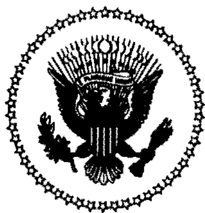

# The President's Commission On Housing

# Financing the Housing Needs of The 1980s

A Preliminary Report on Housing Finance

January 1982

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**Acknowledgments**

Several federal agencies have assisted the work of the Commission and provided various resources, including staff support:

U.S. Department of Housing and Urban Development
Federal Home Loan Bank Board
Board of Governors of the Federal Reserve System
Environmental Protection Agency
Federal National Mortgage Association
Federal Trade Commission
Office of Management and Budget

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# PREFACE

The Interim Report of the President's Commission on Housing, delivered to the President on October 30, 1981, stressed the nation's commitment to housing and the need to develop a coherent set of policy options to help create a more viable housing finance system in the years ahead. It also noted the importance of the recent legislative proposal submitted by the Administration dealing with thrift institutions. The Commission appointed a task force to address these topics in depth. This preliminary report is based on the analysis and findings of the task force.

Dramatic changes have taken place in the financial system of this country in recent years. Indeed, the system of housing finance in the United States, driven by economic and market pressures, is in transition. Further change is inevitable. Within this shifting environment, a more broadly based and revitalized system of housing finance is essential if the nation is to meet the considerable demands for housing during this decade.

This report highlights the importance of housing finance and focuses on ways to provide a more reliable supply of residential mortgage credit over the long term. It addresses the need for changes in the legal and regulatory structure governing the operations of private housing finance specialists; the implications of such changes for the overall supply and cost of mortgage credit; the importance of thrift institutions as a continuing source of mortgage finance; and ways to encourage diversified institutions such as commercial banks, pension funds, insurance companies, and finance companies to invest more heavily in residential mortgages.

The Commission believes that the steps recommended in this document are important ingredients of a well-rounded national housing policy that will help develop a new framework for the delivery of funds to finance the housing needs of the 1980s. However, this preliminary report does not purport to present a complete framework, and further study is underway on a number of other issues that will be discussed in the Commission's Final Report. Also, because the focus of this report is essentially long term, the Commission has appointed a Committee on Present Housing Issues to address the short-term problems of housing finance.

The first chapter of the report -- Summary and Recommendations -- provides a brief discussion of the evolution of the present housing finance system, outlines the types of changes that are needed to allow mortgage lenders and borrowers to compete more effectively for funds in the coming years, and summarizes the recommendations of the Commission. The next four chapters provide background information and analysis supporting these recommendations. Chapter 2 discusses the history and performance of the housing finance system, and Chapters 3, 4, and 5, respectively, discuss the operating powers of housing finance institutions, tax incentives for mortgage investors,

and laws and regulations that discourage diversified private institutions from investing in residential mortgages or raise the cost of credit for mortgage borrowers.

The last chapter considers the patterns of housing finance that are likely to evolve during the 1980s, and indicates how the recommendations contained in this report can influence the process of change in ways that will lead to a stronger and more resilient system. The chapter concludes with the Commission's agenda for further study related to housing finance.

The recommendations and underlying philosophy in this report are consistent with the statement of principles enunciated by the Commission in its Interim Report. The principles adopted by the Commission are applicable in many aspects of economic life, but they apply with special relevance to the housing concerns confronting the country. In order to address housing issues successfully, the Commission believes that the nation must:

- Achieve fiscal responsibility and monetary stability in the economy;
- Encourage free and deregulated markets;
- Rely on the private sector;
- Promote an enlightened federalism with minimal government intervention;
- Recognize a continuing role of government to address the housing shelter needs of the poor;
- Direct programs toward people rather than toward structures; and
- Allow maximum freedom of housing choice.

These principles suggest that credit for housing should be provided through the unrestricted access of lenders and borrowers to private financial markets. This approach will expand the sources of funds for residential mortgages and help make the mortgage delivery system more efficient.

# Chapter 1

## SUMMARY AND RECOMMENDATIONS

The President's Commission on Housing was created as an expression of President Reagan's commitment to housing and his desire to find remedies to the current problems that affect millions of homebuyers and many industries. Housing holds a high priority in the United States, and a strong system of housing finance is essential if the housing needs of the American people are to be met. In fact, one of the mandates outlined in the Executive Order that established the Commission is to assess the current housing finance structure and practices in the country and develop housing and mortgage finance options that strengthen the ability of the private sector to maximize homeownership opportunities and provide adequate shelter for all Americans.

For decades, the private housing finance system in the United States has depended heavily upon a highly regulated system of specialized mortgage lenders and a single type of mortgage instrument. It was an excellent system that did a remarkable job of serving the housing needs of the country. In recent years, however, housing has been beset by a series of problems. During the past 15 years, the residential construction industry has undergone three major recessions and the country now is in the process of a fourth. Interest rates recently have risen to record highs and housing activity has dropped drastically. Although interest rates have moderated somewhat, the condition of housing and mortgage lenders still is a matter of serious concern.

The problems of the housing and housing finance industries are largely the result of difficulties that have developed in the overall economy. The Commission's Interim Report pointed out that the most effective step that government could take to deal with current problems in the economy and the housing industry is to bring down the rate of inflation through appropriate and consistent monetary and fiscal policy.

Inadequacies in the system of housing finance have aggravated the problems stemming from inflation and volatile interest rates. The major flaw of the financing system has been a lack of flexibility that has rendered it fragile under pressure. In essence, the structure of housing finance that evolved after the Depression was designed for periods of moderate inflation and reasonably stable interest rates. In an age of rapid inflation, unstable fiscal and monetary policy, evolving technology, and increased competition, market forces have created strong pressures for change. During the past decade, participants in the mortgage system have sought to make modifications to accommodate these pressures, but government regulations and constraints have kept private financial institutions from adapting to new market realities. As a result, the system no longer provides a stable and reliable supply of housing credit.

The deterioration of the private housing finance system indicates that a new legal and regulatory structure must be developed if the nation is to meet the strong underlying demand for housing credit that can be expected in the 1980s. A broader-based, more resilient system of housing finance is essential, and resources to finance housing should be provided through the unrestricted access of mortgage lenders and borrowers to the money and capital markets. In this regard, two major challenges are posed for public policy and will be discussed in the sections that follow. First, the vitality of institutions that traditionally have specialized in mortgage lending must be restored so that those institutions can continue to be important and dependable sources of housing credit. Second, ways must be found to increase the level of investment in mortgage instruments by a broad range of private financial institutions with diversified asset portfolios.

## Development of the Problem and Pressures for Change

The statutory framework for the private housing finance system has not changed substantially since the early 1930s. The Home Owners' Loan Act of 1933 authorized the creation of federal savings and loan associations, and the Federal Savings and Loan Insurance Corporation was established to insure the deposits at savings and loans. The Federal Home Loan Banks and the Federal Home Loan Bank Board were set up to serve as an external source of liquidity for home mortgage lenders and to provide a regulatory mechanism. The Federal Housing Administration (FHA) also was formed to help increase the flow of funds through mortgage markets. FHA patterned its long-term, direct-reduction loan after the model established by the Home Owners Loan Corporation, which required such contracts under its purchase programs. This led to widespread acceptance of the fully amortized, fixed-interest, level-payment mortgage that became the dominant form of mortgage instrument.

The measures adopted during the 1930s to strengthen the housing finance system helped to restore public faith in the safety and soundness of the entire financial structure and established a highly regulated group of specialized private mortgage finance institutions commonly referred to as thrift institutions (savings and loan associations and mutual savings banks). Since that time, regulatory constraints and tax laws have led savings and loan associations to hold long-term, fixed-rate residential mortgages as their principal assets and to rely upon household deposits as their major source of funds. Mutual savings banks, chartered in a limited number of states and with deposits insured by the Federal Deposit Insurance Corporation or state agencies, have a similar structure, although they are less committed to mortgages in their asset structure.

This system of housing finance -- heavily dependent upon financial institutions that concentrate their investments in long-term, fixed-rate residential mortgages -- was highly successful until the 1960s. The savings and loan business became the second largest system of financial intermediaries and, together with the mutual savings banks, supplied more than half of all residential mortgage

credit. Since then, however, these mortgage lending specialists have undergone frequent and increasingly severe financial shocks, and there have been serious lapses in the ability of the thrift institutions to serve the housing credit needs of the country. The problem has stemmed from the combination of an inflexible legal and regulatory structure, various judicial actions, innovations by unregulated institutions, accelerating inflation, and progressively higher and more volatile market interest rates.

The inadequacies of the legal and regulatory structure have been pointed out by numerous commissions and studies. The Commission on Money and Credit submitted its report in the early 1960s; and in the past two decades the topic has received increasing public and private attention because of pressure created by market developments. In 1970, the President appointed a special Commission on Financial Structure and Regulation (Hunt Commission), largely in response to difficulties faced by the housing and mortgage finance industries during the 1966 and 1969 episodes of financial instability. The Hunt Commission recommended substantial restructuring of financial institutions, especially savings and loan associations and mutual savings banks, but the recommendations were largely ignored in the highly expansive economic environment that followed the issuance of the Commission report at the end of 1971.

The issue reappeared in the wake of the financially violent recession of 1974-1975. This time, the Senate passed the Financial Institutions Act of 1975; and the House Committee on Banking, Currency and Housing developed and held hearings on a set of Discussion Principles entitled "Financial Institutions and the Nation's Economy" (FINE). Both of these efforts envisioned a substantial restructuring of thrift institutions, primarily through the authorization of new asset and liability powers. As before, however, the urgency of the moment diminished as economic recovery took hold by late 1975, and Congress abandoned the effort for extensive legislative change.

The comprehensive financial reform proposals developed during the first half of the 1970s failed to become law largely because they were opposed by various segments of industry and society. On each occasion, the primary questions debated were essentially the same: (1) Would the elimination of ceilings on deposit rates create financial chaos for institutions and result in higher costs for mortgage credit? (2) Would broader asset powers for thrift institutions result in a diversion of funds from the housing market and put upward pressure on mortgage rates? (3) Would mortgage contracts that enable lenders to reduce their interest rate risk -- e.g., through adjustable-rate features, due-on-sale clauses, and prepayment charges -- put borrowers in too vulnerable a position? These were matters of great contention, and lack of agreement prevented development of the consensus necessary for passage.

Although comprehensive legislative reform was slow in coming during the 1970s, a number of important changes occurred in the marketplace and through specific regulatory and legal actions. Most of these changes affected the liability side of the balance sheets of depository institutions as deposit rate ceilings came under growing attack for reasons of equity and efficiency. First, the adverse effects of rate ceilings on households with modest amounts of savings were widely denounced as a veritable "savers revolution" erupted. Second, it became increasingly obvious that deposit rate ceilings, by denying funds to thrift institutions, tended to constrain the volume of mortgage lending in periods of rising interest rates, thus perhaps raising -- rather than lowering -- the cost of mortgage loans. This phenomenon became more pronounced as the ingenuity of the private sector spawned market instruments designed to appeal to rate-sensitive households.

In response to these pressures, regulatory and legislative changes were made to reduce the effect of deposit rate ceilings. In mid-1973, financial regulators authorized a four-year certificate free of interest rate limitations. This so-called "wild card" account raised concerns, however, about deposit costs and about the competitive position of thrifts vis-a-vis commercial banks, and Congress mandated the reimposition of rate ceilings late in the same year. In mid-1978, the regulators of depository institutions created a short-term, market-related savings instrument called the money market certificate; and a longer-term, variable-ceiling deposit instrument named the small savers certitificate was introduced a year later. Finally, Congress enacted the Depository Institutions Deregulation and Monetary Control Act of 1980 (DIDMC Act), which established the Depository Institutions Deregulation Committee (DIDC) to provide for the phased removal of all deposit rate ceilings by 1986.

Variable-ceiling deposit certificates have been attractive to savers. As a result of the success of the money market certificate, however, the maturity structure of thrift liabilities has shortened considerably and the cost of funds for these institutions has become much more sensitive to market rate movements. Despite this significant restructuring of liabilities, the assets of thrifts remained under strict regulatory control until quite recently. Consequently, the portfolios of thrift institutions are now locked into long-term, fixed-rate mortgages that carry yields well below current mortgage rates as well as below the current cost of funds to these institutions. Such problems have been generated by the legacy of continuing regulatory constraints on thrift asset powers, and have been compounded by federal macroeconomic policies of the past two decades that have engendered unprecedented movements in prices and interest rates.

The DIDMC Act of 1980 granted federally chartered thrift institutions modest increases in authority to acquire nonmortgage assets; more recently, federal regulations promulgated after 1966 prohibiting acquisitions of adjustable-rate home mortgages by thrifts have been largely repealed. The recent adjustments to asset powers, however,

have come at a late date, and have fallen far short of both the substantial deregulation that has already taken place on the liability side of thrift balance sheets and the further deregulation mandated by legislation already in place. The net result is that thrifts now have a liability structure that must sustain the pressure of open market forces. They have largely lost the deposit rate differential that provided them an advantage in competing for funds with commercial banks, and yet they still must vie for funds with limited asset and earnings flexibility against competitors who are highly diversified.

The piecemeal and delayed responses of the statutory and regulatory structure to sweeping market developments have not only altered the competitive balance among regulated depository institutions, but also have placed these institutions, as a group, at a serious disadvantage vis-a-vis other participants in the financial system. Investment banking firms, consumer finance companies, insurance companies, commercial and industrial firms, and participants in international markets have responded to the heavy burden of regulation and lack of flexibility imposed on the depository institutions in an effort to increase their shares of the financial transactions that take place in this country. Recent developments that offer advantages to the unregulated or less regulated financial services industries include: growth of money market mutual funds and the commercial paper market; the acquisition of investment banking, real estate brokerage, and mortgage brokerage activities by commercial and industrial enterprises; and innovations in the insurance industry.

