january

Rent Controls: Panacea, Placebo, Or Problem Child?

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FEDERAL RESERVE BANK of PHILADELPHIA

business review

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IN THIS ISSUE . . .

On our cover: Morven is the residence of the Governor of New Jersey as well as a national historic site. The eighteenth-century mansion, located in Princeton, was built and occupied by the prominent Stockton family for generations. Richard Stockton, grandson of the builder, was a signer of the Declaration of Independence. His wife, Annis Boudinot Stockton, named the house "Morven." Walter E. Edge, the late former Governor, purchased the property in 1945 and deeded it to the state in 1954 for a year-round Governor's residence. (Photo courtesy of the New Jersey Department of Environmental Protection.)

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Rent Controls: Panacea, Placebo, Or Problem Child?

By Howard Keen, Jr. and Donald L. Raiff

The falling gavel signals the opening of a meeting of the Verdant Valley Tenants Association. The evening's program features the financier and builder of the community's largest apartment complex who will explain why he hiked the rents on his housing units. The guest of honor proceeds to explain about his increasing costs, the effects of not being able to pass on cost increases, and the increased demand for his units from employees of the new plant down the road.

Timothy N. Tenant opens the question-and-answer session, complaining about "exorbitant" rent increases and asking about the "shortage" of alternative rental housing units. The verbal jousting continues until boredom descends, and the meeting is adjourned. The issues remain unresolved, but the Association is more resolved than ever to seek relief through rent controls.

Meetings such as these could be occurring in communities throughout the land. Some levels of government are now feeling the political clout of tenant associations. Tenant groups regularly air their grievances before voter-sensitive city councilmen. Rent control measures have been debated in the halls of Congress. And, only recently in New Jersey the state Supreme Court upheld the legality of local rent controls ordinances.[1]

The push for rent control legislation appears at first glance to interest only tenants and landlords. However, if allocation problems arise in any sector of the housing market, all other sectors stand to be affected. Rent controls have costs which must be compared with their benefits both for renters and the rest of society. Understanding these costs and benefits requires knowledge of the probable effects of this form

[1] *Inganamort et al.* v. *Borough of Fort Lee et al.*, 62 N. J. 521 (1973).

of government intervention on the price and availability of rental housing relative to that found in an uncontrolled housing market.

The topic of rent controls evokes varied responses. Many people view rent controls as a solution—a panacea of sorts—for the nation's immediate and long-range housing problems. Others hold that such controls make little difference one way or the other. Still others (landlords, homeowners, and even some renters) see the controls as creating more problems than they solve—in other words, begetting a perpetual problem child. Clarification of the arguments concerning rent controls can be accomplished by examining some basic principles of economics.

NOT NEW BUT LARGELY FORGOTTEN

Rent controls are nothing new to Americans. Uncle Sam used them from 1942 to 1952. In the late '50s and '60s only New York City had them. Then in '71 under Phase I, rents along with other prices were controlled. Phase II decontrolled about 45 percent of all rental units affected, and Phase III lifted controls on the remainder. Today under Phase IV rents remain uncontrolled, despite strong political pressures on Congress to revive them.

Demands for government intervention in the rental housing market appear to be one of the many reactions to escalating rental prices. If rents climb faster than before, then controls are presumably a way of harnessing these increases. Rents, as measured by the rental component of the Consumer Price Index, increased at an average rate of 1.6 percent per year from 1960 to 1969. The average annual increase from 1970 to 1972 was 4.1 percent.

RENT CONTROLS: A RESPONSE TO AN SOS FROM THE RENTAL HOUSING MARKET

In general, rent controls are a response to large or rapid hikes in rent; however, their specific purposes often are unclear and not uniformly accepted by their backers. Proponents claim that these controls prevent owners from "gouging" tenants with large rent increases. This dovetails with the idea that controls would prevent only "unreasonable" rent increases. (Of course, agreement might be difficult to reach among renters, owners, and the general public as to what is gouging or unreasonable.) But why do rent hikes in particular bring forth these claims of "gouging" and "unreasonable" increases? Part of the answer is that not everyone understands how the rental housing market operates. Another part is that the rental market has a couple of characteristics that leave renters feeling helpless when faced with stiff rent hikes, such as high relocation costs, information costs, and time-lags in changing the stock of rental housing.[2]

Consider, for example, the effect of relocation costs. Besides the problem of moving his belongings, a renter's living habits often undergo major disruptions whenever he has to move. Suppose Mr. Tenant estimates the cost of disrupting his daily habits and moving to a new apartment to be roughly $1,000. If at lease-renewal time Mr. Owner raises the rent above the value that Mr. Tenant places on his living quarters, then the renter might be expected to move. This would force Mr. Owner to compete with other landlords for new tenants. However, if the rent increase, computed over the full duration of Mr. Tenant's expected stay in this rental market, falls short of the relocation cost estimate of $1,000, he'll not move. In this instance, relocating would cost more than the rent saved by moving to the less expensive apartment.

Moreover, the cost of obtaining information on both sides of the rental housing market can be quite high if the information is needed quickly. Renters want to know about the location and quality of services they can expect for

[2]These characteristics (see below) cause the rental housing market to fall short of the economists' idealized notion of "perfect competition." The basics of "perfect competition" are many small buyers and sellers, a homogeneous product, free mobility of resources, and low market-information costs. The rental housing market meets only the first condition to a high degree. Apartment locations and surroundings differ widely, relocating can be expensive, obtaining information on other units takes time and effort, and building new units quickly is costly.

what they pay. Owners desire to know about potential renters to insure that rent payments will be made and the rented units won't be damaged. Gathering information is time-consuming. If needed quickly, obtaining it is probably expensive. Giving tenants plenty of advance notice for rent hikes allows more time to collect the necessary facts. This lowers the cost of securing the additional information. So over longer periods, owners and renters can make less costly adjustments to the pressures and incentives of market forces.

Meeting the housing demands of the market is not easy. Forecasting what renters will want in the future, and making rapid adjustments to changes in demand are difficult. Building new units or converting existing ones to new uses takes time and money. If demand increases, this slow adjustment of supply over short periods will cause rents to rise more than they would if units could be created instantaneously.

If to the extent the immediate effects of market changes are not understood, rent increases from this source are likely to seem "exorbitant" and "unreasonable." Rent controls offer no real solution to these short-run problems (see Box 1). Rather, they just keep the market from allocating the existing rental housing units to demanders on the basis of the price they are willing to pay. This effect, along with others, can be seen by applying some basic economic principles.

WHAT'S LIKELY UNDER RENT CONTROLS

Shifts in the supply and demand for housing occur with and without rent controls. Landlords will see their property taxes, construction costs, and operating costs change. Demands for particular apartments and units in specific locations shift whenever industry relocates or renters' preferences change. When this happens, prices change until a new market-clearing price is reached. At any price other than the market-

Box 1

PROPOSALS TO INCREASE COMPETITION

Rent controls govern the stated rental price. But is that the problem on which their proponents wish to zero in? The effective price—stated price plus other costs necessary to secure the rental unit—would be the better target. No matter the level of the effective price, it will decline as the rental housing market becomes more competitive. Proposals which attack the problems of relocation and information costs will, if enacted and effective, provoke more competition among the owners and tend to lower the resulting rental price. For example, specific subsidies to renters to cover part of their normal relocation costs would allow renters to be more responsive to market changes. Programs to collect and disseminate information on the rental housing services available in a locality would lower renters' information costs, whether the programs are backed by tenant associations or government resources. The same applies to surveys of employers and renters to assist owners in projecting the demand for current and potential units.

