certificates are similar to GNMA-guaranteed MBSs, in that timely principal and interest payments are made to investors. The guaranteed mortgage certificates are similar to bonds, with semiannual interest payments and annual principal repayments made to investors.

Although the FHLMC is similar to the FNMA in many respects, the agencies differ in their forms of organization, their methods of financing, and their types of mortgage transactions. The two organizations differ because the FNMA is a privately owned, federally chartered agency with publicly traded voting stock, while the FHLMC is a federally sponsored agency of the FHLBB with nonvoting private stock held by the Federal Home Loan Banks. The FNMA finances its mortgage purchases by debt issuances of short- and medium-term bonds and stock, while the FHLMC finances its mortgage purchases primarily by issuing MBSs. Finally, although the FHLMC--like the FNMA--can make transactions in both FHA/VA and conventional loans, the FHLMC has specialized in conventional loan transactions and has made an active market in them.

Differences in the Securities of Secondary Market Credit Agencies. The securities issued or guaranteed by the federally sponsored secondary market credit entities differ in the types of mortgages backing them, the type of guarantee provided, and the role played by the agency. 16/ First, whereas GNMA-guaranteed MBSs are backed exclusively by federally insured or guaranteed mortgages, the FNMA MBSs and the two FHLMC instruments may be backed by either conventional or FHA/VA mortgages. Second, while GNMA-guaranteed MBSs carry the full-faith-and-credit guarantee of the federal government, guarantees provided by the FNMA and the FHLMC do not carry that backing and, therefore, are generally considered to be of less value. Finally, while GNMA securities are issued by private lenders (primarily mortgage bankers) and guaranteed by the government, the FNMA and FHLMC certificates are issued, guaranteed, and marketed directly by the agencies. In addition, both the FNMA and the FHLMC own the mortgages backing their security instruments.

TAX PROVISIONS

Four major categories of federal tax provisions affect the housing finance system--either providing incentives to invest in housing or affecting

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16. For a comprehensive discussion of the many types of mortgage-backed securities see Jack M. Guttentag, "Mortgage Passthroughs: Structure and Policy," prepared for the Mortgage Insurance Companies of America, June 1982.

the supply or price of mortgage credit. The principal tax provisions include those governing homeownership expenses, rental housing investment subsidies, the tax exemption provided for certain mortgage revenue bonds, and the special tax treatment afforded mortgage lending institutions. Together, these tax provisions substantially lower the after-tax cost of purchasing homes and increase the after-tax return on investments in housing, thereby increasing the demand for housing and, indirectly, the supply of mortgage credit.

Homeownership Tax Subsidies

Several tax provisions provide incentives for individuals to become homeowners by reducing the after-tax cost of ownership. These provisions include: the deductibility of mortgage interest and property tax payments from taxable income, the tax exemption for the rollover of capital gains from the sale of residences into successive home purchases, and the one-time exemption from taxes of up to $125,000 in capital gains not rolled over after age 55. 17/

All these elements of the tax code cost the federal government sizable amounts in lost revenue annually. The revenue loss due to mortgage interest deductibility for owner-occupied homes alone is estimated at $25.1 billion for fiscal year 1983, and that due to the deductibility of property tax payments is estimated at $8.8 billion. An additional $3.8 billion in subsidies to homeowners stems from the deferral of income taxes on capital gains from selling homes, while $1.3 billion is estimated to be lost from excluding from taxation $125,000 in capital gains income for persons 55 years of age and older. 18/

Middle- and upper-income households receive most of the benefits from these tax provisions. In 1981, for example, households with annual incomes between $20,000 and $50,000--41 percent of all households--received 63 percent of the benefits from the deductibility of mortgage

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17. For a more complete description of homeownership tax subsidies, see Congressional Budget Office, The Tax Treatment of Homeownership: Issues and Options (September 1981).

18. Estimates of Federal Tax Expenditures for Fiscal Years 1983-1988, prepared by the staff of the Joint Committee on Taxation for the Committee on Ways and Means and the Committee on Finance, 98 Cong. 1 sess. (March 7, 1983).

interest and 55 percent of the benefits from the deductibility of property tax payments on owner-occupied units. 19/ In that same tax year, households with incomes greater than $50,000--7 percent of all households--realized 29 percent and 37 percent, respectively, of all the benefits from these provisions.

