evolved featured long-term, fixed-rate mortgage loans provided predominantly by savings and loan associations and mutual savings banks. Because these long-term assets were funded by short-term deposits in the thrift institutions, this financing system worked well as long as long-term rates exceeded short-term ones, and both were stable. This was generally the case for the 20 years immediately following World War II.

CHANGES IN ECONOMIC CONDITIONS AND FEDERAL POLICY SINCE 1960

By the 1960s, rising and increasingly volatile interest rates initiated a chain of problems for the housing finance system, prompting a series of policy adjustments over the next two decades.

To hold down the cost of deposit accounts to thrift institutions--and thereby the interest rate charged on mortgages--the government began to regulate the interest rates that thrift institutions could pay on deposits. In 1966, an interest rate ceiling was imposed on the thrift institutions at a level slightly higher than a pre-existing ceiling for accounts at commercial banks, in order to give mortgage lending institutions an advantage in attracting deposits. 5/ Because deposits at thrift institutions were federally insured, and because few alternative investments requiring only small initial sums of money existed, the thrift institutions were able to maintain their supply of funds from small savers despite the cap on interest rates. Nonetheless, despite occasional increases, the ceiling soon presented problems for mortgage lending institutions when the interest rates available on other investments occasionally rose to levels well above the ceiling. Thrift institutions were then faced with the loss of deposits as investors with large accounts sought to achieve higher yields through alternative investments--a process referred to as disintermediation. 6/

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5. Regulation Q--the Federal Reserve regulation that sets interest rate ceilings for deposit accounts at the federally chartered depository institutions--was established for deposit accounts at commercial banks in the 1930s and was extended to accounts at savings and loan associations and mutual savings banks in 1966.

6. The net effect of the rate ceiling on deposit accounts on the supply and cost of mortgage credit remains a matter of some disagreement. On the one hand, because the ceiling reduced the cost of funds to thrift institutions, it may have lowered mortgage interest rates as well. On the other hand, the ceiling may also have lowered the volume of deposits, and, in any event, there is some question concerning how

In the late 1960s and early 1970s, the federal government greatly expanded its role in the secondary mortgage market--in part to help primary-market lending institutions replenish their funds. During this period, the government partitioned the existing federal secondary market agency--the Federal National Mortgage Association (FNMA)--creating a taxpaying federally chartered quasi-private FNMA and a new government agency, the Government National Mortgage Association (GNMA). The latter assumed the credit-market-support functions of the original FNMA and established a new guarantee program for mortgage-backed securities. The government also established the Federal Home Loan Mortgage Corporation (FHLMC) as a publicly managed corporation under the aegis of the Federal Home Loan Bank Board to facilitate secondary market transactions of the thrift institutions that are members of the Federal Home Loan Bank System.

Among them, these credit entities could purchase mortgages outright, issue securities backed by pools of mortgages--that is, mortgage-backed securities (MBSs)--and guarantee privately issued securities backed by pools of federally insured or guaranteed mortgages. 7/ The programs of these secondary market entities grew rapidly during the 1970s, as did the availability of federal mortgage insurance and guarantees--expanding the indirect sources of mortgage capital. They did not, however, assist the thrift institutions to attract and hold funds during periods when market interest rates substantially exceeded the ceiling on their accounts. 8/

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6. (Continued)
much of any interest rate savings was passed along to borrowers. To the extent that the ceiling lowered mortgage interest rates, its effect was to transfer wealth from the small savers who held deposits in thrift institutions to homebuyers who obtained loans from those institutions. For a discussion of the issues surrounding the impact of deposit account ceilings on the cost of credit, see A. Thomas King, "The Deposit Rate and the Mortgage Rate: Does Regulation Q Promote Homeownership?" Research Working Paper No. 85, Office of Economic Research, Federal Home Loan Bank Board (September 1979).

7. A mortgage-backed security (MBS) is investment paper that derives its value from the mortgages assembled in a pool to back it. MBSs are discussed in greater detail in Chapter III in connection with the operation of federal secondary market credit entities.

