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Appendix A

Note on Mortgage Discounts

Mortgages may be traded at prices below or above par, as are securities in other capital markets. For several reasons, this practice is most common in the case of FHA and V.A. loans. The maximum interest rates on these mortgages are the same in all geographic areas. They have usually been set so as to encourage lending at or near par in areas with ample supply of funds. The government-underwritten loans are traded in an active secondary market in which lenders buy mortgages from other lenders. In contrast, when a conventional mortgage loan is made, the interest rate can reflect geographic differentials in interest rates and variations in the quality of loans, as well as other individual circumstances. Also, conventional loans are rarely traded in secondary mortgage markets. Discounts on conventional loans are common only for junior mortgages; in this case, they usually serve to raise the yield on these higher-risk investments to a level above the ceilings set in the usury laws of the various states.

Discounts on government-underwritten mortgages with fixed maximum interest rates may perform any or all of the following functions:

1. They adjust the yields on these loans to changes over time in the general level of interest rates. A 4.5 per cent loan made in 1954 at par, for example, may be sold in late 1955 at a price of 97, that is, at a discount of 3 points, solely because the general level of interest rates increased during the interval.

2. They adjust yields to regional differences in mortgage interest rates between capital-deficit areas such as the West and Southwest and capital-surplus areas such as New England. In addition to regional variations in "pure" interest rates, mortgage investments made over a long distance are

more costly. As each transaction is unique, it is more expensive to bring together lenders and borrowers who are separated by distance.[1]

3. They adjust yields to differences in the terms of loans and in borrowers' equities. Although the loans are insured or partially guaranteed by the federal government, lenders generally accept loans with the maximum maturity and smallest down payment permitted by law only at somewhat higher yields than those expected on more conservative loans.[2]

4. They adjust yields to differences in the quality of the underlying security (location and construction of the house), in the credit standing of the borrower, and in some cases in foreclosure costs (which are much higher in some states than in others) and in redemption periods. This kind of differentiation and the one under (3) above occur because lenders take into account risks not covered by the insurance or guaranty contracts with FHA or V.A.

Discounts or premiums may also vary depending on whether the loans are offered for immediate or future delivery. Discounts are usually higher on "stand-by" commitments than other commitments, because stand-by commitments pledge a bank or other institution providing interim financing to accept the mortgage if the borrower cannot dispose of it elsewhere, in which case the price under the stand-by commitment reflects a penalty for the borrower's failure to liquidate the interim loan.

The numerous price variations, in addition to the low degree of organization of the secondary mortgage market, make it difficult to establish generally applicable price quotations. The following discussion is limited to discounts from par, since premiums were not characteristic of mortgage market developments in 1953-1957.

Differential Effects of Changes in Discounts and Interest Rates

Theoretically, the discount should be a perfect means of adjusting the expected yield on fixed-interest-bearing FHA and V.A. loans to fluctuations in the general level of interest rates. In practice, it is not. The supply of

[1] The purchase price schedule of the Federal National Mortgage Association usually lists separate prices for 5 groups of states. The purely geographical price spread for any type of loan is usually a maximum of 2 points, i.e. if 99 is offered for a given type of loan in the states with the lowest discounts, 97 is offered in the states with the highest discounts. The gradation of purchase prices from one group of states to the next is half a point. See a sample price schedule in *Review of Federal Housing Programs,* Annual Report of the Senate Committee on Banking and Currency, 84th Congress, 2nd Session, January 26, 1956, pp. 62-66.

[2] Thus, the FNMA price schedule referred to in note 1 above provides for a price differential of half a point each for loans meeting the following criteria: (1) maturity of 25 years or less as against maturity of more than 25 years, and (2) down payments of 10 per cent or more of appraised value, of 5 per cent or more but less than 10 per cent, and of less than 5 per cent.

funds for mortgage investment does not respond to increases in discounts as freely as it would respond to increases in interest rates, and large discounts have effects on home builders' operations that differ from the effects of high interest rates.

Large numbers of financial institutions are reluctant to acquire government-underwritten mortgage loans at high discounts. They feel that such transactions may expose them to public disapproval because they have an aura of "unethical" practice. While perfectly understood and accepted in the case of securities negotiated in free markets by financiers and corporations or governments, the discount is still widely considered to be in a different class when loans to consumers and especially government-underwritten loans are involved. Consequently, some institutions refrain from lending on government-underwritten mortgages when high discounts would be required to make the yields on such mortgages competitive with those on other investments. This attitude is reinforced by recurrent adverse Congressional reaction to discounts. Whenever discounts have reached high levels, Congressional committees or influential members of both Houses have expressed the view that the acquisition of government-underwritten mortgages at less than par circumvents the intent of Congress in setting maximum interest rates. Thus, the Chairman of the Subcommittee on Housing of the Senate Banking and Currency Committee stated at a hearing on mortgage market problems in late 1955: "The discounting of V.A.-guaranteed and FHA-insured loans is a recurring practice that tends to negate public policy." [8] Twice within the period 1950-1957, this view has been legislated into a mandate to both the Federal Housing Administration and the Veterans Administration to control discounts (see below).

