

Fall 1972

Home Financing at the Crossroads - A Study of the Federal Home Loan Mortgage Corporation

Richard W. Bartke
Wayne State University

Follow this and additional works at: <http://www.repository.law.indiana.edu/ilj>

 Part of the [Banking and Finance Law Commons](#), and the [Property Law and Real Estate Commons](#)

Recommended Citation

Bartke, Richard W. (1972) "Home Financing at the Crossroads - A Study of the Federal Home Loan Mortgage Corporation," *Indiana Law Journal*: Vol. 48 : Iss. 1 , Article 1.

Available at: <http://www.repository.law.indiana.edu/ilj/vol48/iss1/1>

This Article is brought to you for free and open access by the Law School Journals at Digital Repository @ Maurer Law. It has been accepted for inclusion in Indiana Law Journal by an authorized editor of Digital Repository @ Maurer Law. For more information, please contact wattn@indiana.edu.



JEROME HALL LAW LIBRARY

INDIANA UNIVERSITY
Maurer School of Law
Bloomington

INDIANA LAW JOURNAL

Volume 48

FALL 1972

Number 1

HOME FINANCING AT THE CROSSROADS—A STUDY OF THE FEDERAL HOME LOAN MORTGAGE CORPORATION*

RICHARD W. BARTKE†

The increased activity of the federal government in the field of home financing is well known and has been repeatedly discussed.¹ Congressional legislation has, over the years, provided a large number of governmental and quasi-governmental bodies directly or indirectly active in the field. The importance attached to the problem by Congress is attested to, *inter alia*, by the fact that home financing has attained cabinet status.² These various agencies, although their tasks are frequently overlapping, perform several distinct functions. Some of them are regulatory agencies which supervise certain segments of the financial community.³ Others are designed primarily to insure or guarantee certain kinds of mortgage loans to make them more acceptable to private lenders,⁴ and thus these

* This article is based on a study prepared by me for the Federal Home Loan Mortgage Corporation. The consent of the Federal Home Loan Mortgage Corporation and the Federal Home Loan Bank Board to use the study as a basis for this article is gratefully acknowledged. The views expressed herein are my own and do not necessarily represent the views of the Federal Home Loan Mortgage Corporation or the Federal Home Loan Bank Board.

The final revision of the manuscript was made in early July, 1972. Any developments after July 1, 1972, are not reflected.

† Professor of Law, Wayne State University; on leave 1972-73 Fulbright-Hays Visiting Professor of Law, University of Tehran.

1. See Colean, *A Review of Federal Mortgage Lending and Insured Practices*, 8 J. FIN. 249 (1953); THE PRESIDENT'S COMMITTEE ON URBAN HOUSING, *A DECENT HOME* 54-100 (1968) [hereinafter cited as *DECENT HOME*]; NATIONAL COMMISSION ON URBAN PROBLEMS, *BUILDING THE AMERICAN CITY* 94-180 (1969) [hereinafter cited as *AMERICAN CITY*].

2. The Department of Housing and Urban Development (HUD) was created by the Department of Housing and Urban Development Act, Pub. L. No. 89-174, 79 Stat. 667 (1965) (codified in scattered sections of 3, 5, 12, 42 U.S.C.). However, all housing functions of the federal government are not handled by HUD, a fact recently complained of by Secretary Romney. See *Hearings on H.R. 13694, H.R. 14639, H.R. 15402 & H.R. 11 Before the House Comm. on Banking and Currency, 91st Cong., 1st Sess.* 589 (1970) [hereinafter cited as *1970 House Hearings*].

3. *E.g.*, The Federal Home Loan Bank Board (FHLBB) and the Federal Home Loan Bank System, created by the Federal Home Loan Bank Act of July 22, 1932, ch. 522, 47 Stat. 725, as amended 12 U.S.C. § 1421 *et seq.* (1970).

4. *E.g.*, The Federal Housing Administration, created by the National Housing Act of 1934, ch. 847, 48 Stat. 1246, as amended 12 U.S.C. § 1701 *et seq.*

agencies have a direct influence on the kind, location and quality of housing being built.⁵ Finally, there are institutions whose main task is to provide additional amounts of money for home construction and home purchase.⁶ A recent addition to this last group is the Federal Home Loan Mortgage Corporation, created by title III of the Emergency Home Finance Act of 1970.⁷

The Federal Home Loan Mortgage Corporation has been in operation for just over a year. Even in this short period of time it has already asked Congress for amendments⁸ to its Charter Act because of the stringent limitations on its operations.⁹ The agency has been in existence long enough to give us an indication of where it is going, but not long enough to have acquired a ballast of historical background which might fossilize its structure. Therefore, the time would seem to be propitious for an examination of its background, its present structure and the direction in which it should be moving.

BACKGROUND

It is obvious that the home construction market depends on financing. Home buyers seldom have enough cash to make such a purchase. Even those who have sufficient cash or could obtain it without borrowing, usually rely on financing. Favorable tax provisions¹⁰ and a rising market for investments make it wiser to borrow the greater part of the purchase price

(1970). While the term Federal Housing Administration (FHA) is no longer used in the statute, it became so ingrained in the language of the industry that it continues to be employed. The FHA's functions are now performed by a branch of HUD.

5. FHA's concept of its function in this respect can be gauged by reading 7 FHA MANUAL, UNDERWRITING HANDBOOK, HOME MORTGAGES (1959). For a brief discussion of FHA's role in urban sprawl, see Bartke, *The Federal Housing Administration: Its History and Operations*, 13 WAYNE L. REV. 651, 658 & n.48 (1967).

6. *E.g.*, The Federal National Mortgage Association (Fannie Mae) and the Government National Mortgage Association (Ginnie Mae), created in their present form by title VIII of the Housing and Urban Development Act of 1968, ch. 448, 82 Stat. 536, as amended 12 U.S.C. §§ 1716-23d (1970). For the history and background of these organizations, see Bartke, *Fannie Mae and the Secondary Mortgage Market*, 66 NW. U. L. REV. 1 (1971) [hereinafter cited as Bartke]. For a short discussion from the agency's perspective, see Hunter, *The Federal National Mortgage Association: Its Response to Critical Financial Requirements of Housing*, 39 GEO. WASH. L. REV. 818 (1971) [hereinafter cited as Hunter]. For a discussion from a business perspective, see Breckenfeld, *Nobody Pours It Like Fannie Mae*, FORTUNE, June 1972, at 86.

7. Federal Home Loan Mortgage Corporation Act, 12 U.S.C. § 1451 *et seq.* (1970).

8. S. 1671, 92d Cong., 1st Sess. tit. III (1971); H.R. 7740, 92d Cong., 1st Sess. tit. III (1971).

9. For the positions of the Corporation and of the FHLBB, see the summary of the testimony of FHLBB Chairman Preston Martin, in FHLBB JOURNAL, May 1971, at 4.

10. INT. REV. CODE of 1954, §§ 121, 163, 164, 1014, 1034. See generally AMERICAN CITY, *supra* note 1, at 399-401.

and invest the cash in stocks or land. Real estate development or investment via financing is also profitable to the commercial sector, where advantageous tax provisions¹¹ and the "leverage" principle¹² greatly increase the effective rate of return. Besides buyers, home builders need an ample supply of construction financing since most builders are small and undercapitalized.¹³ For all of these reasons, it becomes apparent that the home construction and home purchase market cannot function effectively without a steady supply of mortgage money.¹⁴

Unfortunately, the home mortgage market lacks several prerequisites of a smoothly operating market and therefore finds it difficult to compete with other money markets for the available amount of savings. First, the trading units are usually too large to attract modest investors. Secondly, the units lack homogeneity and fungibility. Mortgages are different from each other in a bewildering number of ways. The principal amounts are different and vary from installment payment to installment payment. The interest rates are different. Many of the provisions depend on the idiosyncrasy of the originator. Furthermore, each of the fifty states has a different set of mortgage laws.¹⁵ Also, the security of the instrument depends on the financial responsibility of the borrower and on the value of the real estate itself which, in turn, depends on a host of factors from the economic condition of the general area to the condition of the immediate neighborhood.¹⁶ Thirdly, there are servicing problems to consider. Unlike most forms of investment, such as corporate equities, bonds and debentures, which present few servicing problems, mortgages need continual atten-

11. The most important provision is that governing accelerated depreciation deductions on new construction. INT. REV. CODE of 1954, § 167. *See also* Treas. Reg. § 1.167 (1956).

12. "Leverage" is the ability to control large investment with a small outlay of equity capital, used by investors to enhance the rate of return or capital gain on a given investment.

Dasso, *Changing Economic Conditions and the Condemnation Value of Real Property*, 48 ORE. L. REV. 237, 241 n.7 (1969). *See generally* Miller, *Real Estate Syndication Under the California Corporate Securities Law of 1968*, 16 U.C.L.A.L. REV. 371 (1969).

13. *See* Lefcoe & Dobson, *Savings Associations as Land Developers*, 75 YALE L.J. 1271, 1273-79 (1966).

14. *See* STAFF OF SUBCOMM. ON HOUSING OF THE SENATE COMM. ON BANKING AND CURRENCY, 86TH CONG., 2D SESS., *STUDY OF MORTGAGE CREDIT, DOES THE DECADE 1961-70 POSE PROBLEMS IN PRIVATE HOUSING AND MORTGAGE MARKETS WHICH REQUIRE LEGISLATION BY 1960?* (1960) [hereinafter cited as *MORTGAGE CREDIT*].

15. For a summary of the state foreclosure procedures, and of the time and cost involved therein, see A.B.A. Committee on Mortgage Law and Practice, *Cost and Time Factors in Foreclosure of Mortgages*, 3 REAL PROPERTY PROB. & TRUSTS J. 413 (1968).

16. For further discussion of the mortgage instrument, see Bartke, *supra* note 6, at 4-6; *see also* *The Secondary Mortgage Market*, MONTHLY BUSINESS REV. FED. RES. BANK OF CLEVELAND, July 1971, at 14, 17-18 [hereinafter cited as *RES. BANK OF CLEVELAND*].

tion.¹⁷ Lastly, mortgages lack liquidity or marketability and therefore, once again, are at a disadvantage when compared to competing investments. Corporate securities benefit from an efficient, well-developed secondary operation. The buyer of securities traded on one of the exchanges or on the over-the-counter market can quickly convert his investment into money, an option not open to the mortgage investor.

Authorities have long suggested that if home financing is to be competitive in today's money market, an effective secondary market for mortgages must be established.¹⁸ That is, a way should be provided for mortgage investors

in an organized fashion either to dispose of mortgages in their portfolios through sale or to convert such mortgages into securities acceptable to other segments of the investing public, directly or indirectly.¹⁹

The Federal National Mortgage Association (Fannie Mae) was established to perform this service for the FHA/VA sector of the mortgage market.²⁰ Fannie Mae's success in stemming the financial "crisis" of 1969-70²¹ led to demands by the savings and loan industry for a similar facility to service the conventional mortgage market.²² Adding to these demands was the fact that savings and loan associations had borne

17. See MORTGAGE CREDIT, *supra* note 14, at 285-86.

18. See *Hearings on Mortgage Market Problems Before the Subcomm. on Housing of the Sen. Comm. on Banking and Currency, 84th Cong., 1st Sess. (1955)*; O. JONES & L. GREBLER, *THE SECONDARY MORTGAGE MARKET, ITS PURPOSE, PERFORMANCE AND POTENTIAL* (1961).

19. Bartke, *supra* note 6, at 7-8.

20. See generally Bartke, *supra* note 6.

21. See Bartke, *supra* note 6, at 50-55; *1970 House Hearings, supra* note 2, at 604-10 (statement of Secretary Romney); RES. BANK OF CLEVELAND, *supra* note 16, at 14, 22-23.

For descriptions of the condition of mortgage markets in 1969-70, see *Hearings on S. 2958, S. 3503, S. 3508 & S. 3442 Before the Subcomm. on Housing and Urban Affairs of the Sen. Comm. on Banking and Currency, 91st Cong., 2d Sess. (1970)* [hereinafter cited as *1970 Senate Hearings*]; Mayer, *The Housing Shortage Goes Critical*, *FORTUNE*, Dec. 1969, at 86; Klamman, *The Outlook for Housing and Mortgage Markets*, *COMM. & FIN. CHRONICAL*, May 7, 1970, at 17, col. 3, at 47, col. 5; Maisel, *Mortgage Money in the 1970's*, *BUS. ECON.*, Sept. 1970, at 35; Schwartz, *Policies and Techniques for the Mortgage Market*, *BUS. ECON.*, SEPT. 1970, at 40.

While money was scarce throughout the economy during the 1969-70 crisis, the crunch was felt most severely in home financing and home construction. See MORTGAGE INTEREST RATES COMMISSION, *REPORT ON MORTGAGE INTEREST RATES 22-27 (1969)* [hereinafter cited as *MORTGAGE INTEREST RATES*]. Several institutional suppliers of home credit either abandoned the market altogether or radically curtailed their investments.

22. Bartke, *supra* note 6, at 61-62.

the brunt of supplying credit for home ownership during the 1966 and 1969-70 "crises."²³

The Savings and Loan Industry

The savings and loan industry has its roots in the 19th century, both in England and in this country. It started as a series of mutual cooperative associations, the aims of which were (1) to provide a means for profitable investment of modest savings of its members, and (2) to pool those savings for the purpose of increasing home ownership.²⁴ The only characteristic which modern savings and loan associations have retained from their original models is their commitment, both practical and legal, to the financing of improved real estate.²⁵ In all other aspects they have undergone tremendous structural changes and can no longer be viewed as aggregations of small scale savers, pooling their resources for a particular goal. On the contrary, the leaders of the industry are huge financial institutions performing a specialized service in the nation's money markets.

