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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
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CONFIDENTIAL (FR)
CLASS II FOMC

TO: Federal Open Market Committee

FROM: Arthur L. Broida

Attached is a memorandum entitled "Junior Mortgages on Homes" prepared in the Board's Research and Statistics in response to a request at the May FOMC meeting.

Attachment

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Date June 17, 1977

To Federal Open Market Committee

Subject: Junior Mortgages on Homes

From Division of Research and Statistics
(David F. Seiders)

For Information Only

This memo has been prepared in response to a request for information about the use by homeowners of junior mortgages to borrow against accumulated equity in their houses. In some areas, such credit is identified as second mortgages, homeowner loans, or equity loans.

Summary

With house prices soaring, household sector equity in homes has risen dramatically in recent years, providing the potential for a large expansion of debt secured by the stock of existing homes. Indeed, there are indications that households have borrowed unusually large amounts of funds against this equity in recent periods.

Junior mortgages constitute one means by which households can liquefy their accumulated housing equity though borrowing. Fragmentary data indicate that a wide variety of financial institutions has traditionally invested in junior mortgages to some degree.[1/] Moreover, the junior mortgage lending powers of Federally-

1/ Some junior mortgages are also acquired by households, particularly during periods of tight money. Homeowners who sell their houses subject to the assumption by the buyer of the outstanding first mortgage may take back a second "purchase-money mortgage" as partial payment.

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chartered depository institutions have been expanded in recent years. Also, restrictions on junior mortgage lending by State-chartered depository institutions and finance companies have been eased in some areas. On the other hand, approximately half the states still prohibit certain institutions from making loans secured primarily by junior liens on homes, and restrictions on household use of funds as well as maximum interest rates, loan sizes and/or loan maturities may limit junior mortgage lending even where permitted by law.

Press reports and trade sources have indicated some increase in junior mortgage activity during the past year, particularly at commercial banks and finance companies. Contract interest rates in excess of 10 per cent and favorable charge-off experience in recent periods[1/] have encouraged some institutions to invest in junior mortgages secured by growing home equities. From the household's point of view, junior mortgages have become a more attractive borrowing vehicle, particularly in view of the general price inflation of recent years. These loans usually provide larger amounts of funds, at longer terms, than are available

1/ Scattered data from finance companies and credit unions indicate that delinquency rates on junior mortgages have been quite low in recent years, in comparison with delinquencies on consumer instalment credit. Moreover, delinquency rates on first mortgages at major holders rose only slightly in the recent recession, and foreclosure rates have changed little.

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via unsecured personal loans. Moreover, the funds may ordinarily be used by households for a variety of purposes including home improvement, debt consolidation,[1/] or education. Unless constrained by law or discouraged by lenders, such funds may also be used for investment purposes--including the purchase of additional homes.

A recent Federal Reserve survey of large commercial banks indicated that increasing numbers of banks are either actively promoting junior mortgage lending or are seriously considering such a policy; more than a fourth of the banks surveyed in early June fell into this group. Activity appears to be greatest in areas of the country where home price appreciation has been relatively rapid. Even so, less than a tenth of the banks surveyed reported junior mortgage holdings in excess of $10 million. The largest amounts were held by banks in California, where promotion has been vigorous in recent months. About three-fifths of the banks actively promoting junior mortgages have been reporting these assets as consumer credit, reflecting the widespread practice of originating junior mortgages in consumer loan departments.

1/ If used for debt consolidation, junior mortgages do not, of course, provide additional funds to consumers. However, the maturity of outstanding household debt would ordinarily be lengthened, and a larger proportion of personal disposable income would thus be available for current consumption.

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To date, the extent of junior mortgage lending against home equities by all types of institutions appears to be quite limited, albeit growing. Under these circumstances, the special risks to lenders that may be associated with default on either the first or the junior liens have yet to pose any substantial problems for financial institutions. 1/

Housing Equity and Household Borrowing

Household sector equity in homes has increased substantially in recent years, even though capital expenditures on homes have been considerably smaller than the sum of depreciation and increases in home mortgage debt. Rapid increases in existing home prices have been responsible for the growth in housing equity under these conditions. (Table 1)

A substantial amount of the large increase in home mortgage debt recorded during the past year or so has been for purposes other than home purchase. These funds represent borrowing

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1/ If a first mortgage is foreclosed and the property is sold, the junior lien will be wiped out unless the sale price is sufficient to pay off both mortgages. Ordinarily, the holder of the second mortgage has the right of reinstatement--if borrowers default on the first mortgage, second mortgage holders may take over the payments (reinstate the first loan) and foreclose and sell or bid-in the property themselves.