Rental Housing Investment Tax Subsidies

Existing tax laws provide a variety of incentives to invest in rental housing. First, owners of real property may use accelerated depreciation to shelter their investment income from taxes during the early years of ownership, and, when they sell their properties, they may use limited recapture provisions to convert most of their receipts into capital gains--a tax treatment not available to owners of other types of assets. Second, the amortization of construction-period property tax and interest expenses over a ten-year period provides a tax break to developers of rental housing, relative to the tax provisions governing costs incurred in the development of other capital assets. 20/ Moreover, developers of low-income housing may treat construction-period interest and tax payments as current expenses, deducting them from income as they occur. Finally, a substantial tax credit is provided for rehabilitation expenses for income-producing residential and nonresidential property certified as historic; rehabilitation expenses for residential property occupied by low-income households may be depreciated over a five-year period.

Tax-Exempt Mortgage Revenue Bonds

The federal government subsidizes housing credit by permitting state housing finance agencies and local governments to issue revenue bonds, the

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19. Ibid. Income is measured as expanded income--the sum of adjusted gross income plus minimum tax preferences (mostly excluded capital gains) less investment interest expense (to the extent of investment income)--for the analysis of benefits from the tax provisions. Income is measured as household earnings to determine the proportion of households in the given income categories.

20. Because separate transitional rules were established to gradually increase the amortization period for construction-period interest payments and property taxes from four to ten years for nonresidential and residential real estate, ten-year amortization for nonresidential real estate was established in 1982 but will not be established for residential real estate until 1984.

interest on which is exempt from federal taxes, and to use the proceeds to finance residential mortgages. Because of the tax exemption, the bonds pay rates of interest below those on taxable investments, thus providing a source of mortgage funds that may then be lent at below-market rates.

While the use of bond-financed mortgages for multifamily housing is limited to projects with at least 20 percent of their units occupied by low-income renters, under current federal law, no income restriction applies to the use of tax-exempt bonds to finance mortgages on single-family homes. Although state housing finance agencies have been using tax-exempt mortgage revenue bonds to finance single-family housing since the early 1970s, in 1978 localities also began to issue bonds for that purpose. As a result, the volume of tax-exempt mortgage revenue bonds for all forms of housing increased dramatically in the late 1970s, totaling $14 billion in 1980 alone--more than one-fourth of the volume of all tax-exempt bonds issued. The $10.5 billion of bonds issued in that year to finance single-family home purchases accounted for 1 percent of all single-family mortgage loans made in 1980. The federal revenue loss associated with all the single-family mortgage revenue bonds outstanding in 1980 was $0.7 billion.

In reaction to the rapid growth in the volume of tax-exempt mortgage revenue bonds--and the associated revenue loss--the Mortgage Subsidy Bond Tax Act of 1980 was passed, limiting the volume of tax-exempt financing for single-family housing beginning in April 1979 and eliminating the tax exemption for bonds issued after December 31, 1983. 21/ Under the 1980 act, the annual volume of bond issuances in any state is limited to the greater of $200 million or 9 percent of the average of all home mortgages originated in the state during the preceding three years. The 1980 act also imposed price limits for homes purchased with bond-financed mortgages, required that a portion of bond proceeds be used to finance mortgages in geographically targeted areas, limited eligibility primarily to principal residences of first-time homebuyers, restricted the assumability of the low-rate mortgages, and limited the differential between bond interest rates and interest rates on the mortgages they finance. The 1982 Tax Equity and Fiscal Responsibility Act liberalized the terms of mortgage revenue bonds somewhat. 22/

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21. Under the 1980 act, mortgage revenue bonds for veterans' housing secured by the general obligation of the issuing state will continue to be permitted after 1983.

22. See Chapter IV for a discussion of the 1982 tax act changes.

The volume of single-family mortgage revenue bonds dropped sharply in 1981 as a result of the limits imposed in 1980, but then grew again in 1982, reaching a level about equal to the 1980 volume. These fluctuations were a response to high market interest rates and housing market conditions as well as to the provisions of the 1980 and 1982 acts. Revenue losses associated with the bonds are expected to total $1.5 billion in fiscal year 1983 and to rise to $1.7 billion in fiscal year 1984, if the December 31, 1983, sunset on bond issues goes into effect. In fiscal year 1988, the revenue loss from the bonds is expected to be $1.5 billion, if the sunset takes effect.