Some proponents of rent controls have taken a longer-range view, hoping that these controls could assist in providing decent rental housing for everyone who wants it at a reasonable price. On the surface this rental housing goal can be realized either by raising personal income or by lowering the rental price. However, lowering the rental price through rent controls will have feedback effects thereby reducing the supply of housing. A less disruptive approach suggests raising personal income rather than circumventing the market allocation scheme by controlling rents.

clearing one, owners and renters would not agree to an exchange of rent money for housing. At a higher price owners would be willing to build more units or activate vacant ones, but renters would not desire more.[3] At a lower price renters would want more apartments, but owners would be unwilling to provide them.

In the rental housing market, the price is the monthly rent. Under recent and proposed rent control measures, however, rents would not be completely free to move, and they could rise only if approved under the selected cost pass-through arrangements (see Box 2). But what if these pass-through measures result in rental housing prices that do not satisfy both renters and owners?

How Will Owners Respond? In the face of cost increases, profit-maximizing owners will attempt to increase rents if they are to supply the same amount of rental housing. Although this is at best a trial-and-error process, rent controls make matters more uncertain for the owner. Rent controls generally have some pass-through provision for rising costs. However, the owner cannot up the rent in excess of the pass-through allowances without convincing the rent control authority he needs the extra amount because of financial hardship.

The pass-through formula could allow all increases in supplier's costs to be passed on to the renters. But then what has the legislation contributed, other than creating work for those involved? Even if the pass-through allows rents to reach their market-clearing levels, such controls still have costs. Owners, renters, and the rent control board will respond to the new laws by using resources to understand and cope with the regulations. Without controls, this extra time, effort, and money could be put to other uses.

The costs of controls are compounded if the pass-through allowance prevents rents from rising to their market-clearing levels. When this occurs, rent can no longer perform two important functions. It cannot allocate the present supply of rental units among renters so that everyone who is willing to pay the new rent can get rental housing. Nor can it provide incentive for owners to increase the supply of housing to satisfy demand at the new price. Without the freedom to up the rent, the owner can maximize his profit (or at least minimize his losses) only by cutting costs, which usually means lowering the quality or quantity of his rental units. This is the expected response as the owner tries to protect his investment over the short run in the face of a binding rent ceiling. The resulting supply of rental housing services would be less than if rents were free to rise to market-clearing levels. Although current rent control proposals prohibit lowering quality for a given level of rent, the difficulty of policing such actions would increase the administrative and enforcement costs of rent control with questionable results on quality.

Controls inject an additional degree of uncertainty into investment in rental housing. This occurs even if an owner could charge as high a rent as the market would bear for a unit when leasing it for the first time. An important factor when considering a particular investment is the ability to alter it when market conditions change. Rent controls hinder the owner's ability to respond to changing market conditions. And, consequently, such controls—or even the possibility of their being enacted—could make construction of rental housing less attractive as an investment than it would be without them.

Over the long haul rent controls will tend to make would-be owners reluctant to invest in rental housing. Current owners would adjust prices until the controls ceiling impinges on their planned rent hikes. Then they'll adjust by trying to cut operating costs. On the heels of decreased operating costs comes less and lower-quality housing services.

How Will Renters Respond? Suppose a new plant opens in a community. As the plant hires more nonresidents, demand for housing in the

[3]Businessmen hold inventories as a buffer against unexpected changes in demand. In many cases, apartment owners hold vacant rental units. This lowers their costs of adjusting to changes in present and future demand.

Box 2

SAMPLE PROPOSALS FOR RENT CONTROLS

If the demands for rent controls are successful, the program set in motion will have certain major characteristics. Two model rent control bills and two rent control amendments to the 1973 extension of the Economic Stabilization Act can be considered representative of recent rent control proposals. One model rent control bill was prepared by the South Jersey Tenants Association and the other was prepared by the Apartment House Council—an affiliate of the New Jersey Builders Association. The proposed Congressional amendments (introduced March 20, 1973) are one by Senator Clifford Case of New Jersey and one by Senator Lawton Chiles of Florida. Four major provisions are found in each of these proposals. One is a set of rules established to pass through cost increases incurred by the owner. A second is that rents are controlled on all multi-family units except those being rented for the first time. A third characteristic is the establishment of a rent control authority to adjudicate disputes arising under the controls. A fourth is the mechanism which activates the powers of the rent control legislation.

A central issue in every legislative consideration of rent control is the pass-through of cost increases. If the landlord's costs increase and he's prohibited from raising his rents, eventually he'll go out of business. So generally all rent-control legislation enables the landlord to pass some of his increased costs on to the tenant. Each of the proposals allows complete pass-through of tax changes. Two of the bills afford similar treatment to capital improvements. Other cost increases are considered under the umbrella of specific formulas which range from allowing rent increases of 2.5 percent a year to one allowing a rate of change commensurate with movements in the Consumer Price Index.

Exempting new units from initial controls shows a concern for the effects of such controls on the construction of new rental units. If rents are set below the level which generates a satisfactory rate of return on the owner's investment, new sources of supply would be cut off. Yet proponents of rent controls fail to realize that controlling the rents after the first renewal causes uncertainty and lowers the likely stream of rental income. The increased uncertainty and lower expected revenue will deter the construction of new rental housing despite the original exclusion of units rented for the first time.

Another common characteristic is the appointment of a person or board, whose job it is to evaluate rent increases and enforce the controls against illegal hikes. Such a board might function by examining costs and rent changes or, depending on how it's structured, render judgments on rental complaints before it. The administrative expense of this board is a tangible cost of rent control, but this cost is probably small compared to the misallocation costs that can occur when the market is not allowed to operate.

The suggested mechanism that activates rent controls ranges from some measure of the relative housing supply to formal Congressional action. Local controls are activated when a survey estimate of the vacancy rate for rental housing goes below a specified level. Thus, they could come and go depending on the variance of local vacancy rates. The Federal controls would end with expiration of the Economic Stabilization Act.

community increases. Presumably, part of this increased demand will be for rental housing. In an unfettered market, rent increases would induce tenants who do not value this location so highly to surrender their apartments and move to rental housing elsewhere. To some, this may be viewed as driving current residents out of their living quarters. But the market is simply allocating a scarce resource among competing demanders, so that those who most desire a particular type of housing can bid for it. The resulting rent increases also spur owners to provide more and better housing. But under a binding rent ceiling these adjustments cannot occur. Price can no longer provide the needed supply incentive nor be used as a rationing device.

Under rent controls, apartments might be handed out on a first-come, first-serve basis. However, opportunities for discrimination based on looks, race, religion, and a host of other nonmonetary characteristics would result. If renters can compete for housing services, using both monetary and nonmonetary methods, an owner who discriminates on nonprice grounds risks losing rental revenue. When monetary methods of competing are severely limited, as they are under rent controls, the potential loss of revenues from nonprice discrimination is less. This would lower the cost of these forms of discrimination, thereby encouraging their use.

Tenants unable to obtain controlled units could be forced to pay relatively high rents for uncontrolled units or share living quarters with other families. When tenants desire more rental housing than landlords are willing or able to provide, controls may allow some segments of the population to avoid economizing on rental housing while others might be forced to live penuriously. As a result, black markets and "under-the-table" deals become commonplace. The "have-nots," who value a particular unit more than the "haves" occupying it, might offer some payment in exchange for that unit. In this way the market would still operate, but the costs of arranging mutually agreeable exchanges would be raised.