The industry is by no means monolithic. On the contrary, there are both structural and legal differences among industry members. First, some savings and loan associations are chartered by states²⁶ and, there-

23. "Savings and loan associations accounted for 53 per cent of the increase in home mortgage credit during the first three quarters of 1969 compared to their more normal 45 per cent . . ." *1970 House Hearings, supra* note 2, at 534 (statement of FHLBB Chairman Preston Martin). As money policies tightened during the 1969-70 crisis, the entire savings and loan industry encountered considerable problems. See Grebler & Doyel, *Effect of Industry Structure and Government Policies on Housing Demand and Cyclical Stability: Study of 1966 Experience*, in 3 *STUDY OF THE SAVINGS AND LOAN INDUSTRY* 1241 (I. Friend ed. 1969) [hereinafter cited as Grebler]; Duesenberry, *Appraisal of Selected Policy Instruments Affecting Savings and Loan Associations*, in 4 *STUDY OF THE SAVINGS AND LOAN INDUSTRY* 1591 (I. Friend ed. 1969) [hereinafter cited as Duesenberry].

For tables showing mortgage activities of the principal groups of institutional investors, see 57 *FED. RES. BULL.* A52-A55 (Nov. 1971).

24. J. EWALD, *A BUSINESS REBORN: THE SAVINGS AND LOAN STORY 1930-1960*, at 72-90 (1962); L. RODWIN, *HOUSING AND ECONOMIC PROGRESS: A STUDY OF HOUSING EXPERIENCES OF BOSTON'S MIDDLE-INCOME FAMILIES* 26-34 (1961); Sause, *Associations "For the Meritorious Purpose of . . . Mutual Benefit": A Chronicle of the Building and Loan Industry in Maryland from 1852-1961*, 22 *MD. L. REV.* 1, 91 (1962).

25. Illustrative is the case of federally chartered savings and loan associations, where the governing statute provides in part:

Such associations shall lend their funds only on the security of their savings accounts or on the security of first liens upon real property . . . which constitute first liens upon homes, combinations of homes and business property, other dwelling units, or combinations of dwelling units, including homes, and business property involving only minor or incidental business use . . .

12 *U.S.C.* § 1464(c) (1970).

26. There are at present 5,632 operating associations in the country. Of these, 3,585 are chartered by various states and 2,047 by the federal government. Source: Letter dated Jan. 5, 1972, from Kenneth M. Plant, Director of Research, Federal Home

fore, dependent for their legal framework on the applicable state statute and subject to its regulatory authority, while since 1933, increasingly larger numbers are chartered by the federal government.²⁷ This latter group automatically become members of appropriate federal home loan banks and are subject to supervision by the Federal Home Loan Bank Board (FHLBB).²⁸ The industry is also divided into those associations which are owned by shareholders and those which are chartered on the mutual principle. At present all federal associations must be mutual,²⁹ although bills pending before Congress would change that.³⁰ Most state associations are mutual too, since not all states permit the chartering of stock associations.³¹ However, the stock associations are among the leaders of the industry, and although their absolute numbers are relatively small, they loom very large in terms of assets and growth.³² Finally, most associations are insured by the Federal Savings and Loan Insurance Corporation.³³ This insurance is available not only to federally chartered associations but also to qualified state associations.³⁴ Although in numerical terms there are still many associations which do not qualify or have not applied for insurance,³⁵ in terms of assets they play a relatively insignificant role.

Despite these variations, there is sufficient commonality of interests

Loan Mortgage Corp., to Richard W. Bartke (a copy of which is on file in the offices of the Indiana Law Journal) [hereinafter cited as Letter].

27. See 12 U.S.C. § 1461 *et seq.* (1970).

28. *Id.* §§ 1464(a), 1464(f).

29. *Id.* § 1464(b) (1), (2).

30. S. 1671, 92d Cong., 1st Sess. § 101 (1971); H.R. 7740, 92d Cong., 1st Sess. § 101 (1971). Hearings on the bill have disclosed deep differences of opinion on the matter within the industry. See *Hearings on S. 1671 Before the Subcomm. on Housing and Urban Affairs of the Sen. Comm. on Banking, Housing and Urban Affairs*, 92d Cong., 1st Sess. (1971) [hereinafter cited as *1971 Senate Hearings*].

31. Twenty states authorize stock associations. ARIZ. REV. STAT. ANN. § 6-402 (1956); ARK. STAT. ANN. § 67-803 (1947); CAL. FIN. CODE §§ 5500, 6400 (1968); COLO. REV. STAT. ANN. §§ 122-2-4, 122-2-5 (1963); HAWAII REV. STAT. §§ 407-14, 407-15 (1968); IDAHO CODE § 26-1803 (1968); ILL. REV. STAT. ch. 32, §§ 728, 761 (1970); KAN. STAT. ANN. §§ 17-5401, 17-5402 (1964); MD. ANN. CODE art. 23, § 144 (1966); MICH. COMP. LAWS ANN. §§ 489.910 to 489.920 (Supp. 1972); MISS. CODE ANN. § 5290 (1956); NEV. REV. STAT. §§ 673.080, 673.080-3 (1967); N.M. STAT. ANN. § 48-15-58 (Supp. 1971); OHIO REV. CODE ANN. § 1151.20 (1968); ORE. REV. STAT. § 722.035 (1969); TEX. REV. CIV. STAT. art. 852(a), § 2.02 (Supp. 1972); UTAH CODE ANN. §§ 7-13-2, 7-13-31 (1971); VA. CODE ANN. § 6.1-133 (1966); WASH. REV. CODE § 38.48.020 (1964); WYO. STAT. ANN. §§ 13-279.01, 13-279.1 (1965).

32. See Hester, *Ownership and Behavior in the Savings and Loan Industry*, in *CONVERSION OF MUTUAL SAVINGS AND LOAN ASSOCIATIONS TO STOCK FORM: LEGAL AND ECONOMIC ISSUES* 30 (K. Scott & D. Hester ed. 1967). See also Bentley & Macbeth, *Mortgage Lenders and the Housing Supply*, 57 CORNELL L. REV. 149 (1972).

33. Altogether 4,287 associations are so insured. Letter, *supra* note 26.

34. 12 U.S.C. § 1726(a) (1970).

35. Of the 3,585 state-chartered associations, 2,240 are insured. Letter, *supra* note 26.

in the industry to permit certain broad generalizations. All of these associations depend for their funds primarily on passbook deposit accounts.³⁶ While technically associations can require a notice before withdrawal and may delay payment of funds for varying periods,³⁷ usually thirty days, such a requirement is seldom enforced. Competitive forces in the market effectively preclude invoking these legal sanctions except in extreme circumstances. Both for historical reasons and because of statutory requirements,³⁸ the associations invest very heavily in mortgages, primarily home mortgages.³⁹ Therefore, their assets are tied up in long-term investments with maturity dates twenty, thirty or even forty years in the future.⁴⁰ The home mortgage used during the last twenty years is a fully amortizable one, which means that each monthly payment consists of both interest and principal, and therefore even with a thirty or forty year maturity some principal is repaid during the early years.⁴¹ Experience has also shown that because of the mobility of the American people few mortgages are held to maturity. Most of them are prepaid through refinancing at sale or otherwise, long before the maturity date.⁴² A combination of these factors indicates that savings and loan associations operate with a revolving fund and take in principal funds during each business day.⁴³ Never-

36. In September, 1971, the savings and loan industry had liabilities and reserves in excess of 199 billion dollars, of which 168 billion dollars were represented by savings accounts. 57 FED. RES. BULL. A40 (Nov. 1971).

37. See, e.g., 12 U.S.C. § 1464(b) (1) (1970).

38. See, e.g., 12 U.S.C. § 1464(c) (1970).

39. As of September, 1971, the savings and loan industry held assets in excess of 199 billion dollars, of which 168 billion dollars were represented by mortgages. 57 FED. RES. BULL. A40 (Nov. 1971).

40. Some state statutes now authorize savings and loan associations to invest a percentage of their assets in consumer loans. See, e.g., ALASKA STAT. § 06.30.520 (Supp. 1971); CONN. GEN. STAT. ANN. § 36-178(aa) (Supp. 1971); MASS. GEN. LAWS ANN. ch. 170, § 26(8) (Supp. 1971); NEB. REV. STAT. § 8-319 (1970); N.H. REV. STAT. ANN. § 393:15-a (Supp. 1971); TEX. REV. CIV. STAT. art. 852a, § 5.10 (Supp. 1971). For examples of some of the recent lending practices by such associations, see Wall Street Journal, Dec. 6, 1971, at 1, col. 1.

41. For a discussion of the characteristics of the level-premium, fully amortized mortgage, see L. PEARSON, A THEORETICAL APPROACH TO HOME MORTGAGE TERMS 2-48 (1969) (unpublished doctoral dissertation, on file in the library of Indiana University, and available through University Microfilms, Inc., Ann Arbor, Michigan) [hereinafter cited as PEARSON].

42. For a study of repayment patterns, see Dhrymes & Taubman, *An Empirical Analysis of the Savings and Loan Industry*, in 1 STUDY OF THE SAVINGS AND LOAN INDUSTRY 67, 115-32 (I. Friend ed. 1969). As the study indicates, repayment rates diminish in times of rising interest rates.

43. In August, 1971, the Federal Reserve Board published a staff study, R. FISHER, MORTGAGE REPAYMENTS AS A SOURCE OF LOANABLE FUNDS (1971), which fully substantiates the revolving fund analysis. However, the study also shows that (1) there is a secular downward trend in the rate of amortization caused by longer maturities and higher interest rates, and (2) in times of rising interest rates prepayments decrease.

theless, the associations essentially operate with funds they borrow short and lend long.⁴⁴

The problems created by this method of doing business may become particularly acute in periods of rising interest rates. To remain competitive the associations must offer a higher interest rate to their depositors. Furthermore, it is impossible for them to raise their interest rates for new accounts only, for then existing depositors would simply withdraw their funds on an interest payment date and take them across the street to a competitor. This would create monumental bookkeeping problems and could actually bankrupt some of the associations. At the same time that they are forced to pay increased rates of return on their accounts, the long-term nature of their investments limits the yield of their portfolios. Furthermore, since the amount of interest they are able to pay on their accounts is limited not only by the effective yield on their long-term portfolio but also by regulatory agencies, when interest rates rise sufficiently in the money market, they experience mass disintermediation, that is, many of their depositors withdraw funds and invest them directly, frequently in short-term paper.⁴⁵ This reduced attractiveness of their accounts as investment media, coupled with the prospect of loss of some of the funds already on deposit directly affects their ability to continue doing business in the market. The end result is that for the associations to remain liquid they must curtail their lending activities.⁴⁶

It has been argued that savings and loan associations are handicapped by the lack of diversification of their investment portfolios and by geographical restrictions which artificially further splinter the market into a multitude of semi-independent submarkets.⁴⁷ Many of these restrictions have been, or are being, gradually removed and the lending powers of savings and loan associations generally are being expanded rapidly.⁴⁸

44. For discussions of this syndrome and some of its implications, see Friend, *Changes in the Asset and Liability Structure of the Savings and Loan Industry*, in 3 STUDY OF THE SAVINGS AND LOAN INDUSTRY 1353 (I. Friend ed. 1969) [hereinafter cited as Friend]; Duesenberry, *supra* note 23; Klamann, *Public/Private Approaches to Urban Mortgage and Housing Problems*, 32 LAW & CONTEMP. PROB. 250 (1967). This mode of doing business may create problems not only in times of rising interest rates but also when interest rates are falling. See Wall Street Journal, Jan. 20, 1972, at 3, col. 2.

45. See *Monetary Policy and the Residential Mortgage Market*, 53 FED. RES. BULL. 728, 732-33 (May 1967); RES. BANK OF CLEVELAND, *supra* note 16, at 14, 21-26.

46. For a study of the liquidity problems of the industry, see Cootner, *The Liquidity of the Savings and Loan Industry*, in 1 STUDY OF THE SAVINGS AND LOAN INDUSTRY 283 (I. Friend ed. 1969) [hereinafter cited as Cootner].

47. For a discussion of the structure of the mortgage markets, see R. GOLDSMITH, *THE FLOW OF CAPITAL FUNDS IN THE POSTWAR ECONOMY* 274-307 (1965).

48. See, e.g., Emergency Home Finance Act of 1970 § 706, Pub. L. No. 91-351, § 706, 84 Stat. 462.

However, the reform movement is by no means completed and further changes have been either asked for or are in the process of being accomplished.⁴⁹

The Studies and Recommendations

Prompted by the experiences of 1966, by the recognized housing needs of the nation and by the ambitious goals set by the Housing and Urban Development Act of 1968,⁵⁰ various studies of the country's housing problems were commissioned. On the national level two separate studies of the entire field of housing, with particular emphasis on low and moderate income housing were conducted.⁵¹ Aimed at a more specific problem, a commission also was appointed to study mortgage interest rates.⁵² At approximately the same time, the FHLBB commissioned its own study of the savings and loan industry.⁵³ These studies and reports emphasized several points. First, despite continuing and increasing deficiencies in the nation's housing stock, the percentage of national resources invested in housing has been steadily declining, both in terms of the percentage of gross national product and in the percentage of total borrowing.⁵⁴ Secondly, the studies showed that the housing sector has consistently borne the brunt of tight money policies.⁵⁵ Thirdly, observers concluded that the burdens of monetary policies should be shared more equitably and that if the nation's housing goals are to be attained, structural changes in home financing are necessary.

As a result of these studies, and particularly of the special interest

49. See, e.g., S. 1671, 92d Cong., 1st Sess. tit. I, §§ 101-05 (1971); H.R. 7740, 92d Cong., 1st Sess. tit. I, §§ 101-05 (1971). In order to improve the competitive position of the associations, the FHLBB announced a change of policy permitting "satellite" offices in retail stores and automated teller facilities. *Wall Street Journal*, June 29, 1972, at 4, col. 1.

50. The Congress reaffirms the national housing goal and determines that it can be substantially achieved within the next decade by the construction or rehabilitation of twenty-six million housing units, six million of these for low and moderate-income families.

42 U.S.C. § 1441a (1970).

51. DECENT HOME, *supra* note 1; AMERICAN CITY, *supra* note 1.

52. The commission was established pursuant to Pub. L. 90-301, 82 Stat. 114 (1968), and filed its report with the President and with the Congress on August 13, 1969. MORTGAGE INTEREST RATES, *supra* note 21, at ii.