8. The Federal Home Loan Bank System--which oversees the thrift institutions--advances funds to its member institutions to meet their needs during periods when they attract insufficient deposits.

By the late 1970s, the rise in interest rates to historic highs--fueled by rising inflation rates--had created substantial difficulties both for borrowers and for the thrift institutions. Borrowers faced more costly mortgage payments on larger loan amounts financed at higher interest rates. 9/ For the thrift institutions, as elevated rates made savers increasingly eager to seek higher yields, competing investments in the form of money market mutual funds developed, exacerbating disintermediation. 10/ Also, although the interest-rate ceiling on deposits did not keep pace with the rates paid on alternative investments, it was raised enough to approach the thrift institutions' yields from their portfolios of fixed-rate long-term mortgages. Because the profitability of thrift institutions is determined by the relationship between the interest-rate cost of their short-term deposits and the yield from their long-term, fixed-rate assets (mainly mortgages), the rise in market interest rates--and the resulting rise in the interest-rate ceiling on deposits--threatened the profitability of these institutions.

The most recent federal response to changing circumstances has been to deregulate partially the federally chartered financial institutions that had become the core of the housing finance system. Beginning in 1978, mortgage lending institutions were permitted to offer accounts and certificates of deposit that were subject to market-determined interest ceilings, in order to attract new funds with which to finance additional lending at profitable rates of interest. Initially, however, these accounts led to a shift in deposits from lower-interest to higher-interest instruments without attracting large amounts of new funds. As a result, by 1980 total interest expenses exceeded interest income, causing large losses for the savings and loan industry and the failure or forced merger of many institutions. More recently, the availability (since December 1982) of small-denomination accounts not subject to any interest rate ceiling has succeeded in attracting new funds to the thrift institutions, while lessened inflation has moderated the profit squeeze for the institutions.

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9. Although nominal interest rates were high, the high inflation made real interest rates low enough to sustain a high level of homeownership demand during this period.

10. A money market mutual fund is an investment company that pools investors' funds for investment in high-grade, short-term debt and bank deposits paying market rates of return. Examples of these money market instruments include U.S. Treasury bills, certificates of deposit, and commercial paper. Owners of a money market mutual fund hold proportional shares in the entire pool of securities in which a fund invests and pay taxes on distributions from the fund. In addition to their investment features, most money market mutual funds offer check-writing redemption features.

Deregulation has also affected the asset side of the ledger for thrift institutions. Beginning in 1979, savings and loan associations and mutual savings banks were permitted to offer mortgages on which the interest rate varies with market conditions over the life of the loan, providing variable-rate assets to match lending institutions' market-determined rate liabilities. Also, since 1980, the lending authority of these institutions has been broadened, permitting thrifts to devote some share of their assets to consumer, agricultural, commercial, and corporate loans. 11/ Although these expanded asset powers may eventually reduce the concentration of savings and loan associations and mutual savings banks on mortgage lending, the remaining incentives provided through the federal tax system and the greater familiarity of thrift institutions with residential finance have thus far kept them focused heavily on housing.

Another effect of federal policy shifts has been to expand the sources of mortgage credit and more fully integrate the housing credit sector with the rest of the economy. For example, although savings and loan associations still originate more than one-third of all new mortgages on single-family homes (more than any other single source), other sources--particularly mortgage bankers--now account for an increased share of the total. At the same time, depository institutions are much more likely either to sell the mortgages they originate or to pool them to back securities that are subsequently sold--often through programs operated by federally sponsored secondary mortgage market entities. As a result, thrift institutions now provide a smaller proportion of all net additions to mortgage credit, and other sources--primarily the investors in mortgage pools--account for an increasing share.

The forms of mortgage credit available and its cost have also changed. Mortgage loans on which the payment schedule varies in a predetermined way in order to reduce the burden on homebuyers in the early years, and mortgages on which the interest rate varies with market conditions over the life of the loan are now available. To date, however, few borrowers have been willing to accept the risk associated with the latter types of loans, at least on the terms they are currently offered. In addition, the cost of mortgage credit has varied with recent changes in interest and inflation rates.

