceilings or were indexed to more attractive market rates. Only in 1983 did lower costs of funds contribute noticeably to an improvement in thrift profitability.

Even then, thrifts still faced an overhang of low-yielding, long-term, fixed-rate mortgage assets that rendered them vulnerable to increases in market rates. Moreover, at times of upward interest rate pressures, new mortgage lending—and associated opportunities for fee and related income—dropped off. Also, repayments from older fixed-rate loans slackened and thus limited the volume of reflows of funds available for reinvestment at higher yields. For these and other reasons, the asset side of thrift balance sheets has continued to undergo restructuring more slowly than the liability side.

Recent regulatory and legislative changes have made ARM lending possible nationwide. In several months last year, 70 percent or more of conventional home mortgages closed at S&Ls and savings banks carried some type of adjustable-rate feature; with long-term market interest rates lower now, the proportion most recently has fallen below 60 percent. Increased ARM lending is an important innovation because returns on adjustable-rate mortgages, attuned to changes in market conditions, can reduce the risk that rates of return on portfolios of older loans may not keep pace with changes in current interest rates.

New and expanded powers provided by recent legislation and regulations have also allowed federally chartered thrift institutions to diversify more into assets such as commercial and consumer loans with shorter maturities that can help reduce the interest-rate risk
of loan portfolios. However, most FSLIC-insured institutions have been slow to expand the nonmortgage share of their assets, owing to income tax incentives for continued mortgage lending and to the comparative advantage that S&Ls, in particular, enjoy in this area of specialization. Even so, by the end of last year mortgage loans and mortgage-backed securities held by FSLIC-insured institutions had declined to 73 percent of total industry assets, compared with 86 percent six years earlier.

In the mortgage market more generally, other innovative measures were under way to improve portfolio performance in a regime of more volatile interest rates. Shorter maturities on fixed-rate home mortgages, for example, have become more common. Stimulated in part by purchase programs recently initiated by FNMA and FHLMC, so-called "Yuppie" mortgages, carrying terms of around 15 years, have helped to bolster lenders' cash flow from a given amount of funds invested in mortgages. From a consumer's view, such loans have helped to accommodate borrowers with ample resources who are looking for slightly lower interest rates on this shorter-term financing than on a standard 30-year loan, and much lower total interest costs over the life of the loan.

Meanwhile, issuance of mortgage-backed securities has been stepped up, in many cases providing an alternative source of funding in lieu of direct recourse to thrifts. Typically involving GNMA, FNMA, or FHLMC guarantees, new issues of residential mortgage pass-through securities, including swaps, exceeded $85 billion in 1983 and $60 billion in 1984, compared with less than $25 billion in the early 1980s. These securities, more liquid than individual loans, have helped to tie the mortgage market more closely to general financial markets here and abroad.
The ongoing securitization of the mortgage market has advanced farthest in the case of residential mortgages. Increasingly sophisticated methods of mortgage-backed security financing have been developed, including both pass-through and bond-type arrangements such as collateralized mortgage obligations. In 1982 the Federal Reserve Board amended its regulations in order to permit private mortgage pass-through securities meeting certain criteria to be used as collateral for margin credit at securities brokers and dealers. This action facilitated the mortgage securitization process by making these mortgage-pooling arrangements more useful to a wider class of money market participants.

Aggregate mortgage lending from all sources, especially through mortgage pooling arrangements, has remained fairly active. Growth in sources of funding other than thrifts—as especially through the securitization of mortgages—has allowed seekers of housing credit to rely less heavily on thrifts, and the mortgage market to be disturbed less by variations in the growth of thrifts. To illustrate, home mortgage credit in the first quarter of this year was well maintained even though expansion in S&L mortgage-related assets was the slowest since mid-1982, apparently owing in large part to the constraint of new, more stringent net worth requirements.

These and other strategies for restructuring financial institutions and for strengthening mortgage markets are not unique to the United States. A comparative study published recently by the International Union of Building Societies and Savings Associations suggests that many other countries have been relying more heavily on mortgage loans bearing adjustable rates of interest. Indeed, widespread use of adjustable-rate lending has for some time been a common practice.
in Australia, Canada, Switzerland, and the United Kingdom. Moreover, in order to compete effectively under changing market conditions, the study indicates that in various countries, lenders that formerly specialized in housing finance have diversified their activities. On occasion, the international study points out, diversification has proceeded to the point that traditional housing finance institutions have, in effect, become banks, and altered their names accordingly.

The search for greater flexibility in adapting institutions, laws, and regulations to a more volatile financial environment is nonetheless far from fully accomplished here at home. At thrifts, virtually all deposit accounts have been deregulated. But earnings on thrift assets continue to be quite insensitive to changes in interest rates, owing to the still large share of asset portfolios in mortgages bearing fixed interest rates and long maturities. At the end of 1984, less than one third of total holdings of mortgages and mortgage-backed securities by all FSLIC-insured thrifts were adjustable-rate loans or short-term balloon loans.

Moreover, techniques already used by lenders to shift more of the risk of interest rate changes to borrowers are not yet fully tested under a range of economic and financial conditions. Despite interest rate caps and other consumer protection features commonly associated with ARMs, it has already become obvious that lenders have, on occasion, laid off some risk of interest-rate fluctuations onto borrowers in return for more risk of delinquency and foreclosure as borrowers become unwilling or unable to meet changing mortgage payment schedules. A higher incidence of default claims on home mortgages is already evident. In response, private
mortgage companies have tightened their underwriting standards and have raised the price of their insurance premiums on new business.

The transition in U.S. financial markets--sparked by adaptations to inflation followed by disinflation and by deregulation--thus remains under trial and adjustment. We still have to see how well and how far the mortgage market has moved from recurrent problems of credit feast or famine to a more efficient system where borrowers can readily obtain credit at competitive costs at all times; that is, a market where the price, rather than the availability, of credit is the key issue. At the same time, further progress in narrowing the gap between asset and liability maturities or repricing intervals can help lending institutions pare their exposure to changing interest rate risks.

Our evolving financial environment will continue to challenge traditional business practices. Only prudent and thoughtful reaction to changing circumstances will sustain our effort to increase the safety, soundness, and adaptability of our financial system. Thus you are being counted on to continue crafting techniques and methods for your industry which will promote a market place that is both efficient and resilient.