Market-search costs form a lion's share of the total transaction costs. And it's difficult to see how rent controls would lower such costs for renters. Under conditions in which rent has been controlled at a level below the market-clearing price, potential renters would need to ascertain the types of allocating schemes employed. Then they must develop a *modus operandi* for enhancing their chances of getting the desired housing services. All of this is more likely to raise rather than lower renters' market-search costs.

Tenants who somehow obtain controlled units will spend less on rent than they would if rents could rise to market-clearing levels. This may sound like a good deal for those fortunate renters, but actually such fortune has indirect costs. In addition to the possibility of deteriorating quality of housing services, there's the problem of mobility. In terms of the freedom to change residence, rent controls can be expected to make renters less mobile. Rents that are held at artificially low levels would not force particular renters to economize on housing as they would if rents were free to rise. Renters now living in controlled units would have little chance of duplicating their current housing and its cost at a new location. This would create a premium on obtaining and *retaining* controlled units.

Wealth Transfers Can Result. To the extent that renters spend less on housing at the expense of rental housing owners, there is a net transfer of wealth from owners to renters. Adequate housing is a desirable goal, but there's no economic or sociological rationale for imposing the costs of such subsidies on owners of rental housing alone. Furthermore, there's no assurance that all renters are economically disadvantaged or that all owners are economically advantaged. The only empirical study found in the literature on this issue concluded that no evidence existed to indicate that tenants were poorer than landlords.[4] So if rent controls are

[4]D. G. Johnson, "Rent Control and the Distribution of Income," *American Economic Review* 41 (1951): 569-82.

intended to redistribute income from the rich to the poor, they're probably an ineffective vehicle for doing it.

Spillover to Owner-Occupied Housing. The prices of owner-occupied housing are not regulated under rent control proposals. But this doesn't mean that this portion of the housing market will be unaffected by rent control. Since owner-occupied housing is a close substitute for rental housing, any imbalances in the latter market may alter the demand or supply for owner-occupied housing. As potential renters find they are unable to obtain rental units, they will turn to the ownership market to obtain housing. Some developers will cater to this demand and shift from supplying units for rent to units for sale. The ultimate effect on the price of these housing units depends upon the strengths of these shifts.

The spillover effects of rent controls do not have to be confined to the price and quantity of owner-occupied housing. Another spillover channel is possible through the property tax system. If the quality of controlled rental housing deteriorates so that its assessed value drops, then a heavier tax burden could fall on residential homeowners or other tax revenue sources. (See Box 3 on pages 10 and 11 for details of the major U.S. experience with rent controls.)

PANACEA, PLACEBO, OR PROBLEM CHILD?

Rent controls are not a panacea for the rental housing market. They neither improve its operation nor provide the incentives to insure that renters' demands will be met over the long haul. In the meantime, controls can be a placebo—that is, they delude society into thinking government intervention is beneficial. In fact, they start down the path of problem creation. With the usual demand increases, controls will initially aid renters living in controlled units—holding down their monthly payments—at the expense of the owners of controlled rental housing. This short-circuits the role of rent to provide incentive for tenants to economize on housing usage and for owners to meet the demand for housing services. All of this is done without coming to grips with the roadblocks to competition, such as relocation costs, inadequate information about alternatives, and time-lags in building new units.

In the longer run, rent controls beget a problem child. They deter suppliers from providing the quality and quantity of rental housing services tenants want and are willing to pay for. Rent controls do this by lowering the income stream of owners relative to what they would have received in an unfettered market. Thus, they provide an incentive for present owners to "disinvest" in housing by allowing their properties to deteriorate as well as encourage new investors to steer clear of the rental housing market.

Summing up, it seems the rent-control bandwagon "on its way to the happy housing grounds" could get stuck at a rundown tenement shack. And, that's reason enough for considering its destination before hopping aboard.

Box 3

THE NEW YORK CITY EXPERIENCE

New York City has had rent controls since 1943 and they remained basically unchanged until 1969. The characteristics of these pre-1969 controls are not identical with the proposals described in Box 2. Housing built after 1946 was not subject to rent controls.[1] The Office of Rent Control under the Housing and Development Administration administered the controls, and owners were permitted to hike rents when there was a change of renters. The rent hike was limited to 15 percent, but it could be less if the building in question was not violation-free. In some cases, rent reductions could be ordered. In addition, various cost pass-through allowances were permitted—major capital improvements, economic hardship of the owner, increased service, and rising labor costs. The triggering mechanism was a vacancy rate below 5 percent in the controlled sector. Surveys were conducted every two years to determine this rate, but it never climbed higher than 3.2 percent in the post-World War II period.

There is little evidence of any major problems in the rental housing market before 1960. In the early 1960s storm warnings appeared, and around 1965 Gotham's rental housing market plunged into a crisis. The pervasiveness of the crisis is evident in a 1970 study by the Rand Institute in New York City.

> Vacancies are acutely scarce, construction is at its lowest level in many years; rents in the previously uncontrolled sector rose so rapidly in 1969 that a new form of control was imposed, and large numbers of recently habitable buildings have been reduced to shambles or withdrawn entirely from the market. Tenants are deeply dissatisfied either with the quantity of service provided by their landlords or with the rents demanded, or both. Landlords are equally dissatisfied with the yields of their property, the behavior of their tenants, the burdens of public regulation, and the illiquidity of their investments.[2]

Rent controls alone did not cause the crisis, but they contributed heavily because they prevented rents from rising in tandem with costs. This protected many tenants from major rent increases. Rand found that since 1945 the costs of supplying well-maintained rental housing rose about 6 percent per year, while rents moved upward only 2 percent per year.

When the costs of operating and maintaining rental housing began accelerating in 1965, the gap between costs of supplying rental housing and controlled rental revenues widened

[1]In 1969 the New York City Council passed a law which widened the coverage of rent controls to include housing built after 1946.

[2]Ira S. Lowry, ed., *Rental Housing in New York City. Volume 1, Confronting the Crisis* (New York: The New York City Rand Institute, 1970), p. 1.

appreciably. The same Rand study discovered that in the first half of the '60s the stock of rental housing grew at an average annual rate of 22,000 units. But in the second half the available supply declined by an average of 7,000 units per year. Quality suffered too, according to the Rand Institute. From 1960 to 1967 the inventory of rental housing classified as "sound" increased 2.4 percent, while that rated "deteriorating" rose by 37 percent, and "dilapidated" by 44 percent. Moreover, about 80 percent of the housing inventory losses (for reasons other than merger or demolition) during 1966 to 1968 involved units in buildings classified as either "sound" or "deteriorating" but *not* "dilapidated" in 1965. It's not surprising that proposals to alleviate the city's rental housing shortages included drastic changes in rent controls ostensibly to reflect supply and demand forces better and revive incentives to supply rental housing.