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11. Also in 1980, state ceilings on mortgage interest rates for first mortgages were preempted by the federal government, allowing mortgage lending institutions to realize higher returns on their loans.

CURRENT ISSUES

Continuing high rates of interest (especially high rates in real terms), the deregulation of mortgage lending institutions, and the resulting increased integration of the housing credit sector with broader credit markets raise two general issues concerning future federal housing finance policies.

The first issue is what changes, if any, in federal policies would make the existing housing finance system operate more efficiently. Historically, federal intervention resulted in a highly regulated and partially insulated housing credit sector. Now that the insulation has been reduced--largely through increased reliance on secondary mortgage markets--the question arises whether conditions remain that unnecessarily increase the cost of housing credit by impeding the flow of funds to housing. Part of this question is whether some federal programs themselves constitute impediments by discouraging the development of private-sector alternatives.

Numerous actions have been suggested to increase the efficiency of the housing finance system. While they reflect different assumptions regarding the net effect of present federal activity, none would return to the highly regulated system of past decades, although some options would expand the federal role somewhat. Alternative approaches include: expanding federal mortgage insurance or secondary-market programs to cover subsectors that are not now served; removing remaining regulatory and statutory impediments to broader investment in certain private mortgage-backed securities; and reducing direct federal mortgage insurance or secondary-market programs in the hope of stimulating increased private activity.

A second general issue is whether adjustments should be made in the present system of federal subsidies for housing. This issue arises from two quite different--but not necessarily contradictory--concerns. First, despite substantial benefits for homeowners provided through the federal income tax system, a combination of steep increases in housing prices and sharply higher interest rates in the recent past have made it increasingly difficult for low- and moderate-income households to afford to purchase homes, especially their first ones. At the same time, there is growing concern that the current volume of subsidies for homeownership may already tilt overall investment incentives unduly toward owner-occupied housing and away from other uses, potentially contributing to declining rates of growth in other sectors of the economy. Increasing subsidies for selected groups could address the first concern, while reducing untargeted subsidies for housing could address the second. Either approach could be pursued separately, or both could be undertaken simultaneously, with some or all of the savings resulting from reducing untargeted benefits used to finance increases in targeted subsidies.

The remainder of this paper is intended to assist the Congress in considering possible policy changes to address these issues. The following chapter describes current federal programs, the next one details recent market and policy shifts, and the final chapter presents options to deal with the two issues discussed here.

CHAPTER III. CURRENT HOUSING FINANCE PROGRAMS

A wide variety of federal policies and programs directly and indirectly affect the housing finance system. Although general monetary and fiscal policies of the government have broad impacts on the housing finance system by affecting the supply and cost of all forms of credit, these policies are beyond the scope of this paper. The specific housing policies discussed here--and summarized in Table 1--include:

- Regulation of the private lending institutions that invest in housing;
- Direct intervention to insure and guarantee mortgages and to provide a secondary market to generate additional mortgage funds; and
- Favorable tax treatments of investment in housing by homebuyers, developers, and lending institutions.

REGULATORY POLICIES

Federal regulation of depository institutions, of pension plan investments, and of securities registration all influence the housing finance system.

Regulation of Depository Institutions

Federal regulation of depository institutions--savings and loan associations, mutual savings banks, and commercial banks--affects both the supply and cost of mortgage credit, directing investments by some types of institutions toward residential mortgages, controlling interest rates on certain deposit accounts, and advancing funds to the institutions. In addition, the federal government provides deposit insurance to encourage depositors to establish accounts without concern about the riskiness of the portfolios of the depository institutions.