53. STUDY OF THE SAVINGS AND LOAN INDUSTRY (I. Friend ed. 1969).

54. Between 1950 and 1968 the percentage of the gross national product invested in residential construction declined from over seven per cent to under four per cent. MORTGAGE INTEREST RATES, *supra* note 21, at 16, Figure 1. During the same period residential mortgages, as a percentage of total funds raised, declined from approximately 37 per cent to approximately twenty per cent. *Id.* at 19, Figure 2.

55. See generally Grebler, *supra* note 23; MORTGAGE INTEREST RATES, *supra* note 21, at 15-26.

devoted to the savings and loan industry, various proposals were made to increase the industry's ability to attract and hold funds during tight money periods.⁵⁶ One proposal advocated the extension of the authority of Fannie Mae into the conventional mortgage market or, preferably, the creation of a similar specialized institution attuned particularly to the needs and desires of the savings and loan industry.⁵⁷ The Commission on Mortgage Interest Rates explored these matters⁵⁸ and made its recommendations to Congress which translated them *inter alia* into the provisions of Title III of the Emergency Home Finance Act of 1970.⁵⁹

Legislative History

In 1970, home financing was ushered onto Capitol Hill in an atmosphere of crisis.⁶⁰ A number of bills were introduced in each House, lumped together under the general heading of emergency home financing.⁶¹ The common theme of all the bills and of most of the testimony presented during the hearings was the generation of additional financing for housing. Differences arose concerning the means to this end. Some proposals suggested weird schemes of forcing pension funds to invest a

56. MORTGAGE INTEREST RATES, *supra* note 21, at 104-05; Friend, *Summary and Recommendations*, in 1 STUDY OF THE SAVINGS AND LOAN INDUSTRY 1, 29-34 (I. Friend ed. 1969).

57. *E.g.*, M. KAPLAN & R. RICKS, WORKING PAPER #6, SECONDARY MORTGAGE MARKET (1970) (prepared for the FHLBB) [hereinafter cited as KAPLAN]; L. GREBLER, COMMENTS ON PROPOSAL TO CREATE A FEDERAL HOME LOAN MARKETING CORPORATION (1970) (prepared for the FHLBB) [hereinafter cited as COMMENTS ON PROPOSAL].

58. The Commission sought the opinions of the Federal Reserve Board, but the Board's attitude was generally negative. For the questions submitted and the answers given by the Federal Reserve Board, see *Housing Production and Finance*, 55 FED. RES. BULL. 228, 232-33 (Mar. 1969). The reservations of the Board were again voiced by Sherman J. Maisel, in *1970 Senate Hearings, supra* note 21, at 68.

59. Federal Home Loan Mortgage Corporation Act, 12 U.S.C. § 1451 *et seq.* (1970).

60. *Cf. 1970 House Hearings, supra* note 2, at 1-3 (remarks of Committee Chairman Wright Patman).

61. The House bills were: H.R. 13694, H.R. 14639, H.R. 15402, and H.R. 11, 91st Cong., 1st Sess. (1969). The Senate bills were: S. 2958, S. 3503, S. 3508 and S. 3442, 91st Cong., 1st Sess. (1969). Although most of these bills were introduced in 1969, they nevertheless belong in the category of 1970 legislation because it was only in 1970 that Congress started to consider them seriously. Hearings were held in February and March, respectively, by the Committees on Banking and Currency of the two houses, and both committees reported a single bill in greatly modified fashion. S. 3685, 91st Cong., 2d Sess. (1970); H.R. 17495, 91st Cong., 2d Sess. (1970). The Senate passed its version first and sent it to the House. The House struck the entire Senate bill, except for the enacting clause, and substituted the bill reported by its committee. The differences between the houses were resolved by a conference committee which essentially agreed upon the Senate version with some minor modifications. CONF. REP. No. 1311, 91st Cong., 2d Sess. 1 (1970).

predetermined percentage of their assets annually in home mortgages.⁶² Other proposals would have forced the Federal Reserve System to subsidize housing through the purchase of housing agency paper in the open market,⁶³ in effect thereby creating new money. Still another proposal advocated direct subsidy grants from the federal government.⁶⁴ Finally, the suggestion to extend the authority of Fannie Mae into the conventional market and the creation of a similar facility in the Federal Home Loan Bank System was introduced. However, because of Fannie Mae's domination by the mortgage banking fraternity,⁶⁵ the savings and loan industry did not view this proposal with enthusiasm. It desired a facility more responsive to its own particular needs and desires. When FHLBB Chairman Preston Martin testified before the Congressional committees he indicated that a new facility, in tune with the industry's structure, was more desirable.⁶⁶ The Corporation is the direct result of these efforts.

PURPOSES AND POLICIES

Although the Corporation is an innovation in the field of federal aid to home financing, the Charter Act nowhere spells out its purposes.

62. H.R. 15402, 91st Cong., 1st Sess. tit. I (1969). See also the dissenting views of Congressman Patman and Congresswoman Sullivan in MORTGAGE INTEREST RATES, *supra* note 21, at 130-32.

The more extreme form of such proposals would have limited the rate of return on pension fund investments. See the dissenting views of Congresswoman Leonor K. Sullivan in H.R. REP. No. 1131, 91st Cong., 2d Sess. 20-21 (1970). For a criticism of such schemes, see Bartke, *supra* note 6, at 74 n.312; Schotland, *Private Pension Funds: A Guide for Modern Investments*, 59 GEO. L.J. 355 (1970).

63. E.g., H.R. 15402, 91st Cong., 1st Sess. tit. II (1969).

64. H.R. 13694, 91st Cong., 1st Sess. (1969).

65. See Bartke, *supra* note 6, at 59 n.249.

66. 1970 Senate Hearings, *supra* note 21, at 57-58; 1970 House Hearings, *supra* note 2, at 532. While the legislation was pending the FHLBB prepared or commissioned some studies of its own. KAPLAN, *supra* note 57; COMMENTS ON PROPOSAL, *supra* note 57. Unlike some members of Congress, who used secondary market terminology without clearly understanding the nature of the organization they were about to foster, the FHLBB researchers explored the choices open to such a new facility. They perceived the immediate need to be the provision of additional funds for housing and the alleviation of the liquidity problems of the industry. KAPLAN, *supra* note 57, at 7-10, 18.

The Board initially determined that the Corporation should assume the position of principal risk-taker in assuring credit and terms to builders—a role which many private lenders had refused to accept. The Board's decision was reflected in the pricing of forward commitments for FHA-insured mortgages in terms of fixed discount points on mortgages carrying the highest permissible face rate of interest at the time of sale. See FEDERAL HOME LOAN MORTGAGE CORPORATION, SELLER'S GUIDE FHA/VA § 204a(iii) (1971) [hereinafter cited as SELLER'S GUIDE]. (This pricing method is no longer employed. See text accompanying notes 150-153 *infra*.) This pricing technique was different from that employed by Fannie Mae, which priced its pre-commitments in terms of yield. Hunter, *supra* note 6, at 823-27. Use of Fannie Mae's method means that builders are uncertain of the discounts they will have to contend with at the time of closing.

These have to be derived from the hearings, the committee reports and the whole background of information provided by the long history of Fannie Mae.⁶⁷

The House and Senate committee reports contain the same laconic statement:

This title [title III] would authorize the establishment of a secondary mortgage market facility, called the Federal Home Loan Mortgage Corporation, under the direction of the Federal Home Loan Bank Board. . . .⁶⁸

Implicit in this statement is an assumption that there is a commonly understood or accepted meaning of the term "secondary mortgage market facility." To date, however, there are no two writers in the field who use the term identically.⁶⁹ Both reports also provide:

The Corporation would be a supplement to, and would have parallel authority to, the Federal National Mortgage Association under its expanded authority proposed by title II of the bill.⁷⁰

This indicates that the history of Fannie Mae and the role it has played in the past are relevant to the determination of Congressional intent with respect to the Corporation. However, as indicated previously, the mandate of Fannie Mae is ambiguous and has forced a certain degree of schizophrenia upon this organization.⁷¹ While the absence of more direct Congressional mandates in the statute itself may help the Corporation to avoid some of these pitfalls, the provisions of the Charter Act and the historical ballast forced upon it by the committee reports indicate that those entrusted with its management will have problems of interpretation.

Despite these ambiguities, some aspects of Congressional intent are clear. The Corporation is meant to provide additional and dependable funds for home building and home buying. These funds are to be provided primarily through the savings and loan industry and secondarily

67. For a history of Fannie Mae, see Bartke, *supra* note 6, at 16-29.

68. H.R. REP. No. 1131, 91st Cong., 2d Sess. 7 (1970); S. REP. No. 761, 91st Cong., 2d Sess. 7 (1970).

69. For a review of definitions, see Bartke, *supra* note 6, at 7-8 nn.26, 27. My own definition of the secondary market is: "the ability of mortgage investors, in an organized fashion either to dispose of mortgages in their portfolios through sale or to convert such mortgages into securities acceptable to other segments of the investing public, directly or indirectly." *Id.* at 7-8.

70. H.R. REP. No. 1131, 91st Cong., 2d Sess. 8 (1970); S. REP. No. 761, 91st Cong., 2d Sess. 7 (1970).

71. See Bartke, *supra* note 6, at 28-29, 77-78.

through the mutual savings banks and, to a certain extent, commercial banks. The Corporation also is intended to alleviate the periodic liquidity problem of the savings and loan industry. Three factors indicate that the Corporation is meant to be self-supporting and to obtain most of its operating funds through the general money markets. First, the structure of the Corporation is analogous to that of Fannie Mae, which is both self-sustaining and deeply involved in the money markets. Secondly, the statute provides for only nominal capitalization but authorizes elaborate financing provisions involving a variety of market securities.⁷² This dependence on the money markets means that, to defray the Corporation's expenses, the yield on its portfolio must exceed its debt service requirements. The same problem was demonstrated by Fannie Mae's experience in 1969-70.⁷³ Lastly, the requirement that mortgages purchased by the Corporation be of a quality acceptable to private mortgage investors⁷⁴ is a further indication that active trading in the money markets is intended.

The Corporation has authority to purchase both over-the-counter and by means of forward or pre-commitments. Essentially, forward or pre-commitments are advance agreements to take up future mortgages originated by designated mortgage lenders. Both over-the-counter purchases and precommitments are subject to such stringent limitations, however, that it is virtually impossible for the Corporation to move in the direction of creating a secondary market facility at this time.

Interrelation Between Titles II and III

Before examining the Corporation and title III, some consideration must be given to title II of the Emergency Home Finance Act of 1970.⁷⁵ This investigation is necessary because (1) the statutory pro-

72. 12 U.S.C. § 1455(a) (1970).

73. See Bartke, *supra* note 6, at 52-53.

74. 12 U.S.C. § 1454(a) (1970).

75. Emergency Home Finance Act of 1970, Pub. L. No. 91-351, tit. II, 84 Stat. 50-51 (codified at 12 U.S.C. §§ 82 (para. 11), 1717(b) (2)). This title amended § 302(b) of the National Housing Act by adding a new subsection (2), which provides:

For the purposes set forth in section 301(a), and with the approval of the secretary of Housing and Urban Development, the corporation is authorized, pursuant to commitments or otherwise, to purchase, service, sell, lend on the security of, or otherwise deal in mortgages which are not insured or guaranteed as provided in paragraph (1), (such mortgages referred to hereinafter as "conventional mortgages"). No such purchase of a conventional mortgage shall be made if the outstanding principal balance of the mortgage at the time of purchase exceeds 75 per centum of the value of the property securing the mortgage, unless (A) the seller retains a participation of not less than 10 per centum in the mortgage; (B) *for such period and under such circumstances as the corporation may require*, the seller agrees to repurchase or

visions are very similar, and (2) legislative history indicates that the provisions are to be complementary.

Title II of the Emergency Home Finance Act of 1970 extended the purchasing authority of Fannie Mae to include conventional mortgages. However, certain limitations were placed on this authority. First, conventional mortgage purchases must be approved by the Secretary of Housing and Urban Development (HUD).⁷⁶ Secondly, subject to exceptions, purchases are limited to mortgages with a loan-to-value ratio of not more than 75 per cent.⁷⁷ Thirdly, the proposed House bill prohibited Fannie Mae from offering its securities to help finance its conventional mortgage operations at any time in which, as determined by the Secretary of HUD, such offerings would inhibit financing of low and moderate income housing by the Government National Mortgage Association (Ginnie Mae).⁷⁸ Although this proposal was eventually dropped, the political importance of the view expressed by the House managers in the conference report may influence the decisions of the Secretary of HUD.

This last possibility has certain disquieting implications. Because Fannie Mae views its role as that of a lender of last resort, rather than a secondary market facility, it will undoubtedly operate by pre-commitments only, when it starts buying conventional mortgages.⁷⁹ This means that

replace the mortgage *upon demand of the corporation* in the event that the mortgage is in default; or (C) that portion of the unpaid principal balance of the mortgage which is in excess of such 75 per centum is guaranteed or insured by a qualified private insurer as determined by the corporation. The corporation shall not issue a commitment to purchase a conventional mortgage prior to the date the mortgage is originated, if such mortgage is eligible for purchase under the preceding sentence only by reason of compliance with the requirements of clause (A) of such sentence. The corporation may purchase a conventional mortgage which was originated more than one year prior to the purchase date only if the seller is currently engaged in mortgage lending or investing activities and if, as a result thereof, the cumulative aggregate of the principal balances of all conventional mortgages purchased by the corporation which were originated more than one year prior to the date of purchase does not exceed 10 per centum of the cumulative aggregate of the principal balances of all conventional mortgages purchased by the corporation. The corporation shall establish limitations governing the maximum principal obligation of conventional mortgages purchased by it which are comparable to the limitations which would be applicable if the mortgage were insured by the Secretary of Housing and Urban Development under section 1709(b) or 1713 of this title.