Some persons did benefit from rent controls, however. Renters who obtained and retained controlled units spent less on housing than they would have in the absence of such controls. Some of the monetary costs and benefits were examined in a study using 1968 data. It's estimated that the net benefit to families living in controlled housing was $270 million (an average of $213 per family). However, the cost to landlords totaled $514 million, and the cost of administering rent controls hit $7 million. So the estimated excess of costs over benefits to the market participants was $251 million.[3] Both "poor and nonpoor" alike received these benefits. It was estimated that in 1967 a family of four could manage a "low-to-moderate" standard of living in New York City on a gross income of $6,800 to $7,400. In that year about 45 percent of all renters living in controlled units had incomes above $7,000.[4]

It is easy to see how a premium can be attached to controlled units. Families who lived in rent-controlled housing in Manhattan in 1968 paid an estimated average of $1,200 less per year than they would have paid for the same housing in an uncontrolled market.[5]

While rent control in New York City was not the only cause of the housing crisis, several independent studies, including some commissioned by the City, concluded that the rent increase limitations were a major contributor. In response to this, the City adopted a major reform of its rent control law in mid-1970, and a New York State law, passed in the spring of 1971, decontrolled all controlled units vacated after June 30, 1971.[6]

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[3]Edgar O. Olsen, "An Econometric Analysis of Rent Control," *Journal of Political Economy* 80 (1972): 1094.

[4]Ira S. Lowry, *et al.*, *Rental Housing in New York City. Volume 2, The Demand for Shelter* (New York: The New York City Rand Institute, 1971), p. 81.

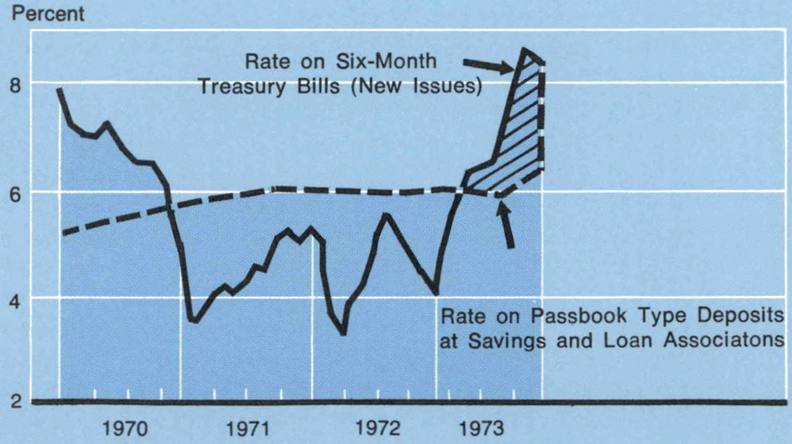
[5]Ibid., p. xv.

[6]For details of the reformed rent controls, see Alan S. Oser, "City Details Rent Formulas for '72 and '73," *New York Times*, October 3, 1971, sec. 8, p. 1.

Pace of Housing Starts Slows as Deposit Growth at S&Ls Declines

CHART 1

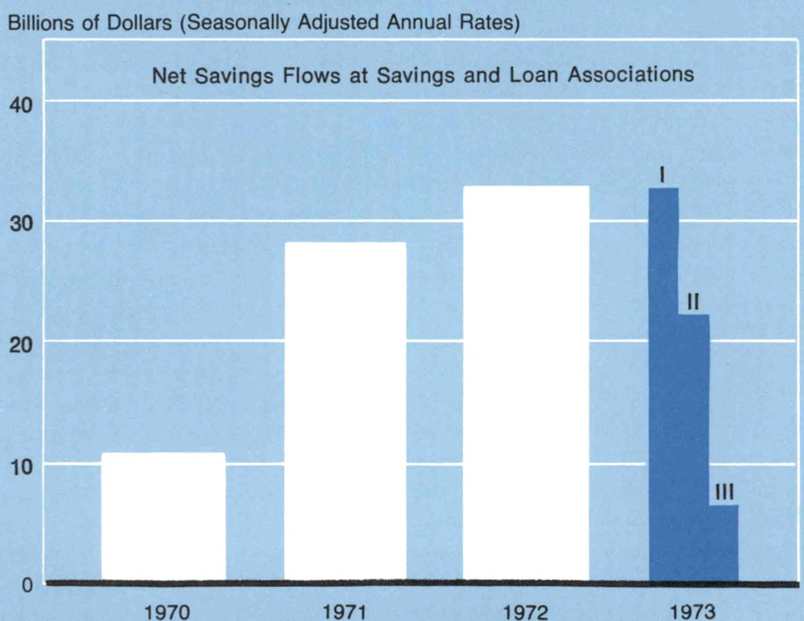
RECENTLY, YIELDS ON MARKETABLE GOVERNMENT SECURITIES HAVE CLIMBED ABOVE DEPOSIT RATES AT SAVINGS AND LOAN ASSOCIATIONS . . .



Source: Federal Reserve Bulletin

CHART 2

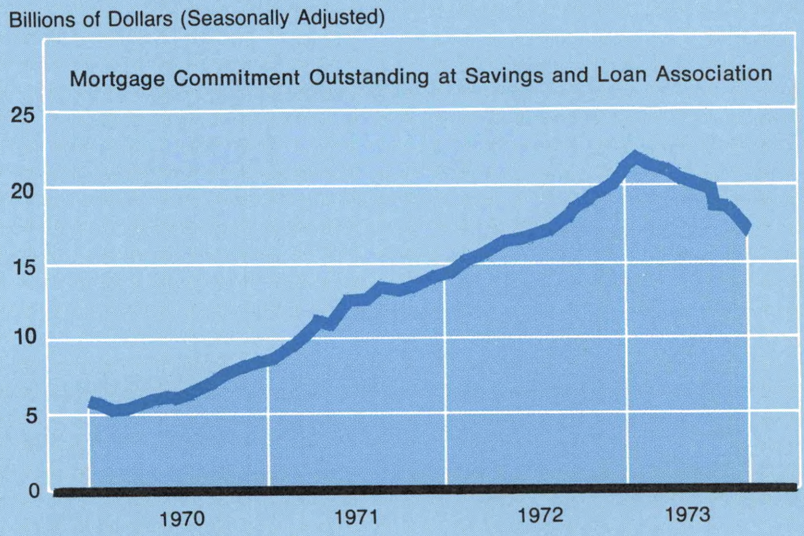
RESULTING IN A MARKED SLOWING IN THE GROWTH OF DEPOSITS AT THESE INSTITUTIONS . . .



Source: Federal Home Loan Bank Board, September 1973 Preliminary.

CHART 3

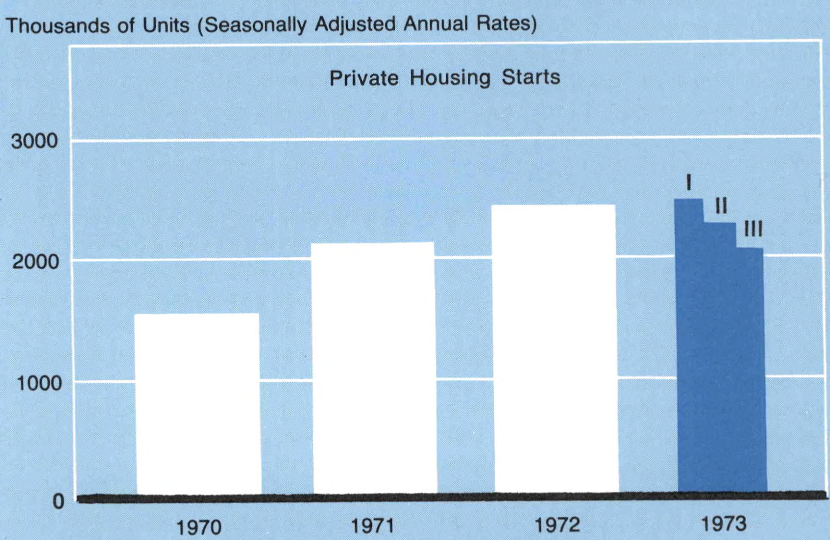
SO THAT S&Ls HAVE HAD TO CUT BACK ON COMMITMENTS FOR NEW MORTGAGE LENDING . . .