In summary, it is clear that the environment for home financing has changed dramatically since the statutory framework for the system was established in the 1930s, and it has become evident that the rules governing the operation of housing finance institutions are no longer in the best interests of the nation. The system of housing finance that evolved after the Depression worked well during periods of stable interest rates. But rapid inflation, high and fluctuating interest rates, and increased market competition have seriously weakened the system. The thrift industry has suffered from rate volatility and from a mismatch in the maturities of assets and liabilities. Homebuyers and the housing industry have been caught in the ensuing crunch. The nation's system of housing finance is in transition and change is inevitable -- even though change means moving away from arrangements that worked well in the past.

## Sources of Funds for Housing During the 1980s

The current problems of the housing industry and the housing finance system are closely related. Both are strongly affected by events in the overall economy and by the structure and behavior of interest rates. Since the mid-1960s, high and variable rates of inflation have raised the level and increased the degree of fluctuation in market interest rates, thereby making housing construction

and finance still more volatile. In order to deal with this problem, it is necessary to bring down the rate of inflation through consistent monetary and fiscal restraint over a long period of time. Success in this endeavor will bring about lasting reductions in mortgage and other interest rates, and will constitute the most effective contribution government can make to housing stability and to mortgage finance.

In addition, a broader-based and more resilient system of housing credit is needed to finance the housing needs of the 1980s. Thrift institutions have a long tradition of mortgage lending, and they undoubtedly will remain an essential component of the system. But diversified investors -- such as commercial banks, insurance companies, and pension funds -- will need to play an increasing role in addressing the housing finance requirements of the future. Although growing participation by these investors will be motivated by the profitability of the market, government can help to achieve this result by providing economic incentives for mortgage investment, by dismantling rigid or costly regulatory barriers, and by encouraging the development of mortgage instruments that will appeal to both borrowers and a wide range of investors.

The future role of thrift institutions in housing finance. Developments in financial markets in recent years clearly indicate that broader operating powers are essential to the health of thrift institutions, and that special tax incentives designed to keep the assets of these institutions concentrated in residential mortgage instruments should be modified. The prospect of portfolio diversification by institutions that traditionally have specialized in mortgage investment naturally raises the same question asked earlier in the context of financial reform proposals: what are the implications for the supply and cost of housing credit?

Broader operating powers will give individual thrift institutions greater flexibility to adjust to shifting demand and supply conditions in local, regional, and national markets. Although broader powers will do little to solve the immediate problems of the thrifts, over the longer run greater flexibility should result in a healthier, more adaptable, and generally faster-growing industry. A vital thrift industry certainly will account for a major share of residential mortgage origination and servicing because these are profitable activities; the thrifts have built up considerable expertise in these areas, and they are not likely to give up this advantage. Moreover, a strong industry that devotes a smaller portion of its portfolio of assets to mortgages could be a better source of housing funds than a weak industry fully committed to mortgage investment. Equity investments in real estate, for example, could support the housing market directly and also allow thrift institutions to participate in the appreciation of housing and rehabilitation development.

Recent market and regulatory developments undoubtedly will encourage some thrift institutions to continue to concentrate large portions of their assets in residential mortgages, even if nonmortgage asset powers of thrifts are expanded. While focusing on housing, these institutions could follow several strategies to reduce their exposure to interest rate risk. First, risk could be shared with households through the use of recently authorized alternative mortgage instruments. Second, hedging in the nation's rapidly developing financial futures markets, also made possible by recent regulations, could be utilized by thrift institutions to shift interest rate risk to parties outside the mortgage markets. Third, stock institutions could build larger capital buffers so as to increase their capacity to bear risk.

But it also is likely that many thrift institutions would choose to operate more like mortgage bankers, by specializing in the origination and servicing of long-term residential mortgage loans, and by selling these assets through the secondary markets to investors who do not want to be involved in the origination and servicing process but who are better suited to hold mortgages in their portfolios. The broader investor base that would result, involving institutions with various liability structures, would better meet the needs of mortgage borrowers who also are likely to be quite diverse in their abilities and inclinations to absorb interest rate risk.

Attracting diversified institutions into housing finance. To the degree that asset diversification by thrift institutions would result in a slowdown in the growth of mortgage supply, mortgage yields would tend to rise relative to other capital market yields, and investors who operate in both mortgage and bond markets would then move funds into mortgages. In properly functioning markets, therefore, the final result would involve a different structure of mortgage supply, but the overall level and the cost of mortgage credit should be essentially unchanged.

The efficiency of secondary mortgage markets and the diversity of funds for housing have improved markedly in recent years. For example, the proportion of mortgage investments held by commercial banks has followed an upward trend since the mid-1960s, and the banks are now second only to savings and loan associations in terms of mortgage investments. Examples also abound of less regulated institutions participating in the mortgage market. Various types of financial institutions hold mortgages or pass-through securities and growing numbers of nonfinancial institutions are participating in the housing finance industry. These trends are likely to continue because financing the housing market is profitable, not because of regulation or indirect credit allocation.

Even so, the mortgage markets and other components of the capital markets are not yet fully integrated. The secondary markets for federally underwritten mortgages and pass-through securities have become well developed in recent years, but the secondary markets for conventional instruments -- which have been the specialty of the

thrifts -- have shown less development. This phenomenon can be traced to a number of factors, including insufficient standardization of primary and secondary market instruments, and legal or regulatory constraints on the investment activities of some types of investors.

Given the current state of market development, prudence dictates that the provision of broader investment powers for thrift institutions be accompanied by measures designed to facilitate an orderly transition to a more broadly based and flexible housing finance system. The surest ways to guard against shortfalls in supply during the period of transition would be to provide tax incentives for a broad range of investors to move more funds into mortgages and to remove artificial barriers to mortgage investment by yield-sensitive financial institutions. Further development of secondary market instruments and trading facilities also would help to facilitate the flow of funds into housing finance from many sources.

Policies designed to lessen restrictions on the operations of thrift institutions and other types of investors, to provide economic incentives for a wide range of institutions to invest in mortgage assets, and further to develop secondary market instruments and institutions, should lead to a much healthier housing finance system. The credit needs of homebuyers, builders, and investors in rental properties will be served best, both over the cycle and in the longer run, by a system involving continued significant participation by thrift institutions supplemented by heavier involvement on the part of mortgage bankers, commercial banks, pension funds, life insurance companies, finance companies, individuals, and other private investors.

In addition, a vital housing finance system involving a variety of private institutions must be based on enforceable mortgage contracts. It is essential that investors be able to rely on the integrity of all aspects of mortgage documents, such as due-on-sale clauses. Uncertainties concerning the enforceability of such clauses make it impossible to arrive at firm prices for mortgage contracts in the secondary market. Moreover, a situation in which some institutions can enforce due-on-sale clauses but others cannot -- a dichotomy that currently exists -- easily can discourage new sources of capital from entering the housing markets.

Flexibility in the form of financial institutions is also important to the functioning of mortgage markets. Thrift institutions should be able to convert from mutual to stock forms of ownership so that they need not rely solely upon retained earnings to build capital positions. Concerning mergers and acquisitions of financial institutions, it seems apparent that the regulatory authorities should have and use the authority to deal efficiently with current transitional problems. And over the long term, government policy should encourage evolution of an institutional structure that will provide financial services at the lowest possible cost to all segments of society.

## RECOMMENDATIONS

The Commission's recommendations in the area of housing finance are directed toward a single goal -- the creation of a system that will provide a stable and growing supply of housing credit, at reasonable cost, with minimal federal involvement. The Commission recognizes that substantial changes in the present system of housing finance are already underway. The long-term recommendations set forth in this report are designed to lead to a strong and resilient system of housing finance that will be able to compete in this changing environment. It is expected that thrift institutions will gradually utilize new powers over a period of time. However, since change could create some problems, it is appropriate that certain incentives and safeguards be installed to encourage continued mortgage investment during a period of transition. Further, it should be stressed that the recommendations of the Commission in the housing finance area are to be considered as elements of a package, because the financial system is an integrated and interdependent mechanism. Experience from the past has amply demonstrated that piecemeal adjustments can be counterproductive.

The recommendations are organized around five premises. First, the asset, liability, and service powers of depository institutions must be broadened in order to permit traditional mortgage finance specialists to compete more effectively in the markets for funds over the long term, and to allow banks and thrift institutions to expand their real estate activity. Second, in order to stimulate a variety of lenders, such as commercial banks, to increase their mortgage holdings, the same tax incentives to encourage mortgage investment should be applied to all types of financial institutions. Third, laws and regulations that restrict the flow of funds to housing from any source, or unduly raise the cost of mortgage credit for borrowers, should be eliminated. Fourth, mortgage contracts that meet the diverse needs of both borrowers and investors should be developed, and secondary markets for mortgages and mortgage-backed securities should be strengthened. Fifth, the roles of federal agencies in underwriting credit risks on mortgage instruments and in channeling funds to mortgage markets from other sectors of the capital markets should be reevaluated.

The recommendations outlined in this report deal only with the first three of these areas -- operating powers of depository institutions, tax incentives for mortgage investment, and laws and regulations that adversely affect the supply and cost of mortgage credit -- and the focus is essentially long-term. Additional recommendations in these areas, as well as recommendations addressing the short-term problems of housing finance, the development of primary and secondary mortgage market instruments, and the appropriate roles of various federal credit and insurance programs, will be contained in the Commission's Final Report.

I. <u>Asset and Liability Powers of Housing Finance Institutions:</u>

A. Savings and loan associations and mutual savings banks (thrift institutions) should have powers sufficient to enable them to serve the deposit and credit needs of all sectors of the economy, including expanded authority to:

1. Accept demand deposits from all types of customers.

2. Invest in secured and unsecured consumer loans.

3. Invest in secured and unsecured commercial and agricultural loans as well as commercial paper and other corporate debt instruments.

4. Invest in municipal securities, including both revenue bonds and general obligations.

5. Invest in residential and nonresidential real estate loans, whether first or junior liens, without loan-to-value restrictions or mortgage insurance requirements.

B. The powers of thrift institutions also should be expanded in the following areas, subject to percent-of-asset limitations and regulatory supervision:

1. Direct investment in real estate of various types, including joint ventures with developers.

2. Investment in service corporation affiliates.

3. Equipment leasing.

C. The powers of commercial banks to invest in residential mortgages and real estate should be clarified and expanded, in order that banks can continue their important role in housing finance and be competitive with other institutions such as thrifts and investment banks:

1. The statutory framework governing the real estate lending powers of banks should be reviewed and updated to reflect current market realities and needs.

2. Direct investment by banks in real estate should be permitted, including joint ventures with developers (subject to percent-of-asset limitations and regulatory supervision).

3. Banks should be permitted to establish service corporations, similar to those in the savings and loan industry, in order to facilitate the activity of smaller, community-oriented banks in real estate investment, secondary mortgage market operations, and a broad array of financial activities.

D. Thrift institutions and commercial banks should be provided, where necessary, with the following powers:

   1. Adequate authority to engage in activities incidental to the exercise of authority conferred by law.

   2. Authority to make over-the-counter sales of certificates backed by mortgages or by equities in real estate, with or without recourse.

   3. Authority to make over-the-counter sales of interests in the loans originated and held by them, subject only to the regulations of their respective supervisors and the federal deposit insurers.

II. Tax Incentives for Mortgage Investment:

The Commission's Task Force on Taxation is studying specific types of tax incentives for mortgage investment; the Commission will include detailed recommendations in the Final Report. At this time, the Commission makes the following general recommendations:

A. To encourage greater residential mortgage activity by a broad range of institutions, equivalent tax incentives should be provided to all types of investors with similar portfolios.

B. At the same time, the tax law should be amended to permit thrift institutions to reduce the concentration of mortgages in their asset portfolios and still qualify for the same level of tax advantages as in existing law.

III. Laws and Regulations Affecting Housing Finance:

A. Due-on-sale Clauses in Home Mortgage Contracts

   1. Action should be taken at the federal level to prevent, or to discourage, states from restricting the enforcement of clauses in outstanding mortgage contracts that give lenders the option to declare these existing loans due and payable in full upon sale of the mortgaged property. Two recommended options are:

      a. State legislative or judicial efforts to restrict the enforcement of due-on-sale clauses should be preempted by federal action.

         -- Ideally, the preemption should be extended to all "federally related mortgages," as defined in the regulation implementing the federal preemption of of state ceilings on mortgage interest rates contained in the Depository Institutions Deregulation and Monetary Control Act of 1980: all loans made by federally insured or regulated institutions, or by mortgagees approved by the Department of Housing

and Urban Development (HUD); loans that are guaranteed, insured, or assisted by HUD; loans eligible for purchase by the Government National Mortgage Association, Federal National Mortgage Association, or Federal Home Loan Mortgage Corporation; loans made by lenders that regularly extend credit payable in more than four installments, where there is a finance charge, and where the lender makes more than $1 million in residential real estate loans per year.

b. In states where enforcement of due-on-sale clauses is restricted by legislative or judicial action, incentives should be provided to encourage the states to relax their restrictions. Several approaches are possible, including the following:

-- Premiums charged for federal insurance of deposits could be raised sufficiently to account for the greater risks placed upon the federal deposit insurance agencies;

-- Federal deposit insurance could be denied to depository institutions located in states that prohibit enforcement of due-on-sale clauses. This policy would require states that place a high priority on assumability to organize their own insurance funds.

2. Lenders and borrowers should have the option to negotiate the inclusion and the price of due-on-sale clauses in all mortgages to be made in the future. Thus, federal regulations should be changed to permit the inclusion of due-on-sale clauses in mortgages that are insured by the Federal Housing Administration or guaranteed by the Veterans Administration.

B. Private Pension Funds

The President has already endorsed recommendations made by the Commission in its Interim Report that would relax or eliminate provisions of current laws or regulations that limit investment in residential mortgage instruments by pension funds. The Commission urges the Department of Labor to continue to proceed as expeditiously as possible to implement these recommendations, which are as follows:

1. The Department of Labor should promptly issue the housing portions of proposed regulations that would exclude from Employee Retirement Income Security Act regulations mortgage pools associated with pass-through securities issued or guaranteed by the United States or an agency or instrumentality thereof, including the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association.