Different types of depository institutions were originally established to serve different purposes, and incentives provided by regulations and the federal tax system (discussed later in this chapter) have resulted in their

TABLE 1. HOUSING FINANCE-RELATED POLICIES AND PROGRAMS

Policy	Purpose	Program Operation
	Regulatory Policies a/	
Regulation of depository institutions	Establish criteria to foster the solvency of institutions and the safety of deposits. Encourage investment in residential mortgages.	Provide deposit insurance. Originally specified the asset/liability structure of these institutions through regulatory incentives and tax laws. Later established interest rate ceilings for deposit accounts.
Regulation of pension plan investments	Protect solvency of pension plans.	Specify prohibited and permissible investment transactions.
Regulation of securities registration	Protect investors by increasing information about issues.	Specify terms under which issues are made available for purchase by investors.
	Direct Market Intervention	
Federal mortgage insurance and guarantees	Encourage lenders to make mortgages for certain population groups, areas, and types of housing.	The FHA b/ insures lenders against losses from default on mortgage loans. The VA c/ guarantees lenders against losses from default on loans made to veterans. The FmHA d/ has the authority to guarantee privately written mortgages in rural areas.
Secondary market intervention	Establish secondary market in mortgages to increase supply of funds for housing.	Federal agencies and federally sponsored credit entities guarantee certain mortgage-backed securities issued by private lenders, purchase privately written mortgages, and issue securities backed by pools of privately written mortgages. e/

(Continued)

TABLE 1. (Continued)

Policy	Purpose	Program Operation
Taxation		
Federal tax subsidies to homeowners	Encourage homeownership.	Mortgage interest and property tax payments are deductible from taxable income. f/ Capital gains from sale of residence are tax-exempt if rolled over into successive home purchase. Up to $125,000 in capital gains from sale of residence not rolled over are tax-exempt after age 55.
Federal tax subsidies to rental project developers	Encourage development of rental housing.	Favorable depreciation and limited recapture of excess depreciation after the sale of property are permitted on all rental housing, along with the rapid amortization of construction period interest and taxes. Additional benefits are available for low-income rental housing and historic structures.
Federal tax exemption of interest on state and local mortgage revenue bonds	Enhance ability of state and local entities to fund housing and other developments.	State and local entities issue federally tax-exempt mortgage revenue bonds, the proceeds of which are lent to financial institutions that relend them to homebuyers.
Special tax treatment for lending institutions	Encourage thrift institutions to invest in mortgages.	Thrift institutions are allowed to deduct as much as 34 percent of total taxable income as an addition to bad debt reserve if specified percentage of assets is held in mortgages and other qualifying forms.

(Continued)

TABLE 1. (Continued)

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a. State and local regulations that specify the terms and the forms of investments by state and local government employee pension plans are not discussed in this paper. Other state regulations governing the operation of fiduciary institutions are also not covered here.

b. Federal Housing Administration.

c. Veterans Administration.

d. Farmers Home Administration.

e. In addition, the Farmers Home Administration guarantees and sells securities to finance its subsidized direct homeownership and rental housing loans.

f. Purchasing housing is an investment, and the interest payments on investments normally are deductible from taxable income. Considered in this manner, the advantage of the deductibility of mortgage interest payments comes from the fact that the implicit income from forgone rent payments on owner-occupied housing is not taxed.

maintaining different investment patterns. The savings and loan associations were intended principally to provide home mortgage loans, and their portfolios consist predominantly of those. Mutual savings banks hold somewhat more diversified portfolios, reflecting the intent that they provide consumer credit as well as residential mortgage loans. Commercial banks--which were federally chartered before savings and loan associations and mutual savings banks--were not created to encourage investment in home mortgages and, in fact, hold the most diversified portfolios among the depository institutions.