Source: Federal Home Loan Bank Board

CHART 4

THUS CONTRIBUTING TO A DECLINE IN THE PACE OF ECONOMIC ACTIVITY IN THE HOUSING SECTOR.



Source: Census Bureau Data, Seasonal Adjustments by the Federal Reserve System.

Helping Americans Get Mortgages

By Jack Clark Francis

Millions of Americans have received help getting their home mortgages from "Ginnie Mae," "Fannie Mae," and "Freddie Mac." Yet most of them probably can't recall hearing the names. This "awareness gap" is a little surprising. "Fannie Mae," for example, is a corporation that owns more assets than General Motors and whose stock is traded on the New York Stock Exchange. Probably the main reason so few people appreciate Fannie Mae, Ginnie Mae, and Freddie Mac is because they operate behind the scenes in their efforts to strengthen mortgage markets.

These home-financing institutions began as U.S. Government agencies with the assignment of bolstering the mortgage markets to help the everyday home buyer. The Federal Government undertook these programs because it wanted more money channeled into housing than private institutions were providing. So Congress set up agencies of the Federal Government to facilitate mortgage financing.

Down through the years the agencies have expanded, and today they help home buyers, home builders, and others. The most direct form of assistance the three mortgage agencies provide is the provision of secondary mortgage markets. It is also sometimes argued that these agencies help the mortgage market by obtaining savings from sources which heretofore did not invest in mortgages and by channeling these dollars into mortgage loans. Increasing the supply of mortgage credit tends to reduce the cost of a mortgage. The agencies also provide mortgage funds during "credit crunches," when other sources of mortgage credit reduce their lending. And, the agencies sometimes buy high-risk mortgages on subsidized homes that are not 100 percent covered by insurance. Thus, through these techniques government agencies attempt to even out and increase the flow of funds for home financing.

IN THE BEGINNING

Uncle Sam started making home buying easier for Americans decades ago. The Federal Housing Authority (FHA) was started in 1934 and the Veterans Administration (VA) was started in 1944 to provide default insurance on home mortgages. The two insurance programs are similar. Essentially, they indemnify the lender against all or part of the losses realized on a guaranteed loan if the home buyer can't meet the mortgage payments.

The FHA and VA charge one-half of 1 percent of the value of the mortgage per year for their insurance service. As a result of FHA and VA insurance, savings and loans associations (S&Ls), banks, life insurance companies, and other groups that loan mortgage money are more willing to make loans to some risky home buyers who show promise of honoring their debts. But, perhaps the most interesting thing about these insurance programs is that the charges add up to more than the FHA's total costs and losses on repossessions.

The FHA and VA are large, old, well-known institutions that have helped millions of Americans get their homes financed over the years. So, although they perform a valuable insurance service, there is really nothing new about the FHA or VA. It's names like Fannie Mae that are making headlines now.

MEET FANNIE MAE

The Federal National Mortgage Association (FNMA) was born in 1938 and was affectionately nicknamed Fannie Mae. Originally, her job was to take the proceeds from selling U. S. Government agency bonds, her own FNMA bonds, and buy FHA- or VA-insured mortgages. Fannie did not interfere with the VA's and FHA's insurance programs in any way. She snared mortgage capital by selling the bonds of a U. S. Government agency to investors who were unwilling to take the risk of investing in private business. Then, this money was channeled into the mortgage markets.

Fannie's Goals. FNMA's purpose, as stated in the Congressional charter which created her, is to help the housing business in several ways.[1] First, by pouring the money she scooped up by selling FNMA bonds (bonds which are backed by the U. S. Government) into the purchase of mortgages, Fannie was supposed to make more mortgage loans to home buyers. Second, by increasing the supply of mortgage money available, Fannie Mae should put downward pressure on mortgage interest rates. Third, Fannie was charged with helping to smooth out any temporary restrictions in the availability of mortgage credit. Thus, families that must move during a period of "tight mortgage money" are more likely to be able to get a mortgage to buy another house. And, little construction companies won't be so likely to go bankrupt if tight credit makes it hard for home buyers to get mortgages. After all, since virtually no one can afford to pay cash for a home, most new home sales depend on the potential owner's ability to get a mortgage loan.

Like a person who must learn to crawl before walking, Fannie moved slowly at first. But, in 1968 FNMA had her "coming out party," and has been stepping smartly ever since.

Fannie Mae's Debut. Congress passed the 1968 Housing Act which transformed Fannie Mae from a government agency into a private corporation. She entered private corporate life with a flourish. During '69 and '70 there was a period of tight credit called a credit crunch. As a result, many families that would ordinarily have no problem getting mortgages suddenly encountered difficulties in securing them. But, Fannie Mae quietly aided many distressed home buyers, as her Congressional charter stipulated. Fannie sold her own bonds and bought FHA- and VA-insured mortgages from mortgage bankers and others who had been making mortgage loans. This replenished the mortgage lenders' supply of funds and helped people get mortgages who might not have gotten them otherwise.

[1] William Atteberry, *Modern Real Estate Finance* (Columbus, Ohio: GRID, Inc., 1972), p. 306.

Some of Fannie Mae's critics suggest that part of the money invested in FNMA's bonds may be savings deposits withdrawn from banks and S & Ls.[2] This problem tends to be the worst during periods when FNMA's bonds yield higher rates of interest than savings deposits. It's not possible to trace the flows of funds closely enough to measure this substitution of FNMA bonds for savings deposits. But, to the extent this substitution occurs, Fannie isn't increasing the total supply of mortgage credit as much as her total borrowings would indicate.

Smooth Out the Construction Business. Traditionally the construction industry has been a feast-or-famine business largely because of tight periods in the availability of credit, such as the credit crunches of 1966 and 1969-70. A crunch usually lasts for less than a year. But during the crunch banks and other institutions that normally take in customers' savings and then loan them out to investors temporarily experienced decreased deposit inflows. Deposits slow down because savers prefer to invest directly in market assets which offer higher interest rates than the legal ceilings allow savings accounts to pay. As a result, banks, S & Ls, and other institutions that usually make mortgage loans have less deposit inflows available from which to make loans. So, they ration their limited supply of loanable funds to those investments which they think will earn the highest rate of return at each level of risk. Mortgage credit is usually reduced by loan officers during temporary periods of tight money because mortgage rate ceilings keep mortgage rates from rising high enough to be competitive with other investments of equal risk in which the lending institutions might invest. The resulting restriction in mortgage credit causes a big reduction in home buying. Thus, tight credit not only makes it difficult for most families to get home mortgages, but also bankrupts some construction companies that can't sell their inventory of new houses because home buyers can't get mortgages.

Fannie's efforts to smooth the ups and downs of the construction business during tight-money periods have made an important contribution to the industry. For example, in 1970 when credit was tight Fannie financed almost one-fourth of the home purchases in the U.S. Fannie's assistance to the housing industry so impressed Congress that it gave her new power to do even more.