2. The Department of Labor should expand its recent class exemption for mortgage pass-through securities that are not issued or guaranteed by a federally related entity, in order to cover pools of second mortgages and to clarify the treatment of forward-purchase commitments that are commonplace in mortgage market transactions.

3. In the case of whole mortgages or mortgage participations, the Department of Labor should issue a class exemption in order to permit normal business transactions.

4. The mechanisms for evaluating applications for mortgage-related exemptions should be streamlined and improved. To accomplish this goal, the Department of Labor should rely upon the mortgage and housing expertise that already exists at the Federal Home Loan Bank Board or the Department of Housing and Urban Development.

C. Industry Structure and Institutional Form

1. Charters and forms of ownership:

   a. All state-chartered savings banks and savings and loan associations should be permitted to convert to federal charters, and vice versa.

   b. All federally chartered savings and loan associations and savings banks should be permitted to convert from mutual to stock forms, and vice versa.

   c. All federal savings and loan associations should have the opportunity to convert to savings banks, and vice versa.

   d. The Federal Home Loan Bank Board should be provided with authority to grant *de novo* federal stock charters to savings and loan associations.

2. Mergers and acquisitions:

   a. Interstate and interindustry mergers sought by the private sector should be permitted in the evolution of a financial system that will provide financial services at the lowest possible cost to mortgage borrowers and other participants in the financial markets and will lead to more stable flows of housing credit.

   b. Regulatory authorities should continue to have, and to use, the power to arrange interstate and interindustry mergers and acquisitions of institutions whose viability is evaluated as uncertain by the regulators. Supervisory mergers and acquisitions should cover a broad range of situations, including the following arrangements:

-- Merger of any insured thrift institution into any other insured thrift or bank, or into any savings and loan or bank holding company, regardless of the locations of the respective institutions being combined.

-- Holding company acquisitions of insured institutions, without the present differentiation between unitary and multiple holding company systems.

# Chapter 2

# HISTORY AND PERFORMANCE OF THE HOUSING FINANCE SYSTEM

The United States has a unique system of housing finance that has done a remarkable job of serving the housing credit needs of the country until recent years. The current system is composed of more than 4,000 savings and loan associations, almost 500 mutual savings banks, more than 14,000 commercial banks, at least 1,000 mortgage bankers, numerous other nondepository private financial institutions, and agencies at all levels of government.

The following discussion briefly sketches the evolution of the housing finance system during the past several decades and indicates some of the major problem areas that have emerged. The focus is concentrated upon savings and loan associations and mutual savings banks; these specialized institutions hold more than half of total residential mortgage assets in the country, and their operations have been heavily influenced by federal regulations and tax provisions. More extensive discussions of other elements of the housing finance system -- both private and public -- will be contained in the Final Report of the Commission.

## Evolution of the Housing Finance System

Residential mortgage loans have been made, or originated, primarily by mortgage companies and depository institutions that maintain lending offices in communities throughout the country. Some originators hold the loans they make, but others sell loans through the secondary market to various institutions that hold mortgages in their portfolios.

Table 1 traces changes in the structure of mortgage holdings since 1950. As the table indicates, many types of private financial institutions and public agencies have residential mortgages in their portfolios.[1] The dominant private mortgage investors have been depository institutions. On average, savings and loan associations have held nearly 40 percent of total residential mortgage debt outstanding during the past 20 years; this number rose close to 45 percent in the mid-1970s, but has declined in the past several years. Mutual savings banks also have been important in the mortgage market, but their share has decreased within the past decade and a half and is now less than 10 percent. Although below the importance of savings and loan associations, commercial banks also have played a major role in the mortgage market. Starting around 12 percent in the mid-1960s,

1/In Table 1, mortgages held by various institutions exclude holdings of federally related pass-through securities; the mortgage pools backing these securities are shown as a separate type of institution.

Table 1

Percent of Total Residential Mortgage Debt Outstanding by Type of Institution

| | Thrift Institutions | | | | | | |
|---|---|---|---|---|---|---|---|
| End of Period | Savings and Loan Associations | Mutual Savings Banks | Commercial Banks | Life Insurance Companies | Federal and Related Agencies | Mortgage Pools[a] | All Others[b] |
| 1950 | 24.14% | 12.76% | 18.87% | 20.06% | 2.73% | 0.00% | 21.45% |
| 1955 | 29.85 | 15.18 | 15.49 | 20.68 | 3.31 | 0.00 | 15.48 |
| 1960 | 35.47 | 14.98 | 12.55 | 17.71 | 5.03 | 0.00 | 14.26 |
| 1965 | 39.72 | 15.56 | 12.57 | 14.90 | 2.90 | 0.02 | 14.33 |
| 1970 | 38.75 | 13.94 | 12.74 | 11.92 | 7.03 | 0.72 | 14.90 |
| 1975 | 42.19 | 10.79 | 14.03 | 6.29 | 8.49 | 4.96 | 13.25 |
| 1976 | 43.76 | 10.18 | 4.27 | 5.34 | 7.24 | 6.66 | 12.57 |
| 1977 | 44.71 | 9.50 | 14.89 | 4.37 | 6.27 | 8.29 | 11.97 |
| 1978 | 44.24 | 8.89 | 15.73 | 3.77 | 6.40 | 9.11 | 11.85 |
| 1979 | 42.86 | 8.13 | 15.94 | 3.52 | 6.61 | 0.78 | 12.17 |
| 1980 | 41.71 | 7.54 | 15.77 | 3.41 | 6.96 | 11.85 | 12.76 |
| 1981 (Q3) | 40.98 | 7.21 | 16.05 | 3.28 | 6.89 | 12.44 | 13.16 |

[a]/Mortgages in pools backing pass-through securities issued and/or guaranteed by the Government National Mortgage Association, Federal Home Loan Mortgage Corporation, and Farmers Home Administration.

[b]/Includes mortgage companies, real estate investment trusts, private pension and retirement funds, state and local government credit agencies and retirement funds, credit unions, and individuals.

Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

the percent of mortgage debt outstanding held by commercial banks has risen somewhat, and commercial banks are now the second largest holders of mortgage debt. Together, savings and loan associations, commercial banks, and mutual savings banks hold nearly two-thirds of total residential mortgage debt outstanding.

One of the major developments in mortgage markets during the past decade has been the introduction and growth of federally related pass-through securities issued against pools of government-underwritten and conventional residential mortgage loans (Table 2). These secondary market instruments have opened important channels between mortgage markets and other sectors of the nation's capital markets and have helped to broaden the base of mortgage supply to include more investors with diversified portfolios. Although thrift institutions have acquired significant portions of the federally underwritten mortgage pass-through securities, other institutions such as insurance companies, commercial banks, bank trust departments, and public and private pension funds also have acquired substantial amounts.

Figure 1 shows net funds supplied to residential mortgage markets by major groups of institutions, either directly through acquisitions of mortgages or indirectly through acquisitions of pass-through securities. As shown, the relative importance of diversified private institutions in the mortgage supply system has been increasing. Recommendations contained in Chapters 4 and 5 of this report should help to expand the participation of these types of institutions in mortgage finance.

Although the secondary market for federally underwritten mortgage securities has become well established in recent years, the secondary market for private securities has been slow in developing. The Commission therefore is examining ways to stimulate the development of private mortgage-related securities and will include proposals to achieve this goal in the Final Report.

Savings and loan associations and mutual savings banks (thrift institutions) have been led by regulations and tax incentives to allocate very large proportions of their assets to residential mortgages while their liabilities have been limited primarily to short-term and intermediate-term deposits of households. Other industries, including commercial banks, have not been led by government policy into such an investment strategy. The thrift institution practice of borrowing short and lending long, in conjunction with large movements in interest rates that were not anticipated, has led to widespread earnings problems at these institutions and has threatened the viability of the industry and its ability to serve the mortgage credit needs of the country. The remainder of this chapter

Table 2

Federally Underwritten Mortgage Pass-through Securities

(Amounts Outstanding in Billions of Dollars)

| End of Period | Guaranteed By | | | Total | Total as Percent of All Residential Mortgage Debt Outstanding |
|---|---|---|---|---|---|
| | GNMA[a]/ | FHLMC[b]/ | FmHA[c]/ | | |
| 1970 | $0.4 | $0.0 | $2.3 | $2.7 | 0.7% |
| 1971 | 3.1 | 0.1 | 3.7 | 6.9 | 1.7 |
| 1972 | 5.5 | 0.4 | 5.2 | 11.1 | 2.4 |
| 1973 | 7.9 | 0.8 | 5.6 | 14.3 | 2.8 |
| 1974 | 11.8 | 0.8 | 6.9 | 19.5 | 3.6 |
| 1975 | 18.3 | 1.6 | 9.5 | 29.4 | 5.0 |
| 1976 | 30.6 | 2.7 | 10.8 | 44.1 | 6.7 |
| 1977 | 44.9 | 6.6 | 12.2 | 63.7 | 8.3 |
| 1978 | 54.4 | 11.9 | 14.5 | 80.8 | 9.1 |
| 1979 | 76.4 | 15.2 | 17.1 | 108.7 | 10.8 |
| 1980 | 93.9 | 16.9 | 19.3 | 130.1 | 11.9 |
| 1981 (Q3) | 97.2 | 17.1 | 19.9 | 134.2 | 12.1 |

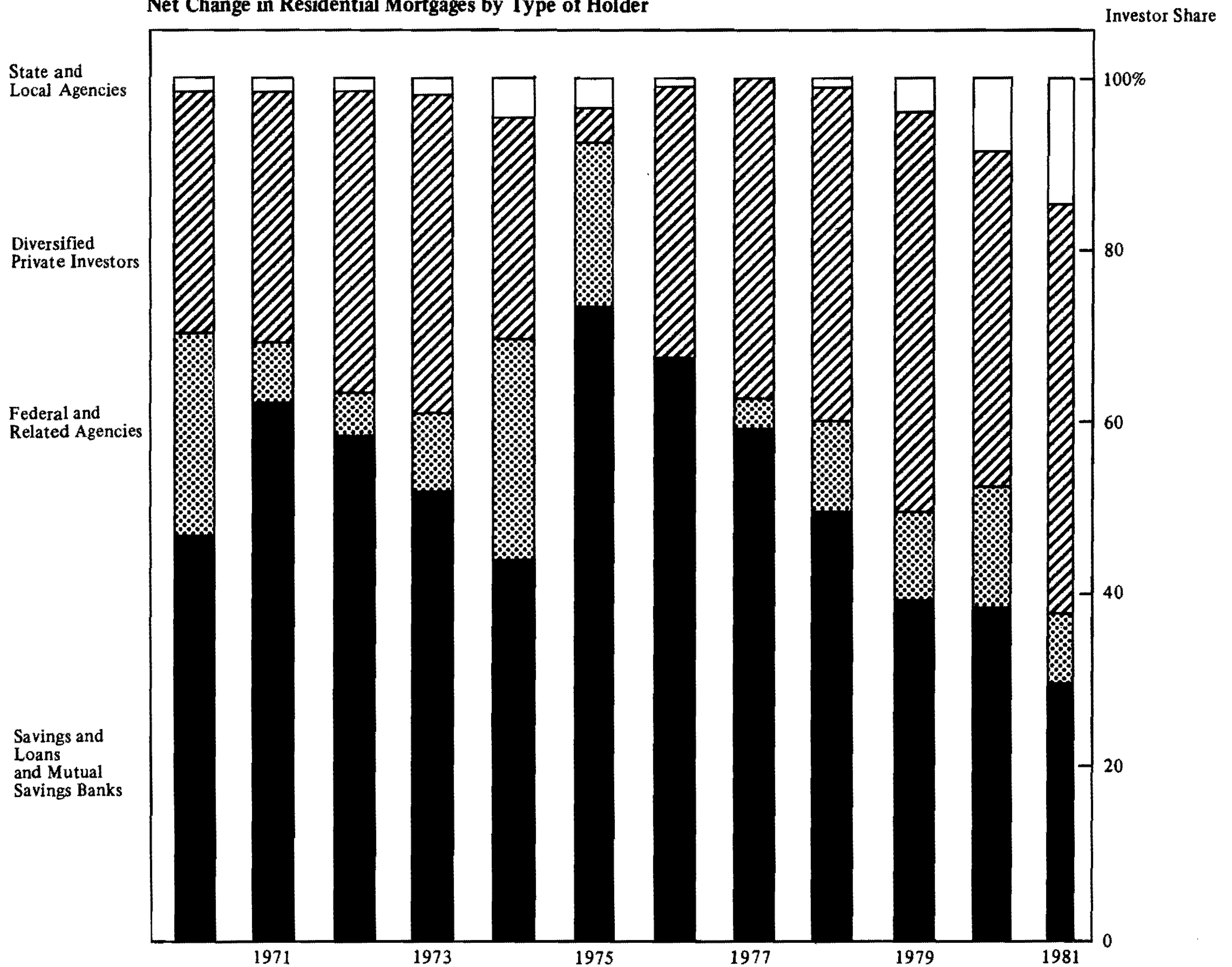
[a]/Government National Mortgage Association.

[b]/Federal Home Loan Mortgage Corporation.

[c]/Farmers Home Administration.

Sources: Government National Mortgage Association, Federal Home Loan Mortgage Corporation, Farmers Home Administration, and Board of Governors of the Federal Reserve System.

**Figure 1**
**Net Change in Residential Mortgages by Type of Holder**




Note: Mortgages in pools backing issues of federally guaranteed pass-through securities have been allocated to the holders of the securities.