Several government entities regulate the depository institutions. The Federal Home Loan Bank Board (FHLBB) regulates and examines federally insured savings and loan associations--both federally chartered and state-chartered institutions--as well as federally chartered mutual savings banks. The Federal Deposit Insurance Corporation (FDIC) regulates state-chartered, federally insured mutual savings banks and state-chartered, federally insured commercial banks that are not members of the Federal Reserve

System. The Comptroller of the Currency regulates federally chartered commercial banks, all of which are members of the Federal Reserve System and are insured by the FDIC. 1/ The Federal Reserve Board regulates state-chartered commercial banks that are members of the Federal Reserve System. Finally, the Depository Institutions Deregulation Committee (DIDC) determines the rate to be paid on deposit accounts at all depository institutions. 2/ In addition to exercising regulatory authority, both the Federal Home Loan Bank System and the Federal Reserve System can supplement funds at the depository institutions. 3/

Federal deposit insurance began during the Depression to encourage persons to place their funds in lending institutions by insuring accounts up to certain limits. The FDIC was created in 1933 to insure deposits of commercial banks and most mutual savings banks. One year later, the Federal Savings and Loan Insurance Corporation (FSLIC) was established under the aegis of the FHLBB to insure the accounts of all federal savings and loan associations, qualified state-chartered building and loan associations, homestead associations, and cooperative banks, and to prevent their defaults. Both the FDIC and the FSLIC collect premiums from depository institutions to finance the insurance, and in both instances the insurance

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1. All federally chartered commercial banks are termed national banks.

2. The DIDC was established by the Depository Institutions Deregulation and Monetary Control Act of 1980 to oversee the phasing out of interest-rate ceilings on deposit accounts. The Committee is comprised of the Comptroller of the Currency as a non-voting member and the following voting members: the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Board of Directors of the FDIC, the Chairman of the FHLBB, and the Chairman of the National Credit Union Administration.

3. The Federal Home Loan Bank System provides advances to member institutions--federally insured savings and loan associations and those mutual savings banks that are members of the Federal Home Loan Bank System--to bolster their liquidity and to foster greater mortgage lending activity. The Federal Reserve Banks provide advances to assist depository institutions in need of liquidity. Although all depository institutions with reservable deposit accounts have access to the Federal Reserve discount window--a facility that provides advances on the basis of eligible collateral, usually Treasury bills valued at par--the discount window is mainly used to meet short-term borrowing needs of member banks.

funds consistently have been able to cover claims. 4/ In addition to encouraging persons to invest their funds in lending institutions, deposit insurance may provide insured institutions with a price advantage in attracting funds, while encouraging those institutions' managers to undertake riskier investments than they otherwise might, since the safety of the investments is of less concern to the insured depositors.

Regulation of Pension Plan Investments

Federal regulation of investments by private pension plans--a significant source of long-term investment capital--indirectly affects the housing finance system by limiting the extent to which pension plans can invest in mortgages. Specifically, as a result of the 1974 Employee Retirement Income Security Act (ERISA), the Department of Labor regulates the conditions under which investments in mortgages and in securities backed by mortgages can be made. 5/ Because funds put aside for retirement represent long-term assets, and mortgages represent long-term liabilities, pension plans could be an appropriate source of funds for housing credit.

Although recent changes in regulations have encouraged pension plan investment in many forms of mortgages and in securities backed by mortgages, the amount of this investment remains small. This limited investment results in part from lingering concerns of the plans' investment managers about the liquidity and marketability of mortgage-backed securities (MBSs) and in part from remaining regulatory disincentives for investment in MBSs backed by conventional mortgages, that is, mortgages neither insured nor guaranteed by a federal agency. 6/ In addition, the inherent nature of an MBS, with an uncertain income stream and maturity due to the possibility of prepayment of the underlying mortgages, may discourage investment by fund managers.

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4. In fiscal year 1982 premiums paid to the FDIC amounted to $1.4 billion; premiums paid to the FSLIC were $359 million. Both agencies insure individual accounts up to a maximum of $100,000.

5. The 1974 Employee Retirement Income Security Act (ERISA) governs both noninsured and insured private pension plans that use separate investment accounts.