As for the home builders, high discounts tend to reduce their profit margins to the point where they cut down or even suspend operations under the government programs. This tendency, in turn, reduces total home building since the larger down-payment requirements and shorter maturities for conventional loans make substitution of conventional for government-underwritten financing difficult. The direct impact of high discounts on builders' profit margins is associated with the fact that FHA and V.A. appraisals in principle do not recognize discounts as cost items that may be included in appraised values. Under the law, the "reasonable value" placed by V.A. on the property also controls the maximum price the veteran is permitted to pay for the home. In the case of FHA loans, the home buyer is not legally prohibited from paying more than the appraised value, but the latter determines the necessary down payment; moreover, as FHA is required to inform

[8] *Mortgage Market Problems,* Hearings before a Subcommittee of the Senate Banking and Currency Committee, 84th Congress, 1st Session, November 28-29, 1955, p. 102.

him of its appraisal, the purchaser will rarely be inclined to pay a price substantially exceeding the FHA-appraised value.

If appraisal practice conforms to principle, the discount must be absorbed by the builder or, in the case of existing property, the seller. Builders' profits are usually large enough to make it possible for them to absorb moderate discounts. But when discounts reach high levels, operations tend to become unprofitable. This may be illustrated by the following example:

Sale Without Mortgage Discount		*Sale with Mortgage Discount*	
Sales price	$12,000	Sales price	$12,000
Cost to builder	11,200	Cost to builder:	
Profit to builder	800	Land and building	11,200
		Discount[a]	720
		Total	11,920
		Profit to builder	80

[a] Assumes a discount of 6 points on a $12,000 mortgage loan which equals the sales price, as it may under the veterans' home loan program.

In this case, the builder would be unlikely to proceed with the project if he knew that the mortgage could be marketed only at the specified discount. The discount has a direct effect on his production schedule. A higher interest rate, on the other hand, would influence his production schedule only through the effect of the higher rate on housing demand. Since the demand for homes is much more sensitive to down-payment requirements and mortgage loan maturities than to changes in interest rates as such, this effect is not only indirect but less pronounced.

Appraisal practice, however, does not necessarily conform to principle. Builders attempt to obtain higher appraisals when discounts increase and, the art of appraising property being less than precise, they may succeed in an appreciable number of cases. The evidence on this point is not clear. The Administrator of Veterans Affairs stated in 1957: "During the past 18 months, increasing pressures have been brought to bear on the Veterans Administration to establish higher and allegedly 'more realistic' reasonable values. Although the Veterans Administration does not contend that it has been wholly successful in defeating efforts of builders to include discounts in the purchase price of the home, it is believed that . . . appraisals have required builders generally to absorb a substantial portion of the discount involved in the financing of their units."[4] Others have held that V.A. appraisers in many local offices have been easily persuaded to "stretch" appraisals when discounts are high. In any event, to the extent that large mortgage loan discounts tended to raise appraised values and purchase

[4] Letter of the Administrator of Veterans Affairs to the Chairman of the House Committee on Veterans Affairs, in *Hearings before the House Committee on Veterans Affairs,* 85th Congress, First Session, January 24-February 6, 1957, p. 19.

prices, the home buyer paid for the discount in the form of a higher price and through payments on a larger mortgage than would otherwise be required. In the above example of sale with mortgage discount, the price might have been increased from $12,000 to $12,600, leaving the builder with a profit of $680. The buyer would pay the larger purchase price on the strength of the V.A. appraisal and also because he often has no alternative to the no-down-payment, or low-down-payment, long-maturity loan available through the V.A. guaranty.

No matter how successful the government agencies were in resisting the pressures for making allowances for discounts in their appraisals, the builders' ability to pass high discounts along to the home buyer in the form of higher purchase prices depended also on the strength of housing demand. In 1956 and 1957 demand was probably not strong enough to make it possible for builders generally to pass along all or even most of the discounts to home purchasers, although this may have been true in certain areas. If this interpretation of market conditions is correct, high discounts had the effect of reducing the production schedules of builders. The difficulties were compounded when Congress, in the Housing Act of July 1957, established discount controls, which, however, were repealed in April 1958.[5]

Control of Discounts

The episode of discount controls between July 1957 and April 1958 repeated the experience with similar restrictions imposed under Congressional mandate in 1950, substantially modified in June 1953, and finally withdrawn in August 1954. The removal of uncertainty over the legality of discounts was one of the factors in the great expansion of mortgage investment by major financial institutions in 1954 and 1955 and in the associated increase in residential building.