Sources: Federal Home Loan Bank Board, National Association of Mutual Savings Banks, and Farmers Home Administration.

therefore focuses on the history and performance of thrift institutions and the need for new policies. The discussion includes a review of the structure of the thrift industry, a brief analysis of the role of thrift institutions in the mortgage market, a review of functions performed by thrift institutions, and an assessment of the recent performance and problems of the thrift industry.

## Structure of the Thrift Industry

At the end of 1980, there were 4,613 savings and loan associations with total assets of $629 billion. Nearly half of these associations, holding about 55 percent of the assets of the savings and loan industry, had federal charters and were regulated by the Federal Home Loan Bank Board; the balance were chartered by the states in which they operated and were regulated by agencies of state governments. Most savings and loans are mutual organizations, having depositors as owners, and the remainder are owned by stockholders. All federal associations, and most state-chartered associations, have deposits insured by the Federal Savings and Loan Insurance Corporation.2/

Mutual savings banks operate in 17 states, concentrated in the Middle Atlantic and New England regions. At the end of 1980, there were 462 savings banks with $172 billion in total assets. All of these institutions are of the mutual form and most have state charters; in fact, savings banks were not permitted to convert to federal charters until 1978. Mutual savings banks generally are regulated by the states where they are chartered and by the Federal Deposit Insurance Corporation, which insures deposits at most of these institutions.3/

## Thrift Institutions in the Mortgage Market

The assets of savings and loan associations traditionally have been heavily concentrated in residential mortgage instruments. Despite a slight downward trend evident since the early 1950s, mortgage assets (including mortgage pass-through securities) still account for more than three-fourths of the total assets of the associations (Figure 2). Because of this investment orientation and the substantial long-term growth of the industry, the savings and loan share of the residential mortgage market had an upward trend through the 1970s. The share of total mortgage assets accounted for by these associations reached 45 percent in the late 1970s but has receded since then (Figure 3).

2/Some institutions in four states (Maryland, Massachusetts, North Carolina, and Ohio) are insured by corporations chartered by the state governments.

3/Some savings banks in Massachusetts have deposits insured by the Mutual Savings Central Fund, Inc.

Figure 2
Residential Mortgages as a Percent of Total Assets

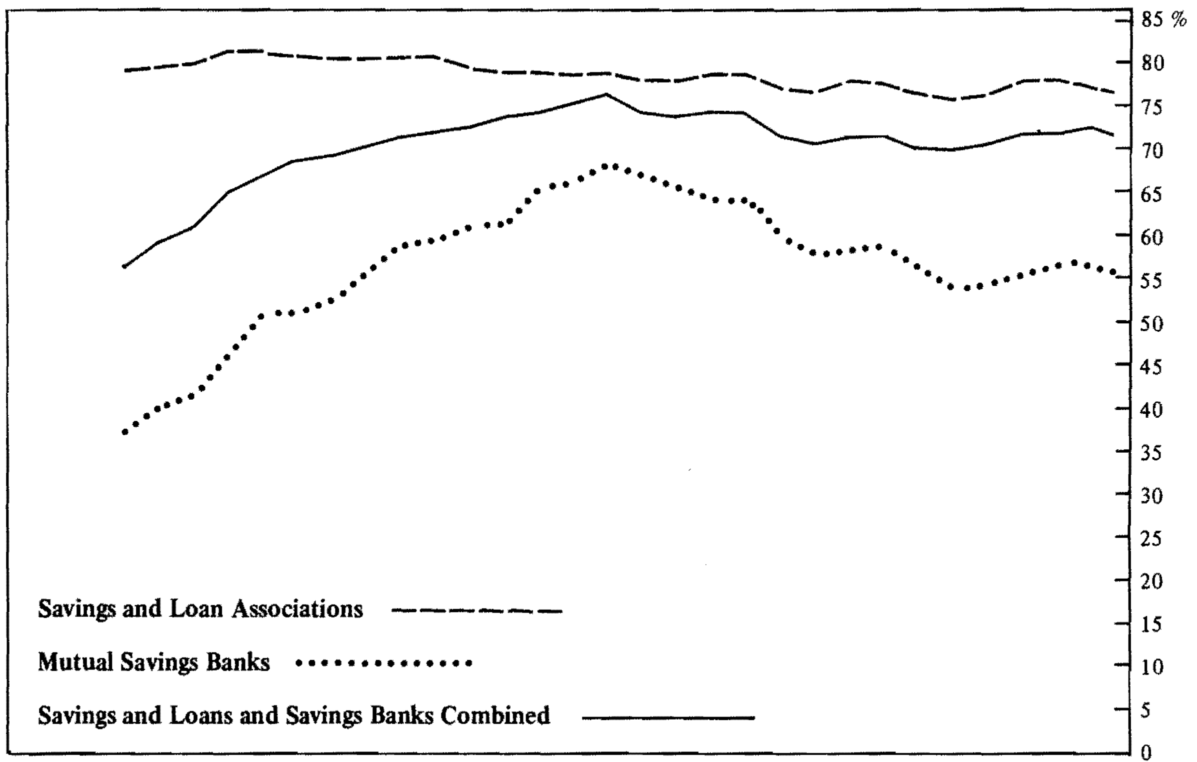
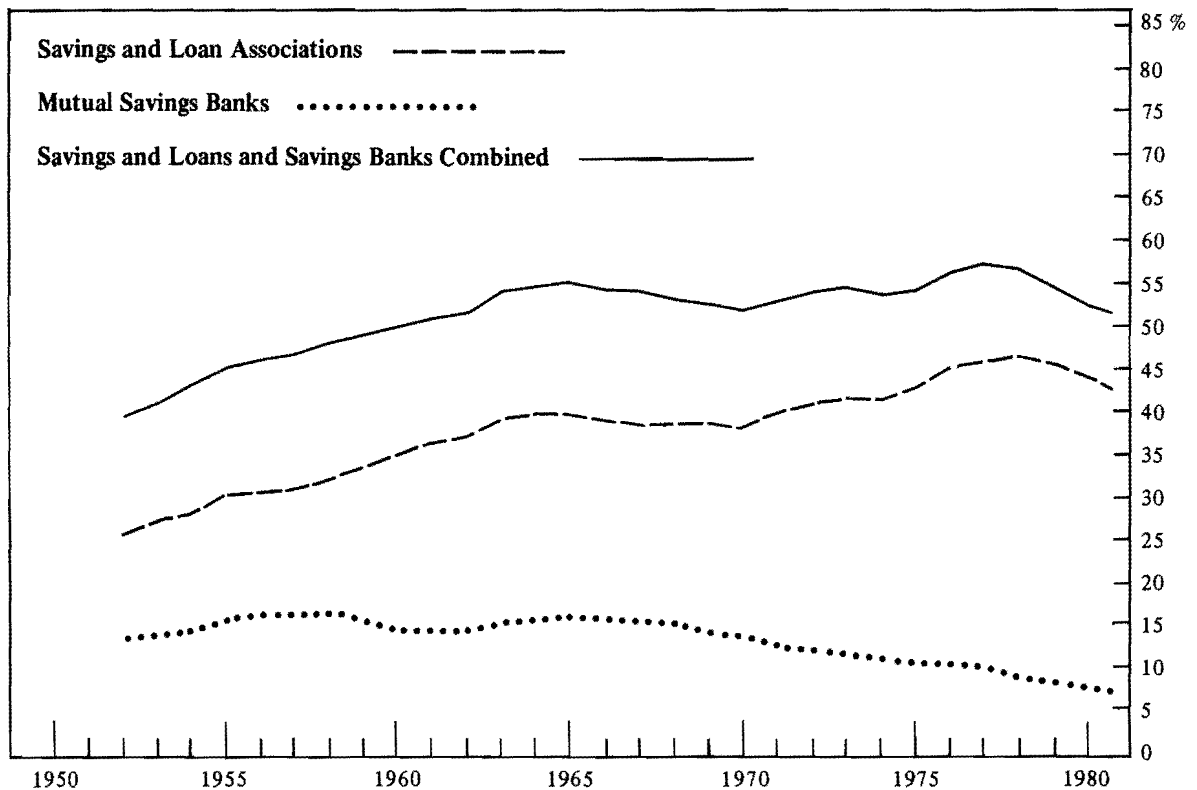



Figure 3
Residential Mortgages as a Percent of Total Mortgages Outstanding




Note: Federally related pass-through securities are included in both residential mortgages at thrift institutions and total mortgages outstanding.

Sources: Federal Home Loan Bank Board; National Association of Mutual Savings Banks; and Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

The share of total residential mortgage assets held by mutual savings banks has fallen markedly since the mid-1960s for two reasons: the ratio of residential mortgages to total assets has declined somewhat, and total industry assets have grown relatively slowly. The decline in the importance of residential mortgages in the portfolios of mutual savings banks reflected, in part, relatively weak demands for mortgage credit in the local markets served by these institutions. Moreover, until 1980, state-imposed mortgage rate ceilings were relatively low in the primary mortgage markets served by the mutual savings banks, and state restrictions limited their purchase of mortgages originated in other areas.

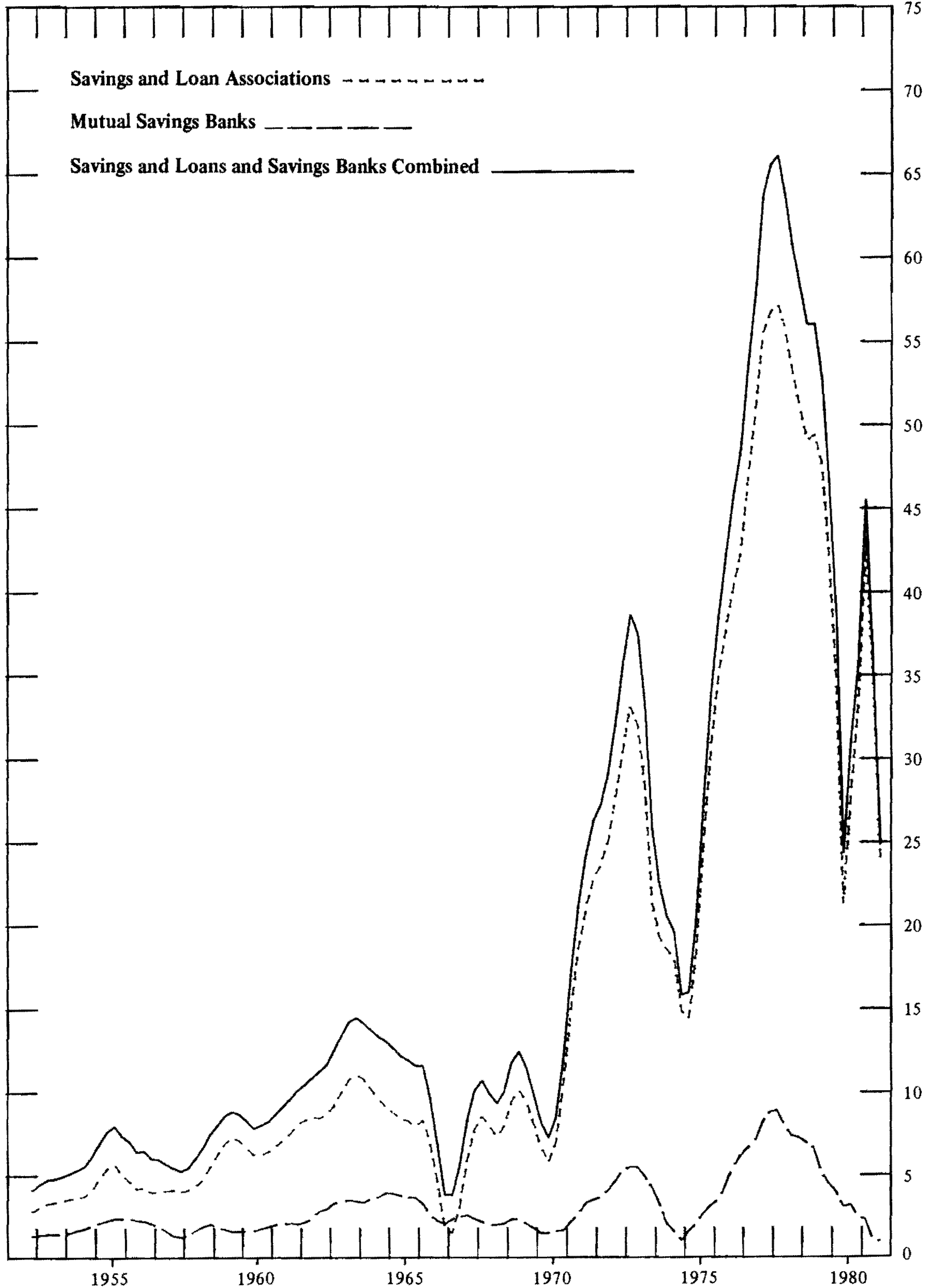
Since the mid-1960s, savings and loan associations and mutual saving banks, combined, have accounted for roughly 55 percent of total residential mortgage assets, on average. The importance of federal and federally related credit agencies operating in the mortgage markets increased moderately during this period, and agencies held nearly 10 percent of the total at the end of 1980. The balance, amounting to more than a third, is held by state and local government credit agencies and diversified private institutions such as commercial banks, life insurance companies, and pension or retirement funds.

Net acquisitions of mortgage assets by thrift institutions have fluctuated widely during the interest rate cycles recorded since the mid-1960s (Figure 4). A substantial degree of fluctuation is inevitable, of course, because the quantity of mortgage credit demanded is highly sensitive to interest rate variations. However, mortgage lending at thrifts has declined more sharply than total mortgage lending during periods of high and rising interest rates -- 1966-1967, 1969-1970, 1973-1974, and 1979-1981. To some degree, these relative declines have reflected the downward trend in the mutual savings bank share of the market as well as support provided by the federal and related credit agencies operating in the secondary mortgage markets. But a marked reduction in the supply of loanable funds at thrift institutions also has been a major factor, particularly during the most recent episode. Weakness in supply at the thrifts has occurred as deposit rate ceilings or inadequate earnings have prevented them from competing effectively in the markets for funds.