6. Recent changes in ERISA regulations governing investment in mortgages and MBSs are discussed in Chapter IV.

Regulation of Securities Registration

The federal Securities and Exchange Commission also affects secondary mortgage market transactions. Specifically, the Commission's interpretations of securities laws that demarcate the sizes of security offerings limit the sales of mortgage-backed securities (MBSs) by thrift institutions. By constraining the sale of MBSs by thrift institutions, these regulations have helped discourage the development of a private market for securities backed by pools of mortgages that are neither insured nor guaranteed by the federal government. 7/

DIRECT MARKET INTERVENTION

The federal government directly intervenes in the housing finance sector to stimulate mortgage lending and to establish a secondary market in certain types of mortgages. It does so through mortgage insurance and guarantee programs and through the activities of federally chartered credit entities whose programs facilitate secondary mortgage market transactions. These programs vary in their cost to the government--some charge fees that generally cover costs, while others generate net federal expenses. Because of the programs' functions--insuring or guaranteeing payment on mortgage loans and securities and issuing and marketing MBSs--many create large contingent liabilities for the federal government.

Federal Mortgage Insurance and Guarantees

The federal government insures and guarantees selected privately written mortgages through the Federal Housing Administration (FHA) and the Veterans Administration (VA). In addition, the Farmers Home Administration, an agency within the U.S. Department of Agriculture, has the authority to guarantee privately made mortgages for certain homebuyers in rural areas. These programs increase the willingness of lenders to make loans to borrowers they might otherwise be less likely to serve and on terms they would otherwise be less likely to offer--thus redirecting and potentially expanding the flow of mortgage credit.

FHA Mortgage Insurance. The Federal Housing Administration--established in 1934, and now an agency within the U.S. Department of

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7. As discussed later in this chapter, programs operated by federal housing credit entities have actively promoted the development of a secondary market in securities backed by federally insured or guaranteed mortgages.

Housing and Urban Development (HUD)--insures lenders against defaults on privately written mortgage loans made for certain single-family units and multifamily projects. The FHA operates more than 40 different programs, financed through four insurance funds. The largest individual program--the Section 203(b) program--provides insurance for mortgages on single-family homes, with moderate limits applying to the value of the loans insured.

Borrowers pay premiums for FHA insurance which, in the case of the principal single-family program, are sufficient to cover losses. Premiums paid under other programs--such as those insuring subsidized mortgages for low- and moderate-income homebuyers and those insuring mortgages on residences located in declining neighborhoods--are not sufficient to cover losses, however. As a result, taken together, the FHA programs run at a loss--amounting to $2 billion in fiscal year 1982. Because fewer new commitments have been made in recent years under some of the more risky programs, the financial position of the FHA funds could improve in the future as the outstanding high-risk mortgages are paid off.

FHA-insured mortgages on single-family homes represent a sizable, but varying, share of that market. Since 1970, for example, FHA-insured Section 203(b) mortgages have averaged 10 percent of all mortgages written on single-family homes in each year. During this period, the FHA's market share ranged from a high of 23 percent in 1970 to about 6 percent between 1973 and 1978.

Over its long history, FHA insurance has contributed substantially to the development of a national mortgage market. Most notably, it has: assisted in the popularization and standardization of the fully amortized, fixed-interest, level-payment mortgage; promoted the use of longer-term mortgages; promoted higher loan-to-value ratios on residential mortgages; assisted in the development of minimum property standards and standardized appraisals; and assisted in the provision of information on risks of default. 8/

Today, private mortgage companies overlap with the function of the FHA, but the availability of FHA insurance may still encourage lenders to

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8. See James Barth, Joseph Cordes, and Anthony Yezer, "Federal Government Attempts to Influence the Allocation of Mortgage Credit: FHA Mortgage Insurance and Government Regulations," in Congressional Budget Office, Conference on the Economics of Federal Credit Activity, Part II--Papers (September 1981), pp. 159-232.

make loans that they might otherwise consider too risky. 9/ Also, FHA-insured loans are among the most liquid mortgages, both because they are secured by the federal government and because they are eligible for sale or pooling to back securities under programs operated by the federal and federally sponsored secondary market credit agencies. This, in turn, provides a further inducement for lenders to write these mortgages.