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TABLE 1

HOUSEHOLD EQUITY IN HOMES
(Amounts in billions of dollars)

End of Year	Value of Housing Stock Owned by Households 1/	Home Mortgage Debt Owed by Households 2/	Household Equity in Homes (Col.(1) - Col.(2)
	(1)	(2)	(3)
1970	767.5	292.7	474.8
1971	807.5	321.0	486.5
1972	907.9	360.9	547.0
1973	1,035.4	402.2	633.2
1974	1,168.7	436.8	731.9
1975	1,265.0	477.4	787.6
1976	1,370.0	543.5	826.5

1/ Owner-occupied dwellings in both single family and multifamily structures, including estimates of improved land. Mobile homes are excluded.

2/ First and junior mortgage debt secured by 1- to 4-family properties, excluding construction loans. Mortgages on condominium units in multifamily structures are included.

SOURCES: MIT-PENN-SSRC model, Flow of Funds Accounts, HUD.

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against equity in the stock of existing homes--an estimated $32 billion in 1976. 1/ (Table 2)

Borrowing against accumulated housing equity may be accomplished by the household sector in several ways:

1. Through transactions in existing homes. 2/
2. By increasing the size of first mortgages through refinancing.
3. By raising additional funds through open-end first mortgages.
4. By taking out first mortgages when homes are owned free and clear. 3/
5. By taking out junior mortgages.

A large proportion of the recent increases in mortgage debt incurred for purposes other than home purchase has apparently

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1/ The true mortgage amounts are even larger than this. The benchmarks for the 1- to 4-family mortgage debt statistics released by the Board exclude junior mortgage lending by finance companies and credit unions, and as mentioned above, some banks have been reporting junior mortgages as consumer credit.

2/ Transactions involving existing homes give rise to increases in mortgage debt outstanding under the following conditions (a) households trade existing homes among themselves and, on average, mortgages taken out by purchasers exceed the outstanding mortgage debt of sellers (normally extinguished at the time of sale): (b) sellers of existing homes buy new homes, and the sum of the downpayment on the new home and the downpayment on the existing home by the new entrant is less than the equity that had been accumulated in the existing home by the seller (the original downpayment, repayments of mortgage principal, and increases in the market value of the home); (c) sellers of existing homes leave the homeowner group (rent or double-up), and the mortgage incurred by the buyer exceeds the outstanding debt of the seller.

3/ According to HUD's Annual Housing Survey, about 30 per cent of all owner-occupied dwellings were free of mortgage debt in 1975.

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TABLE 2

MORTGAGE BORROWING AND HOME PURCHASES BY HOUSEHOLDS
(Amounts in billions of dollars)

Period	Increases in Home Mortgage Debt of Households[1/]	Net Purchases of Homes by Household Sector[2/]	Home Mortgage Funds Raised for Purposes Other Than Home Purchase[3/]
	(1)	(2)	(3)
1970	16.4	18.7	1.7
1971	28.4	25.2	8.7
1972	39.8	32.0	14.5
1973	42.1	35.9	13.0
1974	34.7	34.3	7.7
1975	42.6	31.9	17.7
1976	66.1	43.7	32.0
1977-Q1	79.2	52.5	36.2

1/ First and junior mortgage debt.

2/ Household sector purchases of new homes (including condominium units in multi-family structures) and realtor commissions on the sale of existing homes. Purchases of mobile homes and expenditures on additions and alterations to existing homes are excluded.

3/ Column 1 less column 2 plus estimated downpayments on new homes purchased by households.

NOTE: Figures for 1977-Q1 are expressed at seasonally adjusted annual rates, and are partially estimated.

SOURCES: Flow of Funds Accounts, HUD.

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been generated through transactions in existing homes. Existing home sales have reached unusually high rates, prices of existing homes sold have risen sharply, and average loan/price ratios on first mortgages closed for the purchase of existing homes have been increasing.