## Functions Performed by Thrift Institutions

Thrift institutions traditionally have operated as financial intermediaries between households as depositors and households as mortgage borrowers. In this role, the thrifts have performed two major functions: denomination intermediation and maturity intermediation. With the benefit of deposit insurance, moreover, the thrifts have enabled depositors to lend, indirectly, to mortgage borrowers without concerns about default risk.

**Figure 4**
**Net Change in Residential Mortgage Assets at Thrift Institutions**




Note: Mortgage assets include federally related pass-through securities.

Sources: Federal Home Loan Bank Board; National Association of Mutual Savings Banks; and Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

When engaging in denomination intermediation, thrifts gather the small savings of many households and, in turn, make large mortgage loans available to borrowers; this is a valuable service for both borrowers and lenders, and does not subject the institution to risk. In the case of maturity intermediation, the thrift institutions accept short-term deposits, which are preferred by most savers, and make long-term mortgage loans that meet the needs of households who are purchasing durable assets with long service lives. When the mortgages carry yields that are fixed for the lives of the loans, the process of maturity intermediation clearly exposes the institution to risks associated with changing market interest rates.

A balance sheet composed of short-term liabilities and long-term fixed-rate assets need not cause problems for an institution, despite its asymmetrical structure, if a number of conditions are fulfilled. As long as yields on the long-term assets exceed the average of short-term rates prevailing during the lives of these assets, the institution will generate positive profits, on average. In this case, proper management of reserve accounts can enable the institution to compete effectively for funds at all stages of the interest rate cycle, assuming that rate ceilings do not prevent the payment of competitive rates on liabilities. For this strategy to work, however, long-term interest rates prevailing in the market at any given time must embody expectations of future levels of short-term rates that are not biased downward. Also, prepayment charges must be sufficient to compensate mortgage holders for the loss of income associated with refinancings by borrowers in periods of relatively low interest rates, and mortgage holders must be able to enforce due-on-sale clauses in periods of relatively high market rates.[4]

## Recent Performance of Thrifts

For many years, maturity intermediation was a profitable function for depository institutions because long-term yields generally exceeded short-term yields -- this was the "normal" shape of the yield curve -- and market expectations of future rate movements were reasonably accurate. During the past decade, however, long periods of flat or inverted yield curves have been encountered and the market has systematically underestimated future levels of short-term interest rates. Under these conditions, balance sheets composed of short-term liabilities and long-term assets inevitably generate losses over a protracted period of time. During the first half of 1981, for example, the average rate of return on mortgages held by savings and loan associations was 9.72 percent, while the average cost of funds was 10.31 percent.

4/Mortgage contracts need not, of course, contain due-on-sale clauses. When these clauses are absent, the interest rate paid by the borrower should be higher to reflect the value of the option he owns, i.e., the option to sell the loan to a new buyer in a rising interest rate environment.

This type of relationship between return and cost has led to a large decline in net earnings at savings and loan associations and mutual savings banks (Table 3). From the historically high levels reached in 1978, profit rates for these industries have turned negative, a development that inevitably has led to a reduction in capital positions (Table 4). The loss of profitability has been associated not only with market interest rate developments but also with an erosion of the ability of regulators to manage the structure of deposit rate ceilings in order both to limit deposit outflows and hold down the average cost of deposits at the thrifts.

Although net earnings have turned negative and net worth has been declining, most thrift institutions have been able to maintain their operations. The assets of the thrift industry are high in quality and generate large and predictable cash flows that generally have been more than adequate to meet current payment obligations. Moreover, most of the institutions still have substantial amounts of liquid assets, and have continued to add to their mortgage portfolios; these liquid assets and recently acquired mortgages and pass-through securities serve as additional sources of liquidity that can be tapped, if needed, without booking capital losses. Thus a widespread liquidity crisis has not emerged at thrift institutions.5/ It is essential, of course, that public confidence in the ability of the supervisory authorities to protect the interests of insured depositors and other creditors against default be maintained; otherwise, withdrawals of funds from the institutions could create severe liquidity problems.

5/ Some mutual savings banks that had invested substantial amounts of funds in long-term bonds have encountered serious liquidity problems, because the bonds do not provide amortization of principal.

## Table 3

## Profitability of Thrift Institutions, 1961-1981

(Retained Earnings as Percent of Average Total Assets)

| Year | Savings and Loan Association | Mutual Savings Banks |
|---|---|---|
| 1961-1965 | 0.80% | 0.45% |
| 1966-1970 | 0.56 | 0.30 |
| 1971-1975 | 0.65 | 0.47 |
| 1976 | 0.64 | 0.45 |
| 1977 | 0.79 | 0.55 |
| 1978 | 0.84 | 0.58 |
| 1979 | 0.68 | 0.46 |
| 1980 | 0.14 | -0.12 |
| 1981[a] | -0.49 | -0.64 |

[a]/First half results at annual rates.

Sources: National Association of Mutual Savings Banks, 1981 National Fact Book of Mutual Savings Banking (1981), p.39; National Association of Mutual Savings Banks, "Research Analysis of Monthly Savings Bank Trends" (August 25, 1981), p. 6; and Federal Home Loan Bank Board, news release (September 29, 1981). For savings and loan associations, 1961-1975 data apply to institutions insured by the Federal Savings and Loan Insurance Corporation and 1976-1981 data apply to all institutions.

Table 4

Capital Position of Thrift Institutions, 1960-1981

(Net Worth as a Percent of Assets)

| End of Year | Savings and Loan Association | Mutual Savings Banks |
|---|---|---|
| 1960 | 6.97 | 8.75 |
| 1965 | 6.72 | 8.01 |
| 1970 | 7.04 | 7.25 |
| 1971 | 6.60 | 7.07 |
| 1972 | 6.27 | 6.91 |
| 1973 | 6.27 | 7.12 |
| 1974 | 6.24 | 7.27 |
| 1975 | 5.85 | 6.96 |
| 1976 | 5.61 | 6.71 |
| 1977 | 5.48 | 6.77 |
| 1978 | 5.55 | 6.90 |
| 1979 | 5.64 | 7.05 |
| 1980 | 5.29 | 6.63 |
| 1981[a] | 4.88 | 6.21 |

[a] June 30.

Sources: National Association of Mutual Savings Banks, 1981 National Fact Book of Mutual Savings Banking (1981), p. 10; National Association of Mutual Savings Banks, "Research Analysis of Monthly Savings Bank Trends" (August 25, 1981), p. 6; and Federal Home Loan Bank Board, "Savings and Loan Activity in September" (October 30, 1981).

# Chapter 3

# ASSET AND LIABILITY POWERS OF HOUSING FINANCE INSTITUTIONS

The structure of liabilities at mortgage lending depository institutions has changed substantially since the mid-1960s. The changes have been associated with the management of deposit rate ceilings by regulators, the creation of new types of accounts, and an expansion in nondeposit borrowing powers. Until 1978, regulators were able to limit increases in the cost of funds to the institutions during periods of rising market rates and to lengthen the average maturity of their deposits. Since then, however, the maturity structure of liabilities has shortened considerably and a major share of liabilities now bear competitive market yields. Recent large increases in market interest rates thus have greatly increased the cost of funds to the institutions.

The asset side of balance sheets, however, has been slow to change. Long-term, fixed-rate mortgages continue to account for the lion's share of total assets at institutions that traditionally have specialized in mortgage finance. The substantial mismatch in the maturity structures of assets and liabilities at such institutions, together with the fact that rate expectations embodied in long-term mortgage contracts written in the past were much too low, has led to the sharp deterioration in net earnings. State efforts to prevent the enforcement of due-on-sale clauses in outstanding mortgage contracts have exacerbated the situation.

The problems are most acute for the thrift institutions whose deposit and lending powers have been tightly circumscribed by law and regulation. Many commercial banks have chosen to specialize in mortgage lending and to rely heavily on household deposits, and they too are encountering profit difficulties. But because commercial banks already possess a wide range of asset and liability powers denied to the thrifts, the focus of the Commission's work in this area has been on the savings and loan associations and mutual savings banks. This chapter therefore reviews the liability and asset structure of thrift institutions and presents recommendations for change.

## Regulation Q and Thrift Liability Structure

The structure of thrift liabilities has been heavily influenced by the management of deposit rate ceilings by the regulatory authorities. Adjustments to the structure of rate ceilings have been made during each of the cyclical upswings in market interest rates since 1966 in order to enhance the competitive position of deposits vis-a-vis market instruments. Until the mid-1970s, certificates were introduced with higher ceiling rates but also longer maturities, allowing thrifts to retain some rate-sensitive deposits without having to raise rates paid to those depositors who left funds in one of the existing accounts. The introduction of higher-rate certificate accounts thus accomplished a significant lengthening of the average maturity of thrift liabilities, and stiff early withdrawal penalties further helped to protect the thrifts against instability in the volume and cost of deposits.

The ability of the regulators sucessfully to pursue this policy was fully dissipated in the closing years of the 1970s. Money market mutual funds and other market instruments became major competitors with deposits for the savings of households. In response to this competition, the regulators in June 1978 authorized the six-month money market certificate with a rate ceiling tied to six-month Treasury bill rates and a minimum denomination of $10,000. In January 1980, the small savers certificate, with a minimum maturity of 30 months and a ceiling rate that varied with the yields on comparable-maturity Treasury securities, was introduced partly to help counteract the shortening of deposit liabilities that resulted from the popularity of the money market certificate.1/

The effect of the changing deposit rate structure on the composition of thrift liabilities has been striking (Tables 5 and 6). At the end of 1966, 94 percent of the total interest-bearing liabilities of savings and loan associations were subject to fixed ceilings, and the bulk of these funds were in passbook accounts. The introduction of longer-term time deposits with higher rate ceilings resulted in a marked shift from savings to small time deposits until mid-1978, when money market certificates were introduced and market yields rose above rates payable on all fixed-ceiling accounts. By September of 1981, only 30 percent of savings and loan liabilities were in deposits with fixed-rate ceilings, while 48 percent of liabilities were in accounts with ceilings tied to Treasury securities rates. In addition, 22 percent of savings and loan liabilities were in forms not subject to any type of rate ceiling.

The growth of money market certificates, small savers certificates, large-denomination time deposits, and market borrowings has largely freed thrift institutions from the constraints of deposit rate ceilings and has resulted in a sharp rise in the average cost of funds to these institutions. The one-year, tax-exempt "all savers" certificates, authorized on a temporary basis by the Economic Recovery Tax Act of 1981, also have market-determined ceilings, but the thrifts have to pay only 70 percent of the one-year Treasury bill yield for these funds. Early experience with the "all savers" certificates, however, indicates that significant portions of the funds flowing into these accounts represent transfers from fixed-ceiling accounts at lower interest rates.

Title II of the Depository Institutions Deregulation and Monetary Control Act (DIDMC) of 1980 mandated a phased removal of all deposit rate ceilings. To implement the purposes of Title II, the Depository Institutions Deregulation Committee (DIDC) was established, comprised of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Board of

1/The small savers certificate was first introduced in June 1979 as a four-year certificate with no minimum denomination but with a ceiling rate set considerably below comparable-maturity Treasury yields.

Table 5

Distribution of Interest-Bearing Liabilities at Savings and Loan Associations, 1966-1981

(Percent)

| | Dec. 1966 | Dec. 1969 | Dec 1973 | Dec. 1974 | Dec. 1978 | Dec. 1980 | Sept. 1981 |
|---|---|---|---|---|---|---|---|
| NOW Accounts | -- | -- | -- | -- | 0.1% | 0.1% | 1.1% |
| Passbook Savings | 83.1% | 64.1% | 43.5% | 40.1% | 29.3 | 19.1 | 15.6 |
| Fixed-Ceiling Time | 10.9 | 29.7 | 48.7 | 49.4 | 50.6 | 23.0 | 13.0 |
| Total Subject to Fixed Ceilings | 94.0 | 93.8 | 92.2 | 89.5 | 80.0 | 42.2 | 29.7 |
| Money Market Certificates | -- | -- | -- | -- | 8.4 | 30.7 | 34.3 |
| Small Saver Certificates | -- | -- | -- | -- | -- | 9.3 | 13.8 |
| Total Subject to Market-Determined Ceilings | -- | -- | -- | -- | 8.4 | 40.0 | 48.1 |
| Large-Denomination Time Deposits | -- | -- | 1.2 | 1.7 | 3.1 | 7.0 | 7.7 |
| Other Borrowings (Except FHLB[a]/ Advances) | 0.4 | 0.3 | 0.8 | 1.2 | 2.2 | 2.9 | 4.2 |
| FHLB Advances | 5.6 | 5.9 | 5.8 | 7.6 | 6.3 | 7.9 | 10.3 |
| Total Not Subject to Rate Ceilings | 6.0 | 6.2 | 7.8 | 10.5 | 11.6 | 17.8 | 22.2 |

[a]/Federal Home Loan Banks.

Source: Federal Home Loan Bank Board.

Table 6

Distribution of Interest-Bearing Liabilities at Mutual Savings Banks, 1966-1981

(Percent)

| | Dec. 1966 | Dec. 1969 | Dec 1973 | Dec. 1974 | Dec. 1978 | Dec. 1980 | Sept. 1981 |
|---|---|---|---|---|---|---|---|
| NOW Accounts | -- | -- | 0.1% | 0.2% | 0.7% | 1.0% | 2.4% |
| Passbook Savings | 94.5% | 91.7% | 67.6 | 64.9 | 50.2 | 34.5 | 30.2 |
| Fixed-Ceiling Time | 4.9 | 7.7 | 31.3 | 33.4 | 38.5 | 22.0 | 12.3 |
| Total Subject to Fixed Ceilings | 99.4 | 99.4 | 99.0 | 98.5 | 89.4 | 57.5 | 44.9 |
| Money Market Certificates | -- | -- | -- | -- | 8.3 | 30.0 | 35.3 |
| Small Saver Certificates | -- | -- | -- | -- | -- | 7.5 | 11.2 |
| Total Subject to Market-Determined Ceilings | -- | -- | -- | -- | 8.3 | 37.5 | 46.5 |
| Large-Denomination Time Deposits | -- | -- | 0.5 | 0.8 | 1.2 | 1.9 | 3.5 |
| Other Borrowings | 0.6 | 0.6 | 0.5 | 0.7 | 1.1 | 3.1 | 5.1 |
| Total Not Subject to Rate Ceilings | 0.6 | 0.6 | 1.0 | 1.5 | 2.3 | 5.0 | 8.6 |

Sources: National Association of Mutual Savings Banks and Board of Governors of the Federal Reserve System.