The Taxation of Lending Institutions

Current federal tax law encourages thrift institutions to invest heavily in residential mortgages through an excess bad debt reserve tax deduction. Section 593 of the Internal Revenue Code specifies that a thrift institution may deduct as much as 34 percent of its total taxable income as an addition to its bad debt reserve, if a specified percentage of its assets is held in mortgages or other qualifying forms. 23/ The full 34 percent deduction is available to savings and loan associations with at least 82 percent and to mutual savings banks with at least 72 percent of their assets in qualifying forms. 24/ As the proportion of an institution's assets held in qualifying forms declines, so does the permissible excess bad debt reserve deduction. The deduction reaches zero for savings and loan associations with 60 percent or less of their assets in qualifying forms and for mutual savings banks with 50 percent or less of their assets in qualifying forms.

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23. Qualifying assets include: 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.

24. The Tax Equity and Fiscal Responsibility Act of 1982 reduced the maximum excess bad debt reserve tax deduction from 40 percent to 34 percent.

CHAPTER IV. RECENT CHANGES IN THE MARKET AND IN FEDERAL POLICY

Developments since the late 1970s have appreciably altered the housing finance system. Although savings and loan associations continue to originate more mortgages than any other single source, rather than holding mortgages in their portfolios they now either sell a large proportion of them to federally sponsored credit entities or pool them to back securities. In addition, the forms of housing credit have been affected. This chapter discusses recent shifts in the housing credit market and in federal policies, and analyzes their impact on the sources, forms, and cost of mortgage credit.

CHANGES IN THE HOUSING CREDIT SECTOR

As noted in Chapter II, the rapid inflation and elevated interest rates of the late 1970s significantly affected both borrowers--potential homebuyers--and lenders in the interest-rate-sensitive housing sector. Although rising home prices and mortgage interest rates increased the before-tax cost of ownership during this period, the homeownership deductions provided through the tax system and the expectation that future home-price increases would more than keep pace with inflation helped fuel a continued strong demand for housing. 1/ During 1977 and 1978, the increased demand for homes was reflected in increased demand for credit to purchase housing, with buyers expecting to capture sizable enough appreciation in the value of their homes to offset the high interest costs. Also, buyers were willing to take on the burden of mortgages with higher interest rates because they expected their nominal incomes to increase in the future with inflation.

Eventually, however, the rise in mortgage interest rates increased the cost of credit to borrowers sufficiently to reduce demand and, thus, both house sales and housing construction. Between the first quarter of 1978 and the fourth quarter of 1981, the average interest rate for new mortgages on

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1. Demographic factors also influenced the demand for housing. The 17.4 million increase in the number of households between 1970 and 1980, reflecting the passage of the peak post-World War II baby boom cohort into the years in which many first buy homes, increased housing demand throughout the 1970s, an effect that could continue in the 1980s.

existing homes increased from 9.0 percent to 15.6 percent, and the average percentage of median family income required to support an average mortgage grew from 22 percent to 38 percent. House sales remained roughly constant during 1978, but trended downward from 1979 through 1981, as interest rates rose and expected appreciation in value began to lag. Between 1978 and 1981, total housing units started annually also fell--from 2.0 million to 1.1 million.

Rising interest rates also adversely affected thrift institutions--the major source of mortgage credit. First, these institutions found their supply of credit dollars dwindling as their investors withdrew funds in search of the higher yields that the depository institutions were not allowed to offer at that time. This left the savings and loan associations and mutual savings banks with limited funds with which to finance new mortgage loans.

Thrift institutions also found their earnings squeezed and thus their profitability lessened by the higher interest rates. Formerly, the short-term rates paid on deposit accounts had been fixed by regulation and held below the long-term yields from the mortgage assets in the portfolios of the institutions. The rise in interest rates altered this relationship, however, as the federally imposed ceiling on interest rates on deposit accounts was raised to a level closer to the average yields on outstanding mortgages, many of which were issued in an earlier period of lower interest rates.

CHANGES IN FEDERAL POLICY

Federal housing finance policy has also changed markedly in the past five years--partly in response to the impact of market conditions on thrift institutions. Recent policy changes have altered the regulation of both federal financial institutions and pension plan investments. At the same time, the forms of direct federal market intervention have been changed, and relevant tax provisions have been modified.

