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Working Paper #29

HOUSING FINANCE AND SECONDARY MORTGAGE MARKETS

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HOUSING FINANCE AID SECONDARY MORTGAGE MARKETS

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This working paper presents some reflections of the author on a basic program for instituting a Housing Finance System in a developing country not encumbered with an existing system. It considers the establishment of secondary mortgage markets to assist in the orderly growth of the mortgage markets.

A. Summary of the suggestions is as follows (not necessarily in chronological order of suggested implementation):

Establishing a Housing Mortgage Finance System

1. Establish a specialized housing finance system
2. Adopt a system of title search and registration modeled after the Torrens System
3. Establish a savings account insurance system and mortgage default system
4. Standardize the mortgage document
5. Establish an appropriate balance between concentration of new housing and maintenance of the existing stock of housing
6. Develop a Central Housing Bank
7. Provide education and counseling on home purchasing and renting decisions

8. Establish uniform regional zoning standard procedures
9. Emphasize small lot zoning
10. Emphasize home ownership
11. Establish taxation policies that are not disproportionately applied on housing
12. Develop a secondary mortgage market

#### Establishing a Secondary Mortgage Market

1. Establish one or more nationwide secondary mortgage market corporations
2. Do not ask these corporations to utilize their profits for housing subsidies
3. Establish the goal of maximizing the amount of buying and selling of commitments and of mortgages by private lenders
4. Investigate operations of the stock markets, bond markets, commodities options markets and other future markets to determine principles that might be applicable to the mortgage market
5. Incorporate innovative ideas -- experiment in institution building
6. Encourage the secondary mortgage market corporation to issue advance commitments to purchase mortgages at a price sufficiently attractive to encourage builders and

mortgage originators to finance housing but not to usurp the the private market

7. Concentrate on maximizing the involvement by private lending institutions so that the secondary mortgage market corporation does not dominate the national market in commitments, mortgage loans, mortgage price insurance or access to the capital markets

## Housing Finance and Secondary Mortgage Markets

by R. Bruce Ricks

I am very delighted that AID has taken the leadership in establishing this working conference. It is a very important conference on a very important aspect of the development of mortgage markets and housing finance, both in Latin American countries and the United States.

The gentlemen you have on your program from the Federal National Mortgage Association, the Government National Mortgage Association, and the Federal Home Loan Mortgage Corporation are truly the United States' leading technical experts on this subject. Yet, in my judgment they are more than that -- they must justifiably be counted among this country's intellectual leaders in this complicated subject. For, in addition to implementing technical aspects of the secondary mortgage market, they are truly creating and examining the philosophy of secondary mortgage markets, mortgage transfers, and the fundamental structure of housing finance in the United States. In the fashion of true, good intellectuals, they are very open and willing to admit that much is not known about the ideal functioning of mortgage

markets, and much of the work done in the United States is experimental. We are truly a developing country in this aspect of housing finance. In fact, we may not yet have secondary mortgage markets in the United States. If we define a mortgage "market" as we define a capital "market", where buyers and sellers can meet either face-to-face or over the communication system and trade rapidly in instruments for immediate or deferred transfer of ownership in what we define "a bundle of financial rights", we may not have a "market." If we define "secondary" mortgage markets like we define a secondary market in stocks and bonds where the transactions take place not between a specific borrower and a lender directly or through an intermediary, but as a market in existing instruments between an investor who wishes to sell and an investor who wishes to buy (with the transactions taking place either direct or through brokers or agents), then we now have neither a mortgage "market" in general, or a "secondary" mortgage market, in particular. But, as these intellectual, expert gentlemen have been telling you, we are rapidly approaching it.

These gentlemen have been explaining to you how their organizations operate and developments they expect in the future in their organizations so that you may decide which

of these techniques you wish to adopt. I have been wondering how I could be most helpful to you. I have not been fully involved in the technical or operational details, the specific techniques or operations of the mortgage markets corporations, but I have simply offered suggestions to these gentlemen for their consideration. My background prior to the Federal Home Loan Bank Board has been one of being a professor, an economist, and somewhat of a theorist about housing finance and the structure of mortgage markets. Therefore, I thought I might be most helpful to you if I could offer for your consideration and discussion a list of suggestions as to how I would set up a housing finance structure, if I had the exciting and challenging responsibility in a developing country which many of you gentlemen are privileged to have. It is quite presumptuous of me to do so, but let me take the risk of being presumptuous in the hope of being helpful.