The impact of FHA insurance on net housing costs is harder to assess. Currently, the interest rate on most mortgages insured under FHA's principal single-family program--Section 203(b)--is governed by a ceiling that is set periodically by HUD. 10/ Although the maximum allowable interest rate is generally fixed at a level slightly below the then-current market, the borrowers' final costs are not necessarily lower, since mortgage lenders generally charge up-front fees--referred to as "points"--to bring the effective yield up to the market rate. While the number of points--each equal to 1 percent of the loan--that may be charged to a homebuyer is limited in some cases by state law, points paid by the seller may nonetheless be passed along to the buyer in the form of higher house prices.

VA Mortgage Guarantees. The Veterans Administration (VA)--in a program similar to the FHA Section 203(b) program--guarantees privately written home loans for eligible veterans and for military personnel on active duty. The maximum interest rate on VA-guaranteed mortgages is tied to the FHA maximum, with the guarantee available for up to 60 percent of the principal value of the loan or $27,500, whichever is less. As of fiscal year 1983, borrowers under the VA guarantee program may be charged a fee equal to 0.5 percent of the value of the loan. Operating costs of the guarantee program are covered with transfers from a revolving fund used to finance a small direct loan program.

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9. In mid-1983, the private mortgage insurance companies insured 40 percent of all newly issued unsubsidized insured or guaranteed one- to four-unit mortgage loans while the FHA and the VA insured or guaranteed the rest. Although there is some overlap in coverage by private mortgage insurers and the FHA, there are differences in the groups of borrowers served by the two, relating primarily to borrowers' incomes and locations.

10. Effective May 20, 1982, the greater of 50,000 Section 203(b) mortgages or 10 percent of the mortgage loans insured under Section 203 during the previous fiscal year are eligible for negotiated interest rates. During fiscal year 1983, 50,000 Section 203(b) mortgages became eligible for rate negotiation, because 10 percent of the mortgages insured under the Section 203 program during fiscal year 1982 amounted to only 9,205 loans.

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FmHA Mortgage Guarantees. The Farmers Home Administration (FmHA) also has the authority to guarantee privately written mortgages for moderate-income homebuyers in rural areas, although 1981 was the last year in which the agency was authorized to initiate new mortgage guarantees. When available, the guarantee program was limited to households with incomes below $30,000. The agency could guarantee up to 90 percent of the mortgage amount, with interest rates negotiated by the borrower and the lender.

Secondary Market Agencies

The federal government promotes the flow of capital to housing through several secondary market credit entities. These have contributed greatly to the development and trading of MBSs, thereby increasing the efficiency of the housing credit market by making mortgage loans more liquid investments. The increased trading of MBSs also has caused concern about the quality of the instrument to shift from evaluating the underlying loans to evaluating the issuer/guarantor of the securities.

The three major federal secondary market credit entities are the Government National Mortgage Association, the Federal National Mortgage Association, and the Federal Home Loan Mortgage Corporation. The Government National Mortgage Association is a government agency that guarantees payments to investors in certain privately issued MBSs. The Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation--the former a quasi-private entity and the latter a publicly managed but privately owned corporation--purchase privately written mortgages and issue their own MBSs. (The Farmers Home Administration--FmHA--also guarantees and sells securities, called Certificates of Beneficial Ownership, to finance subsidized direct mortgage loans. Although the FmHA could sell its certificates in the private market and did so until 1975, it currently sells them primarily to the Treasury through the Federal Financing Bank.) 11/

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11. FmHA sales of securities to the Federal Financing Bank--an off-budget office within the Treasury Department--constitute borrowing by the agency to finance a direct assistance program, rather than a mechanism for increasing the liquidity of privately written mortgages. Therefore, FmHA's financing practices are not discussed in this paper. For a description of FmHA's housing programs and the procedures used to finance them, see Congressional Budget Office, Rural Housing Programs: Long-Term Costs and Their Treatment in the Federal

The Government National Mortgage Association. Established in 1968 as an agency of the U.S. Department of Housing and Urban Development, the Government National Mortgage Association (GNMA) guarantees privately issued securities backed by pools of mortgages that are insured by the FHA, guaranteed by the VA, or guaranteed by the FmHA. 12/ The GNMA supplements the insurance or guarantee on the underlying mortgages with a guarantee of the payment of MBS principal and interest, backed by the full faith and credit of the federal government. 13/ The federal guarantee of payment makes these the most marketable of all MBSs and has created a strong secondary market in them. 14/ Because the commitment and guarantee fees that GNMA collects from the securities' issuers have thus far covered all operating expenses, the GNMA MBS program has produced net revenues for the government.