Deregulation of Financial Institutions

Since the middle of the 1970s, the restrictions on depository institutions have been eased, enabling them to attract additional funds, expand the types of investments they can make, and be more flexible in choosing their institutional form. This has involved:

- Allowing market-determined-rate deposits;

- Authorizing the use of alternative mortgage instruments;

- o Broadening lending powers; and
- o Liberalizing chartering options.

Allowing Market-Determined-Rate Deposits. Beginning in the late 1970s, federally chartered depository institutions were authorized to offer several deposit accounts on which interest rates are determined by market conditions. This was the first step toward the legislated elimination by January 1, 1984, of all deposit-interest-rate ceilings that had been established by the Federal Reserve rule commonly known as Regulation Q. 2/ Although the new accounts were intended to enable thrift institutions to compete for deposits during periods of high interest rates, restrictions on the alternatives offered by the thrifts still limited their ability to compete with the money market mutual funds offered by other types of private financial institutions. Not until late in 1982 were the thrift institutions allowed to offer money market deposit accounts.

The move toward market-determined-rate deposits at the thrift institutions began in 1978 with the authorization of 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 longer-term Small

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2. The 1980 Depository Institutions Deregulation and Monetary Control Act established March 31, 1986, as the deadline for the complete phase-out of account rate ceilings. The 1982 Garn-St. Germain Depository Institutions Act moved this deadline to January 1, 1984. Regulation Q currently limits the maximum passbook savings account yield to 5.5 percent.

   At the same time that interest-rate ceilings on deposit accounts are being phased out, ceilings on mortgage interest rates (usury ceilings) also are being removed. In the 1980 Depository Institutions Deregulation and Monetary Control Act, the federal government preempted state ceilings on first mortgages made by all major types of lenders for home purchases and gave states until April 1, 1983, to override this preemption. Twelve states and Puerto Rico have overridden the preemption, but only one state--Kansas--has both overridden this preemption and established a state ceiling for mortgage loan interest rates. In Kansas, the ceiling was set at 1-1/2 percentage points above the average weighted yield effective on the FHLMC weekly purchase program on the first day of each month. (This ceiling was established before the FHLMC shifted from a weekly to a daily purchase program.)

Savers certificate was introduced, with a minimum maturity of 30 months (and a maximum of 48 months) and a variable ceiling rate--related to the yields on Treasury securities of comparable maturities, and originally capped at 12 percent. The Small Savers certificate was introduced in part to counteract the shortening of deposit liabilities that resulted from the popularity of the Money Market certificates. To enhance their competitiveness the 12 percent cap on the Small Savers certificate has been removed, and the minimum denomination of the Money Market certificate lowered to $2,500, but penalities for premature withdrawal continue to limit their attractiveness compared with money market mutual funds. Finally, between October 1981 and December 1982, one-year, tax-exempt All Savers certificates were issued--with rates set at 70 percent of the average annual yield of the most recent auction of 52-week Treasury bills, and with 75 percent of the funds earmarked for housing loans.

The 1980 Depository Institutions Deregulation and Monetary Control Act continued this trend by allowing federally chartered savings and loan associations and mutual savings banks to establish Negotiable Order of Withdrawal (NOW) accounts--equivalent to interest-earning checking accounts. On January 5, 1983, so-called Super NOW accounts became available, offering higher yields but also requiring larger minimum balances than the regular NOW accounts.

The availability of market-determined-rate accounts and certificates of deposit substantially altered the deposit structure of thrift institutions. Liabilities shifted from those subject to fixed interest-rate ceilings to those subject to interest-rate ceilings tied to various market rates, and to liabilities that are not subject to any interest-rate ceiling. Between 1974 and 1982, for example, the share of savings and loan associations' liabilities subject to fixed interest-rate ceilings declined from nearly 90 percent to less than one-fifth, while liabilities subject to market-determined ceilings grew from zero to nearly one-half of the total, and liabilities subject to no interest-rate ceiling increased from about one-tenth to one-third of the total (see Table 2).