Conventional Mortgages Too. In 1970 Congress passed the Emergency Home Finance Act which, among other things, allowed FNMA to buy uninsured mortgages—or conventional mortgages, as they are usually called. Since about two-thirds of all mortgages on single-family homes are conventional mortgages, this new power widened Fannie's scope of operations.[3]

As a result of her powers to raise large quantities of cash at market interest rates by selling Government-guaranteed FNMA bonds, and, also because of her Congressional instructions to steady the housing business by buying mortgages, Fannie's holdings of mortgages grew from slightly over $1 billion in 1952 to over $18 billion by 1972. But, this growth doesn't mean that FNMA never sells mortgages.

Making a Secondary Market. To interest more investors in buying mortgages, Congress told Fannie Mae to try maintaining a secondary mortgage market.[4] Accordingly Fannie buys mortgages during periods of tight credit and sells a few mortgages when credit is plentiful. Such countercyclical buying and selling not only tends to smooth the ups and downs in the mortgage and housing business, it provides a secondary market which encourages more investors to invest in home mortgages. These secondary mortgages increase the liquidity and flexibility of banks and other mortgage investors.

[2]Leo Grebler, "Broadening the Sources of Funds for Residential Mortgages," *Ways to Moderate Fluctuations in Housing Construction* (Washington: Board of Governors of the Federal Reserve System, 1972), pp. 177-253. See also pp. 7-18.

[3]*Federal Reserve Bulletin* 59 (February 1973), p. A51.

[4]A secondary market is a market which deals in used items. The New York Stock Exchange is an example of a secondary

ENTER GINNIE MAE

In 1970 when Congress allowed FNMA to buy conventional mortgages it also created a new Government home-financing agency to replace its departed daughter, FNMA. The new agency is officially named the Government National Mortgage Association (GNMA), but like Fannie, it has a nickname—Ginnie Mae.

Ginnie and Fannie are sister-like creations of the Federal Government. Both perform similar home-financing functions and both are accountable to the Secretary of Housing and Urban Development. However, they differ in two important aspects. First, Ginnie Mae is still a Federal agency, while Fannie is a private corporation. And second, whereas Fannie sells her own bonds to raise money, Ginnie borrows temporarily from the U. S. Treasury to buy mortgages and then sells them.

GNMA finances mortgages by first buying FHA- or VA-insured mortgages from mortgage bankers or other people who may have originally made mortgage loans to the home buyers. Ginnie buys mortgages with money she borrowed from the Treasury and sometimes "pools" them. These pools have a minimum value of $2 million and contain mortgages on similar types of housing at similar interest rates which are all VA- or FHA-insured. Ginnie then either sells individual mortgages or sells "shares" in pools of mortgages she has formed to obtain funds to repay the Treasury.

Proceeds from selling "shares" in a pool of mortgages entitle each "shareholder" to a piece of every mortgage in the pool. But, these "shares" are riskless because all mortgages in the pool must be insured by the FHA or VA or Ginnie won't put them in the pool. Since the assets behind the "shares" in the pool are mortgages, the "shares" are often called mortgage-backed securities. These securities are also frequently referred to as GNMA pass-throughs because all the monthly mortgage payments by home buyers to the pool are passed through it to the investors who bought "shares." Thus, the investors who bought pass-through securities backed by mortgages get guaranteed monthly payments until their investment is repaid with interest. GNMA also offers special bond-type pools in which the principal is reinvested as the mortgages are paid off. Then, when the mortgages all mature, the principal is repaid in one lump sum. Ginnie's pass-throughs are such good investments that S & Ls themselves have invested billions in them rather than directly in mortgages.[5]

FREDDIE MAC HELPS THE S & Ls, TOO

Savings and loans associations take in millions of dollars every year and invest most of them in mortgages. In fact, S & Ls make more mortgage loans than any other group of investors in the U.S.

The S & Ls wanted an organization like Fannie Mae to provide them with the liquidity offered by a secondary mortgage market. But they wanted an agency which specialized in dealing with S & Ls. So, in 1970 Congress empowered the Home Loan Bank Board, the Government agency which oversees S & Ls, to start the Federal Home Loan Mortgage Corporation (FHLMC), nicknamed Freddie Mac.

Freddie Mac, a Government agency, sells its own Government-insured bonds and uses the proceeds to buy either insured or conventional mortgages from Federally insured savings institutions. Freddie can't issue pass-through securities like his sister Ginnie. And, he isn't a private corporation like Fannie Mae. But, they are all Federally chartered organizations which have

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securities market. Security owners want a place to sell their securities if they need cash. People are more willing to invest in securities which have secondary markets than in securities that have no secondary markets in order to keep their holdings liquid.

[5]Federal Home Loan Bank Board *News*, Washington, D.C., September 28-October 1, 1973 news release, table 3, footnote 3. Unfortunately, S & Ls investing in GNMA's securities circumvents one objective of GNMA—that is, raising *new* money for the mortgage markets.

similar basic purposes— the financing of homes. And, they have certainly changed mortgage markets in the U.S.

HOME BUYERS BENEFIT

Fannie Mae, Ginnie Mae, and Freddie Mac have all made it safer and easier to invest indirectly in mortgages (see Box). Their efforts have brought some investors into the mortgage markets because the bonds they sell to raise mortgage money are backed by the Federal Government, are actively traded and therefore liquid, and the interest yields on agency bonds are slightly above the rates paid on similar savings instruments. Consequently, savings are invested in these bonds and in turn reinvested in mortgages. Raising this (hopefully new) capital is the first thing that these three home-financing organizations may do for the home buyer.

CRITICISMS OF FANNIE, GINNIE, AND FREDDIE

Just about everybody who has been out in the "real world" for very long agrees on one thing—you can't expect to get something for nothing. Extending this hard-learned logic to FNMA, GNMA, and FHLMC leads one to ask if these agencies don't cost somebody something. The answer is yes, they have costs—just like everything else. These costs are indirect and hard to see because they aren't usually paid by the mortgage recipient who obtains the benefits. Some of the more troublesome questions about these costs which could be asked of Fannie, Ginnie, and Freddie are below.

1. Do we really need three similar agencies like FNMA, GNMA, and FHLMC? Couldn't one big one do it all?

   One big mortgage agency could probably do all the work of Fannie, Ginnie, and Freddie. But, mortgage banks and S & Ls prefer to have their own agencies to deal with.

2. Wouldn't most of the people who get their mortgages purchased by FNMA, GNMA, and FHLMC get the mortgage without these agencies' participation in the market?

   They probably would over time. The agencies' main benefits are to people who want mortgages during a credit crunch and probably couldn't have gotten them without the agencies' help, and, to illiquid financial intermediaries that need to liquidate a mortgage.

3. Doesn't some group of people or organization lose the savings inflows that now go into the U. S. agency bonds that FNMA, GNMA, and FHLMC sell?

   Yes, to some extent savings and loan associations' deposits, bank deposits, and even the sale of U. S. Treasury bonds are hurt by the sales of housing agency bonds.*

4. Doesn't the money invested in Federal Home Loan Bank, FNMA, GNMA, and FHLMC bonds come out of some other useful investment or savings?

*Jene K. Kwon and Richard M. Thornton, "An Evaluation of the Competitive Effect of FHLB Open Market Operations on Savings Inflows at Savings and Loan Associations," *Journal of Finance* 26 (1971): 669-712.