#### Steps in Establishing a Housing Mortgage Finance System

1. Set up a system of financial institutions with specific responsibilities for investing their assets in housing

finance but encourage competition for housing finance investments by other diversified financial institutions.

2. Adopt a system of title search and registration modeled after the TORRENS system. This is a system whereby only the activity since the last search is reviewed, registered and charged for. This is much easier if the title protection is provided by the Government, or if the Government reinsures the accuracy of the search activity done by private businesses. At the time the search is made, the price and terms of the transaction causing the search can also be reported, so that good quality, comprehensive data can be made available to appraisers, real estate research people, and planners.

3. Develop simultaneously a savings account insurance system and a mortgage default insurance system. Consider the following:

a) Whether each of these should be government or private.

b) Whether there should be a competing government and private system for each of the savings and mortgage insurance functions.

c) Consider whether the same entity or entities should do both of these two functions. (The advantage of one entity insuring both savings and mortgages is coordination. The disadvantage is primarily concentration of economic and financial risks.)

4. Standardize the mortgage document. In my judgment, the advantages of having nationally standardized mortgage document far outweigh the disadvantages of centralization of decision and authority. The mortgage market cannot become a good functioning secondary market without this action. Therefore, I suggest that a highly-skilled, technical group of document drafters learn from the mistakes of others and develop a mortgage instrument which can be used throughout the developing country.

5. Establish an appropriate balance between concentration on production of new housing and maintenance of the existing stock of housing. In the United States our annual housing production is only between two and three times the annual loss in inventory of housing units which is due to deterioration and to conversion of the land to other use.

In that respect, it is extremely important that in particular the country plans its highway program expansions so that the space is set aside for a number of years in the future, and it is not necessary to demolish good quality housing in order to expand the highway system.

a) In the program for maintenance of existing units, it should be made possible for home owners to borrow easily in order to improve their housing. Lenders should advise on what is truly an improvement, rather than something that would please only the present homeowner, and might detract from the resale of the property. It should be made easy to "open end" mortgages by increasing the outstanding balance on the existing mortgage without having to go through the cost of rewriting a new mortgage. One should consider making it a rule that the owner of a home be required to leave the refrigerator, stove, washing machine -- and perhaps the rugs, curtains and draperies. It is expensive to move these items, and if left with the house, they could be financed with the house much more cheaply than being financed on consumer credit.

b) In programs for the production of new housing, concentration, to the maximum extent that is politically feasible, should be on construction of middle and lower-middle class housing -- housing at a price range which people can buy without subsidy but with liberal mortgage terms such as a low down payment and a long number of years to amortize the mortgage. If the country concentrates on a very large supply of this type of housing, it will build up 1) a sense of pride in private ownership, 2) incentives for the people to work hard to secure job advancement and 3) incentives to save. As enough of this type of housing is built it will filter down to lower-income people at the same time that lower-income people filter up to this price housing. It will be less expensive to the Government to have nonsubsidized housing produced and will facilitate homeowner mobility if there is also concentration on keeping transfer costs low and making the mortgages assignable and easily refinaceable.

6. A Central Housing Bank should be developed which provides 1-5 year loans to savings institutions and other institutions which are active in supplying mortgage credit to homeowners and apartment owners. Consider the possibility that this Central Housing Bank could assist builders and lenders to carry an inventory of housing for awhile so that builders could build somewhat ahead of the rate at which the market is, at the moment, ready to buy housing. The Central Housing Bank should be a warehouse of credit as well as possibly facilitate warehousing of housing by builders and lenders. However, one must be EXTREMELY CAREFUL that such housing is of a type, location, and quality that the market desires.

7. Education and counseling should be provided widely to the public on how to purchase or rent housing, how to transfer title to it, how to select the right location, how to evaluate quality of construction, how to maintain and improve the housing unit, and how to budget for housing occupancy. The limited experience with these programs in the United States indicates that we have waited far too long to institute education and training on the utilization of an asset which represents an extremely high percentage of all personal wealth of the United States. Such counseling can reduce delinquencies and foreclosures and maintain the value of the existing inventory of housing.

8. National or regional uniformity of zoning laws and requirements, and standards for zoning decisions should be emphasized. Building codes should pertain to standards of performance and quality of product rather than to specific types of products or brands of merchandise. National building codes (which would vary by climatic conditions in parts of the country) and metropolitan zoning requirements on a metropolitan basis (rather than a multiplicity of small municipal jurisdictions within a metropolitan area) would permit economies of scale in the construction industry.

9. Small lot zoning should be emphasized in order to keep down land costs and avoid surrounding a growing metropolitan area with low density zoning which is wasteful of important land.