While the availability of market-determined-rate deposits induced many savers to shift funds already held in thrift institutions in order to earn higher rates of return, they attracted few new deposits because the early instruments were poor competitors with money market mutual funds. To rectify this, the Garn-St. Germain Depository Institutions Act of 1982 directed the Depository Institutions Deregulation Committee (DIDC) to allow the establishment of deposit accounts at federal depository institutions that would be "directly equivalent with money market mutual funds."

On December 14, 1982, the new money market deposit accounts were established with a minimum balance no smaller than $2,500. 3/

Because the early market-determined-rate accounts and certificates of deposit shifted funds from low-yielding fixed rate accounts to those yielding higher and varying rates, they helped contribute to a serious earnings squeeze for many thrift institutions whose assets were still concentrated in long-term, low-yield, fixed rate mortgages. Between 1978 and 1982, the profitability of savings and loan associations--measured by retained earnings as a percent of average total assets--declined from 0.84 percent to -0.65 percent, and the profitability of mutual savings banks dropped from 0.58 percent to -0.72 percent. In addition, the number of savings and loan associations declined from 4,002 to 3,343 between the end of 1980 and the end of 1982, and the number of mutual savings banks declined from 463 to 424--reflecting, in large part, the failure or forced merger of financially strapped institutions. 4/

The money market deposit accounts and the Super NOW accounts, on the other hand, have attracted a large volume of new dollars to depository institutions at a time when the cost of variable-interest-rate deposits has fallen relative to mortgage revenues. Between December 1982, when they were first authorized, and the end of the first half of 1983, money market deposit accounts had acquired balances of $105 billion at savings and loan associations. Super NOW accounts--first authorized in 1983--had established balances of $7 billion at savings and loan associations at the end of the first half of 1983. 5/ The availability of these additional funds, combined with the sharp decline in short-term interest rates since mid-1982, has improved the profit prospects for the thrift institutions. For example, FSLIC-insured savings and loan associations had a net after-tax loss of $1.0 billion in the July-December period of 1982, less than a third of the record loss experienced during the preceding six months. 6/

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3. On September 30, 1983, the Depository Institutions Deregulation Committee (DIDC) voted to gradually eliminate by January 1, 1986, the minimum-deposit restrictions on the already ceiling-free money market deposit accounts and Super NOW accounts.

4. Andrew S. Carron, The Rescue of the Thrift Industry (Washington, D.C.: The Brookings Institution, 1983), pp. 2 and 6.

5. "Savings and Loan Activity in July," FHLBB News, August 30, 1983, Table 2.

6. "Bank Board Reports Sharp Improvement in Savings and Loan Operating Results in Second Half of 1982," FHLBB News, April 27, 1983.

TABLE 2. PERCENTAGE DISTRIBUTION OF INTEREST-BEARING LIABILITIES AT SAVINGS AND LOAN ASSOCIATIONS, SELECTED YEARS, 1966-1982[a]

Type of Liability	1966	1969	1973	1974	1978	1980	1981	1982
Subject to Interest-Rate Ceilings								
Fixed Rate Ceilings								
NOW Accounts	--	--	--	--	0.1	0.2	1.4	2.0
Passbook Savings	83.1	64.1	43.5	40.1	29.3	18.4	15.2	13.1
Fixed-Ceiling Time	10.9	29.7	48.7	49.4	50.6	20.8	11.1	4.8
Subtotal	94.0	93.8	92.2	89.5	80.0	39.4	27.7	19.9
Market-Determined Ceilings								
Money Market Certificates	--	--	--	--	8.4	32.6	30.5	24.9
Small Savers Certificates	--	--	--	--	--	9.6	16.0	20.8
All Savers Certificates	--	--	--	--	--	--	3.3	1.0
Subtotal	--	--	--	--	8.4	42.2	49.8	46.7
Not Subject to Interest-Rate Ceilings								
Large-Denomination Time Deposits	--	--	1.2	1.7	3.1	7.1	7.9	12.3
Money Market Deposit Accounts[b]	--	--	--	--	--	--	--	6.0
Other Borrowings (Except FHLB[c] Advances)	0.4	0.3	0.8	1.2	2.2	3.0	3.1	3.5
FHLB Advances	5.6	5.9	5.8	7.6	6.3	8.3	10.4	9.8
Retail Repurchase Agreements	--	--	--	--	--	--	1.1	1.7
Subtotal	6.0	6.2	7.8	10.5	11.6	18.4	22.5	33.3
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

SOURCE: Federal Home Loan Bank Board data. Components may not add to totals because of rounding.

a. Data are for December each year.

b. Money market deposit accounts are the money market accounts first issued by savings and loans in December 1982.

c. Federal Home Loan Bank.