Yes. Some of the money invested in Government agency bonds comes out of savings accounts.** Thus, the money GNMA uses to buy a mortgage from a S & L may have been withdrawn from that S & L to buy a GNMA pass-through. Thus, the agencies may not increase mortgage credit totals. Unfortunately, it is not easy to measure the relevant flows of funds and thus determine the extent of this substitution of savings.

5. Aren't some people helped more than others by FNMA, GNMA, and FHLMC?

   Yes. Middle-class Americans who own mortgaged homes benefit from the Government mortgage agencies more than people who rent or people who can't afford a home. Essentially, the mortgage borrowers receive an interest rate subsidy.***

6. Could a more efficient private firm provide services for the mortgage market cheaper than FHA, VA, FNMA, GNMA, and FHLMC?

   MGIC Investment Corporation, a private concern, insures mortgages for half the fee charged by the FHA. And, Maggie Mae, a private mortgage firm, beats FNMA and GNMA out of some mortgages because Maggie has a minimum of red tape and can move faster. Some technical financing intricacies make it difficult to compare the costs of these various agencies.

**See footnote 5 in the text.

***Dan Larkins, *$300 Billion in Loans: An Introduction to Federal Credit Programs* (Washington: American Enterprise Institute for Public Policy Research, 1972).

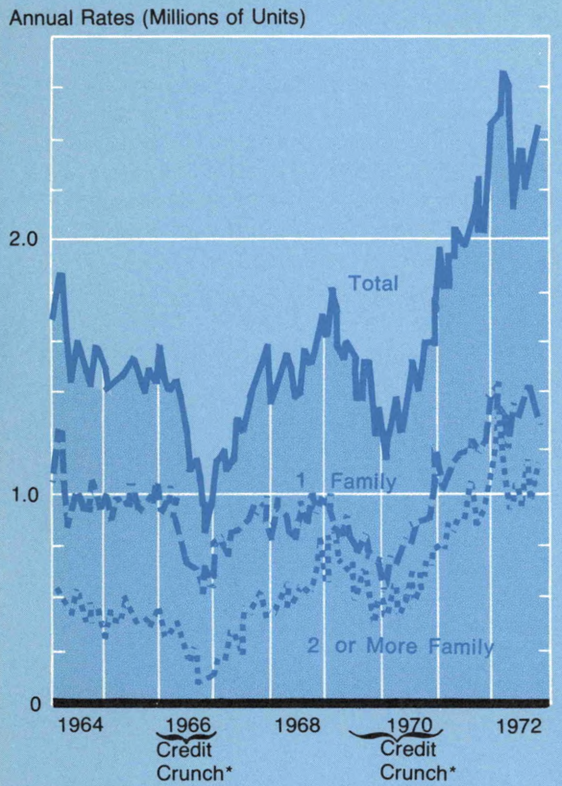
Lower Mortgage Interest Rates. The funds that FNMA, GNMA, and FHLMC pull in are obtained at Government agency bond rates which are low. As a result of these low-risk, and therefore low-return, sources of capital and other factors, financial analysts estimate that mortgage interest rates are at least half of 1 percent less than they used to be at any given level of interest rates.[6] This second benefit from Fannie, Ginnie, and Freddie helps everyone who gets a mortgage loan, not just those whose mortgages they finance.

Tight Credit Periods Eased. FNMA, GNMA, and FHLMC also help home buyers and construction companies by smoothing the big hills and valleys in mortgage credit which can occur. Thus, Fannie, Ginnie, and Freddie tend to concentrate their mortgage purchases in periods when credit is tight and it is impossible for some credit-worthy families to get mortgages. This helps new home sales during those temporary credit crunches and reduces the risks faced by the homebuilding industry.

Housing starts dropped considerably during the crunches of 1966 and 1969-70 because potential home buyers couldn't get mortgages (see Chart). New housing construction might have

[6]J. B. Cohen and E. Zinbarg, *Investments Analysis and Portfolio Management* (Homewood, Ill.: Richard D. Irwin, 1967), pp. 469-71 and 702-3; Atteberry, op. cit., p. 287; J. L. Kochan, "Federal Agency Issues: Newcomers in the Capital Market," *Economic Review* of the Federal Reserve Bank of Cleveland, February 1972.

NEW PRIVATE HOUSING STARTS



*Actually, the reduction in mortgage credit was more than the Chart indicates. FNMA relieved much pressure on the private mortgage market by buying mortgages issued in 1970.

Source: Federal Reserve Chart Book.

dropped even more if the mortgage agencies hadn't been on hand to pour out mortgage money.

Secondary Mortgage Markets. In addition to Fannie Mae, Ginnie Mae, and Freddie Mac concentrating their purchases in periods of tight credit, they also try to sell some of their mortgages when money is plentiful. This buying and selling is not only countercyclical, it also develops secondary mortgage markets. The increased mortgage liquidity provided by these secondary markets makes mortgage investing less risky and encourages more investors to buy mortgages. Thus FNMA, GNMA, and FHLMC not only make the mortgage markets stronger, they also decrease the possibility that some savings institutions could become insolvent because no buyers exist for their mortgages.

Mortgage Money Geographically Mobile. When Fannie buys mortgages on West Coast homes, she may pay for them with money from FNMA bonds sold on the East Coast. And, when Ginnie buys mortgages in the North, she may pay for them with GNMA pass-throughs sold in the South. Also, Freddie Mac may buy mortgages from S & Ls that need cash in one part of the country and sell FHLMC bonds to finance purchases in some other place where cash is plentiful. As a result of transactions like these, mortgage credit flows freely from state to state. The funds are raised where they are plentiful and invested where they are scarce. This means the money is spent where it is needed most, no matter where it comes from.

Subsidize the Needy. Finally, Fannie invests in insured mortgages on subsidized housing facilities for families with incomes so low that they tend to have difficulty getting a mortgage. Subsidized mortgages make up about a fourth of Fannie Mae's portfolio; these may have unusually high default rates and the insurance may not cover all the losses. Fannie took many of those questionable mortgages because the Secretary of Housing and Urban Development urged her to do so. But, Fannie goes on helping people in spite of these headaches. As a matter of fact, helping people get homes isn't a completely unprofitable business. FNMA's annual profits are usually in the millions. So, it doesn't cost a dime of the Government's tax revenue.

NOT A BAD PROGRAM, BUT. . .

Uncle Sam's home-financing agencies have achieved some worthwhile successes. By creating a viable secondary market for home mortgages, Fannie, Ginnie, and Freddie have strengthened the lending institutions that make mortgage loans and have increased the attractiveness of mortgages as investments. During credit crunches they have actively supported mortgage lending by pumping additional funds into the residential financing markets. They have also probably been able to attract some additional money to the mortgage markets through the sale of their agency bonds.

However, any good idea will have its imitators, and these organizations are no exception. A private firm called MGIC Mortgage Company (Maggie Mae) which finances mortgages is now in operation. Maggie can move quickly and effectively; she has been quite profitable. Her parent company, MGIC Investment Corporation, is one of several firms that have been successful in competing with the Government's mortgage insurance programs.

It's a tribute to the Government programs that they have been able to show private enterprise the viability of these services. Nonetheless, the successes of the private imitators may reflect adversely on the efficiency with which the Government-sponsored programs are run.

