

# Solving the Long-Range Problems of Housing and Mortgage Finance

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The very title of this session is encouraging. We have passed through a decade of intense public concern over housing finance. Yet this concern has tended to be focused on short-term palliatives which have had very limited success. The mortgage market in its fundamentals has not changed in the past decade, despite the obvious need for change. The mortgage market was just about as sensitive to swings in short-term money rates in 1974 as it was eight years earlier in 1966.

After a decade of failure, it is time to turn away from makeshift responses to the problem of housing finance and begin to seek fundamental answers. These answers, it seems to me, lie in the restructuring of the mortgage instrument. I would like to emphasize that the views I express are solely my own and not necessarily those of the Federal Reserve System.

The year 1966, it seems to me, was the turning point for the mortgage market. We learned in that year that the thrift institutions, as they were then structured, were not well adapted to an economy characterized by inflation and sharp swings in short-term money rates. This fact raised two major public concerns. First, there was anxiety over the viability of the thrift institutions themselves. Second, there was concern because the vulnerability of our thrift institutions to swings in short-term money rates aggravated the impact of monetary policy on the housing industry.

Housing will always be the most sensitive sector in the economy to shifts in monetary policy, no matter how well we organize and perfect the mortgage market. This will be so because the level of the mortgage rate is much more critical in limiting the ability of the consumer to carry such debt than is the interest rate on any other type of borrowing. But the problems of housing finance in the United States are compounded by the fact that the principal sources of mortgage money in our system, the thrift

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institutions, find that their own money flows tend to dry up or turn negative when short-term money rates rise. As a consequence, we have been subjected to much larger swings in housing construction than would have been the case if the thrift institutions were in a position to adapt to changes in short-term money rates.

In attempting to deal with this problem during the past decade, the Congress has fostered a group of governmental financial intermediaries empowered to raise money in the open market and to channel the funds into the housing market. This approach has met with only limited success for reasons which are familiar to you all.

More recently the Congress has been contemplating credit allocation as a possible solution. Short of comprehensive administrative control over all sources of finance, which would carry with it heavy costs to society in the form of a less dynamic and less efficient economy, this approach is also likely to fail to meet the problems of housing finance.

While the Federal Government has been trying to innovate in the mortgage market, even if not too successfully, there has been a remarkable lack of innovation on the part of the thrift institutions over the past decade. While it is true that the liability side of their balance sheets has been substantially changed by a major increase in longer-dated liabilities, the composition of their assets has not changed much in the past decade. As a result, the thrift institutions were not in a very much better position to meet the pressures of 1974 than they were to meet the pressures of 1966.

In my judgment, the answer to the problems of the thrift institutions is not to convert them into commercial banks. What we need are specialized housing finance institutions which are capable of functioning in an inflationary economy. To produce this capability, it will be necessary to move away from sole reliance on the long-term, fixed-rate mortgage, a financial instrument which was a product of the Great Depression, when stable prices and low interest rates were properly imbedded in expectations.

At a recent conference on financial innovation at New York University, the question arose: why have we not seen, until very recent months, any significant thrust by private institutions to produce a mortgage instrument better suited to our times? Why have private markets failed to innovate in this case?

The answer, it seems to me, lies in the shelter provided by Regulation Q. In the absence of this shelter, the thrift institutions would have been compelled to innovate. Regulation Q is a crutch which has been just barely strong enough to prevent the necessary adaptation from taking place.

However, it seems to me that the shelter of Regulation Q is rapidly eroding for two principal reasons. First, the market is responding by designing new open-market financial instruments to meet the needs of the small saver. In 1973-1974, we saw two such new instruments introduced: the floating-rate note and the money-market mutual fund. The success of

these new instruments, particularly the money-market mutual fund, assures that, in the next period of tight money, the competition of open market instruments is likely to be more severe than ever before.