In a move that enhances the flexibility of market-determined-rate deposits for financial institutions, effective October 1, 1983, the Depository Institutions Deregulation Committee (DIDC) eliminated all interest-rate ceilings and minimum-deposit restrictions on newly issued, renewed, or enlarged savings accounts that remain on deposit more than 31 days. The DIDC also eased the minimum penalties that can be levied by financial institutions on customers who withdraw funds from these accounts before maturity. This change affected Money Market certificates and Small Savers certificates. The only remaining accounts with interest-rate ceilings are passbook savings accounts, regular checking accounts (that earn no interest), and regular NOW accounts. The only remaining accounts with minimum-deposit requirements are the money market deposit accounts and the Super NOW accounts.

Authorizing the Use of Alternative Mortgage Instruments. Also beginning in the late 1970s, lending institutions were authorized to make mortgages other than fixed rate, long-term, level-payment loans-- alternatives that became attractive during this period of rapidly rising home prices and high and uncertain interest rates. Beginning in 1979, for example, savings and loan associations and mutual savings banks were permitted to write graduated payment mortgages that involve lower initial mortgage payments rising on a predetermined schedule during the early years of the loan before leveling off. The graduated payment mortgage--and variations on it such as the growing equity mortgage with which payment increases are used to pay off the principal more rapidly--were offered, in part, to make homeownership more easily affordable. These alternative mortgage instruments achieve this objective by reducing the mortgage-payment burden in the early years of a loan. 7/

In 1981, the FHLBB and the Office of the Comptroller of the Currency implemented regulations to permit federally chartered savings and loan associations, mutual savings banks, and commercial banks to originate, purchase, and hold adjustable rate mortgage loans--mortgages with interest rates that can vary over the life of the loan based on market conditions. Adjustable rate mortgages shift some of the interest-rate risk from lenders to borrowers, and, over time, could make the assets and liabilities of depository institutions more compatible, because both would be responsive to current market rates on an ongoing basis. To date, however, the portfolios of thrift institutions remain dominated by fixed-rate level-payment mortgages. Borrowers appear to be reluctant to accept variable-rate loans, although some of this may be due to the pricing and marketing practices of the thrift institutions.

7. See Appendix C for a comparison of these and other alternative mortgage instruments.

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In 1982, both the FHLBB and the Office of the Comptroller of the Currency proposed amendments to existing regulations to increase the flexibility of depository institutions in designing adjustable rate mortgage instruments. Among other things, these new rules abolish limits on the frequency of interest-rate and payment adjustments and on the magnitude of interest-rate adjustments. 8/ The revised FHLBB rules went into effect in 1982; the new rules of the Comptroller of the Currency became final in 1983.

Broadening Lending Powers. Acts passed in 1980 and 1982 further enhanced the lending flexibility of thrift institutions by expanding the instruments in which they can invest. The 1980 Depository Institutions Deregulation and Monetary Control Act authorized federally chartered savings and loan associations to invest up to 20 percent of their assets in a combination of consumer loans, commercial paper, and corporate debt securities; to offer credit card services; and to exercise trust and fiduciary powers. The act also authorized savings and loan associations to make second mortgage loans and to originate residential mortgage loans without geographic restrictions. Federally chartered mutual savings banks 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.

The Garn-St. Germain Depository Institutions Act of 1982 continued the broadening of lending powers. The 1982 act provided federally chartered thrift institutions with commercial, agricultural, and corporate lending authority without geographic restrictions for up to 5 percent of their assets (7-1/2 percent for savings banks) beginning on the date of enactment of the bill, with the permissible share rising to 10 percent of assets for all thrift institutions in 1984. This commercial lending authority may be in the form of either direct loans or participations, that is, shares of loans. In addition, the act allows a maximum of 10 percent of a thrift institution's capital accounts to be invested in government securities that are obligations of a single governmental unit, with no limit on the number of governmental units.