Directors of the Federal Deposit Insurance Corporation, the Chairman of the Federal Home Loan Bank Board, and the Chairman of the National Credit Union Administration as voting members, and the Comptroller of the Currency as a nonvoting member.

The Deregulation Committee has been directed by Congress to increase to market rates, as soon as feasible, all limitations on the maximum rates of interest and dividends that may be paid on deposits and accounts. As of March 31, 1986, authorities to impose interest rate ceilings on deposits by any of the federal financial regulatory agencies are to be repealed; all authorities that had been transferred to the Deregulation Committee will become ineffective and the committee shall cease to exist.

Congress gave the DIDC little guidance as to how to proceed with deregulation and, in fact, the basic thrust of Title II has been subject to different interpretations: some have viewed the legislation as a clear mandate to eliminate rate ceilings while others view the act as a six-year extension of Regulation Q and the rate differential in favor of thrifts. The DIDC has attempted major forms of deregulation of deposit rates on two occasions, but the committee was challenged in the courts in both cases. At this time, the prospects for deposit rate deregulation by the committee are uncertain. However, if the shift in deposit mix toward rate-sensitive instruments continues, fixed ceilings may apply to only a small proportion of thrift liabilities by 1986.

## Asset Structure at Thrifts

The earnings problems encountered by thrifts, and the fact that short-term market yields generally have been close to or above long-term yields, have encouraged the institutions to move unusually large amounts of funds into short-term nonmortgage assets during the past two years in order to maximize short-run returns and minimize interest rate risk. However, thrift assets still are heavily concentrated in long-term, fixed-rate forms, many of which were acquired when interest rates were much lower. At the end of 1980, in fact, long-term mortgages bearing interest rates below 10 percent accounted for two-thirds of all mortgages held by savings and loan associations; the proportion was even larger for mutual savings banks. The concentration of low-rate mortgages is greatest in areas where turnover of the housing stock has been relatively slow or where state ceilings on mortgage interest rates have been relatively low.2/ The problem is most acute in the northeastern part of the country, particularly New York (Tables 7 and 8).

2/The DIDMC Act of 1980 preempted state ceilings on home mortgage rates, subject to reimposition by the states within three years.

Table 7

Low-Rate Residential Mortgages as Percent of All Residential Mortgages Held by Savings and Loan Associations, by Federal Home Loan Bank District, 1980

| Federal Home Loan Bank District | Less than 6% | Less than 7% | Less than 8% | Less than 9% | Less than 10% |
|---|---|---|---|---|---|
| Boston | 4.7% | 9.0% | 19.5% | 47.4% | 71.8% |
| New York | 4.2 | 10.0 | 27.5 | 64.2 | 86.2 |
| Pittsburgh | 1.5 | 5.1 | 16.5 | 45.9 | 75.5 |
| Atlanta | 1.0 | 3.8 | 13.9 | 43.9 | 71.4 |
| Cincinnati | 1.0 | 4.7 | 13.9 | 41.2 | 68.2 |
| Indianapolis | 1.6 | 4.7 | 14.0 | 39.4 | 67.0 |
| Chicago | 1.3 | 4.8 | 13.7 | 34.8 | 61.5 |
| Des Moines | 1.8 | 5.4 | 15.8 | 41.4 | 74.9 |
| Topeka | 1.2 | 4.0 | 11.8 | 30.9 | 62.3 |
| Little Rock | 1.2 | 3.7 | 11.9 | 33.1 | 79.3 |
| San Francisco | 0.3 | 3.8 | 11.7 | 23.1 | 52.7 |
| Seattle | 0.6 | 3.1 | 10.0 | 24.4 | 56.2 |
| All Savings and Loan Associations | 1.3 | 4.6 | 14.1 | 37.0 | 66.7 |

Source: U.S. League of Savings Associations.

Table 8

Low-Rate Residential Mortgages as Percent of All Residential Mortgages Held by Mutual Savings Banks, by State, 1979

| State | Less than 7% | Less than 8% | Less than 9% |
|---|---|---|---|
| New York | 23.2% | 44.7% | 79.7% |
| City | 26.1 | 49.0 | 78.9 |
| Upstate | 15.3 | 33.0 | 81.9 |
| Massachusetts | 12.1 | 27.5 | 62.2 |
| Boston | 22.3 | 39.4 | 72.0 |
| Other | 9.9 | 24.9 | 60.0 |
| Connecticut | 7.7 | 21.2 | 58.3 |
| Pennsylvania | 21.0 | 38.8 | 67.3 |
| New Jersey | 8.1 | 22.2 | 62.8 |
| Washington | 7.6 | 20.9 | 35.5 |
| New Hampshire | 8.1 | 18.4 | 44.2 |
| Maine | 6.8 | 18.2 | 47.5 |
| Rhode Island | 10.4 | 24.3 | 60.3 |
| Maryland | 14.2 | 31.7 | 59.5 |
| Vermont | 6.1 | 22.4 | 52.0 |
| All Savings Banks | 17.4 | 35.5 | 69.2 |

Source: National Association of Mutual Savings Banks.

Prepayment of mortgage principal at par has slackened because of both declining sales of existing homes and widespread assumptions of outstanding low-rate loans; some of the assumptions have occurred as a result of state actions to prevent the enforcement of due-on-sale clauses in outstanding mortgage contracts. These factors have driven the mortgage turnover rate at savings and loan associations to an historically low level. Moreover, the associations have not been able to dispose economically of the seasoned low-rate mortgages held in their portfolios because sales during periods of high market rates require them to book capital losses, in the year of the sale, against current operating income and net worth.[3] Largely because of this factor, net sales (sales less purchases) of mortgage assets (including pass-through securities) by the savings and loan industry have been small or negative in recent years.

The asset powers of federally chartered thrift institutions have been expanded significantly during the past two years. The DIDMC Act 1980 authorized federally chartered savings and loans to invest up to 20 percent of assets in consumer loans, commercial paper, and corporate debt securities; to offer credit card services; and to exercise trust and fiduciary powers. Federal associations also were authorized to make second mortgage loans, to originate residential mortgage loans without geographic restrictions, and to invest in open-end investment companies where portfolios are restricted to eligible investments. Federal mutual savings banks, in addition, were permitted to invest 5 percent of their assets in commercial, corporate, and business loans made within their states or within a 75-mile radius of their home offices.

A series of regulatory changes, made largely in response to the marked shortening of thrift liabilities, has permitted federal thrift institutions to offer a variety of adjustable-rate home mortgages (ARMs), and the federal preemption of state mortgage rate ceilings -- authorized by the DIDMC Act of 1980 -- removed an important practical impediment to ARM expansion. In April 1981, revised ARM regulations were issued for federally chartered savings and loan associations and federal mutual savings banks. These regulations override any state laws or regulations on the subject and permit large interest rate adjustments as well as a great deal of latitude for negotiation of terms between borrowers and lenders. Because of the record high levels of interest rates, the financial plight of thrift institutions, and some confusion among potential borrowers faced with a wide variety of mortgage instruments, however, issuance of adjustable-rate home mortgages under the new regulations has been modest. At mid-1981, adjustable-rate mortgages of all types accounted for only about 6 percent of total mortgages held by the savings and loan industry, and many of these loans were contracts with limited rate flexibility that had been acquired by state-chartered institutions (particularly in California) during the latter years of the 1970s.

[3] The Federal Home Loan Bank Board recently changed its regulatory accounting procedures to permit savings and loans to amortize the loss on sales of mortgages over the expected life of the mortgages. The Commission has appointed a Taxation Task Force to evaluate ways for the institutions to move low-rate assets off their books without incurring large losses in the period of disposition.

## Recommendations

The Commission recognizes that the thrift industry has not yet fully utilized the expanded asset powers recently provided by legislation and regulation. This has been a function of two factors: first, the current economic distress of the industry and, second, the concentration of management expertise in mortgage finance. Over the long term, many institutions will need a much broader range of investment opportunities if they are to pay competitive market rates for funds and be able to adapt to shifting conditions in local, regional, and national markets. Such powers should foster a stronger thrift industry and, consequently, provide a more stable supply of residential mortgage credit.

It is expected that the institutions would utilize these powers only gradually during a period of transition; thus, expanded operating powers probably would do little to solve the short-term problems of thrift institutions. Recommendations dealing with short-term thrift problems are being developed by the Commission's Present Housing Issues Committee and will be contained in the Final Report.

The commercial banking industry has had much broader asset and liability powers than thrift institutions in the past. Nevertheless, some expansion of the powers of banks to acquire mortgage loans and invest in real estate would benefit the housing industry. Expanded powers for both thrifts and commercial banks should contribute to development of the housing finance system.

The Commission, therefore, makes the following recommendations concerning the asset, liability, and service powers of depository institutions:

A. Savings and loan associations and mutual savings banks (thrift institutions) should have powers sufficient to enable them to serve the deposit and credit needs of all sectors of the economy, including expanded authority to:

   1. Accept demand deposits from all types of customers.

   2. Invest in secured and unsecured consumer loans.

   3. Invest in secured and unsecured commercial and agricultural loans as well as commercial paper and other corporate debt instruments.

   4. Invest in municipal securities, including both revenue bonds and general obligations.

   5. Invest in residential and nonresidential real estate loans, whether first or junior liens, without loan-to-value restrictions or mortgage insurance requirements.

B. The powers of thrift institutions also should be expanded in the following areas, subject to percent-of-asset limitations and regulatory supervision:

   1. Direct investment in real estate of various types, including joint ventures with developers.

   2. Investment in service corporation affiliates.

   3. Equipment leasing.

C. The powers of commercial banks to invest in residential mortgages and real estate should be clarified and expanded, in order that banks can continue their important role in housing finance and be competitive with other institutions such as thrifts and investment banks:

   1. The statutory framework governing the real estate lending powers of banks should be reviewed and updated to reflect current market realities and needs.

   2. Direct investment by banks in real estate should be permitted, including joint ventures with developers (subject to percent-of-asset limitations and regulatory supervision).

   3. Banks should be permitted to establish service corporations, similar to those in the savings and loan industry, in order to facilitate the activity of smaller, community-oriented banks in real estate investment, secondary mortgage market operations, and a broad array of financial activities.

D. Thrift institutions and commercial banks should be provided, where necessary, with the following powers:

   1. Adequate authority to engage in activities incidental to the exercise of authority conferred by law.

   2. Authority to make over-the-counter sales of certificates backed by mortgages or by equities in real estate, with or without recourse.

   3. Authority to make over-the-counter sales of interests in the loans originated and held by them, subject only to the regulations of their respective supervisors and the federal deposit insurers.

# Chapter 4

## TAX INCENTIVES FOR MORTGAGE INVESTMENT

The federal tax code can be used to influence the investment patterns of individuals and institutions and to alter the allocation of financial and physical capital in the economy. The existing tax law provides a strong incentive for thrift institutions to concentrate their assets in residential mortgage instruments, and some relaxation of these provisions is in order as part of a coherent public policy to broaden the mode of operation of the thrifts. In turn, any tax benefits tied to mortgage investment could be made available to a variety of financial institutions to help insure an orderly transition to a more broadly based housing finance system.

The following discussion analyzes the special bad debt deduction currently available to thrift institutions and discusses alternative tax incentives for mortgage investors, the effect of tax incentives on the supply and cost of mortgage credit, and the relationship between tax avoidance devices and tax incentives for mortgage investment. Finally, the recommendations of the Commission are presented.

### The Special Bad Debt Deduction for Thrifts

Present federal tax law encourages thrift institutions to invest heavily in residential mortgages. The investment incentive is provided in the form of a special bad debt reserve deduction available only to thrifts. Specifically, Section 593 of the Internal Revenue Code of 1954, as amended (26 U.S.C. ¶ 593), provides that a thrift institution may deduct as much as 40 percent of its taxable income as a noncash addition to its bad debt reserve if a specified percentage of its assets is held in mortgages or other qualifying assets.1/

To qualify for the maximum 40 percent bad debt deduction, a savings and loan association must have 82 percent of its total assets in qualifying forms; for mutual savings banks, 72 percent of assets must be in qualifying forms. As the percentage of qualifying assets held by a thrift institution falls, the 40 percent rate is reduced incrementally. For savings and loans, the 40 percent rate is reduced by 3/4 of 1 percentage point for each percentage point the ratio of qualifying assets to total assets falls below 82 percent, and the special deduction cuts off completely at a 60 percent investment

1/Qualifying assets are defined in the Internal Revenue Code as follows: residential real property loans; cash; federal government obligations; loans secured by members' deposits; loans secured by church, school, health and welfare facilities, or commercial property located in an urban renewal or model cities area; student loans; and property used in the conduct of the institution's business.

level. For mutual savings banks, the 40 percent rate is reduced 1.5 percentage points for each percentage point below 72 percent, and cuts off completely at a 50 percent investment level. 2/

The special bad debt reserve provision can be a significant barrier to asset diversification at thrift institutions. Nonqualifying investments would have to provide net pre-tax yields substantially higher than yields available on qualifying assets in order to make up for the additional taxes that would be incurred through diversification.3/ And as long as financial markets are reasonably efficient, it is difficult for an investor to find one type of instrument that consistently has an expected net yield higher than another, after taking into account differences in lending and servicing costs as well as nonrate attributes such as maturity, call or prepayment options, default risk, and liquidity or marketability.4/

In view of the maturity structure of thrift liabilities and the increased interest rate variability evident in recent years, these institutions might be willing to sacrifice some after-tax yield in order to reduce interest rate risk, and there may be some cross-selling benefits to be derived from moving into areas such as consumer lending. Asset diversification by thrifts is liable to be quite limited, however, unless they are permitted to qualify for tax advantages at lower levels of mortgage investment.5/ Indeed, the Interagency Task Force on Thrift Institutions noted that retention of the special bad debt provision in its current form could discourage thrifts from utilizing roughly half of the rather modest expansion of asset powers provided by the Depository Institutions Deregulation and Monetary Control Act of 1980. 6/

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2/Many commercial banks would qualify for the special bad debt allowance on the basis of their ratios of qualifying-to-total assets. More than 1,100 banks have ratios greater than 60 percent, although most of these are small banks with assets of less than $100 million.

