Chapter 5

Postwar Residential Finance

Learning Objectives

- Understand the major forces that have changed and shaped the residential mortgage market since the end of World War II
- Understand how changes in the inflationary environment forced changes in the types of institutions that originated mortgages and in the types of mortgages they offered

History Of Real Estate Finance

1950s
- About half of mortgages held by depository institutions (mostly banks and S&L's, "portfolio lending")
- Decade of S&L Expansion and Stability

1960s
- Creeping Inflation
- Disintermediation (Regulation Q)
- Maturity Mismatch
- 46% of mortgage debt held by S&L's in 65
- Expansion of Secondary Mortgage Market (reduces maturity mismatch problem)
- 1968 GNMA created (1970 Freddie Mac) – See Chapter 10

1970's
- Inflation Increased from 6 Percent to 13 Percent
- Interest Rate Increases Decreased Housing Affordability (Tilt effect, see Table 5-1)
- See Table 5-2
- Development of Alternative Mortgage Instruments (AMI)
- Development of Graduated Payment Mortgage (typically with negative amortization)
- Development of SAM and PLAM
- Development of Adjustable-Rate Loans

1980s
- Mortgage assumability – potentially a high value to borrower when selling, if interest rates increase
- Due-On-Sale and Creative Financing
- Wellenkamp Case (1978) – lender could not enforce Due on Sale with no erosion of credit quality
- US Supreme Court case (1982) allowed enforcement for Federal Home Loan Bank Board to protect S&L industry
- Garn-St. Germain Act allowed more general enforcement of Due on Sale

1980s continued
- FHA and VA set maximum interest rates – points generally were used to balance the low rate. Sellers had to pay the points, so often there was little interest in FHA loans – see Table 5-3. These loans were fully assumable at this time.
- Buydowns – when the seller makes an upfront payment to reduce the early year interest rates (eg., 3/2/1)
- Owner Financing – Used if owner had substantial equity and often took a balloon form. Also called purchase money mortgage
### History Of Real Estate Finance

#### 1980s continued
- **Regulatory and Tax Law Changes**
  - Pre 1982 Thrifts were limited on what they could pay depositors to keep mortgage rates low.
  - How does one deal with S&L’s which now can pay high interest rates to depositors but hold low yielding mortgages?
  - Spreads narrowed from 2.61 in 1980 to 0.45 in 1987 for new mortgages.
  - Prepayment slowed as borrowers held on to low rate mortgages.
  - Thrifts allowed to diversify their investments.
  - Thrifts allowed to use RAP (Regulatory Accounting Principles) rather than GAAP accounting rules.

- **Zombie Theory** – S&L’s engaged in very risky behavior in hopes of survival (like a stock option).
- **S&L Debacle** – Few S&L’s exist today.
- **FIRREA (1989)** – Financial Institutions Reform, Recovery, and Enforcement Act
  - Created OTS under Treasury
  - Risk Based Capital Requirements (Table 5-5)
  - GAAP reporting required
  - No direct RE investments or Junk Bonds

#### 1990s AND INTO 2000s
- **Decreasing Inflation Resulted in Lower Mortgage Rates**
- **Refinancing Craze**
- **Baby Boomers Trading Up Increasing Demand for Up-scale Housing**
- **Dominance of Secondary Mortgage Market, Primarily Fannie Mae (26%, 2003) and Freddie Mac (17%)**
- **By 1997, Mortgage Bankers originated 57% of mortgages**

#### 2000s
- **More Subprime Loans issued**
- **Rapidly increasing house prices in many areas, more recently followed with rapidly decreasing house prices**
- **Problems with mortgage defaults leading to huge losses in secondary markets**
- **Fannie Mae and Freddie Mac under receivership by US government**

### Important Dates In RE Finance

- **1932** – Creation of the Federal Home Loan Bank System
- **1934** – Creation of Federal Savings and Loan Insurance Corporation (FSLIC)
- **1934** – Creation of Federal Housing Administration (FHA)
- **1938** – Creation of Fannie Mae (Fannie Mae)
- **1968** – Creation of Government National Mortgage Association (Ginnie Mae)
- **1970** – Creation of Federal Home Loan Mortgage Corporation (Freddie Mac)**
Important Dates In RE Finance

- 1979 - FHLBB Approved New Mortgage Designs: VRM, GPM, AND RAM
- 1986 - Tax Reform Act Created Modified Accelerated Cost Recovery System
- 1989 - Financial Institutions Reform, Recovery, And Enforcement Act (FIRREA)
- 1993 - Tax Act of 1993 Eased Passive Loss Rules and Extended Nonresidential Depreciation From 31.5 Years to 39 Years
- 1997 - Taxpayer Relief Act of 1997 Established Maximum Long-Term Capital Gains Tax Rate at 20 Percent and Maximum Depreciation Recovery Rate of 25 Percent

History Of Real Estate Finance

**The Big picture**
- Today’s evolving mortgage market exists due to the history that preceded it. Expected changes:
  - Less subprime lending
  - More verification of borrowers income and other ability to repay measures
  - Higher Down Payments
  - More amortizing loans
- Commercial mortgages are also changing, even though to date they are not experiencing the problems common for residential mortgages