Research Department
Federal Reserve
Bank of
San Francisco

May 13, 1977

Business & Financial Letter

Gold-Rush Fever

Gold-rush fever is again sweeping California. The early Californians struck gold, later arrivals struck oil—and now, as many times in the past, Californians are striking pay dirt in the real-estate field. The dimensions of the housing boom can be measured by the rapid sales (and resales) of single-family homes in Orange County, San Diego, the San Francisco Bay Area and other California locations.

The frenzied search for single-family homes reflects a mounting demand/supply imbalance, but it has been aggravated by inflation fears and speculative pressures. The boom has been fueled by ample mortgage financing, primarily from savings-and-loan associations, but now increasingly from commercial banks as well. (One feature of the boom has been a rebirth of the second mortgage, which is utilized by many households as a cheap form of consumer loan.) Needless to add, lenders and regulators are now taking steps to rein in the speculative fever.

Just as there were physical dangers in the search for gold, there are financial dangers inherent in the current home rush. In the areas of strongest demand, home prices have risen 50 to 75 percent in a two-year period. This rapid escalation in the housing price tag has activated speculative buying, adding further demand pressure in an already tight supply situation.

The banks' role

First, how large is the market? California banks and savings-and-loan associations held $71 billion in outstanding residential mortgages at the end of 1976. Banks only account for about one-sixth of the total market, but they play a pivotal role because they can move in and out of the mortgage market, depending on the relative attractiveness of the lending alternatives open to them.

In the last California housing cycle, banks played the decisive role. Indeed, in 1973 they became virtual lenders of last resort, as severe disintermediation effectively removed S&L's from the market. (Net savings inflows into California S&L's, exclusive of credited interest, dropped from $4.1 billion in 1972 to $475 million in 1973—and an outflow of $349 million then occurred in 1974.) Altogether, banks' residential mortgage portfolios rose 80 percent between 1971 and 1974. But by mid-1974, banks also became reluctant lenders, as many withdrew from the market entirely and others restricted home loans to their own customers. The inroads of inflation and recession, along with tight credit, also dampened the ardor of home seekers. While private housing permits dropped from the 1972 peak of 278,000 to 128,000 in 1974, inventories of unsold units mounted.

Another housing cycle

The turnaround began around the second quarter of 1975. By then,

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excess inventories of housing had been worked off, and in some areas actual shortages had developed, reflecting several years of sharply reduced construction activity. Meanwhile, an increase in the size of the young home-buying generation (including an increase in the number of immigrants) plus the improved state of the economy created a growing demand for housing, particularly single-family homes. Construction activity turned around, helped along by an increase in lending by S&L's, which were now awash with funds from a record savings inflow. In 1975, S&L's added $5 billion to their outstanding mortgages, representing a 12-percent increase.

Banks, however, at first showed little interest in participating in the reviving market. In 1975 they actually recorded a $1-billion (8 percent) reduction in their residential mortgage portfolio, and they did not actively reenter the mortgage market until the second quarter of 1976. By then they were experiencing record inflows of savings deposits—the type of funds they normally allocate to housing. Moreover, there were few alternatives for lending, especially with no sign of a revival in business-loan demand. Yet for 1976 as a whole, banks increased their investment in residential mortgages by only 4 percent, compared with the S&L's sharp 19-percent increase.

Current scenario

The boom then took hold in full force in the first quarter of this year. S&L mortgage holdings continued to rise at last year's torrid pace during the first quarter of this year—and in March increased at a 23-percent annual rate. S&L loan commitments in March reached a record $4.2 billion—up 40 percent over the end-1976 level and well over twice the volume at the height of the previous (1972) housing peak. Bank mortgage lending meanwhile rose at a 14-percent annual rate in the January-March period, and some major banks added mortgages at rates of over 20 percent. These sharp increases reflected not only the increased physical volume of housing but also the escalating cost of shelter. For banks, the figures somewhat overstated the amount of funds actually used for home financing, considering the growing amount of loans secured by residential property but utilized for other consumer purposes.