3/The Interagency Task Force on Thrift Institutions estimated that nonqualifying assets would have to provide a net pre-tax yield 52 percent higher than available on qualifying assets in order for a savings and loan association to be indifferent to a shift in its qualifying-to-total assets ratio from 82 to 81 percent; nonqualifying assets would have to provide even greater yields, relative to qualifying assets, for an institution to further reduce its ratio. (Report of the Interagency Task Force on Thrift Institutions, June 30, 1980, pp. 109-112)

4/Studies of the consumer loan market, for example, suggest that the net pre-tax rate of return on consumer loans is not significantly different from the net return on residential mortgages, despite substantially higher gross yields on some types of consumer loans.

## Alternative Tax Incentives

Special bad debt reserve provisions are not the only types of tax incentives that could be used to encourage investment in mortgages. The Hunt Commission recommended that a mortgage interest tax credit (MITC), equal to a percentage of the interest income earned on residential mortgages, be granted to all investors in such loans. This provision was intended as a direct incentive to insure the flow of capital into housing finance; it was meant to replace the indirect incentive provided through the special provisions for loan losses at thrift institutions; and it was viewed as a way to compensate thrift institutions for the loss of tax benefits that would come with elimination of the special bad debt reserve deduction. Thus, compensation was deemed appropriate despite the fact that the Hunt Commission package of proposals provided substantially broader asset and liability powers for thrifts.

The Hunt Commission recommended a multi-level MITC that would have provided higher rates of tax credit for institutions with higher percentages of their assets in residential mortgages, but the Commission did not attempt to establish specific rates and investment levels. The Financial Institutions Act of 1975, passed by the Senate but not by the House, would have eliminated the special bad debt allowance for thrifts and made a progressive MITC available to a broad range of investors. The Senate formulation of the MITC, however, had a number of drawbacks. Thrift institutions actually would have been discouraged from utilizing the expanded asset powers contained in the Act. Moreover, the provision would have provided little or no mortgage investment incentive for institutions with low or zero marginal tax rates -- such as life insurance companies and pension funds.

5/Some mutual savings banks have given up portions of their tax advantages in order to diversify their assets. However, many savings banks are located in areas where extremely low mortgage rate ceilings and restrictions on purchases of mortgages originated in other states made mortgage assets relatively unprofitable even before interest rates rose to recent high levels.

6/Report of the Interagency Task Force on Thrift Institutions, pp. 109-110.

## Tax Provisions and the Supply and Price of Mortgage Credit

The special bad debt deduction for thrifts often has been viewed as a stimulus to housing finance that has resulted in lower mortgage interest rates for home borrowers. It is true that the tax provision allows thrifts to derive a higher net yield from mortgages than is available to other investors, but it does not necessarily follow that market yields will thus be lower. Unless the thrifts are able to meet the entire demand for mortgage credit by households -- which has not been possible -- equilibrium before-tax mortgage rates will be determined in the market by the actions of diversified institutions that operate in both mortgage and bond markets and do not have tax benefits tied to mortgages.[7] In this event, the special bad debt deduction simply constitutes a tax subsidy that is captured by thrift institutions. The subsidy may be viewed as a form of compensation to thrifts for restrictions that have been placed upon their asset and liability powers.[8]

A tax benefit tied to mortgage assets and available to all types of investors could result in lower mortgage rates for borrowers. But institutions with low or zero marginal tax rates would derive little or no benefit from a tax deduction or tax credit. Indeed, because the actions of taxable institutions would lower pre-tax mortgage rates relative to pre-tax yields on other capital market instruments, institutions such as life insurance companies and pension funds actually would be discouraged from acquiring mortgage intruments, unless special tax provisions -- such as refundable credits -- also were enacted.

7/For further discussion of this point, see Patric Hendershott and Kevin Villani, "Savings and Loan Usage of the Authority to Invest in Corporate Bonds," in Savings and Loan Asset Management under Deregulation, Federal Home Loan Bank of San Francisco, December 1980.

8/Other types of financial institutions receive tax benefits, but the thrifts are the only institutions whose benefits are tied to mortgages. Pension funds are tax exempt, life insurance companies pay tax on only a portion of their investment income, and commercial banks avail themselves of numerous devices to lower their effective tax rates.

## Tax Avoidance Devices and Tax Incentives

If an otherwise profitable institution can minimize its taxable income through the use of avoidance devices, the effect of special tax deductions or credits on investment decisions obviously will be lessened. An increase in the authority of thrift institutions to engage in equipment leasing, in conjunction with the leasing provisions of the Economic Recovery Tax Act of 1981, possibly could change the tax status of thrift institutions and alter the effects of the special bad debt reserve provisions on their investment policies. In essence, leasing activity could be used as a tax avoidance device, possibly lowering taxable income to the degree that the bad debt provisions would not discourage thrift institutions from using expanded asset powers.

It would be premature, of course, to draw conclusions at this time about the impact of leasing activities on thrift operations over the long run. For instance, competition among lessors (including thrift institutions) could cause a major portion of the tax benefits to accrue to the lessees. Lease payments, for example, could be insufficient to service the debt incurred to purchase capital equipment, requiring the lessor to expend part of the cash flow generated by tax savings to cover the debt payments.

## Recommendations

The Commission believes that provisions of federal tax laws should not discourage thrift institutions from using the expanded operating powers that are recommended elsewhere in this report. It is possible that expanded powers to acquire tax-exempt securities and to engage in the leasing of equipment would diminish the influence of the current special bad debt allowance upon the investment policies of thrift institutions, but the Commission does not believe that it is necessary to depend upon this eventuality.

The Commission recognizes that an abrupt shift away from mortgage assets by thrift institutions, although unlikely, could create a shortfall in the supply of mortgage credit that might not be made up promptly by other types of institutions operating in the primary and secondary mortgage markets. Thus, tax incentives for mortgage investment by thrifts should be retained. Moreover, equivalent tax incentives for mortgage investment should be provided for other types of financial institutions during the period of transition to a more broadly based and resilient housing finance system. This approach would be equitable to all types of institutions, would encourage a variety of lenders such as commercial banks to increase their mortgage holdings, and would help provide for an orderly transition to a stronger housing finance system.

The Commission therefore makes the following recommendations concerning tax incentives for mortgage investment:

A. In order to encourage greater residential mortgage activity by a broad range of institutions, equivalent tax incentives should be provided to all types of investors with similar portfolios.

B. At the same time, the tax law should be amended to permit thrift institutions to reduce the concentration of mortgages in their asset portfolios and still qualify for the same level of tax advantages as in existing law.

These recommendations provide a general framework and the Commission's Task Force on Taxation is studying specific types of tax incentives for mortgage investment. The analysis includes a review of the special bad debt reserve deduction, examination of various forms of mortgage interest tax credit, and consideration of whether tax incentives should be tied to institutions or to mortgage instruments. Tax provisions such as refundable credits also are being considered to encourage greater degrees of mortgage investment by institutions with zero or low marginal income tax rates, such as pension funds and life insurance companies. Detailed recommendations in these areas will be included in the Commission's Final Report.

# Chapter 5

# LAWS AND REGULATIONS AFFECTING HOUSING FINANCE

Numerous federal and state laws and regulations currently inhibit the free flow of funds in mortgage markets and raise the cost of credit to borrowers. The general thrust of the Commission's recommendations is to discourage such barriers and to encourage the uninhibited flow and turnover of funds in mortgage markets. Although a broader range of legal and regulatory issues will be considered as the work of the Commission proceeds, this chapter reviews four areas: due-on-sale clauses in mortgage contracts, the operations of private pension funds, chartering and conversion of depository institutions, and mergers and acquisitions of financial institutions.

## DUE-ON-SALE CLAUSES

As mortgage interest rates have soared at institutional sources, various forms of "creative" seller financing have become more common. According to surveys conducted by the National Association of Realtors, about half of all resale transactions in 1980 and 1981 involved some form of financing technique other than a new first mortgage loan from a financial institution. The most prevalent techniques involve the transfer of outstanding low-rate first mortgages from home sellers to home buyers, often in combination with second mortgages provided by home sellers or third party investors. Another practice involves the creation of "wraparound" mortgages by third party lenders; these loans encompass outstanding low-rate first mortgages and the amount of additional financing needed by buyers.

The increased incidence of loan assumptions and wraparounds has contributed to the slowdown in the rate of turnover of outstanding home mortgages at institutional mortgage lenders, thus reducing the supply of loanable funds available at these institutions and holding down their earnings. Consequently, many lenders have attempted to invoke due-on-sale clauses that are incorporated in most outstanding conventional mortgage contracts (but not in loans insured by the Federal Housing Administration or guaranteed by the Veterans Administration). Efforts by lenders to enforce due-on-sale clauses, in turn, have provoked litigation on behalf of home sellers in a number of states. Seventeen states currently significantly restrict the full exercise of due-on-sale clauses in outstanding home mortgage contracts.

Restrictions upon the exercise of due-on-sale clauses in mortgage contracts clearly benefit home sellers at the expense of holders of the mortgage contracts. Home buyers, however, may actually accrue little, if any, benefit; indeed, in highly competitive markets, selling prices should rise by just enough to eliminate any advantages for buyers.1/ In fact, the use of creative financing eventually

1/This conclusion was reached in a recent report to Congress by the Department of Housing and Urban Development, entitled "An Economic Analysis of Due-on-Sale Clauses" (April 1981).

may create serious financial problems for homebuyers. The National Association of Realtors reports that the bulk of the second mortgages made in conjunction with assumptions of first mortgages have terms of only three to five years, have monthly payments covering interest only, and require a balloon payment of the entire principal amount upon maturity; thus, these loans apparently were viewed by borrowers as a way to "buy time" until conditions in institutional mortgage markets improved. It also appears that many home sellers took back second mortgages at below-market rates in order to get higher prices for their homes, adding an additional artificial element to home prices. If market interest rates do not decline substantially, many homeowners may have difficulty arranging full refinancing of their second mortgage debts at a cost they can afford.

Whether buyers truly gain through creative financing, total home sales might be larger if buyers perceive benefits from this type of financing and if sellers would not place their homes on the market at prices that did not incorporate the value of the assumable loan. The total flow of funds to the mortgage markets may also be augmented, despite the drain on loanable funds at the institutional holders of the outstanding mortgages, as long as individuals increase their investment in mortgages. However, the diversity of treatment of due-on-sale clauses throughout the nation, and the uncertainties created by various court cases, have interfered with the operation of the national secondary markets for conventional loans and conventional pass-through securities because investors find it more difficult to determine the appropriate prices for these instruments.

## Recommendations

The Commission believes that the ability of investors to enforce due-on-sale clauses in existing mortgage contracts is essential to prevent windfall wealth transfers among mortgage market participants and to insure proper operation of the secondary mortgage markets. The Commission also believes that borrowers and lenders should be free to negotiate the inclusion and price of due-on-sale clauses in all newly originated home mortgage contracts.

The Commission recommends the following measures:

A. Action should be taken at the federal level to prevent, or discourage, states from restricting the enforcement of clauses in outstanding mortgage contracts that give lenders the option to declare these existing loans due and payable in full upon sale of the mortgaged property. Two recommended options are:

   1. State legislative or judicial efforts to restrict the enforcement of due-on-sale clauses should be preempted by federal action.

      -- Ideally, the preemption should be extended to all "federally related mortgages" as defined in the regulation implementing the federal preemp-

tion of state ceilings on mortgage interest rates contained in the Depository Institutions Deregulation and Monetary Control Act of 1980: all loans made by federally insured or regulated institutions, or by mortgagees approved by the Department of Housing and Urban Development (HUD); loans that are guaranteed, insured, or assisted by HUD; loans eligible for purchase by the Government National Mortgage Association, Federal National Mortgage Association, or Federal Home Loan Mortgage Corporation; loans made by lenders that regularly extend credit payable in more than four installments, where there is a finance charge, and where the lender makes more than $1 million in residential real estate loans per year.

2. In states where enforcement of due-on-sale clauses is restricted by legislative or judicial action, incentives should be provided to encourage the states to relax their restrictions. Several approaches are possible, including the following:

   -- Premiums charged for federal insurance of deposits could be raised sufficiently to account for the greater risks placed upon federal deposit insurance agencies.

   -- Federal deposit insurance could be denied to depository institutions located in states that prohibit enforcement of due-on-sale clauses. This policy would require states that place a high priority on assumability to organize their own insurance funds.

B. Lenders and borrowers should have the option to negotiate the inclusion and the price of due-on-sale clauses in all mortgages to be made in the future. Thus, federal regulations should be changed to permit the inclusion of due-on-sale clauses in mortgages that are insured by the Federal Housing Administration or guaranteed by the Veterans Administration.