Refinancings of first mortgages, on the other hand, have probably been relatively infrequent since interest rates on new first mortgages have been at historically high levels. Moreover, trade sources suggest that use of open-end first mortgages is as yet infrequent,[1/] and the high costs of executing a new first mortgage (e.g., property appraisal, title search, recording fees) have no doubt limited such borrowing by households without outstanding mortgage debt.

While press and trade reports have indicated increases in junior mortgage activity during the past year,[2/] current data

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1/ There are exceptions. In Kentucky, for example, most first mortgages written by State-chartered commercial banks contain a clause allowing extensions of first mortgages for home improvements.

2/ Transactions costs are ordinarily smaller with second mortgages than with firsts, and lenders promoting these loans often absorb whatever closing costs are involved--planning to recoup these costs through interest income.

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on amounts of second mortgages are not available from trade associations, Federal Credit agencies, or Federal and State regulatory agencies. 1/ Fragmentary data from 1971 and 1975 indicate that a variety of financial institutions engage in second mortgage lending (Table 3), although in the past the amounts have been rather small. In 1971, junior mortgages accounted for less than 2 per cent of total home mortgage debt outstanding.

Junior Mortgage Lending Powers and Restrictions

The various types of institutions that make junior mortgages have differing degrees of lending power, as defined by Federal or State regulations. Moreover, state-imposed 2/ interest rate ceilings may make such lending unprofitable for some lenders, and provisions of state constitutions may limit the use of second mortgage funds by households.

National banks. Until August 1974, National banks were permitted to make junior mortgages only in "abundance of caution"

1/ Moreover, a search of data collected in the Board's Form FR Y-6 (Bank Holding Company Annual Report) uncovered no information on second mortgage activity of BHC nonbanking subsidiaries. In some instances, a subsidiary of a BHC will list second mortgages as a secondary activity of the company, but no asset or income information is included.

2/ There are no Federal junior mortgage programs or rate ceilings.

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TABLE 3

JUNIOR MORTGAGE DEBT ON 1- TO 4-FAMILY PROPERTIES
HELD BY SELECTED INSTITUTIONS
(Amounts in millions of dollars)

Type of Holder	Mid-1971 1/	Mid-1975 2/
Savings and Loans	476	NA
Commercial Banks	547	NA
Mortgage Companies	289	NA
Mutual Savings Banks	90	NA
Life Insurance Companies	30	NA
Finance Companies	NA	1,946
Credit Unions	NA	370

1/ Based on the 1971 Census Bureau Survey of Residential Finances.
2/ Based on the 1975 Federal Reserve Survey of Finance Companies, and the 1975 Credit Union National Association Mortgage Lending Survey.
NA--not available.

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situations. 1/ Currently, loans secured primarily by junior liens on homes may amount to as much as 10 per cent of the maximum amount National banks are permitted to invest in conventional real estate loans. 2/ There are no restrictions on the use of funds by borrowers.

Federal S&Ls. Until June 1975, Federally-chartered savings and loan associations could acquire junior mortgages only if they also held the first mortgages on the same properties. Currently, Federal S&L's may invest from 2 to 5 per cent of total assets in junior mortgages where they do not also hold the first mortgages. 3/ There are no restrictions on the use of funds.

Federal credit unions. Federally-chartered credit unions currently may make junior mortgages with maturities of up to 10 years, with no per cent-of-asset or use-of-funds restrictions. Regulations soon to be issued will permit Federal credit unions to make junior mortgages with maturities of up to 12 years. 4/

1/ Such loans are to be based primarily on the credit worthiness of the borrower.

2/ In practice, this maximum is usually equal to the bank's time and savings deposits.

3/ The exact percentage will depend on the association's net worth position.

4/ The change in maturity was authorized by the Depository Institutions Act of 1977, signed into law on April 19.

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State-chartered depository institutions. The junior mortgage powers of State-chartered depository institutions vary from state-to-state, and are often different for types of institutions within a state. 1/

--Commercial banks. While restrictions have been eased in a few cases in recent years,[2/] State-chartered commercial banks are currently prohibited from making loans secured primarily by junior liens on real estate in about one-third of the states (including California).[3/] In a few other states, junior mortgages may be made only for home improvements. Most states that permit their banks to make junior mortgages place restrictions on loan size, maturity, proportion of property value that may be mortgaged, and/or proportion of bank portfolio that may be invested in such assets.