In response to what appears to have been a flagrant abuse,[6] Congress, in the Housing Act of 1950 (Section 504), authorized and directed both the FHA and V.A. to limit fees and charges imposed upon builders and home purchasers in connection with loans insured or guaranteed by the agencies. The interpretation of this legislative mandate and its enforcement proved to be extremely difficult. The FHA and V.A. issued regulations

[5] Cf. *Housing Act of 1957, Public Law 85-104,* 85th Congress, approved July 12, 1957, Sec. 605. Also, *Public Law 85-364,* 85th Congress, approved April 1958, Sec. 6.

[6] The abuse occurred in connection with government-underwritten mortgage loans tendered to the Federal National Mortgage Association which at that time bought these loans at par and issued advance commitments to lenders. Mortgage originators charged builders substantial sums for obtaining the financing which eventually resulted in mortgages acquired at par by a government agency. Cf. *Housing Act of 1957,* Hearings before the Subcommittee on Housing of the House Banking and Currency Committee, March 4-15, 1957, pp. 83-91.

limiting permissible discounts, but dubious practices were quick to develop and confronted the agencies with a veritable Pandora's box of legal questions. The Veterans Administration's instructions to its field offices on this issue over a period of little more than one year cover 20 pages of fine print in a Congressional document.[7] The government lawyers found it impossible to keep pace with new arrangements which might or might not be within the law. Transactions approved at first were disapproved later, and vice versa.[8] In August 1952, the agency, inundated by a flood of inquiries, began to refuse to render any advance opinions on the validity of proposed arrangements involving discounts or other charges and fees, leaving mortgage lenders in a state of heightened uncertainty.[9] The acute uncertainty and the penalties for violation—including in the case of V.A. the abrogation of the guaranty contract for loans, suspension from participation in the G.I. home loan program, and criminal prosecution—caused an increasing number of financial institutions to withdraw from the market for government-underwritten mortgages. This was true particularly for the veterans' home loans on which discounts were more widespread and larger than for FHA loans.

In response to representations by both builders and lenders, Congress in June 1953 attempted to remedy the situation by an amendment exempting from control "any loss suffered by an originating lender in the bona fide sale or pledge of or an agreement to sell the mortgage."[10] The effect was to permit builders to absorb any discounts that mortgage loan originators incurred when they disposed of FHA and V.A. loans by sale to permanent investors. But the control of discounts charged by lenders originating mortgages for retention in their investment portfolio was maintained. The amendment brought some measure of relief and at the same time created new problems by placing the financial institutions that were making loans directly at a competitive disadvantage. These types of lenders were averse to continuing their customary mode of operation when they could improve mortgage yields by buying FHA or V.A. loans from others. Thus, the whole operational structure of the mortgage market was upset. The legislative mandate for discount control was finally repealed in August 1954,[11] after

[7] *The Mortgage Interest Rate Problem,* Hearings before a Subcommittee of the Senate Banking and Currency Committee, 83rd Congress, 1st Session, January 28, 1953.

[8] For the complex and confused detail, see *ibid.;* also, *Housing Act of 1957,* as cited, pp. 83-91.

[9] *Veterans Administration, Technical Bulletin 4A-124,* August 22, 1952.

[10] *Public Law 94,* Section 23, 83rd Congress, approved June 30, 1953, 67th Stat. 121, 127.

[11] *Housing Act of 1954,* Section 813, *Public Law 560,* 83rd Congress, Second Session, approved August 2, 1954.

the mortgage market had eased so much that the control was obviously unnecessary. For three years thereafter, the Federal Housing Administration and the Veterans Administration confined their regulations, as they had before 1950, to prohibiting discount charges to the borrower and establishing maximum amounts for other charges to him, while leaving discount arrangements between builders or other sellers of property and the mortgage lender, as well as those between parties to a transaction in the secondary mortgage market, to competitive market forces.

The reimposition of discount controls in July 1957 hastened the demise of the veterans' home loan program, although the controls allowed somewhat greater administrative flexibility than had been possible under the earlier version. In the case of the FHA program, increased maximum interest rates, which were permitted under existing administrative discretion, softened the impact of the regulation of discounts. The removal of discount controls in April 1958, coupled with Congressional authorization to raise the maximum interest rate on V.A. loans from 4.5 to 4.75 per cent, again came at a time when credit eased, mortgage funds became more freely available, and discounts tended to decline.[12]

[12] For a discussion of mortgage discounts and their market implications, see also Saul B. Klaman, *The Postwar Residential Mortgage Market*, Princeton for National Bureau of Economic Research, in press, Chapter 4.