12 U.S.C. § 1717(b) (2) (1970) (emphasis added).

76. 12 U.S.C. § 1717(b) (2) (1970).

77. *Id.*

78. H.R. 17495, 91st Cong., 2d Sess. § 201(a) (1970).

79. In this connection consider the revealing statement of Oakley Hunter, President of Fannie Mae, about a policy of not buying above par, and the reason therefor. Hunter, *supra* note 6, at 824.

for a fee it will enter into contracts to purchase mortgages of a certain quality sometime in the future. The purchaser of such a commitment, however, is under no legal obligation to deliver any mortgages,⁸⁰ so that Fannie Mae can never be certain how many of its forward commitments will actually be exercised, this being a function of market conditions at the time of maturity. Thus, Fannie Mae must gear its borrowing activities to the influx of pre-committed mortgages.⁸¹ Most pre-committed mortgages will be delivered during money shortages, rising interest rates and heavy demands for funds.⁸² However, this is precisely the period during which the Secretary is exhorted to prohibit additional borrowing. Therefore, the Corporation must fulfill its pre-commitment contracts and buy up mortgages at a time during which it may be prohibited from borrowing the money to finance these purchases. Assuming that the Secretary exercises his authority and honors this request, his actions may put Fannie Mae in a position of having to breach its contractual obligations.

The Senate report accompanying title II implies a further limitation on Fannie Mae's operations in the conventional mortgage market by cautioning the Association that its primary area of operation should always be the FHA/VA market.⁸³ Although no corresponding language is found in title III, the implication would seem to be that the Corporation should concentrate its efforts in the conventional field. This may indicate either Congressional concern for continued support of the FHA/VA market, or an attempt to avoid competition between the two corporations.⁸⁴ So far the competition, if any, has been in the FHA/VA field. The main complaints come from the mortgage banking fraternity which seems to consider the servicing of FHA/VA mortgages as its monopoly.⁸⁵ Generally, due to the different structure of the two bodies, their

80. For a discussion of the forward commitment procedures of Fannie Mae, see Bartke, *supra* note 6, at 49-50; Hunter, *supra* note 6, at 823-25.

81. While this statement is correct, Fannie Mae's demands for funds are more complex than indicated. It also needs money to refinance outstanding and maturing issues, and the amount needed depends on repayment schedules and sales. In times of rising interest rates, however, Fannie Mae's rate of sale of mortgages declines or reaches zero. For tables showing Fannie Mae's mortgage activities, see Bartke, *supra* note 6, at 50-51 n.209.

82. Bartke, *supra* note 6, at 50-51 n.209.

83. S. REP. No. 764, 91st Cong., 2d Sess. 7 (1970). Because of the tight money situation at the time, Fannie Mae was also advised not to enter the conventional field for at least two years. *Id.* Fannie Mae entered the conventional market on February 14, 1972. See Wall Street Journal, Dec. 16, 1971, at 14, col. 1. The first auction of Fannie Mae forward commitments to purchase conventional mortgages has taken place. *Id.*, Feb. 16, 1972, at 15, col. 2.

84. See COMMENTS ON PROPOSAL, *supra* note 57, at 3-4.

85. See *News/Marketing, Making it Big in a Rough Year in a Tough Town—Centennial of Dallas*, 38 HOUSE & HOME, July 1970, at 8, 12 [hereinafter cited as *Making*]

historical backgrounds and the statutory limitations on the Corporation, direct competition is highly unlikely. Furthermore, if indirect competition does materialize, it would seem that the consumer would be the primary beneficiary.

The Federal Home Loan Mortgage Corporation

Title III of the Emergency Home Finance Act of 1970 established the Federal Home Loan Mortgage Corporation.⁸⁶ This title, the official name of which is Federal Home Loan Mortgage Corporation Act, created the Corporation as a kind of subsidiary to the Federal Home Loan Bank System. Following the pattern of the 1954 Federal National Mortgage Association Charter Act,⁸⁷ the legislation creates a board of directors for the Corporation;⁸⁸ grants the Corporation membership in each of the Federal Home Loan Banks;⁸⁹ and otherwise endows the Corporation with the usual attributes of corporate existence.⁹⁰ The Corporation's Charter Act also exempts it from all federal, state and local taxes, except for real estate taxes.⁹¹

The provisions of the Charter Act which define the Corporation's scope, purpose and mode of operation deal both with mortgage purchases and with financing. The two will be discussed separately, but there is a great deal of overlap and interdependence since the availability of funds and the ease with which they can be procured has a direct effect on the Corporation's ability to remain in the market and purchase mortgages.

(1) Purchase Operations

The avowed purpose of Congress was to make the mortgage purchase powers and attributes of the Corporation substantially coextensive with

it Bigl]; 1971 Senate Hearings, *supra* note 30, at 256-58 (testimony of Philip C. Jackson, President of the Mortgage Bankers Association of America).

86. 12 U.S.C. § 1452(a) (1970).

87. Act of Aug. 2, 1954, ch. 649, tit. II, 68 Stat. 590, 612 (1954). For a discussion of this legislation, see Bartke, *supra* note 6, at 22-29.

88. There is created the Federal Home Loan Mortgage Corporation, which shall be a body corporate and shall be under the direction of a Board of Directors composed of the members of the Federal Home Loan Bank Board, who shall serve as such without additional compensation.

12 U.S.C. § 1452(a) (1970).

89. 12 U.S.C. § 1452(a) (1970).

90. *Id.* § 1452(b).

91. *Id.* § 1452(d). In the original version of the bill, as reported by the Senate committee, the Corporation was supposed to pay the Treasury an amount equal to what it would have had to pay if it were subject to the Internal Revenue Code. S. 3685, 91st Cong., 2d Sess. § 303(d) (1970). However, as a result of an objection by FHLBB, the provision was deleted on the floor of the Senate at the motion of Senator Sparkman. 116 CONG. REC. 12232 (1970).

those of Fannie Mae.⁹² Fannie Mae has no statutory limitation on the organizations with which it may do business. It has always limited its purchases to mortgage originators who are qualified to service the loans and, for historical reasons, it deals almost exclusively with mortgage bankers. The Corporation, however, may deal only with savings and loan associations, mutual savings banks and commercial banks.⁹³ This limitation adds nothing to the stability or efficiency of the home mortgage market, but rather creates undue complexities and further subdivides the market into submarkets. Furthermore, as we will see later, it puts limitations on the Corporation's ability to start fostering a secondary market for mortgages, since one of the prerequisites to a smoothly operating secondary market is free access and availability to all those who need its services.

Other statutory limitations on the Corporation's ability to purchase conventional mortgages are contained in § 305(a)(2). Section 305(a)(1) of the Charter Act authorizes the Corporation to purchase residential mortgages of such quality, type and class as meet the general purchase standards imposed by private institutional mortgage investors.⁹⁴ This standard, by itself, would be excellent since it establishes in general terms the quality requirements but does not otherwise limit the Corporation's discretion. However, the § 305(a)(2) limitations curb this discretion by providing: (1) the outstanding balance at time of purchase is not to exceed 75 per cent of value, (2) only ten per cent of mortgages acquired may be originated more than one year prior to purchase, and (3) the principal amounts of mortgages qualifying for purchase must be comparable to the limits imposed by §§ 203(b) and 207

92. [I]n drawing up the legislation, the committee intended to provide FNMA and the Federal Home Loan Mortgage Corporation (established by title III) with the same purchasing authority and limitation so there can be a parallel development of these institutions and so neither would have any competitive advantage over the other.

H.R. REP. No. 1131, 91st Cong., 2d Sess. 7 (1970). The identical language is found in S. REP. No. 761, 91st Cong., 2d Sess. 7 (1970).

93. The Corporation is authorized to purchase, and make commitments to purchase, residential mortgages from any Federal home loan bank, the Federal Savings and Loan Insurance Corporation, any member of a Federal home loan bank, or any other financial institution the deposits or accounts of which are insured by an agency of the United States. . . .

12 U.S.C. § 1454(a)(1) (1970).

94. *Id.* It must be noted that the Corporation is not specifically authorized, or expected, to purchase FHA/VA mortgages. However, the generality of § 305(a)(1), coupled with the language of the committee reports and with the provision of § 306(a) authorizing the Corporation to issue mortgage-backed securities under the provisions of § 306(g) of the National Housing Act, make it clear that such mortgages are eligible for purchase. See 12 U.S.C. §§ 1455(a), 1721(g) (1970).

of the National Housing Act.⁹⁵ All of these limitations further inhibit the ability of the Corporation to function freely and create additional submarkets in an already fragmented field.

The first limitation is presumably designed to decrease risks to the Corporation. If that is the purpose, it is misplaced since the general admonition that the mortgages purchased are to be of a quality acceptable to institutional investors should be sufficient. Furthermore, the limitation is not coordinated with the loan-to-value ratio limitations imposed by the FHLBB on federally chartered savings and loan associations,⁹⁶ which will be the principal customers of the Corporation.

Although the first limitation is subject to several exceptions,⁹⁷ the exceptions are not integrated with the limitation. Exception (A) provides that mortgages with balances in excess of 75 per cent can be purchased if the seller retains a participation of not less than 10 per cent of the mortgage.⁹⁸ Obviously, however, this provision can be satisfied without bringing the Corporation share of the balance down to the 75 per cent level. Exception (B) requires the seller to agree, for a time specified by the Corporation, to take back or replace mortgages which are in default.⁹⁹ The two houses of Congress disagreed on this exception, with the Senate version imposing a flat three-year requirement for repurchase¹⁰⁰ and the later adopted House version leaving the duration of the repurchase obligation to the discretion of the Corporation. To comply with the spirit of the legislation, this period should be long enough to insure that the unpaid principal of the mortgage is reduced to the magic 75 per cent figure. The original Senate version, while not integrated with the 75 per cent requirement, might have conceivably been prompted by the fact that most mortgage defaults occur during the early years in the life of a loan.¹⁰¹

The effect of these two exceptions probably will be negligible. Exception (B) is not likely to be used extensively because of the presumed reluctance of sellers to bind themselves for extended periods of time to

95. 12 U.S.C. §§ 1709(b), 1713 (1970).

96. 12 C.F.R. § 545.6-1 (1972).

97. 12 U.S.C. § 1454(a) (2) (1970).

98. *Id.*

99. *Id.*

100. Eligible mortgages for purchase would be as follows: . . . 3. Conventional mortgages . . . with a loan-to-value ratio of more than 75% if—
. . . (b) the seller agrees to repurchase or replace the mortgage at any time within three years of the date of purchase in the event of default. . . .

S. REP. NO. 761, 91st Cong., 2d Sess. 9 (1970).

101. An excellent recent study, J. HERZOG & J. EARLEY, HOME MORTGAGE DELINQUENCY AND FORECLOSURE 37, 69 (1970), indicates that most mortgage defaults occur during the second to fifth year, or second to seventh year.

unpredictable contingent liabilities. Similarly, exception (A) has a further qualification that mortgages purchased pursuant to it may not be acquired as a result of pre-commitments. Organizations qualified to do business with the Corporation are lenders rather than middlemen and therefore, when they decide to take up mortgages without prior commitments, they usually intend to keep them to maturity. Even if they later decide to sell, it may be too late since the Corporation must purchase most conventional mortgages within one year of origination. Because of this difficulty in purchasing existing mortgages, the net effect of exception (A) is insignificant.

Exception (C) provides that mortgages with balances greater than 75 per cent can be purchased if the balance above that figure is guaranteed by a private insurer.¹⁰² This exception might be an indirect invitation to experiment with conventional mortgages with a loan-to-value ratio in excess of eighty per cent. The FHLBB has just announced that it is going to experiment with 95 per cent conventional mortgages,¹⁰³ which may provide a test of exception (C)'s workability.

The second limitation, requiring ninety per cent of mortgage purchases to be made within one year of origination,¹⁰⁴ is designed to insure that the funds will be used for additional housing.¹⁰⁵ This explanation is not particularly convincing. If mortgages are delivered pursuant to forward commitments, it is safe to assume that the funds were used for housing as a result of such arrangements. However, when mortgages are offered for immediate purchase it seems that their age would have little to do with the use to which the proceeds of sale are put. Of course, the real purpose might have been to insure that the Corporation would operate primarily by way of forward commitments. If this is true, Congress did not make its intent very clear. It should be noted, in passing, that the statute speaks in terms of cumulative aggregates of such mortgages,¹⁰⁶ which would indicate that the limitation is not on a year-to-

102. 12 U.S.C. § 1452(a) (2) (1970).

103. 12 C.F.R. § 545.6-1(a) (5) (1971).

104. 12 U.S.C. § 1452(a) (2) (1970).

105. To assure that the bulk of the purchases would make funds available for additional housing, a further limitation is imposed by the bill relative to the purchase of newly originated mortgages.

S. REP. No. 761, 91st Cong., 2d Sess. 9 (1970).

106. The Corporation may purchase a conventional mortgage which was originated more than one year prior to the purchase date . . . if, as a result thereof, the cumulative aggregate of the principal balances of all conventional mortgages purchased by the Corporation which were originated more than one year prior to the date of purchase does not exceed 10 per centum of the cumula-

year basis but is computed on the basis of total purchases from the beginning of corporate existence. If that is the correct construction, the unused portion of "older" mortgages in any given year can be used in later years. Aside from the bookkeeping chores involved, this should make it possible for the Corporation to purchase larger amounts of seasoned mortgages in times of falling interest rates. Sellers are normally anxious to market their mortgages during these periods since they can demand high prices. In times of rising interest rates, however, sellers may be reluctant to sell earlier mortgages since they would have to sell them at a discount and, therefore, suffer a loss. However, this last assumption is not necessarily correct since the seller may find that the loss of principal occasioned by sale at a discount is more than made up by the availability, with rising markets, of new investment opportunities at higher interest rates.¹⁰⁷ In any event, the Corporation in developing a secondary market must stand ready to enter into transactions, both purchase and sale, at the going market rate, whether this involves discounts or premiums. Any arbitrary limitations will prevent the full development of the market's potential.