The impact of these expanded powers on lending institutions and on the housing finance system will depend on the extent to which the new authority is used. Because there are so many residential mortgages in the portfolios of the savings and loan associations, those institutions could invest all of their net new deposits in consumer loans, commercial paper or loans, and corporate debt securities for the next few years before the 20

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8. See 48 FR 9506 for the final Comptroller of Currency regulation and 47 FR 36612 for the final FHLBB rule.

percent ceiling on these investments would become a constraint. However, these institutions have a strong incentive to limit investments in nonmortgage assets to no more than 18 percent in order to qualify for the maximum bad debt reserve deduction from their taxable income. Also, their expertise in mortgage lending and their limited experience in other areas may make the thrift institutions reluctant to move rapidly into commercial lending.

Liberalizing Chartering Options. As a final means of increasing the flexibility of federally chartered thrift institutions, the 1982 act permitted savings and loan associations and mutual savings banks to convert from one form to the other and, in so doing, to change between the stock and mutual forms of organization. Conversions are subject to rules prescribed by the appropriate regulatory body, but converted associations are entitled to all the benefits of their new form of organization.

The decision to convert depends on the operating position of the depository institution. Conversion from a savings and loan association to a mutual savings bank provides an advantage in the use of the bad debt reserve tax deduction, because mutual savings banks may take the maximum tax deduction while holding only 72 percent of their funds in qualifying assets, compared to the 82 percent required of savings and loan associations. Conversion from a mutual savings bank to a savings and loan association--that is, from a mutual to a stock form of ownership--on the other hand, may be appealing at times, since stockholder-owned institutions have the ability to raise capital beyond that provided by retained earnings, making them better able to absorb interest-rate risks associated with accepting short-term savings deposits and extending long-term mortgage credit. Between October 1982 and October 1983, 113 savings and loan associations have been approved for charter conversion to mutual savings banks while no mutual savings banks have applied for conversion to savings and loan associations.

Changes in the Regulation of Pension Plan Investments

Recent changes in Department of Labor regulations specifying permissible transactions for private pension plans covered by the Employee Retirement Income Security Act (ERISA) also have implications for the housing finance system because they facilitate pension fund investments in mortgage loans. Specifically, on May 18, 1982, the Prohibited Transaction Exemption 81-7 was amended to allow pension plans to invest in a wide range of residential mortgage loans and to purchase mortgage-backed securities issued by the FNMA or the FHLMC, or guaranteed by the GNMA. 9/ In addition, privately assembled pools of conventional mortgages

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9. Residential mortgage loans eligible for pension plan purchase are those on both newly built and existing single-family homes, on two- to four-

no longer must consist of loans meeting FNMA, FHLMC, or GNMA program criteria in order to qualify for pension plan investment. On January 7, 1983, the Prohibited Transaction Exemption was further amended to allow pension plans to purchase MBSs backed by second mortgages and to authorize the issuance of commitments for forward delivery of MBSs purchased by the plans. 10/

Although these amendments broaden the range of housing-related investments that pension plans can make, they do not encourage secondary market investment in privately issued conventional MBSs--an activity with a sizable potential to channel additional funds into housing investment. The remaining regulatory impediment is the requirement that each conventional mortgage backing an MBS be evaluated on its quality as an investment, while the securities alone are so evaluated for the MBSs backed by FHA-insured or VA-guaranteed mortgages. The Department of Labor considers the Prohibited Transaction Exemption still to be incomplete, however, and suggests that it may be amended further to encourage investment in privately issued conventional MBSs. 11/

Changes in Direct Federal Interventions

Federal mortgage insurance and guarantee programs and the programs operated by secondary mortgage market credit entities have also been changed recently to accommodate new housing market circumstances.

Mortgage Insurance and Guarantees. The FHA and VA mortgage insurance and guarantee programs have been broadened recently to include certain alternative mortgage instruments. Since 1982, the FHA Section 245 graduated payment mortgage program--authorized by the 1974 Housing and Community Development Act but not active until amended in 1977--has included growing equity mortgages. Similarly, the VA now guarantees graduated payment mortgages, growing equity mortgages, and below-market-interest-rate mortgages for which builders pay the rate differential. Neither FHA nor VA programs currently include adjustable rate mortgages, however.

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9. (Continued)
unit dwellings, on condominiums, on cooperative units, and on manufactured housing.