The Commission recognizes that federal preemption of state efforts to prohibit enforcement of due-on-sale clauses in outstanding mortgage contracts raises the broader questions of federalism and states' rights. The Commission is considering these broad issues in a number of contexts, and in the Final Report will discuss the appropriate balance of federal and state powers with respect to various housing issues. The Commission presently thinks that insuring the integrity of mortgage contracts is sufficiently important to national and individual interests to justify federal intervention with respect to due-on-sale clauses.

## PRIVATE PENSION FUNDS

There has long been interest in the possibility of increasing mortgage investment from nontraditional sources of funds, particularly pension funds. Private pension plans held more than $400 billion in assets at the end of 1980; three-fifths of this amount was held by noninsured plans and the balance was accounted for by plans with life insurance companies. In addition, roughly $200 billion in assets were held in retirement plans for employees of state and local governments.2/

Some public pension funds have acquired substantial amounts of residential mortgages or mortgage pass-through securities, but investment in mortgage assets by private pension funds has been quite small. Residential mortgages held by private, noninsured plans account for less than 2 percent of the total assets of these funds, and mortgages constitute only a minor share of the investments of insured pension funds that utilize separate investment accounts.3/ Of course, private pension plans with life insurance companies commonly do not involve separate accounts, and thus information on the types of investments behind the reserves for these plans is not available. Overall, life insurance companies, which had been a major source of residential mortgage credit in the 1950s and early 1960s, have shifted away from housing loans toward nonresidential mortgages and other types of assets.

Pension and retirement funds have very long-term liabilities, which should make long-term residential mortgages potentially attractive investments. In this respect, pension funds are more favorably situated for mortgage investment than are the thrift institutions, which traditionally have relied upon short- and intermediate-term deposits for funds and have made long-term, fixed-rate mortgage loans.

In the case of private pension funds -- both noninsured funds and insured funds that utilize separate investment accounts -- implementation of the Employee Retirement Income Security Act of 1974 (ERISA) has imposed constraints upon mortgage investment. ERISA does not specify a list of investments that a pension plan may or may not make. However, it does establish definitions that dictate the types of transactions that are prohibited as well as standards that investment managers of pension funds should follow when making investments.

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2/Board of Governors of the Federal Reserve System, Flow of Funds Accounts.

3/Reliable data are not available on holdings of mortgage pass-through securities by noninsured or insured funds.

The main difficulties have been posed by broad Department of Labor regulatory definitions of the circumstances and conditions under which pension plan investments can and cannot be made. The regulations have attempted to insure that investment managers do not enter into conflict-of-interest situations and unwise investments, but they have failed to recognize the realities of the housing finance marketplace and have had the effect of limiting pension plan investment in mortgages and mortgage-related securities. Moreover, adjustments to ERISA regulations generally have been slow to evolve, and those modifications that have been implemented are not fully adequate to meet the needs of the marketplace.

## Recommendations

The Commission stressed in the Interim Report that transactions involving possible conflicts of interest should not be made to the detriment of pension plan beneficiaries. But the Commission also noted that it is not reasonable to prohibit the development of relationships that arise in the normal course of business between the pension plans and such parties as loan originators, sellers, servicers, and mortgagors.

On December 3, 1981, the President announced his endorsement of the recommmendations made by the Commission in its Interim Report concerning Department of Labor regulations that affect investments in mortgages and mortgage pass-through securities by private pension funds. The Commission urges the Department of Labor to continue to proceed as expeditiously as possible to implement these recommendations, which are as follows:

A. The Department of Labor should promptly issue the housing portion of proposed regulations that would exclude from Employee Retirement Income Security Act regulations mortgage pools associated with pass-through securities issued or guaranteed by the United States or an agency or instrumentality thereof, including the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation and the Federal National Mortgage Association.

B. The Department of Labor should expand its recent class exemption for mortgage pass-through securities that are not issued or guaranteed by a federally related entity, in order to cover pools of second mortgages and to clarify the treatment of forward-purchase commitments that are commonplace in mortgage market transactions.

C. In the case of whole mortgages or mortgage participations, the Department of Labor should issue a class exemption in order to permit normal business transations.

D. The mechanisms for evaluating applications for mortgage-related exemptions should be streamlined and improved. To accomplish this goal, the Department of Labor should rely upon the mortgage and housing expertise that already exists at the Federal Home Loan Bank Board or at the Department of Housing and Urban Development.

## INDUSTRY STRUCTURE AND INSTITUTIONAL FORM

Growing competition from unregulated elements of the financial system has made it clear that the regulated elements, particularly depository institutions, should have the flexibility to choose the forms of ownership and organizational structures that will permit them to maintain their important roles in the financial system. Maintenance of these roles is critical to the growth and stability of the housing markets and other sectors of the economy.

Thrift institutions traditionally have been mutual organizations with depositors as owners. But in today's environment, the appeal of the stock form of ownership has increased. Conversion from mutual to stock form creates an institution with a source of capital beyond retained earnings (and capital certificates), and the greater ability to build capital can give an institution greater flexibility in managing its operations. A more heavily capitalized firm, for example, is better positioned to absorb the interest rate risks that are associated with provision of the service of maturity intermediation to households -- that is, accepting short-term savings and extending long-term mortgage credit.

Despite the advantages of the stock form of ownership, many thrift institutions currently do not have the option to become stockholder-owned institutions. In about two-thirds of the states, state stock savings and loan associations may be formed _de novo_ and state mutual associations may convert to state stock associations; _de novo_ state stock savings banks are permitted in only one state, and state mutual savings banks are permitted to convert to state stock savings banks only in that state. The Federal Home Loan Bank Board does not have the authority to grant _de novo_ federal stock charters, and existing federal associations may convert from mutual to stock status only in states that allow chartering of stock associations. Federal stock savings banks are not permitted in any state.

Conversions from the mutual to the stock form of ownership not only would create stronger institutions but also would establish the potential for a greater number of mergers and acquisitions among financial institutions. Mergers or acquisitions within and across state or industry boundaries can have beneficial effects upon the cost of housing credit, providing that the regulatory authorities give adequate consideration to competitive impacts and to the adequacy of the capital positions of newly organized institutions.

Indeed, to the extent that mergers and acquisitions result in economies of scale and a more efficient financial system, the average level of costs for all users of financial services will be lower.

The ability to convert depository institutions from mutual to stock forms also would help reduce the risk exposure of the federal deposit insurance agencies -- the Federal Deposit Insurance Corporation and the Federal Savings and Loan Insurance Corporation. These agencies have limited resources, and they need maximum flexibility to arrange mergers and acquisitions of financially troubled institutions. In this regard, interstate and interindustry mergers and acquisitions of stock institutions can open the bidding for troubled institutions to more participants, and potential acquirors often are willing to pay premiums for institutions in order to gain access to broader markets.

## Recommendations

The Commission believes that all thrift institutions should have the option to convert from the mutual to the stock form of ownership. Stock institutions have the ability to raise greater amounts of capital; easier access to capital provides stock institutions greater flexibility in designing their modes of operation. Moreover, a broader base of stockholder-owned institutions would provide the basis for expanded merger and acquisition activity among financial institutions, and such activity could lead to a more efficient financial system with lower costs for financial services.

Concerning chartering and the form of ownership of thrift institutions, the Commission recommends the following measures:

A. All state-chartered savings banks and savings and loan associations should be permitted to convert to federal charters, and vice versa.

B. All federally chartered savings and loan associations and savings banks should be permitted to convert from mutual to stock forms, and vice versa.

C. All federal savings and loan associations should have the opportunity to convert to savings banks, and vice versa.

D. The Federal Home Loan Bank Board should be provided with authority to grant _de novo_ federal stock charters to savings and loan associations.

Concerning mergers and acquisitions of financial institutions, the Commission makes the following recommendations, which are in line with the basic principles adopted by the Commission concerning the importance of efficient markets and enlightened federalism:

A. Interstate and interindustry mergers sought by the private sector should be permitted in the evolution of a financial system that will provide financial services at the lowest possible cost to mortgage borrowers and other participants in the financial markets and will lead to more stable flows of housing credit.

B. Regulatory authorities should continue to have, and to use, the power to arrange interstate and interindustry mergers and acquisitions of institutions whose viability is evaluated as uncertain by the regulators. Supervisory mergers and acquisitions should cover a broad range of situations, including the following arrangements:

-- Merger of any insured thrift institution into any other insured thrift or bank, or into any savings and loan or bank holding company, regardless of the locations of the respective institutions being combined.

-- Holding company acquisitions of insured institutions, without the present differentiation between unitary and multiple holding company systems.

# Chapter 6

# CHANGING PATTERNS OF HOUSING FINANCE

Major changes are underway in the nation's housing finance system, and further evolution is certain. The recommendations presented in this report have been designed to help influence the process of change in ways that will lead to a stronger and more resilient system. The Final Report of the Commission will contain additional recommendations directed toward this objective.

The following discussion provides a summary description of the private housing finance system that is likely to develop during the 1980s, and indicates how the recommendations in this report relate to the ongoing process of transition. In general, it is likely that the system of the future will include significant mortgage lending and investment by thrift institutions coupled with a greater degree of mortgage banking, a wider range of mortgage securities and better developed secondary markets, and a variety of private mortgage investors. The final section of this chapter outlines the agenda for future study of the housing finance system by the Commission.

## Thrift Institutions as Primary Housing Lenders

The thrift industry undoubtedly will remain as a major ingredient of the housing finance system during the years ahead. These institutions have a strong community orientation, they have built up a considerable comparative advantage in the origination and servicing of mortgage loans, and they are not likely to give up these profitable activities. The operating powers recommended in this report -- together with the recommended changes in the tax treatment of thrifts -- are intended primarily to enable these institutions to reduce their interest rate risk by achieving diversification on the asset side of their balance sheets. The extent to which these broader powers are utilized will depend on both the structure of demand in the marketplace and the strategies adopted by these institutions to manage their interest rate risk.

Thrift institutions could choose to hold the mortgages they originate and to absorb or shift interest rate risk in various ways. New forms of mortgage instruments -- such as adjustable-rate loans, price level-adjusted mortgages, or shared-appreciation mortgages would allow institutions to share interest rate risk with borrowers. Portfolio risk also could be hedged in the rapidly developing financial futures markets where speculators seek to profit by bearing risk. Or the thrifts could accept interest rate risk associated with investment in long-term, fixed-rate mortgages and bolster their ability to handle this risk by building larger capital buffers. Stockholder-owned institutions would be in a better position than mutual organizations to carry out the latter strategy.

Management of interest rate risk in these ways is not a cost-free process, however, and many thrift institutions are certain to reduce the asymmetry in the maturity structure of assets and liabilities partly by moving into assets that are, by their nature, shorter in term than residential mortgages -- such as consumer loans, commercial paper, or commercial loans to such housing-related businesses as developers or suppliers of building materials. Thus, it is likely that the thrift industry increasingly will seek to perform a mortgage banking function, originating and servicing residential mortgages that meet the needs of borrowers, while packaging and reselling these loans through securities markets to institutions that are better suited to hold them as investments but do not want to be involved in the origination and servicing processes.

## A Broader Base for Housing Funds

Reductions in the level of mortgage investment at the thrift institutions will not affect the overall supply of residential mortgage credit as long as funds can flow freely through financial markets to meet the underlying demands for capital in the economy. In properly functioning markets, a reduction in mortgage supply at thrift institutions would place upward pressure on mortgage yields, and investors that operate in both mortgage and other capital markets would move more funds into mortgages. After the adjustments, the structure of mortgage supply would be different, but the overall level and cost of mortgage credit should be essentially unchanged.

The efficiency of the secondary mortgage markets has improved in recent years because of widespread use of standardized mortgage documents, growth of private mortgage insurance, development of mortgage pass-through securities, and efforts by securities dealers to develop primary and secondary markets for these instruments. But the greatest improvements have been in the markets for federally underwritten mortgages and pass-through securities, which have been principally the domain of mortgage companies rather than thrift institutions. Secondary markets for the trading of conventional residential mortgages, which have been the specialty of the thrifts, still are relatively underdeveloped compared with other capital markets.

A number of policy measures, some of which are recommended in this report, would facilitate an orderly transition to a more broadly based and resilient housing finance system: (1) equivalent tax incentives for all private mortgage investors to encourage greater housing lending by a variety of institutions; (2) removal of regulatory or statutory restrictions that prevent diversified institutions, such as commercial banks, pension funds, and insurance companies from moving more heavily into mortgage assets; (3) development of alternative mortgage instruments to meet the diverse needs of borrowers, lenders, and investors; and (4) development of a broader range of secondary market instruments.

Adoption of these measures will help move the nation in an orderly fashion toward a housing finance system that will enable homebuyers to compete more effectively for funds. In this system, channels will be available to move funds efficiently from capital market investors, through mortgage originators, to ultimate mortgage borrowers. Thrift institutions, commercial banks, and mortgage companies will probably continue to originate the majority of mortgage loans, but the investor base will be much broader than in the past. Moreover, a wider variety of mortgage forms will be present in the market, tailored to the needs of borrowers who are at different stages of the life cycle and who have different abilities and inclinations to absorb interest rate risk. This range of mortgages, in turn, will be held by a variety of investors -- directly or indirectly through mortgage pool securities -- with suitable liability structures and capacities to handle differing risk. Much greater participation can be expected on the part of investors such as commercial banks, private and public pension funds, life insurance companies, finance companies, and individuals.

## Further Study of the Housing Finance System

This report has addressed a number of the steps involved in moving toward a stronger housing finance system, but many major issues remain. The Commission has therefore already begun to examine other topics in the area of housing finance. The agenda for future work includes:

1. Short-term problems of housing finance.

2. Tax incentives for mortgage investment and other tax issues.

3. The appropriate roles of federal credit and insurance agencies in residential mortgage markets.

4. Achieving an orderly transition toward greater reliance on private financial markets.

5. Alternative mortgage instruments for borrowers, lenders, and investors.

6. Regulations and laws that affect the cost or delivery of mortgage credit.

Recommendations in these areas will be contained in the Final Report of the Commission.