The Senate committee report indicates that the third limitation, imposing ceilings on principle balances of conventional mortgages comparable to those of §§ 203(b) and 207 of the National Housing Act,¹⁰⁸ was designed for the dual purpose of minimizing risk to the Corporation and channeling funds to low and moderately priced housing.¹⁰⁹ This reasoning, once again, is simply unsatisfactory. No explanation is given why larger mortgages should be inherently more risky than ones with somewhat smaller balances, and the upper limits imposed can hardly be described as corresponding with low, or even moderately priced housing.¹¹⁰ Furthermore, the language used is rather confusing since it says that the limits are to be *comparable* to those of §§ 203(b) and 207

tive aggregate of the principal balances of all conventional mortgages purchased by the Corporation.

12 U.S.C. § 1454(a) (2) (1970).

107. For an illustrative computation, see FEDERAL HOME LOAN MORTGAGE CORPORATION, FHA/VA OFFERINGS, PARTICIPATION PROGRAMS 3 (1970) [hereinafter cited as PARTICIPATION PROGRAMS].

108. 12 U.S.C. §§ 1709(b), 1713 (1970).

109. S. REP. No. 761, 91st Cong., 2d Sess. 9 (1970).

110. *E.g.*, the upper limit on § 203(b) mortgages for single family residences is now established at 33,000 dollars. Taking into account the loan-to-value ratio limitations contained in the section, the house must sell for an amount in excess of 37,000 dollars in order to obtain a 33,000 dollar mortgage. 12 U.S.C. § 1709(b) (2) (1970). The 37,000 dollar figure presupposes a minimum down payment under § 203(b) of the National Housing Act. However, since § 305(a) (2) of the Charter Act calls for a 75 per cent loan-to-value ratio, the house would have to sell for 44,000 dollars to support a 33,000 dollar mortgage, unless one of the exceptions were applicable.

of the National Housing Act. The Senate committee report, however, dealing with the identical language of title II, states that the conventional mortgages purchased are not to *exceed* the limits imposed by the above sections.¹¹¹ This same report also provides that the limitations and purchasing authority of the two organizations are to be identical.¹¹² Therefore, there is some doubt as to whether the limits set by the National Housing Act are a guidepost for the Corporation or a flat fiat. At present, the Corporation has resolved the doubt by adopting a 35,000 dollar limit.

The statute, further, does not make it clear whether this limitation applies to the original balance or to the balance at the time of purchase. The latter interpretation would seem more logical, since the reports state that security is one of the motives for the limitation, and seasoned mortgages are statistically more secure.¹¹³ This construction would increase, to a small degree, the flexibility of the Corporation, because it could acquire mortgages originated more than one year prior to the date of purchase, within the ten per cent authorization, which originally had larger balances but had been paid down to the statutory limits.

The over-all *modus operandi* imposed upon the Corporation by the statute makes it difficult to foster a secondary market. The bulk of its operations in 1971 were based on forward commitments. The statute tries to impose upon it the role of an institutional investor and supplier of funds to originating mortgagees, while the Corporation makes great efforts to avoid this position. To correct this situation, the Corporation has instituted an over-the-counter market in 1972, and is trying to foster purchases of existing mortgages by means of pricing.

(2) Financing Provisions

To finance its mortgage operations the Charter Act provides the Corporation with essentially two sources of funds. Section 304¹¹⁴ authorizes a form of capital stock and § 306¹¹⁵ sets up a mechanism whereby the Corporation may borrow and issue market securities.

Since the Corporation is a new creation starting from scratch, Congress provided it with a beginning capital of 100 million dollars in the form of common, non-voting stock to be issued only to Federal Home Loan Banks. This financing scheme makes little sense since the same

111. S. REP. No. 761, 91st Cong., 2d Sess. 6 (1970). Fannie Mae has accepted this statement. See Hunter, *supra* note 6, at 834.

112. S. REP. No. 761, 91st Cong., 2d Sess. 7 (1970).

113. *Supra* note 101.

114. 12 U.S.C. § 1453 (1970).

115. *Id.* § 1455.

result could be accomplished by having the Federal Home Loan Banks make contributions to the starting capital of the new Corporation. Possibly, this form was used because a similar method was employed in the capitalization of Fannie Mae. However, in that context the stock made somewhat more sense as it was issued to private organizations doing business with Fannie Mae's secondary market function.¹¹⁶

The statute provides that such stock may be transferable under conditions prescribed by the Corporation.¹¹⁷ This may be an attempt to follow the model of Fannie Mae and to provide the mechanism for an eventual transfer of the Corporation to "private hands."¹¹⁸ Whatever the reasons for this provision, they certainly should have been stated more clearly.

Unlike Fannie Mae, which has always been subject to ratio limitations of debt to equity,¹¹⁹ no corresponding provision is inserted in the Charter Act. This may have been done because Congress felt that the close relationship of the Corporation to FHLBB is a sufficient safeguard, or because it was obvious to the members that 100 million dollars would not be a large enough base if multiple ratio limitations were introduced, unless the ratio were so high as to be practically meaningless. It may also be the result of experiences with quasi-private Fannie Mae, whose ratio limitations are subject to upward adjustment by the Secretary of HUD. In the past three years the Secretary has repeatedly exercised his authority and increased the ratio to make it possible for Fannie Mae to stay in the market.¹²⁰ In any event, the substitution of a board's discretion for mechanical ratios is an improvement.

Subsection (d)¹²¹ permits retirement of all capital stock. This would tend to negate the possibility of eventual transfer to private investors. Here is another example of the ambiguity of the Charter Act. The only limitation on the retirement right is that accumulated reserves and surplus cannot be less than 100 million dollars. This would indicate a desire on the part of Congress that the Corporation finance

116. For a discussion of this provision and the developments thereunder, see Bartke, *supra* note 6, at 23-27.

117. 12 U.S.C. § 1453(a) (1970).

118. For the background and history of the transfer of Fannie Mae's secondary mortgage operations to a quasi-private corporation in 1968, see Bartke, *supra* note 6, at 29-42.

119. 12 U.S.C. § 1719(d) (1970). This section limits the borrowing capacity of Fannie Mae to 15 times its capital, surplus, reserves and undistributed earnings, unless a greater ratio has been fixed by the Secretary of HUD.

120. The Secretary has exercised his discretion by increasing the ratio first to twenty and then to 25 times the basis. See Bartke, *supra* note 6, at 51 n.211.

121. 12 U.S.C. § 1453(d) (1970).

itself essentially from borrowings and from internally generated funds and that the advances of the Federal Home Loan Banks are to be repaid as soon as business conditions permit. Issuance of stock with a view toward retiring it as soon as possible underscores the incongruity of the capital stock structure.

In view of the rather nominal capitalization provided for the Corporation, Congress candidly admitted that "the basic funds to be used [by the Corporation] to purchase mortgages would [have to] be raised in the capital market."¹²² The provisions implementing this mandate are found in § 306 of the Charter Act.¹²³ Although the financing vehicles listed in this section fall into several clearly defined patterns, the Corporation has evidenced great imagination in its financing techniques. It has made more innovations in this respect within one year than Fannie Mae has done in its thirty year history.

Section 306(a) authorizes the Corporation "to issue notes, debentures, bonds and other obligations, or other securities."¹²⁴ This provision suggests financing by sale of general obligation securities of different maturities in the nation's capital markets. This is reminiscent of the financing pattern employed by Fannie Mae and amounts, in effect, to an attempt to outguess the trend of interest rates.¹²⁵ When interest rates climb, the price which the Corporation will be paying for money in the market will exceed the return on its earlier, lower-rate mortgages. Thus, outflow may exceed income. Furthermore, these kinds of obligations compete with all other agency issues and corporate offerings. It is, therefore, highly questionable whether this sort of financing does much to increase the share of savings going into housing.¹²⁶

The Act also prescribes financing through mortgage backed securities issued pursuant to the provisions of § 306(g) of the National Housing Act.¹²⁷ These securities, however, can be issued only against pools of FHA-insured, VA-guaranteed mortgages. Since the institutions with which the Corporation is authorized to do business have, in the past, generally avoided the FHA/VA market, the supply of mortgages of this type is rather limited. The device is only useful on a large scale

122. S. REP. No. 761, 91st Cong., 2d Sess. 9 (1970).

123. 12 U.S.C. § 1455 (1970).

124. *Id.* § 1455(a).

125. For a discussion of Fannie Mae's financing problems in tight money markets, see Bartke, *supra* note 6, at 52-53.

126. See 1970 Senate Hearings, *supra* note 21, at 72-75.

127. 12 U.S.C. § 1721(g) (1970). Section 306(g) is specifically mentioned in the Charter Act. However, it simply authorizes the management and liquidation function of Ginnie Mae to guarantee mortgage-backed securities. The substantive provisions under which such securities are to be issued are found in § 304(d) of the National Housing Act.

if the policy decision is made to encourage the savings and loan industry to expand its activity in this market.¹²⁸ This may be desirable since the life insurance industry, a former power in the FHA/VA field, has conducted a general retreat from the home financing field.¹²⁹ The Corporation has already purchased a considerable amount of FHA/VA paper and started financing with mortgage backed securities. It requires that the sellers of the FHA/VA paper service such mortgages, and this has produced howls of protest from the mortgage banking fraternity which seems to consider that function as its monopoly.¹³⁰ However, if this competition causes the mortgage bankers to increase their capitalization and take a position in the market, home financing will be the ultimate beneficiary. With the advent of a secondary market, the role of the mortgage banker as merely an originator and servicer will have outlived its usefulness.

The Corporation has also started a very imaginative program of selling interests in participations. Under this method, the Corporation first purchases fractional interests in conventional mortgages, with savings and loan associations retaining a fifteen per cent interest in each mortgage sold.¹³¹ These interests are represented by participation certificates. The Corporation then issues its own certificates (each one corresponding to a mortgage participation certificate which it has purchased), endorses its guaranty thereon, and sells them.¹³² This method is quite similar to creating mortgage backed securities of the "pass-through" variety¹³³ in conventional mortgages.

Id. § 1719(d). For a discussion of the nature of these securities, see Bartke, *supra* note 6, at 42-47.

128. The savings and loan industry has already greatly increased its participation in this market. Between January and August, 1970, the industry originated 850,311,000 dollars of such mortgages. During the same period of 1971, industry originations were 1,989,835,000 dollars. Letter, *supra* note 26.

129. See 1970 House Hearings, *supra* note 2, at 67-81 (statement of Kenneth Wright, Vice President of Life Insurance Association of America). See also the table in 57 FED. RES. BULL. at A53 (Nov. 1971), which shows a steady decline since 1967 in the amount of FHA-insured and VA-guaranteed loans held by the life insurance industry.

130. As soon as the Corporation announced its policy the mortgage bankers started protesting. See *Making it Big*, *supra* note 85. See also 1971 Senate Hearings, *supra* note 30, at 256-58 (testimony of Philip C. Jackson, President of the Mortgage Bankers Association of America).

131. PARTICIPATION PROGRAMS, *supra* note 107, at 1.

132. For a description of the process, see Rev. Rul. 71-399, 1971 INT. REV. BULL. No. 35, at 18.

133. The enabling legislation, 12 U.S.C. § 1719(d) (1970), refers to two types of mortgage-backed securities — debt obligations and trust certificates of beneficial interest. These two types have been referred to in the trade as the bond type and pass-through type, respectively. The former is in the form of a conventional debt security with a stated maturity date and a fixed coupon interest rate. The latter pro-

Another example of the kind of imaginative thinking emanating from the Corporation's management is the recent announcement that it is exploring the possibility of establishing a futures market for its advance commitments.¹³⁴ Such a futures market would, for one thing, make it possible for the Corporation to hedge and therefore reduce its own financial risk. At the same time, it might attract additional resources into the home mortgage market and thus assist home financing. Furthermore, it would attract a different type of participant to the capital markets and familiarize them with mortgage paper.¹³⁵

As we have seen, the Corporation, circumscribed by its statutory framework, is in direct competition with many other seekers of funds in the capital markets. Its problem is essentially that of tapping new sources. It is attempting to do this by the projected sale of futures in forward commitments and the sale of interests in participations. It should, however, attempt to provide new opportunities for small and medium size investors.

For this purpose, this author has advocated experimentation with mortgage bonds in small denominations. These bonds would be issued by savings and loan associations against pools of conventional mortgages, and would be marketed through tellers' windows.¹³⁶ Although such a scheme would probably require enabling legislation, the present powers of the Corporation are sufficient to permit some experimentation with this kind of paper. Section 306(a) permits the Corporation to borrow, give security, and issue notes, debentures, bonds and other securities.¹³⁷ Section 306(b) expands these powers and authorizes it to establish liens on all or any part of its assets, and to determine the priority of these liens.¹³⁸ Therefore, there seems to be no impediment to the Corporation

vides for direct fractional participations in the pools; as payments on both principal and interest are made, they are distributed to the holders. For a discussion of both types of mortgage-backed securities, see GOVERNMENT NATIONAL MORTGAGE ASSOCIATION, MORTGAGE-BACKED SECURITIES GUIDE (1969) [hereinafter cited as GNMA GUIDE].

134. Wall Street Journal, Sept. 20, 1971, at 6, col. 1.

135. For an excellent discussion of the proposed futures market, see K. PLANT, THE FUTURES MARKET FOR MORTGAGES AND COMMITMENTS (1972).

The Chicago Board of Trade is in the process of establishing a pilot futures market in cooperation with Citizens Savings & Loan Ass'n of San Francisco. Wall Street Journal, June 21, 1972, at 28, col. 4.

136. For a discussion of these recommendations, see Bartke, *supra* note 6, at 75-77.

137. 12 U.S.C. § 1455(a) (1970).