The second reason why the shelter of Regulation Q is eroding is the rising strength of consumerism. There is a growing awareness that the small saver has been the principal victim of Regulation Q. The rate on home mortgages has been subsidized by artificially depressing the return available to the small saver. This is a very regressive arrangement, since the poorest 40 percent of our population owns 25 percent of all savings deposits, but accounts for only 10 percent of mortgage debt. In the past the interests of the consumer as saver have never received much attention in the Congress. I think this is changing. The survival of the NOW account in Massachusetts and New Hampshire is a symptom of this change. It survived the formidable combined opposition of the commercial banks and the savings and loan associations because the NOW account was considered by the Congress as an innovation favorable to the consumer.

No single form of mortgage instrument can meet all of the housing finance needs of the American people. We need an array of mortgage instruments which, in combination, can move us toward three objectives: first, a more stable flow of funds into the thrift institutions; second, a fairer shake on interest rates for the small saver; and third, the solution of the housing "financing gap" caused by higher interest rates.

The level-payment mortgage is not well adapted to the expected life-income stream of our young adult population. It has always required that a much higher percentage of the total income of young adults be spent on housing during the early years of the mortgage. This was not so critical when interest rates were low, but when mortgage rates rise sharply the problem becomes acute. A move from 5 percent to 9-1/2 percent in the mortgage rate increases the monthly payment on a \$30,000, 30-year mortgage by 57 percent. This creates the "financing gap" I referred to earlier, which is pricing much of our young adult population out of the housing market.

Unless our private institutions respond to this "financing gap" problem by devising a workable graduated-payment mortgage, the Federal Government will have to meet the problem with a mortgage interest rate subsidy. Such a subsidy should gradually phase out over the first five or six years of the mortgage as the income of the homeowner rises.

The mortgage market of the future should offer an array of mortgage instruments to the consumer so that he or she can choose the one which best meets his or her needs. The conventional, fixed-rate, level-payment mortgage should not be eliminated, but it should be offered at a significantly higher rate than the variable-rate mortgage. If the homeowner wishes to be protected against future changes in interest rates, he should expect to pay an interest rate premium for the privilege. He should not expect, at no cost, to push this risk onto the shoulders of the savings depositor, who typically has a lower income than the homeowner.

In addition to the variable-rate mortgage, a graduated-payment mortgage of some sort should be available to the young adult whose income can reasonably be expected to rise substantially in the future. With this array of mortgage instruments, housing finance could be put on a sound basis.

Whenever one talks about restructuring the mortgage portfolios of our thrift institutions, two responses are inevitable. The first is that the idea is impractical because it would take seven or eight years to accomplish significant change. The second is that it is impractical because the consumer will not buy these strange new mortgage instruments. The first argument undoubtedly accounts for much of the lethargic response of the thrift institutions to the idea of the new mortgage instruments. It will, indeed, take a long time before these new instruments can make a significant difference. When money is tight, the attention of the management of thrift institutions must be focused on short-term survival. When the turn in short-term money rates comes, and funds start flowing in again, the whole matter loses its sense of urgency. There is never a really good time to work on the long-term viability of the thrift institutions and the long-term stability of the mortgage market.

With respect to the second argument, that these new mortgage forms cannot be sold to the American consumer, I am not persuaded. It is true that to the person who can afford the high initial payments (which many of our young adults cannot), the fixed-rate, level-payment mortgage is a good deal. The lender (and ultimately the savings depositor) bears all the risks of changing interest rates. But is the present mortgage form really a good deal for the American public if it prevents the mortgage market from functioning properly?

The recent Congressional action on variable-rate mortgages stems from the concern which has led state legislatures in the past to impose usury ceilings on mortgage rates — a concern to protect the public from greedy and unscrupulous lenders. The effect of the usury laws, however, has been to impair the proper functioning of markets and to divert money away from the mortgage market whenever the market rate rises above the ceiling. The consumer gains no protection from markets that do not function.

There is a pressing need to restructure the mortgage market so that it can function effectively in the environment in which we find ourselves today. If our private mortgage-lending institutions fail to adapt to their environment, either due to their own inertia or due to legislative constraints on their ability to adapt, the Federal Government's role in the mortgage market must expand. These are the alternatives as I see them.