The Federal National Mortgage Association. The Federal National Mortgage Association (FNMA) was created in 1938 as a federal financial institution to purchase and resell privately written mortgages; when it was transformed into a privately owned, federally chartered corporation in 1968, the GNMA was created to provide financial assistance for housing subsidy

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11. (Continued)
Budget (June 1982), and the statement of Rudolph G. Penner, Director of the Congressional Budget Office, on the Honest Budgeting Act of 1983, made before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, on September 19, 1983.

12. The GNMA also provides mortgage interest subsidies for certain types of federally assisted housing through several other programs, which are not discussed in this paper.

13. The first MBSs introduced were called straight passthroughs because investors received proceeds only if payments were made by the initial mortgage loan borrower. The modified passthrough MBSs--the securities currently guaranteed by the GNMA--"pass through" principal and interest payments to investors on the basis of their pro-rata shares in the mortgage pools, whenever payments are due, regardless of whether or not payments have been made by the borrowers on their mortgages.

14. There is also an organized futures market in GNMA-guaranteed securities, through which investors are able to guarantee the expected future price of the securities by fixing it in a contract that can be traded openly. The existence of a futures market further encourages trading in GNMA-guaranteed MBSs, and ultimately provides more funds for mortgage loans.

programs and to guarantee MBSs backed by federally insured and guaranteed mortgages. 15/ The FNMA functions as a financial intermediary--purchasing loans from mortgage bankers and other lenders and holding the loans in its portfolio. These purchases are financed primarily through the sale of short- and medium-term bonds and stock, although the FNMA is authorized to sell securities representing fractional interests in pools of conventional mortgages as well. The FNMA can also sell mortgages but very rarely does so. In addition, the agency has a $2.25 billion line of credit with the Treasury upon which it has never drawn.

The FNMA differs from the GNMA in that the former may make profits or incur losses on behalf of its stockholders, may purchase mortgages outright, and may deal in loans that are neither insured nor guaranteed by the government (so-called "conventional" loans) as well as government-insured or -guaranteed mortgages. GNMA, by contrast, is a government agency that guarantees privately issued securities backed by federally insured or guaranteed loans.

The Federal Home Loan Mortgage Corporation. Chartered in 1970, the Federal Home Loan Mortgage Corporation (FHLMC) purchases and sells conventional residential mortgage loans made by FHLBB member institutions, primarily the federally insured savings and loan associations. The FHLMC received initial capital of $100 million through the sale of non-voting common stock to the Federal Home Loan Banks and has since issued bonds as debt to these banks to fund its operations. The FHLMC also has authority to issue preferred stock (but has never used it) and can obtain lines of credit from commercial banks. In addition, the FHLBB can use the assets of its member institutions to provide additional credit, if needed, for the FHLMC.

Although the FHLMC may finance its mortgage purchases by issuing bonds as debt, most of its purchases are financed through the sale of MBSs. The FHLMC issues two types of participations in mortgage pools: participation certificates and guaranteed mortgage certificates. The participation

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15. Although now privately owned, the restructured FNMA was not transformed into a completely private institution in 1968. Even now, the President appoints 5 of the 15 members on FNMA's board of directors, while the remaining members are elected by the shareholders. Also, FNMA's stock issues continue to enjoy a favored market status because they may be issued and purchased through facilities of the Federal Reserve and because they are legal investments for federally supervised institutions. In addition, FNMA stock issues are eligible collateral for Federal Reserve advances and discounts and may be purchased without limitation by national banks.