138. The Corporation may . . . establish prohibitions or restrictions upon the creation of indebtedness or obligations . . . and create liens and charges, which may be floating liens or charges, upon all or any part or parts of the property of the Corporation, including after-acquired property. Such prohibitions, restrictions, liens, and charges shall have such effect, including

designating a pool of conventional mortgages as security for a series of bonds and keeping such mortgages segregated on its books. This would be true of whole mortgages as well as participations. The bonds could then be issued with staggered maturities to correspond roughly to the expected repayment schedule. While a perfect matching cannot be achieved in anything other than pass-through securities,¹³⁹ the relationship would be close enough for working purposes. In addition, the guaranty provisions of Section 306(c)¹⁴⁰ could be used as an equivalent of Ginnie Mae's guaranty powers.¹⁴¹ The issuance of such securities and their marketing to small and medium size savers could give an opportunity to test the public's acceptance of both guaranteed and non-guaranteed bonds.

The pilot project of marketing mortgage bonds in small denominations would, of course, have to be approached cautiously. Such offerings could increase liquidity and disintermediation problems of savings and loan associations if not handled properly. However, if the original offerings were not too large, relatively speaking, and widely distributed geographically, the impact would be controllable. As experience is gained, new offerings could be appropriately spaced. In any event, the advantages of this scheme should outweigh the dangers. Initially, the Corporation could broaden its borrowing base and therefore, facilitate its financing operations. Secondly, the public response to this type of security could be tested and the potential size of the market gauged. Thirdly, experience gained in the initial stages of the project could be used to refine and perfect future instruments. Finally, if the experiment proves to be a success, it would be easier to approach Congress and ask for enabling legislation to permit the savings and loan industry, as well as other regulated thrift institutions, to enter the field directly.

without limitation on the generality of the foregoing such rank and priority, as may be provided . . . [by] the Corporation. . . .

12 U.S.C. § 1455(b) (1970) (emphasis added).

139. A pass-through type of security is unsuitable for sale to small- and medium-size investors in small denominations from both the issuer's and the investor's viewpoint. From the investor's point of view, the receipt of principal amounts every month is too complicated and creates too many investment problems. From the point of view of the issuer, the monthly disbursements would create too many bookkeeping problems.

140. "The Federal home loan banks shall . . . guarantee the faithful and timely performance by the Corporation of any obligation or undertaking . . . with respect to any security. . . ." 12 U.S.C. § 1455(c) (1970).

141. 12 U.S.C. § 1721(g) (1970). For a discussion of Ginnie Mae's role in the issuance of mortgage-backed securities based on pools of FHA/VA mortgages, see text accompanying notes 127-29 *supra*; see also Bartke, *supra* note 6, at 46-47, 53-54.

(3) Relationships to Other Federal Departments

It must be remembered that the Corporation is a subsidiary of the Federal Home Loan Bank System. It is managed by a Board of Directors which consists of the members of FHLBB. By statute, the Corporation is a member of each one of the Federal Home Loan Banks and has all the benefits, powers and privileges and is subject to all liabilities, conditions and limitations inherent in such membership.¹⁴² Since the Corporation's capital stock must originally be issued only to the Federal Home Loan Banks, these banks have complete ownership of the Corporation. Because of this close relationship, the statute does not provide any further guidelines or supervisory powers.

Once we go beyond the Federal Home Loan Bank System, however, the relationships with Federal departments become less clear. Because of a chance remark in the conference committee report, we should first examine the Corporation's relationship with the Treasury Department. The report comment states :

[I]n approving borrowings for the home loan bank system, the Secretary of the Treasury should exercise his authority to prohibit FHLBB borrowings at any time that FHLBB borrowings for conventional secondary market operations would unduly inhibit the financing of GNMA special assistance functions.¹⁴³

The Charter Act, as such, does not give the Secretary of the Treasury any supervisory powers over the Corporation's borrowing. The Federal Home Loan Bank Act does mention the Secretary in three separate sections,¹⁴⁴ but not in a way referable to the Committee report's language. Section 11(i)¹⁴⁵ of the Act grants to the Secretary of the Treasury the authority to purchase obligations issued by the Federal Home Loan Bank System up to the aggregate amount of four billion dollars and directs the Secretary to exercise this authority to provide additional liquidity for the system in times of monetary stringency. Although this has a direct bearing on the marketability of Federal Home Loan Bank securities, it does not constitute authority to approve or disapprove borrowing. Sections 22(a)¹⁴⁶ and 23¹⁴⁷ mention the Treasury, but the former provision deals only with the exchange of information and confidential data,

142. 12 U.S.C. § 1452(a) (1970).

143. CONF. REP. No. 1311, 91st Cong., 2d Sess. 16-17 (1970).

144. 12 U.S.C. §§ 1431(i), 1442(a), 1443 (1970).

145. *Id.* § 1431(i).

146. *Id.* § 1442(a).

147. *Id.* § 1443.

and the latter merely involves mechanical questions concerning the form of securities issued by the system. The only clear authority given to the Treasury Secretary is his power to disapprove the issuance of statutory mortgage backed securities.¹⁴⁸ Thus, the total relationship is a cloudy one. Probably, the Secretary's only major influence on the marketability of the Corporation's securities is his discretion to purchase or not purchase these securities.

Although the Corporation does not have any direct statutory relationship to HUD, the fact that both agencies are concerned with our national housing policies may bring them into conflict. A recent example of such a possibility is HUD's decision to hold the line on interest ceilings on FHA mortgages.¹⁴⁹ As interest rates started declining in late 1970 and early 1971, the Secretary, in a series of moves, reduced interest ceilings on FHA mortgages.¹⁵⁰ However, in the early spring of 1971 the trend was reversed and interest rates started climbing again.¹⁵¹ As the discounts increased, demands were made that the Secretary exercise his discretion and increase the limits.¹⁵² The Secretary resisted these requests for several months, until early August, 1971, when the present policy was announced. Pursuant to this plan FHA mortgages in excess of 22,000 dollars remain subject to the seven per cent limit and are, therefore, heavily discounted. On the other hand, those less than 22,000 dollars are being directly subsidized by a new tandem approach.¹⁵³ This policy decision created many problems for the Corporation.

The Corporation had interpreted its intended purpose to be the provision of dependable financing for home building. Responding to the desire of builders to know in advance the amount of money they would receive, it started pricing its forward commitments differently from the method used by Fannie Mae.¹⁵⁴ The Corporation promised to purchase,

148. *Id.* § 1719(d).

149. Wall Street Journal, Aug. 10, 1971, at 6, col. 2; *News/Policy, President Nixon's new game plan to stabilize the national economy and his program to promote housing and keep mortgage money flowing*, 39 HOUSE & HOME, Oct. 1971, at 4, 8 [hereinafter cited as *President's Program*].

150. Wall Street Journal, Dec. 2, 1970, at 4, col. 3 (reduction from 8.5 per cent to eight per cent); *id.*, Jan. 13, 1971, at 2, col. 3 (reduction from eight per cent to 7.5 per cent); *id.*, Feb. 18, 1971, at 3, col. 1 (reduction from 7.5 per cent to seven per cent).

151. Wall Street Journal, May 26, 1971, at 2, col. 3. The trend continued through August, *id.*, Sept. 24, 1971, at 20, col. 2, and into September, *id.*, Nov. 1, 1971, at 3, col. 4.

152. See, e.g., Mandala, *FHA Mortgage Market Tumbles Into Disarray as Pressures Build on All Sides*, HOUSE & HOME, July 1971, at 8.

153. The announcement was made on Friday, August 6, 1971. Wall Street Journal, Aug. 10, 1971, at 6, col. 2.

154. Fannie Mae prices its forward commitments in terms of yield so that at

at stated discounts, FHA mortgages of an acceptable quality which, at the time of delivery, bear the highest interest rate then permissible.¹⁵⁵ This meant that builders could compute in advance the net amount of money they would receive. Numerous commitments were made at a price of 98, or in other words, at a discount of two percentage "points."¹⁵⁶ This means that a home seller must make a two dollar lump-sum payment to the Corporation for each one hundred dollars paid by the Corporation to the seller. The Corporation assumed that if market interest rates rose the Secretary would increase the statutory interest limits accordingly. As a result of HUD's changed policy, the Corporation was left holding a bag full of some terribly underpriced commitments.¹⁵⁷ This, of course, produced monumental financing problems. Only a sudden downturn in interest rates, which started in September, 1971,¹⁵⁸ saved the Corporation from huge financial losses.

Despite the committee reports' insistence on a parallel development between the Corporation and Fannie Mae,¹⁵⁹ the statute fails to provide any direct form of coordination between the two. This has been recently illustrated by the inability of the two entities to agree on a set of standard forms for conventional mortgages. After months of efforts each entity adopted its own set of forms.¹⁶⁰ As mentioned before, there is always the possibility of competition between the two entities. This competition, in itself, is not necessarily bad. Because of different historical backgrounds and statutory limitations, direct competition is highly unlikely. The com-

time of delivery the points charged are computed on the basis of face interest rates. For a description of this procedure, see Hunter, *supra* note 6, at 823-24.

155. For a description of the Corporation's original pricing policies, see SELLER'S GUIDE, *supra* note 66, § 204 a (ii).

156. Charging "points" is a common method of discounting mortgages. Under this technique, a price of 98 (or a discount of two points) means that the mortgagee will lend only 98 dollars for each 100 dollars of face amount, but the mortgagor must pay interest on 100 dollars. Thus, the mortgagee is compensated for the fact that this mortgage is subject to an interest rate ceiling.

For FHA mortgages, however, HUD requires home sellers, rather than buyers, to make the discount payments. See *Agencies Boost Home Mortgage Interest Ceiling* in G. LEFCOE, LAND FINANCE LAW 985 (1969).

157. The commitments are underpriced because the pre-commitment price of 98 (or a \$2/\$100 discount payment) was calculated to make up for the difference between the interest ceiling and the then current market rate. As a result of rising market rates, this compensation is no longer adequate. The Corporation has recently announced a new price of 94. *President's Program, supra* note 149, at 8.

158. This downward trend has persisted into 1972. Wall Street Journal, Jan. 14, 1972, at 1, col. 6.

159. S. REP. No. 761, 91st Cong., 2d Sess. 7 (1970); H.R. REP. No. 1131, 91st Cong., 2d Sess. 7 (1970).

160. Wall Street Journal, Dec. 16, 1971, at 14, col. 1. The principal differences between the two sets of forms are in their respective prepayment penalties and due-on-sale clauses.

petition, therefore, will be indirect, resulting from their respective pricing and servicing policies and their own particular mix of conventional and FHA/VA paper. These policies, in turn, will influence the investment decisions of the organizations with which they do business. The Corporation also has a direct statutory link to Ginnie Mae through the Corporation's authority to issue and sell statutory mortgage backed securities. In order to receive Ginnie Mae's guaranty, the Corporation will have to comply with the regulations issued by that entity.¹⁶¹

Finally, the Corporation is subject to an audit by the General Accounting Office.¹⁶² Language in the conference committee report indicates that this provision was added because of concern for the proper relationship of FHLBB, the Federal Savings and Loan Insurance Corp. and the Corporation to the General Accounting Office, Bureau of the Budget and civil service laws generally.¹⁶³

A LOOK AT THE FUTURE

The Corporation has existed for slightly over one year. Even this short period of time is sufficient to indicate that its present statutory framework is not equal to the task. Its problems are both philosophical and practical. Its philosophical dilemma stems from the ambiguity of its assigned role. Its practical difficulties are the result of the stringent limitations imposed by the Charter Act.

The Philosophical Dilemma

The statute and legislative history do not indicate a clear mandate for the Corporation to follow. This ambiguity goes much deeper than simply poor draftsmanship. It is primarily caused by the failure of Congress to come to grips with the problem of home financing. Rather than annual tinkering with specific provisions of housing legislation, we urgently need an overall definition of housing goals and means for realizing them.¹⁶⁴ The difficulty is also caused by failure to appreciate the operation of certain schemes and to have a clear understanding of the terms used. The classical example of this problem is use of the term "secondary mortgage market." As indicated earlier, there is a total lack of consensus as to the meaning of the term,¹⁶⁵ yet it is being used by Con-

161. These regulations are contained in GNMA GUIDE, *supra* note 133.

162. 12 U.S.C. § 1456(b) (1970).

163. CONF. REP. No. 1311, 91st Cong., 2d Sess. 17 (1970).

164. See Bartke, *supra* note 6, at 77-78; Bartke, *The Organized Bar in Housing and Urban Development*, 4 URBAN LAW. 206 (1972); Rouse & Wehbring, *Housing as a National Priority*, 39 GEO. WASH. L. REV. 674, 684-89 (1971) [hereinafter cited as Rouse].

165. *Supra* note 69. Oakley Hunter, President of Fannie Mae, purports to describe

gress without any definition whatsoever. This by itself creates latent ambiguities, but moreover, this ambiguity hides basic and possibly irreconcilable differences as to the proper role of the federal government in housing. An attempt to define such a seemingly innocuous term as "secondary mortgage market" may bring to the surface the whole range of inconsistencies in our present housing structure.¹⁶⁶ Once this is brought into the open, there may be a great practical difficulty in finding a solution acceptable to Congress.

Nevertheless, such an attempt is overdue and the longer we delay the more difficult the task will be. In the final analysis, there are only two directions in which the Corporation may move. First, it can progressively become a kind of Fannie Mae for the savings and loan industry and, to a lesser extent, for certain other thrift institutions, with those institutions gradually assuming the roles of mortgage bankers rather than investors. If this role is adopted the Corporation will be drawn into a support operation of undetermined proportion and its entire financing structure will have to be reviewed and modified. More importantly, as the savings and loan industry relies increasingly on the Corporation for funding, the industry will lessen its efforts to develop its own sources of funds. This decrease in new sources will further reduce available outlets for the funds of small and medium sized savers.¹⁶⁷

The other road available to the Corporation would lead it into improving the competitive position of home mortgages in general, and of the savings and loan industry in particular. This would necessitate devising new financing schemes for the industry, improving old ones, and upgrading the liquidity and marketability of home mortgages. The ultimate goal of such a development would be the creation and fostering of a secondary market in mortgages meeting the definition used in this article.¹⁶⁸

While the early clarification of goals by Congress would be desirable, it may not be practicable. The ambiguity of goals in the Charter Act permits the Corporation itself, to a certain degree, to choose its goals and the

the operation of a secondary market in a recent article. See Hunter, *supra* note 6, at 819-20. However, the transactions described by Hunter are atypical of the way in which Fannie Mae does business.