10. Ownership of housing units should be stressed over rental, but should not be restricted to single family homes. Ownership should also be available through condominium and co-operative ownership of apartments and townhouses and ownership of units on leased land.

11. Taxation should not bear disproportionately on housing simply because it is an easy tax to administer. It creates

distortions in land usage. Taxes on gains in land value should not serve as an inducement for speculators to hold land off the market unduly.

12. Develop a secondary mortgage market by emphasizing buying and selling of mortgages both between private lenders and between those lenders and one or more central secondary mortgage markets.

#### Secondary Mortgage Markets

Since secondary mortgage markets is the focus of your conference, let me spend more time talking about how I would approach this subject, if I were to have the luxury of starting from the beginning in a developing country without a history of institutions such as we have in the United States, and if I had the points which I have listed already in the process of being accomplished. The following are some items that I feel are of considerable importance in progressing toward the development of a secondary mortgage market. Some of these will seem a little repetitious with items of the previous list, but this is quite natural since they are heavily interrelated.

1. Establish one of more nation-wide secondary mortgage market corporations. I think more than one would give them some competition and some incentives to innovate, but would make explanations of the functioning of each of them somewhat more confusing. My preference would be for three or four in order to secure competition.

2. Do not ask the corporations to utilize their profits for housing subsidies. If the Government wishes to have housing subsidies it could transfer them to housing occupants through the secondary mortgage market corporations without impacting on their profits. The use as a conduit would, in my judgment, be satisfactory but not to use them as a subsidizer. Maintain continual incentives and inducements (and requirements if necessary) for the profit objectives of these corporations to be long-term profits rather than short-term, year-to-year profits. This can be accomplished, in part, through accounting treatment which calls for amortization of income and losses over several years and by access of these corporations to long-term capital.

3. Set as a goal maximizing the amount of buying and selling of commitments and of mortgages by private

lenders and supported by the secondary mortgage market corporations relative to a minimization of the inventory of mortgages held by the corporations. The direction of these corporations should not be to simply accumulate more and more mortgages that are held for long periods, since this does not constitute a secondary market, and it puts the corporations in an inflexible position. They would then have a tendency, at times, to become the only buyers of mortgages. Their objectives should be to facilitate transfer of mortgages and to offer price or yield insurance during the commitment process.

4. In studying the secondary mortgage market activity of other countries in order to gain a set of suggestions for the establishment of one in my hypothetical developing country, one should not just look at what is currently called secondary mortgage markets, but look also at the way the stock market, bond market, commodities markets, option markets, and other futures markets are established. For it is in these markets that you see active trading in readily identified securities where buyers and sellers understand clearly what they are buying. Some are seeking price insurance; others are looking for short-term investments; still others are looking for long-term investments. The markets act very fluidly and certain firms serve as

secondary market makers. Such is not the case in any secondary mortgage markets I know about.

5. One should not be afraid to consider innovative ideas. Do not conclude that simply because some mechanism does not exist in the more developed countries that it has been considered and rejected. It could be that there are so many institutional and political rigidities in a country with an established mortgage market that it is too late to accomplish worthwhile innovation in certain areas. As examples of innovation, the loan participation arrangement in Chile where individuals buy loans with a guarantee by the savings and loan association to buy it back at a stated yield is something we are only exploring in the United States. An idea suggested to me confidentially by Jose Penna of Brazil seems to go creatively beyond the way we permit savings and loan associations to deal with each other on loan transactions in the United States and beyond the GNMA operations.

6. I would encourage the secondary mortgage market corporations to issue advance commitments to buy mortgages at an interest yield which is sufficiently attractive to encourage builders and mortgage originators to finance new

housing when it is appropriate to do so. But the yield should not be attractive relative to the private competition, in order that the private lenders will be encouraged to actually make the loans. The secondary mortgage market corporations can, thus, collect their commitment fees but not have to be involved in the long-term holding of the mortgage. In other words, they should maximize the relationship or ratio of the commitments extended to the mortgages purchased.

7. The secondary mortgage market corporations should concentrate on maximizing the involvement in their programs by private lending institutions so that the secondary mortgage market corporations do not dominate the national market in commitments, mortgage loans, mortgage price (or yield) insurance or access to the capital markets. These corporations must always remain conscious of the objective of facilitating the workings of the private mortgage and savings markets and aiding their development rather than supplanting or dominating them.

These lists only probe the surface of the complicated subjects of housing finance and secondary mortgage markets, but I hope the points have provided some basis for your further discussion.