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FRBSF Weekly Letter

Year of Reckoning

This is the year of reckoning for many creative financing deals that involve homes purchased between 1980 and 1982. Many recent homeowners will soon have to refinance part or all of the balance of their home mortgages unless they can come up with the necessary cash. Estimates of the magnitude of the required refinancing vary, but the amount is likely to be substantial because short-term creative financing has been a major alternative source of residential mortgage funds in lieu of bank- or S&L-originated mortgages.

As we shall use the term, creative financing refers to some sort of seller-assisted financing at rates below prevailing mortgage rates. Most such loans were to mature in five years or less, and, because the monthly payments were frequently amortized over 30 years, involved substantial lump sum payments at maturity. Because of the latter feature, foreclosures associated with creative financing have risen recently. However, with the decline in mortgage rates and the modest increases in incomes and home values over the past year, most creative financing deals now coming due should not encounter serious refinancing problems even though homeowners will find the new monthly payments higher than they had perhaps anticipated.

Affordability

Back in the halcyon days of the late 1970s, creative financing was relatively uncommon. There was no need for it. The pace of home sales was brisk, prices seemed on an unending upward spiral and mortgage rates were sufficiently low that initial payments did not absorb an unmanageable proportion of homebuyers' current income.

The boom years for housing came to an end rather abruptly, however. As the inflation rate climbed towards the double-digit range, financial markets began to revise their inflation expectations upward, demanding higher inflation premia on their long-term investments, including mortgages. Moreover, on October 6, 1979, the Federal Reserve made a fundamental change in policy that resulted in tightening the availability of credit. The effect of accelerating inflation as well as the credit tightening was a nearly unprecedented rise in interest rates (including mortgage rates) that wreaked havoc in the housing market. Suddenly, house prices that were attractive when mortgage rates were 10 to 11 percent seemed outrageously high with rates in the 17 to 18 percent range. Because potential homebuyers simply did not have sufficient current income to meet the larger mortgage payments and because mortgage contracts did not permit them to borrow against (higher) expected future income, the high rates precipitated a significant drop in the demand for housing.

Enter creative financing

Faced with the prospect of having to offer substantial price discounts in order to sell their homes, homeowners and developers frequently proposed creative financing instead. Developers began to offer interest rate "buydowns" whereby the developer either obtained shorter-term financing at market rates or compensated the mortgage originator for giving first mortgages to buyers at below-market rates for the first few years of the mortgage.

Homeowners wishing to sell their homes frequently agreed to provide prospective buyers with subsidized short-term first or second mortgages. Several state court decisions, the most notable of which was the so-called Wellenkamp decision in California, encouraged the use of seller-assisted financing by declaring that existing first mortgages originated by banks and state-chartered savings and loan associations could be transferred to the new homebuyer.

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Since the older mortgage generally carried lower rates than prevailing mortgage rates, the prospective homebuyer frequently assumed the existing first mortgage and obtained a subsidized second mortgage from the seller to make up the balance.

Surveys conducted by the National Association of Realtors and the National Association of Homebuilders suggest that the incidence of creative financing between 1980 and 1982 was indeed high. An estimated two-thirds of homebuilders offered buydowns on new homes in 1981 and 1982 and an estimated 60 percent of the sales of existing homes involved creative financing during 1981. In California, the incidence of creative financing was even higher—the California Association of Realtors estimates that 77 percent and 74 percent of all sales involved creative financing in 1981 and 1982, respectively.

Such creative financing short-circuited the normal process of financial intermediation in the housing market, and reduced the financial intermediaries' share of mortgage originations. Their share fell from an average of 70 percent of the value of homes sold in the 1970s to 50 percent of the value of homes sold between 1980 and 1982.

The effect of breaking down the intermediation process was to introduce economic inefficiency and greater risk into the housing market. Unlike individual investors, financial intermediaries are able to realize economies from specialization. For example, by specializing in lending and credit evaluation, financial institutions can evaluate a potential borrower's creditworthiness more cheaply or with fewer errors in judgment than can an individual lender. Moreover, financial institutions are able to reduce the risk of default by diversifying their portfolios. Individuals who decide to invest some of their equity in loans to homebuyers, by contrast, may have to accept higher levels of portfolio risk for a given rate of return than they would by investing in the liabilities of financial intermediaries (i.e., by placing their deposits in intermediaries for them to lend out as mortgage loans).

Why creative financing?

Why then did creative financing become such a popular means of selling homes if, by circumventing the financial intermediaries, it introduced increased inefficiencies and risk into housing finance? After all, homesellers could have offered price reductions which would have given homebuyers the same benefits while using conventional financing.

That both homebuyers and sellers preferred creative financing can be attributed, in some measure, to their expectations of an imminent decline in mortgage rates and a return to the upward trend in home prices and incomes that had characterized the mid- to late-1970s. Given these expectations, the risks of creative financing did not appear (*ex ante*) to outweigh the benefits. The expected decline in mortgage rates would enable the homebuyers to refinance the purchase on reasonably favorable terms, while the expected rise in housing prices would reduce the risk of default for the homeseller.