166. For example, the question of whether organizations such as Fannie Mae, and presumably now the Corporation, should deal only with lenders or should make direct loans has been a bone of contention ever since the enactment of title III of the National Housing Act of 1934. See Bartke, *supra* note 6, at 17. This issue is still not resolved philosophically although Fannie Mae is a large institutional investor. The use of the "secondary market" terminology has helped to hide the question. See Rouse, *supra* note 164, at 688-89.

167. See Bartke, *supra* note 6, at 47, 75-76.

168. *Supra* note 69.

direction in which it moves. However, this freedom of choice is hampered by the administrative restriction imposed on the Corporation.

The Administrative Problems

The present Charter Act limits the Corporation's flexibility and prevents it from developing a comprehensive secondary mortgage market. The solution is to try to get Congress to relax the restrictions it has written into the Act. Attempts to achieve that solution, however, encounter the horns of a dilemma. On the one hand, the desire is to get as much relaxation of the restrictions as fast as possible. On the other hand, piecemeal reforms may mask imperfections and prevent fundamental change. There is much truth in the saying that the "good" is the enemy of the "excellent."

(1) Short-Range Solutions

As a result of these considerations, a policy decision has been made to attempt gradual, rather than long term, improvements. The first batch of recommendations is now pending before Congress in the form of title III of the Housing Institutions Modernization Act of 1971.¹⁶⁹ Although the bill was not reported by either committee in 1971,¹⁷⁰ there are indications that some kind of housing legislation will be passed in 1972. The proposed bill is also concerned with matters other than the improvement of the operations of the Corporation,¹⁷¹ and if passed, would introduce far-reaching changes into the structure of federally chartered savings and loan associations and indirectly into the savings and loan industry as a whole.

The changes envisioned by the proposed legislation are all directed towards relaxation of some of the restrictions imposed upon the purchasing powers of the Corporation. None of them are directly concerned with financing as such.¹⁷² One change would permit the Corporation to repur-

169. The bill was introduced almost simultaneously in identical form in both the House and the Senate. H.R. 7740, 92d Cong., 1st Sess. (1971); S. 1671, 92d Cong., 1st Sess. (1971).

170. The same fate befell the other major housing bill introduced in 1971—"Housing Consolidation and Simplification Act of 1971," S. 2049, 92d Cong., 1st Sess. (1971). This bill has essentially become Ch. 1 of "Housing and Urban Development Act of 1972," S. 3248, 92d Cong., 2d Sess. (1972), which passed the Senate on March 2, 1972, 118 CONG. REC. S3152 (daily ed. Mar. 2, 1972), and was sent to the House.

171. S. 1671, 92d Cong., 1st Sess. (1971), consists of four titles. Title I proposes several changes in the structure of federally chartered savings and loan associations; title II deals with the Federal Home Loan Bank Board and title IV with the Federal Savings and Loan Insurance Corporation. Thus, the bill deals with the main component of the Federal Home Loan Bank System.

chase, from any holder or owner, mortgages it had previously sold.¹⁷³ This change may be viewed either narrowly or broadly. In the narrow sense, it might stimulate the Corporation's sales activities by allowing the Corporation to tell prospective purchasers that if they should be in need of liquid funds in the future, there may be a market open to them. On the other hand, this change may be viewed broadly as the opening wedge in attaining the eventual goal of making the Corporation available to all qualified parties. An organization which aspires to the role of a secondary market facility must provide access to its facilities, directly or indirectly, to all those in need thereof. Another proposed amendment may also be viewed as an attempt to facilitate secondary market operations; it would increase the limits on purchases of seasoned mortgages from ten per cent to twenty-five per cent of total mortgages purchased¹⁷⁴ thereby making its secondary mortgage function more available.

Other proposals contained in this legislation are more limited and technical. One would change the loan-to-value limitation,¹⁷⁵ thereby bringing it in line with the present FHLBB regulations.¹⁷⁶ In cases where the mortgage qualifies for purchase because the seller is to retain a participation, another proposal would eliminate the present prohibition against pre-commitments.¹⁷⁷ To the extent that the Corporation continues to operate with pre-commitments or moves in the direction of a support operation and investor position, this proposal may be significant. If, however, the Corporation starts moving in the direction of a secondary market facility, its use of forward commitments should drastically decline.

(2) Long-Range Legislative Goals

On the assumption that the ultimate goal of the Corporation is improving the position of residential mortgages in the nation's money markets through the creation of a secondary market facility, the long-range legislative objectives should all point in one direction—the elimina-

172. This statement is not technically correct, since S. 1671, 92d Cong., 1st Sess. § 305 (1971), provides that the securities issued by the Corporation are lawful investments for fiduciaries. However, the section would simply make explicit what is already implicit in the Charter Act.

173. S. 1671, 92d Cong., 1st Sess. § 301 (which would amend 12 U.S.C. § 1454(a) (1) (1970)).

174. S. 1671, 92d Cong., 1st Sess. § 302 (1971) (which would amend 12 U.S.C. § 1454(a) (2) (1970)).

175. S. 1671, 92d Cong., 1st Sess. § 303 (1971) (which would amend 12 U.S.C. § 1454(a) (2) (1970), by increasing the loan-to-value ratio from 75 to eighty per cent).

176. 12 C.F.R. § 545.6-1 (1971). The eighty per cent ratio is the norm; however, there are several exceptions thereto.

177. S. 1671, 92d Cong., 1st Sess. § 304 (1971) (which would amend 12 U.S.C. § 1454(a) (2) (1970)).

tion of the artificial restrictions written into the Charter Act. These restrictions are: (1) the limitation on the type of institutions with which the Corporation may do business; (2) the artificial restrictions on the kind of mortgages it is permitted to deal in; and (3) the limitation on the date of origination of mortgages.¹⁷⁸ Each one of these is inimical to the ideal of a secondary mortgage market.

Although the Corporation, or any other secondary market facility, would deal primarily with traditional mortgage investors, it should be legally entitled, and also practically prepared, to do business with all who need its services. Once such a facility is firmly established and operational, it is possible that a new class of middlemen or brokers may develop to serve the needs of those who only occasionally may have an opportunity to use the service.¹⁷⁹

All restrictions on the quality of paper eligible for purchase or trading by or through the Corporation should be eliminated, other than the requirement that the paper be of a quality acceptable to institutional investors. This standard, which already is written into the Charter Act and which is somewhat akin to the "prudent man rule" of the law of trusts, is entirely sufficient. As far as trading is concerned, even this standard may be too stringent. With an efficient rating system, paper of lesser quality, properly labeled, should be eligible and made available to those who may be willing to sacrifice some security in exchange for a higher yield. Of course, there would be some limit below which the Corporation would not want to venture. This choice, however, should be left to the Corporation.

The artificial limits on the principal amounts of mortgages must be removed. Similarly, the age of mortgages should have nothing to do with their eligibility for trade. All available studies indicate that the highest

178. *Supra* notes 93 & 95 & text accompanying.

179. The creation of brokerage services in this field has started. The Kislak group organized a new corporation, the J. I. Kislak Mortgage Company, Inc., to perform nationwide brokerage functions. The corporation advertises regularly in publications such as Savings and Loan News.

In addition, the Mortgage Guaranty Insurance Corp., of Milwaukee, Wisconsin, which specializes in insuring conventional mortgages, announced the formation of a subsidiary to buy and sell mortgages. The new corporation, known as MGIC Investment Corp., has obtained the services of William B. Ross, former executive vice-president of Fannie Mae. Konzelman, *More Help for Buyers*, Detroit News, Feb. 27, 1972, at 1-G, col. 6. The new corporation is in the process of developing operational policies and procedures and has not, as yet, entered the market. Source: Letter dated March 16, 1972, from William B. Ross, Senior Vice President, MGIC Investment Corp., to Richard W. Bartke (a copy of which is on file in the offices of the Indiana Law Journal). It proposes to buy over the counter and issue forward commitments, which, however, will not obligate the seller to deliver. It will not buy at a premium. MGIC MORTGAGE CORPORATION, SELLERS GUIDE (1972).

rate of default and foreclosure occurs during the early years of a mortgage.¹⁸⁰ On the other hand, once a mortgage has reached a certain maturity its marketability decreases simply because the proportion of principal to interest in each payment increases rapidly,¹⁸¹ and with servicing costs approximately constant, the net return actually decreases. However, such variations will be taken care of by market quotations and therefore this problem should not affect the mortgages' trading potential.

On the affirmative side, the Corporation should, over a number of years, seek statutory authorization to engage, not only in buying, but also in establishing trading desks or floor operations. Such authorization is clearly implied in the Charter Act,¹⁸² but a specific statement to this effect would be desirable to eliminate any doubts on the part of more conservative investors. The Corporation should further propose amendments broadening the borrowing powers of the various institutional investors such as savings and loan associations and mutual savings banks. In the future, the demand for home financing will be progressively more complex,¹⁸³ due to the increased amount of such financing and to newer, more sophisticated financing instruments.¹⁸⁴ Broadened powers will help the industry cope with these demands. These improvements cannot be achieved, however, until we have assured a steady and dependable share of capital funds for the home mortgage market. In this connection, the fragmentation of the market into submarkets, functional and geographical, is counterproductive. Anything which artificially impedes the free flow of funds to the areas of greatest need is a disservice to the cause of home financing.

The ultimate objective of these activities is an increase in the amount

180. *Supra* note 120.

181. This can be illustrated by the following hypothetical. If we assume a 20,000 dollar mortgage, at seven per cent interest, repayable in 240 monthly installments of \$155.20, the payments at the indicated times would be:

	Interest	Principal
1st payment	\$116.60	\$ 38.60
60th "	100.80	54.40
120th "	78.20	77.00
180th "	46.00	109.20
239th "	1.40	153.80

See FINANCIAL PUBLISHING COMPANY, MONTHLY PAYMENT DIRECT REDUCTION LOAN AMORTIZATION SCHEDULES 7%-33 - 7%-35 (11th ed. 1967).

182. "The Corporation is authorized to purchase . . . and to hold and deal with, and sell or otherwise dispose of . . . any . . . mortgage or interest therein." 12 U.S.C. § 1454(a) (1) (1970).

183. The level-payment, fully amortized mortgage in general use today has recently been criticized on the ground that it fails to account for the different needs of various classes of borrowers. See text accompanying notes 199-200 *infra*.

184. See proposed amendments to 12 C.F.R. §§ 541, 545, contained in 36 Fed. Reg. 20311 (1971).

of funds channeled into home financing and the attraction of new sources of supply for these funds. Some promising sources are the real estate investment trusts established pursuant to the provisions of part II of subchapter M of the Internal Revenue Code.¹⁸⁵ The ability to use the Corporation's facilities would make it that much more attractive for these trusts to enter the market. This would be particularly true if the trustees are primarily interested in an equity position but either desire qualifying investments¹⁸⁶ for surplus funds or wish to maintain a defensive posture. Furthermore, both the more conservative and the more adventuresome of trusts may be interested in trading in the proposed futures market for forward commitments;¹⁸⁷ the former to hedge and thus diminish risks, and the latter to speculate for higher returns. This interest should extend both to forward commitments by the Corporation and commitments by other institutional investors who may follow the Corporation's lead once the experiment has proved successful. It would be necessary, however, to obtain an amendment to the Internal Revenue Code to insure that the income derived from such trading qualifies under the Code.¹⁸⁸

Non-Statutory Considerations

In anticipation of future statutory relaxations, the Corporation must plan for many things which are not directly related to its statutory framework. As stated previously,¹⁸⁹ mortgages lack two prerequisites of a smoothly operating market, namely homogeneity of the product and fungibility of the trading units. Part of the problem was eliminated in one segment of the market by the introduction of FHA insurance which has

185. INT. REV. CODE of 1954, §§ 856-58. For a description of the operation and qualification of real estate investment trusts, see Comment, *Usury and Real Estate Investment Trusts: An Analysis of Treasury Regulation 1.856(c)(2)(ii)*, 60 CALIF. L. REV. 147, 147-51 (1972).

186. To qualify for the benefits of Part II of subchapter M, a real estate investment trust must derive the predominant part of its gross income from real property assets. INT. REV. CODE of 1954, §§ 856(c)(2)-(4).

187. See text accompanying notes 134-35 *supra*.

188. Presently, a real estate investment trust must qualify under the income limitations of §§ 856(c)(2)(D) and 856(c)(3)(C) of the Code. It is doubtful that gains on trading of futures in forward commitments in real estate mortgages would qualify under these provisions. See the definition of "real estate assets" and of "mortgages on real property" in Treas. Reg. § 1.856-3(b).

The suggestion that an amendment to the Code is desirable may seem inconsistent with the proposition advanced later in this paper that tax incentives are not necessarily the best way to achieve housing goals. *Infra* notes 207-10 & text accompanying. However, proposals should be pragmatic; since tax incentives are in vogue, proponents of increased federal action to achieve housing goals should take this into account when formulating recommendations.

189. *Supra* notes 15 & 16 & text accompanying.

provided a certain amount of uniformity among mortgages.¹⁹⁰ This permitted nationwide mortgage lending by life insurance companies in the 1950's and created a vast network of correspondents and servicers.¹⁹¹ Recently, it has been suggested that the situation could be improved further by removing residual risks from FHA mortgages and insuring the stability of monthly cash flows rather than merely guaranteeing the repayment of principal.¹⁹² This is not the place to discuss the merits or demerits of the suggestion, but it must be stressed that it only applies to FHA mortgages and does nothing for the conventional market.