Most major California banks are now actively promoting second mortgages, in the form of "home equity" or "homeowners" loans. Typically, each loan is secured by a second-trust deed, and is available up to a maximum of $25,000, or 80 percent of the current appraised value of a home less the outstanding first mortgage. Maturities range from 5 to 25 years, bear a simple rate of 12 percent, and carry no prepayment penalty. Few, if any, restrictions are imposed on the borrower's use of the loan proceeds. Bank advertisements read: "take a trip around the world; buy a car; buy a second home or a piece of real estate." Present regulations permit both national and state-

chartered banks to undertake this type of financing.

The rebirth of the second mortgage reflects the resurgence of inflation, because this type of financing permits an existing homeowner to benefit from the appreciated value of the equity in his home without sale of the property. In addition, the availability of this type of credit may encourage prospective home-occupant buyers to take the plunge into home ownership despite the high price tag—particularly so in the case of younger buyers without other equity sources to draw on for meeting future borrowing needs. But in the current period of rapidly rising home prices, equity loans may also swell the ranks of speculators, as funds from these second-trust deeds are used to buy residential property in expectation of a quick inflation-based profit.

Beginnings of caution

Bank and S&L mortgage funds still appear ample, but problems could develop unless lenders adopt more cautious attitudes. In the areas of strongest housing demand, speculative buying of residential units has reached a sufficient volume—perhaps 10 to 20 percent of the total—to affect prices significantly. Lenders and regulators have become concerned about the escalation effect which, down the line, could result in equity losses if measures are not adopted to dampen the spread of home investment for quick profit.

Some precautionary measures have now been adopted to slow the torrid lending pace and discourage the speculative buyer. In late April, the San Francisco Home Loan Bank increased its lending rate to member associations by one percentage point on both short- and long-term advances, because of "serious concern about the escalation of home prices and housing speculation" as well as the escalating volume of lending. Many savings-and-loan associations have increased standard mortgage rates to 9¼ percent from 9 percent, and one major bank has increased its prime mortgage rate to 9 percent from 8¾ percent. Some S&L's are charging a "penalty" rate of ¼ to ½ percent, or an extra fee or higher down payment, on mortgages where the borrower will not be an occupant of the housing unit financed. A few banks also are charging an interest-rate premium on such loans, and one institution will not extend credit unless the potential borrower declares that he will occupy the home for a two-year period.

The financial community's increased awareness of the problems inherent in a continuation of the current home rush, as well as its willingness to take measures to discourage speculative activity, should moderate somewhat the frenzied bidding for new housing units. With speculative activity removed, market participants should have a better fix on the size of *basic* home demand at given levels of prices. A more cautious financing approach thus should prevent future equity losses for home owners—and future problem situations for lenders.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/27/77	Change from 4/20/77	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	95,112	− 319	+ 7,761	+ 8.88
Loans (gross, adjusted)—total	72,749	+ 155	+ 7,314	+ 11.18
Security loans	1,567	− 27	+ 481	+ 44.29
Commercial and industrial	23,629	+ 85	+ 1,486	+ 6.71
Real estate	22,646	+ 96	+ 2,756	+ 13.86
Consumer instalment	12,767	+ 85	+ 1,749	+ 15.87
U.S. Treasury securities	9,055	− 354	− 400	− 4.23
Other securities	13,308	− 120	+ 847	+ 6.80
Deposits (less cash items)—total*	95,703	+ 373	+ 8,616	+ 9.89
Demand deposits (adjusted)	27,731	+ 188	+ 4,272	+ 18.21
U.S. Government deposits	839	+ 338	+ 225	+ 36.64
Time deposits—total*	65,432	− 5	+ 3,940	+ 6.41
States and political subdivisions	5,646	+ 137	− 1,268	− 18.34
Savings deposits	31,978	+ 52	+ 6,038	+ 23.28
Other time deposits‡	25,769	− 149	− 580	− 2.20
Large negotiable CD's	9,158	− 232	− 2,177	− 19.21

Weekly Averages of Daily Figures	Week ended 4/27/77	Week ended 4/20/77	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	+ 18	− 45	− 27
Borrowings	11	0	7
Net free(+)/Net borrowed (−)	+ 7	− 45	− 34
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (−)	− 1,094	+ 142	+ 352
Transactions with U.S. security dealers			
Net loans (+)/Net borrowings (−)	+ 179	+ 283	+ 136

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . . Information on this and other publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 544-2184.