10. See 47 FR 21241 and 48 FR 895.

11. Options for further amending ERISA regulations are discussed in Chapter V.

Greater interest-rate variability is also now permissible on some FHA-insured loans. In May 1982, the Department of Housing and Urban Development established an experimental program in which a limited number of loans insured under FHA's principal single-family program can be made at interest rates negotiated by the borrower and the lender, rather than being restricted to a maximum set by the Department. 12/

Secondary Market Agencies. The federal secondary market credit entities have also expanded existing programs and developed new ones in recent years.

The GNMA now guarantees securities backed by some kinds of alternative mortgage instruments and has taken steps to increase investment and trading in all its securities. Privately issued securities backed by FHA/VA graduated payment or growing equity mortgages are now eligible for GNMA guarantee. An innovative mortgage-backed security (MBS) program--known as GNMA II and initiated July 1, 1983--is expected to increase trading in GNMA securities through such changes as providing a central paying agent to disburse single checks to owners of several MBSs.

The FNMA has expanded both the types of mortgages it purchases and its MBS programs. For example, the FNMA now purchases growing equity mortgages and also issues and guarantees MBSs backed both by growing equity mortgages and by rapid payoff loans. 13/ The FNMA also now operates a program in which it trades its securities for old, low-yielding mortgages held by the lending institutions. Because the FNMA securities have the same interest yield as the underlying mortgages, they do not directly affect the cash flow of lending institutions. Nonetheless, this so-called swap program appeals to lenders, because the securities they receive are more readily saleable in the secondary market than the mortgages they replace.

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12. Legislation reported by the Senate Committee on Banking, Housing, and Urban Affairs (S.1338) as amended by the Senate on June 21, 1983, would eliminate the requirement that FHA insurance rates be set by law and would allow them to be set as agreed upon by the borrower and the lender. H.R. 1, as passed by the House of Representatives, also would establish a negotiable rate for FHA insurance programs.

13. Rapid payoff loans are fixed-rate loans on which annual hikes of 2-1/2 to 7-1/2 percent in monthly payments are used to pay off principal in such a way that the home is owned free and clear in 11 to 13 years.

The FHLMC has also recently modified its mortgage purchase program to enhance its ability to provide loanable funds. For example, the FHLMC has begun to buy blanket mortgage loans on cooperative housing projects and to package them in securities for sale to investors. In addition, the FHLMC operates a program, similar to FNMA's swap program, that allows thrift institutions to trade old, low-yielding mortgages for a like amount of FHLMC participation certificates.

Changes in Tax Provisions

Tax laws passed in 1981 and 1982 have altered some of the incentives for investment in rental housing and the subsidies provided to homebuyers through tax-exempt mortgage revenue bonds. In some instances, changes made in the 1981 act were partially offset by provisions of the 1982 law.

The 1981 Economic Recovery Tax Act established a new system for more rapidly depreciating investments in both personal and real property--that is, plant, equipment, commercial buildings, and rental housing. Known as the Accelerated Cost Recovery System (ACRS), it permits capital costs to be recovered for tax purposes using accelerated methods over predetermined periods that are generally unrelated to the useful lives of the assets but are shorter than those in prior law. The act lowered the depreciable life of all real property to 15 years. Over this period, all real property can be depreciated using the accelerated 175 percent declining balance method; low-income rental housing can be depreciated using the 200 percent declining balance method. 14/ When a residential property is sold, only the excess property value depreciated using the accelerated--instead of the straight-line--method is taxed as ordinary income. The rest of the increase in the property's value is taxed as capital gains at a maximum rate of 20 percent--lower than the rate on ordinary income for most investors. In contrast, when nonresidential property is sold, the full increase in its sale value is taxed as ordinary income whether or not its depreciation has been accelerated.

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14. Under the 1981 act, both new and existing residential rental property (acquired since 1981) may be depreciated using either the 175 percent declining balance method over a 15-year capital recovery period, or the straight-line method over either a 15-, 35-, or 45-year period. Although real property may be depreciated initially using accelerated methods, in order to depreciate the property value to zero in 15 years, at some point, straight-line depreciation must be used. By law, the property owner may shift from accelerated to straight-line depreciation when the value of the depreciation under the straight-line method exceeds that under the accelerated method.