In order to facilitate its entry into the conventional market, the Corporation has already initiated a number of steps. First, it has attempted to draft a set of standardized forms to be used by all savings and loan associations, and other thrift institutions, which want to do business with the Corporation.¹⁹³ Although such forms would improve the situation, the forms must operate in fifty different legal systems, and many of the provisions of state substantive law in these areas cannot be altered or waived by agreement of the parties. This raises the problem of unification of mortgage laws. The task has been undertaken,¹⁹⁴ but it will be many years before it comes to fruition, even if an eventual code of real estate transactions is adopted as widely as the Uniform Commercial Code.¹⁹⁵

Another problem facing a prospective purchaser of a mortgage is the evaluation of the commodity he is about to acquire. If, in each instance, the investor must undertake an independent investigation of all the factors, the transaction becomes too cumbersome and expensive. A possible answer would be a national rating system for conventional mortgages and the Corporation should, if possible, start preparing for such a

190. See Bartke, *supra* note 6, at 10-11.

191. This does not mean that all impediments to the free flow of funds have been removed. A.B.A. Committee on Real Estate Financing, *Impediments to Free Flow of Funds in Mortgage Market*, 6 REAL PROPERTY PROB. & TRUSTS J. 215 (1971).

192. This has been accomplished indirectly through Ginnie Mae's guaranty of mortgage-backed securities, particularly those of the pass-through variety. Investor acceptance of the paper seems to be increasing. Wall Street Journal, June 21, 1972, at 36, col. 1. For a full discussion of the proposal, see Guttentag, *Changes in the Structure of the Residential Mortgage Market: Analysis and Proposals*, in 4 STUDY OF THE SAVINGS AND LOAN INDUSTRY 1479, 1510-33 (I. Friend ed. 1969) [hereinafter cited as Guttentag].

193. Although controversial, see *Associations Confront the Critical Consumer*, SAVINGS AND LOAN NEWS, June 1971, at 28; Wall Street Journal, Oct. 26, 1971, at 40, col. 1, the forms have been adopted. Wall Street Journal, Dec. 6, 1971, at 1, col. 1.

194. The Commissioners on Uniform State Laws have appointed a committee to study a real estate transactions code.

195. The Uniform Commercial Code has been adopted in all states, except Louisiana, and in the District of Columbia and the Virgin Islands. A.L.I. & NATIONAL CONFERENCE OF COMMISSIONERS ON UNIFORM STATE LAWS, UNIFORM COMMERCIAL CODE table 1, at xxxv (official text 1972).

system.¹⁹⁶ In this connection, the Corporation may assist the cause of unification and simplification of real estate law by including the local mortgage law as one of its rating elements and assigning minus points to those jurisdictions whose laws unfairly discriminate against the security of the instrument. The market may have already responded to this discrimination by retarding the flow of funds to such jurisdictions, in which event the Corporation would simply be recognizing something which has existed for a long time. However, even such recognition may be beneficial, since considerable publicity might generate needed legislative action.

A further problem with trading mortgages is that the principal amounts, even originally, are different depending on the borrowing needs of the mortgagor. Therefore, they do not present readily quoted units. However, many of the objections to trading in individual mortgages can be eliminated if the trading unit is an undivided interest in an underlying pool, rather than a particular mortgage or block of mortgages. If a dependable rating system is introduced and if all the mortgages in the pool are of the same quality, the very size of the pool and the number of the units in it provide the necessary homogeneity. At that point the chances of default and the extent thereof can be predicted statistically. This predictability transforms the commodity into a homogenous one, and by dividing the common mass into trading units of 50,000 or 100,000 dollars, fungibility of trading units is also achieved.¹⁹⁷ This scheme would make it feasible to start trading participations in conventional mortgage pools, facilitated by a national market with an efficient system of reporting prices, bid and asked. Such a market could constitute an excellent barometer of the price of home financing money.

The previous discussion assumed that the mortgages underlying the pool would be of the equal payment, fully amortized kind which is almost universally employed now. However, these mortgages, which came into widespread use as a result of the enactment of the National Housing Act of 1934 and the activities of FHA,¹⁹⁸ have recently been criticized.¹⁹⁹ The

196. Professor Guttentag feels that a rating system is unnecessary if his proposal for cash flow insurance by FHA is adopted. That may be true in respect to the FHA market, but it does nothing for conventional mortgages. See Guttentag, *supra* note 192, at 1530-33.

197. In view of the language of Rev. Rul. 71-399, 1971 INT. REV. BULL. No. 35, at 18, clarifying amendments to §§ 593(e) and 7701(a)(19)(C)(v) of the Internal Revenue Code are needed to insure that the proposed trading units qualify as "qualifying real property loans" and "loans secured by an interest in real property." Similarly, clarifying amendments would be needed in the case of § 856(c)(6)(C) and Treas. Reg. § 1.856-3(b), which define "real estate assets" for purposes of determining whether there is a real estate investment trust.

198. See *Hearings on S. Res. 102 Before the Subcomm. on Housing and Urban Redevelopment of the Sen. Special Comm. on Post-War Economic Policy and Planning*,

main shortcoming is that they equate all borrowers and put them into an identical mold, whereas borrowers' needs and desires may be quite different. In response to this problem, FHLBB has recently announced a proposed amendment to its rules which would permit federally chartered savings and loan associations to tailor the terms of their mortgages to the conditions of their borrowers.²⁰⁰ This will introduce further variations into the already complex and non-uniform nature of mortgages: *i.e.*, different rate of repayment, varying mix between interest and principal, different relation of rate of repayment to obsolescence and a host of others. However, with an efficient rating system which would take these added variables into account, and with pools of sufficient size, it would seem that even these variations could be accommodated; *i.e.*, those mortgages with limited principal payments and a large balloon payment at maturity could be balanced in the pool by those with more rapid repayment schedules and prepayment privileges. To preserve the homogeneous nature of the commodity, this development makes it even more imperative that trading be in terms of participations in large pools.

The above suggestion, of course, is the counterpart of the conversion of mortgages into bonds of small denominations, suitable for small and medium sized savers.²⁰¹ Participations in large pools would be available only to large investors because of the very size of the trading unit. The two approaches are complementary and each is designed (1) to tap additional resources and make more funds available for home purchases and (2) to improve the liquidity position of the various institutional mortgage investors by both breaking the vicious borrowing-short-lending-long syndrome and creating a market in which interests in mortgages can be expeditiously converted into cash as the need may arise. Obviously, such a market cannot fully succeed until the statute is amended to make the Corporation's services more available.

The Corporation will most likely start experimenting with the possibilities of such a market, once it has begun purchasing conventional mortgages and has gained some experience in the area. Concurrently with its regular purchase program, the Corporation might encourage savings and loan associations, and others with whom it is entitled to deal, to start trading participations in pools of mortgages and assist such endeavors by helping to publicize prices and rating quality. The experience gained in

78th Cong., 1st Sess. 1283-84 (1945); M. COLEMAN, *IMPACT OF GOVERNMENT ON REAL ESTATE FINANCE IN THE UNITED STATES* (1950).

199. Guttentag, *supra* note 192, at 1540-43. PEARSON, *supra* note 41, at 59-101.

200. 36 Fed. Reg. 20311 (1971). For an immediate reaction, see *Wall Street Journal*, Oct. 21, 1971, at 7, col. 1.

201. See text accompanying notes 134-41 *supra*.

such a limited market might help to refine the overall procedure and smooth out its operation by the time it is launched on a national scale. To facilitate the development of such a market § 305 of the Charter Act²⁰² should be amended to explicitly authorize the Corporation to organize and operate limited trading floors.²⁰³

In its continued quest for improved home financing, the Corporation is exploring various approaches, including the concept of variable interest mortgages. Instead of the present form of constant interest rates throughout the life of the loan, such mortgages would have a rate which would rise or fall, depending on the overall interest level in the economy. The movement, of course, will have to be contractually agreed upon and be tied to some external and objective standard.²⁰⁴ This kind of mortgage, it is claimed, would help break disintermediation problems of savings and loan associations and other thrift institutions in times of rising interest rates. It would be easier for the institutions to increase the rate they offer to their depositors when their own rate of return on their entire portfolio rises accordingly.²⁰⁵ Unfortunately, it will take many years before the institutions accumulate a large enough backlog of this kind of paper to make the proposal effective. Moreover, while the device would almost certainly be very efficient as far as passbook savings accounts are concerned, it is not clear that it would meet the needs of many institutional investors whom the Corporation is attempting to interest in the home mortgage market. In times of rising interest rates, such investors would probably be interested in purchasing either individual variable interest rate mortgages, or participations in pools of such mortgages, since they would currently be getting the market rate of return and their investment would also have potential for higher return in the future. However when interest rates go down, the same investors might very well withdraw entirely from the market if they can only purchase variable interest rate mortgages. Although they would currently be buying the market rate of interest, purchase is doubtful because their investments would have a built-in reduced

202. 12 U.S.C. § 1454 (1970).

203. Although such an amendment is highly desirable, it is not a *sine qua non*. See text accompanying note 181 *supra*.

204. The choice of an appropriate standard poses considerable problems. See Wall Street Journal, Nov. 22, 1971, at 6, col. 3. The concept of a floating interest rate has received qualified approval from the Commission on Financial Structure and Regulation. PRESIDENT'S COMMISSION ON FINANCIAL STRUCTURE AND REGULATION, THE REPORT OF THE PRESIDENT'S COMMISSION ON FINANCIAL STRUCTURE AND REGULATION 77, 82-83 (1971).

205. For discussions of some of these problems, see Grebler, *supra* note 23, at 1308-50; Friend, *supra* note 44, at 1408-27; Cootner, *supra* note 46, at 283. See also sources cited in Bartke, *supra* note 6, at 76 n.318.

return as interest rates declined further. At this point, competitive investments, such as corporate bonds with fixed interest rates and long periods of no prepayment, would be considerably more attractive.

FEDERAL SUBSIDIES

A discussion of the home financing problem is not complete without some mention of federal subsidies.²⁰⁶ Because a certain segment of our population cannot afford the market prices of housing,²⁰⁷ the federal government has increasingly assumed a support role and has provided various subsidies for so-called low and lower-middle income groups.²⁰⁸ Most of these supports are indirect by way of either encouraging certain investors to invest in rental housing via very attractive tax provisions or by partially subsidizing some of the elements going into the total cost of housing, particularly interest. Because of the indirect manner in which subsidies are provided, there is an interplay between subsidy and market structure which complicates and confuses both.²⁰⁹ Recently, a very spirited debate has arisen over their general usefulness.²¹⁰

In this connection, questions are asked whether the right people are being subsidized, whether the social cost is justified and whether the subsidy actually achieves the desired ends. The accumulation of data to date tends to indicate that some of these schemes are exceedingly inefficient in channeling resources.²¹¹ More importantly, from our immediate point of view, some of the more recent studies seem to indicate that tax subsidies

206. The concept of subsidization is not clear, and there is a lively debate over what constitutes a subsidy. For example, there is much debate as to whether § 203 of the National Housing Act constitutes a subsidy. See S. GREER, *URBAN RENEWAL AND AMERICAN CITIES* 134-35, 150-51 (1966); B. WEISSBOURD, *SEGREGATION, SUBSIDIES, AND MEGALOPOLIS* 5-6 (1964).

Similarly, there is a lively discussion as to whether the deductibility of mortgage interest under § 163 and the deductibility of real estate taxes under § 164 of the Internal Revenue Code are subsidies. See Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925 (1967); Bittker, *Comprehensive Income Taxation: A Response*, 81 HARV. L. REV. 1032 (1968); Galvin, *More On Boris Bittker and the Comprehensive Tax Base: The Practicalities of Tax Reform and the ABA's CSTR*, 81 HARV. L. REV. 1016 (1968); Musgrave, *In Defense of an Income Concept*, 81 HARV. L. REV. 44 (1967). Pechman, *Comprehensive Income Taxation: A Comment*, 81 HARV. L. REV. 63 (1967).

207. See DECENT HOME, *supra* note 1, at 39-50.

208. For a history of such efforts, see Rouse, *supra* note 164.

209. See Bartke, *supra* note 6, at 65-69.

210. See note 206 *supra*.

211. For a detailed discussion of the impact of accelerated depreciation and leverage on various tax bracket taxpayers, see McKee, *The Real Estate Tax Shelter: A Computerized Exposé*, 57 VA. L. REV. 521 (1971) [hereinafter cited at McKee]. Another recent article, although starting from a different premise, supports Professor McKee's conclusions. Sunley, *Tax Incentive for the Rehabilitation of Housing*, 39 APPRAISAL J. 381 (1971). But see Guido, *The Impact of the Tax Reform Act of 1969 on the Supply of Adequate Housing*, 25 VAND. L. REV. 289 (1972).

actually work against home financing by insulating certain favored groups from the effect of changing interest rates.²¹² To the extent that these very high bracket taxpayers are almost impervious to changes in interest rate levels, they are in a position to outbid their competition and, therefore, in times of rising interest rates, their activities further accentuate the depressing effect of such rates on housing.

CONCLUSION

The housing situation is becoming critical. We cannot have housing without adequate and dependable financing. To provide this financing we need an efficient system of encouraging thrift, collecting savings, and channeling such savings into housing. To do this, investment in mortgages must be made attractive to various classes of investors, small and large.

We should improve the position of home financing paper in the money markets of the nation, simplify the structure generally and make it as efficient and, therefore, as cheap as we possibly can. Having done that, we should also reassess our national goals to decide whether an additional subsidy is needed and devise the most direct and most effective means of providing such a subsidy.²¹³ In devising such subsidies, the touchstone should be fair effectiveness, not their immediate effect on the federal budget.

The title of this piece, "Home Financing at the Crossroads," may sound overly dramatic or represent an attempt at emulating a journalistic headline. However, the underlying thought seems to be well taken. We have coasted a long time on past wisdom and attempted only patchwork repair of the most glaring defects in our home financing edifice. This form of remedy cannot continue much longer.

212. McKee, *supra* note 211, at 532-41; Surrey, *Federal Income Tax Reform: The Varied Approaches Necessary to Replace Tax Expenditures with Direct Governmental Assistance*, 84 HARV. L. REV. 352, 395-408 (1970).

213. HUD is presently experimenting with the concept of a housing allowance. Wall Street Journal, Jan. 10, 1972, at 8, col. 3; *id.*, Jan. 19, 1972, at 10, col. 1.