These expectations alone do not explain the popularity of creative financing, however. For the potential buyer, the lower initial payments associated with creative financing enabled him or her to overcome otherwise binding cash flow constraints. Price discounts of equivalent market value, by contrast, would have been amortized over the 30-year life of the mortgage and would not have reduced monthly payments enough to overcome initial cash flow constraints. In essence, creative financing permitted the buyer to borrow against higher future income by moving all the benefits of a price discount forward.

Sellers also had reasons to prefer creative financing to outright price discounts. In a number of states, restrictions on traditional lenders' ability to enforce due-on-sale clauses in mortgage contracts provided existing homeowners with a valuable asset —that of the low interest rate mortgage which could be transferred to potential homebuyers. The stream of lower payments associated with a $50,000 mortgage with a contractual interest rate of 10 percent when prevailing rates were 18 percent, for example, was worth more than $20,000 (discounted at the prevailing mortgage rate of 18 percent.)*

To realize the value of this asset, however, the homeseller frequently had to offer the buyer a second mortgage to make up the difference between the down payment and the purchase price less the face value of the assumable existing mortgage. Although seller-carried second mortgages entailed default and liquidity risks already described, such arrangements, even at subsidized rates, were clearly in the seller's interest, given the typical terms of these second mortgages. In California, where the Wellenkamp decision made conventional first mortgage loans assumable, over half of all resales are estimated to have involved assumptions of first mortgages supplemented by creative financing involving second and even other "junior" mortgages.

A further reason that creative financing was cheaper to offer than outright price discounts was that it permitted relatively wealthier households to transfer tax benefits to less wealthy households. Because of the income tax-deductibility of mortgage interest payments, households in high income tax brackets could borrow more cheaply (after taxes) than could households in lower tax brackets. Therefore, relatively wealthier households could realize a gain by lending some of their equity to potential homebuyers at below-market rates and, in turn, borrowing a larger portion of the purchase price of the homes they intended to buy.

What happened?

Given the incentives to use creative financing and the apparently widespread expectation that the housing and housing finance markets would soon improve, it is no mystery that creative financing became so popular. In hindsight, however, the creative financing gamble seems far riskier than many had anticipated. Interest rates, particularly in real terms, have remained high by historical standards. Households, whose lump sum payments come due this year will either have to struggle with the higher-than-anticipated monthly payments these rates imply (their incomes may have risen slowly), sell in a still weak resale market or try to renegotiate terms with the seller-lender to avoid foreclosure.

Unfortunately, foreclosure has been forced upon some homebuyers involved in creative financing deals. In the first quarter of 1983, 0.9 percent of all mortgage loans in California were in the process of foreclosure—up from 0.2 percent in the first quarter of 1980 —and 5.7 percent had payments past due (compared to 4.7 percent past due in the first quarter of 1980). Of course, it is difficult to separate the impact of creative financing from that of a general economic and housing downturn, but one recent study by the University of Southern California found that foreclosures are running 10 to 20 percent higher on creatively financed home purchases than on those conventionally financed.

Improved outlook

Creative financing represented a gamble on the future by the homebuyer and a promotional tool using tax laws and assumable mortgages by the seller. For a time, it did not seem to pay off as foreclosures increased because the housing industry, along with the rest of the economy, suffered from the recession longer than expected. Now, with signs of gathering strength in the housing industry and the prospect that mortgage rates will moderate over the next few years, homeowners whose unamortized debt is coming due should be able to breathe easier.

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*This example assumes that a homeowner was selling a home in 1981 that was purchased in 1978.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/17/83	Change from 8/10/83	Change from year ago Dollar	 Percent
Loans (gross, adjusted) and investments*	161,706	402	30	0.0
Loans (gross, adjusted) — total#	141,204	837	– 30	– 0.0
Commercial and industrial	43,458	26	– 887	– 2.0
Real estate	56,454	34	– 1,138	– 2.0
Loans to individuals	24,140	91	787	3.4
Securities loans	2,873	527	152	5.6
U.S. Treasury securities*	7,431	– 390	965	14.9
Other securities*	13,070	– 45	– 905	– 6.5
Demand deposits — total#	41,676	580	3,047	7.9
Demand deposits — adjusted	29,411	– 367	2,467	9.2
Savings deposits — total†	66,003	– 380	35,086	113.5
Time deposits — total#	66,629	420	– 33,686	– 33.6
Individuals, part. & corp.	61,075	362	– 29,508	– 32.6
(Large negotiable CD's)	18,119	– 79	– 19,805	– 52.2

Weekly Averages of Daily Figures	Week ended 8/17/83	Week ended 8/10/83	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	126	129	65
Borrowings	39	5	4
Net free reserves (+)/Net borrowed(–)	87	124	61

* Excludes trading account securities.
# Includes items not shown separately.
† Includes Money Market Deposit Accounts, Super-NOW accounts, and NOW accounts.

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