1/ Information in this section was obtained through an informal Board staff survey of the appropriate state regulatory commissions, and from the National Credit Union Administration.

2/ For example, in Colorado and Nevada, State-chartered banks have the same powers as National banks.

3/ In about a dozen states, loans secured by junior liens may be made by the banks only if the lien is not the primary security. The California State Banking Department issued a statement to this effect last June.

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--Savings and loans. About 10 states prohibit state-chartered S&L's from making loans secured primarily by junior liens, and in about 25 states such institutions may make junior mortgages only if they also hold the first mortgage. Eight states allow their S&L's to make second mortgages only for home improvements.

--Mutual savings banks. Thirteen of the 17 states with mutual savings banks permit these institutions to make loans secured primarily by junior liens on real estate. Four of these states allow junior mortgages only for home improvements.

--Credit unions. Only 3 states specifically prohibit state-charted credit unions from making junior mortgages. 1/ However, in 15 states the credit union statutes are silent as to mortgage loans of any type. In an additional 12 states, the statutes authorize first mortgage loans but are silent as to junior mortgages.

Finance companies. Finance companies in 38 states are permitted to make loans secured by real estate (Table 4). However, trade sources indicate that restrictions on loan size and/or maximum maturity render most junior mortgage loans unprofitable,

1/ Florida, Indiana, Iowa.

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TABLE 4

STATES PERMITTING FINANCE COMPANY LOANS
SECURED BY REAL ESTATE

State	Maximum Loan Size	Maximum Maturity
Alabama	None	None over $1,000
Arizona	$2,500	36-1/2 Months
California	None	84-1/2 Months to $10,000; none over $10,000
Colorado	None	None over $1,000
Connecticut	$5,000	None over $1,800
Delaware	10% Net Worth of Lender	84 Months
Florida	$2,500	36-1/2 Months
Georgia	$3,000	36-1/2 Months
Hawaii	None	72 Months
Idaho	None	None over $1,600
Illinois	$10,000	121 Months
Indiana	None	None over $1,300
Iowa	20% Net Worth of Lender	None over $1,000
Kansas	None	None over $1,000
Kentucky	$7,500	61 Months
Louisiana	$25,000	None over $1,000
Maryland*	$6,000	72-1/2 Months
Massachusetts	None	None
Mississippi	None	None
Missouri	None	None
Montana	$7,500	None over $2,500
Nebraska	$3,000	36 Months
New Hampshire	None	None
New Jersey	None	None
New Mexico	$2,500	None
North Carolina	$7,500	None
North Dakato	$2,500	None
Ohio	$15,000	60 Months
Oklahoma	None	None over $1,000
Oregon	$50,000	None
Pennsylvania	$5,000	60-1/2 Months
Rhode Island	None	None
South Carolina	None	None over $1,000
Utah	None	None over $1,600
Virginia	None	None
Washington	2% of Capital of Lender	24 Months
Wisconsin	None	None over $3,000
Wyoming	None	None over $1,000

Source: Household Finance Corporation.

* Effective July 1, 1977.

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relative to unsecured personal loans, in 7 of these states. 1/ In only one State--Missouri--are finance company junior mortgages restricted in terms of purpose; in this State, the proceeds of the loan may not be used for home improvement. 2/

Mortgage companies. Mortgage company activities are not regulated in any formal way. While mortgage companies ordinarily sell the loans they originate, in some cases the mortgage company subsidiary of a bank holding company will retain the loans.

State usury ceilings. Different types of institutions may be subject to different usury ceilings in a given state. Maximum interest rates permitted under state consumer loan laws ordinarily pose no serious constraints to finance company junior mortgage lending in states permitting these institutions to make loans secured by real estate. In a number of states--including the 7 which have adopted the Uniform Consumer Credit Code 3/ --depository institutions are subject to the same interest rate ceilings as finance companies. An additional 12 states and the District of Columbia have special usury ceilings for junior

1/ Arizona, Florida, Georgia, Nebraska, New Mexico, North Dakota, and Washington.

2/ Home improvement loans are subject to an interest rate ceiling of 10 per cent in Missouri.

3/ Colorado, Idaho, Indiana, Kansas, Oklahoma, Utah and Wyoming.

