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How Meddling with Monetary Policy Shaped Modern Mortgages

Mark Calabria

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The mortgage market has seen a tremendous amount of change over the last four decades. The vast majority of this change can be attributed to the Great Inflation of the 1970s, which permanently changed the nature of our mortgage finance system. If we wanted a face for the Great Inflation, Arthur Burns, who served as Chairman of Federal Reserve from 1970 to 1978, would be the most appropriate.

In 1976, over half of mortgages were originated by savings and loans, with commercial banks, mutual banks and mortgage companies taking up most of the remaining origination. This was largely an era of originate-to-hold. Securitization was largely unheard of, while the activities of Fannie Mae and even Ginnie Mae were rounding errors. Even the Federal Housing Administration was a relatively small part of the market.

The business model of the savings and loan industry greatly depended upon a stable interest rate environment. The S&Ls borrowed short, in the form of deposits, and lent long, in the form of mortgages. As long as you had both a positively-sloped yield curve and stable, predictable rates, this was a solid business, even with the remaining credit risk.

The Great Inflation changed all that. In 1976 the ceiling on deposit rates as mandated by Regulation Q was comparable to the three-month Treasury rate. By 1980 there was an almost 10-percentage-point difference between the two. Banks and thrifts simply could not compete for funds. The average rate for time and savings deposits shot up to over 12%. When the typical outstanding mortgage borrower is paying about 7%, such is a recipe for widespread insolvency, which is exactly what happened.

After monetary policy helped kill the savings and loans, securitization and the government-sponsored enterprises took over the mortgage market, setting us up for the next crisis. The first round of Basel capital accords, which helped drive securitization, was itself a response to the inflation-induced failures of the 1980s.

The Great Inflation also set the stage for the Alternative Mortgage Transaction Parity Act of 1982 and other legislative changes that expanded the availability of adjustable-rate and non-amortizing loans. Whether AMTPA was good policy or not is a separate debate, but it is fair to say it never would have passed in a period less rife with inflation.

It is also fair to say that the growth of alternative mortgage products also gave birth to the subprime market. Prior to the early 1980s, borrowers with poor credit simply did not get mortgages, with only a few exceptions. Even FHA at the time was largely a prime business.

Alternative mortgage products never would have been created without the pressures brought about by the Great Inflation.

The inflation-induced insolvency of the S&Ls also gave momentum to the removal of branch-banking restrictions, both at the state and federal level. Such would ultimately contribute to the massive increase in concentration in our banking system.

Ultimately, the Great Inflation completely changed the face of our mortgage market by changing the industrial structure of mortgage origination and holding, while also changing the variety of products allowed on the market. Some of these changes were good, some were not. The point here is not to cast judgment but remind us that ultimately the shape of the mortgage market bends to fit the macroeconomic environment.

Mark Calabria is the director of financial regulation studies at the Cato Institute.