The institutional structure of the home-financing industry is far from settled. It may be that social priorities will require continuing governmental intervention in these markets to keep the cost of mortgage funds down. Yet, the way has clearly been shown for private business to do this job. As functional distinctions between key institutions in the mortgage market erode, lenders may find they have less need for a government mortgage agency specifically tied to their industry. This would reduce the importance of these agencies and create more opportunities for private firms.

In the meantime, however, Maggie, Ginnie, and Freddie are doing their jobs, and a great many Americans who will never realize it have benefited from their existence.

NOW AVAILABLE
BROCHURE AND FILM STRIP ON
TRUTH IN LENDING

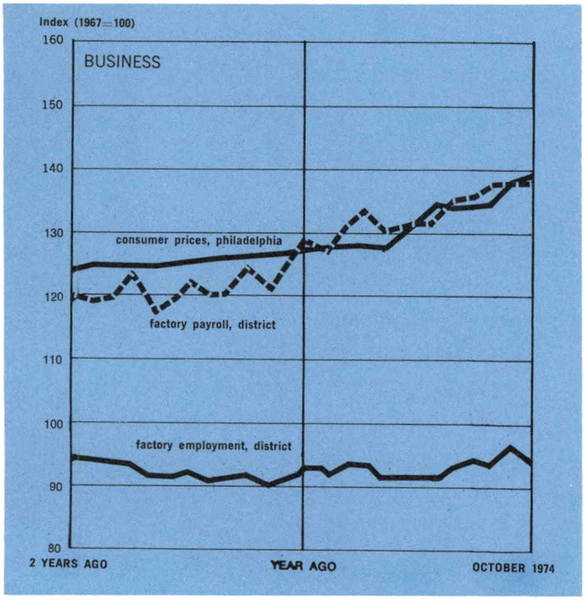
Truth in Lending became the law of the land in 1969. Since then the law, requiring uniform and meaningful disclosure of the cost of consumer credit, has been hailed as a major breakthrough in consumer protection. But despite considerable publicity, the general public is not very familiar with the law.

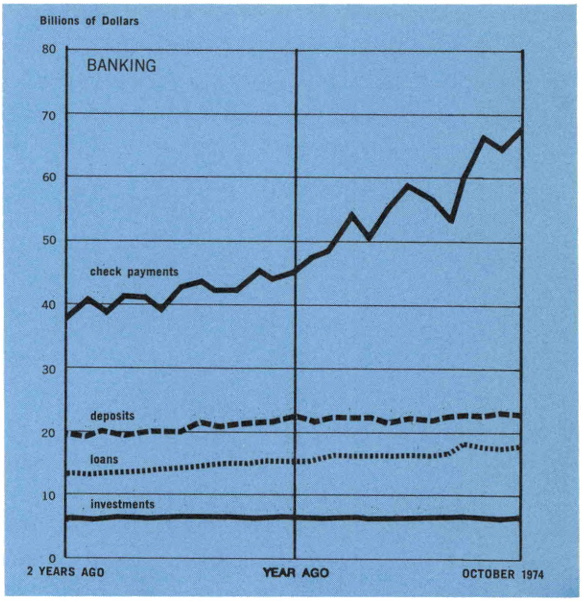
A brochure, "What Truth in Lending Means to You," cogently spells out the essentials of the law. Copies in both English and Spanish are available upon request from the Department of Bank and Public Relations, Federal Reserve Bank of Philadelphia, Philadelphia, Pennsylvania 19101.

Available in English is a film strip on Regulation Z, Truth in Lending, for showing to consumer groups. This 20-minute presentation, developed by the Board of Governors of the Federal Reserve System, is designed for use with a Dukane project that uses 35mm film and plays a 33 RPM record synchronized with the film. Copies of the film strip can be purchased from the Board of Governors of the Federal Reserve System, Washington, D. C. 20551, for $10. It is available to groups in the Third Federal Reserve District without charge except for return postage.

Persons in the Third District may direct requests for loan of the film to Truth in Lending, Federal Reserve Bank of Philadelphia, Philadelphia, Pennsylvania 19101. Such requests should provide for several alternate presentation dates.

for the record . . .





SUMMARY	Third Federal Reserve District			United States		
	Percent change			Percent change		
	October 1973 from		10 mos. 1973 from	October 1973 from		10 mos. 1973 from
	mo. ago	year ago	year ago	mo. ago	year ago	year ago
MANUFACTURING						
Production	....	....	....	+ 1	+ 7	+11
Electric power consumed.	+ 2	+ 8	+ 8	....	....	....
Man-hours, total*	0	+ 2	+ 2	— 1	+ 4	....
Employment, total	0	+ 2	+ 2	0	+ 4	+ 5
Wage income*	— 1	+ 8	+10	— 1	+11	....
CONSTRUCTION**	N/A	N/A	N/A	N/A	N/A	N/A
COAL PRODUCTION	N/A	N/A	N/A	— 1	+ 3	0
BANKING						
(All member banks)						
Deposits	0	+ 3	+ 7	+ 3	+13	+12
Loans	+ 1	+ 1	+14	+ 1	+21	+22
Investments	+ 1	— 4	— 1	+ 2	+ 2	+ 2
U.S. Govt. securities	— 2	—16	— 7	+ 3	—10	— 6
Other	+ 2	+ 2	+ 2	+ 2	+ 8	+ 7
Check payments***	+ 5†	+50†	+37†	+ 3	+32	+26
PRICES						
Wholesale	....	....	....	— 1	+16	+13
Consumer	+ 1‡	+ 8‡	+6‡	+ 1	+ 8	+ 6

*Production workers only
**Value of contracts
***Adjusted for seasonal variation

†15 SMSAs
‡Philadelphia

LOCAL CHANGES Standard Metropolitan Statistical Areas*	Manufacturing				Banking			
	Employment		Payrolls		Check Payments**		Total Deposits***	
	Percent change Oct. 1973 from		Percent change Oct. 1973 from		Percent change Oct. 1973 from		Percent change Oct. 1973 from	
	month ago	year ago	month ago	year ago	month ago	year ago	month ago	year ago
Wilmington	— 2	+ 2	— 6	+ 9	— 5	+ 37	+ 5	+10
Atlantic City	— 1	+ 6	— 1	+12	+ 8	+ 11	— 1	+ 9
Bridgeton	— 2	— 3	N/A	N/A	N/A	N/A	+ 2	+12
Trenton	+ 1	+ 1	+ 1	+ 6	+ 7	+206	+ 8	+15
Altoona	+ 1	0	+ 2	+ 4	— 2	+ 26	+ 5	+10
Harrisburg	0	+ 4	0	+16	+ 7	+ 18	— 4	+ 3
Johnstown	0	0	— 6	+11	+11	+ 17	+ 1	+15
Lancaster	+ 1	+ 5	0	+11	+ 5	+138	— 1	+12
Lehigh Valley	+ 1	+ 3	— 2	+15	+31	+ 21	+ 2	+ 7
Philadelphia	0	+ 1	+ 1	+ 8	+ 7	+ 44	— 1	+ 6
Reading	+ 1	0	0	+ 9	+14	+ 17	+ 2	+12
Scranton	— 1	— 3	0	+ 3	+ 3	+ 16	+ 3	+10
Wilkes-Barre	+ 1	+ 3	— 1	+ 8	— 3	+ 9	0	+ 3
Williamsport	— 1	— 3	— 1	+ 4	+ 9	+ 36	+ 2	+14
York	+ 4	+ 3	+ 4	+12	+ 2	— 44	0	+11

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.

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