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mortgages[1/], permitting annual percentage rates ranging from 11-1/2 per cent to 18 per cent. In some states, however, depository institutions must make junior mortgages under the same usury ceilings that pertain to first mortgages, and these maximums may render junior mortgage lending unprofitable; in New York, for example, all loans to individuals secured primarily by real estate are subject to a ceiling of 8.5 per cent. In a number of states, the usury situation is quite uncertain.[2/]

State constitutional restrictions. State constitutions may contain provisions affecting junior mortgage lending by all types of investors in a state. In Texas, junior mortgage loans secured by homes may not be made by any institution or individual unless the purpose of the loan is home improvement.

Recent Commercial Bank Activity

An informal survey of weekly reporting banks was taken through the Federal Reserve Banks in early June to determine the extent of junior mortgage lending by banks, the most common rates

1/ Delaware, Georgia, Maryland, Massachusetts, New Hampshire, New Jersey, North Carolina, North Dakota, Texas, Virginia, West Virginia.

2/ For example, in Pennsylvania there is no special second mortgage ceiling, and it is not clear whether junior mortgages should fall under the consumer loan limit (12 per cent) or the first mortgage limit (currently 9-3/4 per cent). A decision by the attorney general is expected.

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and terms on these loans, and the uses of the loan proceeds by borrowers. A sample of 158 banks--primarily National banks--was contacted.

Nearly half of the banks surveyed make junior mortgages only under certain conditions, do not actively promote such lending, and are not considering a change in policy (Table 5). Most of these banks have less than $1 million in junior mortgages outstanding. Various banks in this group reported that they would grant junior mortgages only on the request of their own good customers, only for home improvements, only to shore up problem loans, or only if they also held the first mortgage.

One-fourth of the banks surveyed make no junior mortgage loans. However, 10 of these banks refer inquiries about junior mortgages to a nonbank subsidiary of their bank holding company--several of which were reported to be actively seeking junior mortgages--and 3 of the 10 banks purchase the junior mortgages originated by the nonbank subsidiary.

About 15 per cent of the banks reported that they are actively promoting junior mortgage lending (through various types of advertising campaigns), but as yet only 2 of these banks have as much as $50 million outstanding. An additional 13 per cent have definite plans to promote junior mortgages or are seriously studying the situation.

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TABLE 5

FEDERAL RESERVE SURVEY OF JUNIOR MORTGAGE LENDING
BY WEEKLY REPORTING BANKS
June, 1977

Bank Policy on Junior Mortgage Lending

	All Banks Surveyed	Do Not Make and Not Considering Change of Policy	Will Make But do Not Promote	Actively Promoting Junior Mortgages	Planning to Promote in Near Future	Seriously Considering Promotion
Number of Banks	158	39	75	24	9	11
Per Cent of Total	100	25	47	15	6	7

Amounts Held by Banks Actively Promoting Junior Mortgages

	All Banks Actively Promoting	Less than $5 million	$5m. to $25m.	$25m. to $50m.	Over $50 million
Number of Banks	24	13	7	2	2
Per cent of Total	100	55	29	8	8

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Bank interest in junior mortgage lending is currently concentrated on the West Coast, the middle-Atlantic area (D.C., Maryland, Virginia) and in the Southeast. Activity is greatest in California; of the 8 banks contacted, 7 were actively promoting junior mortgages. Scattered evidence of active interest by banks was also found in New England, Oklahoma, Idaho and Utah. Some banks reported they have entered, or are considering entering, the market for junior mortgages in order to meet the competition from other banks in their areas.

Among the banks actively seeking junior mortgages, the majority reported most common interest rates of 12 per cent, although the range of rates charged varied between 10 and 15 per cent. Many banks in this group grant maturities as long as 10, 12, or 15 years. In almost all cases, the junior mortgages are written for no more than 80 per cent of the appraised value of the property, less any outstanding mortgages.

The majority of the banks actively promoting junior mortgages reported that home improvement and debt consolidation were the most common uses. Education and small business expenditures were mentioned in several cases, and a few banks noted that they make short-term "swing loans" secured by junior mortgages

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to customers who are in the process of buying a new house but have not yet closed the sale of their previous home. Several banks allowed that the funds could be used for any purpose, and one large California bank contended that it was discouraging use of junior mortgage funds for speculation in real estate.