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During the last quarter of 1979, housing starts declined substantially and most forecasters predict that residential construction activity will be further depressed in 1980. This prospect has led the Congress and the Administration to consider reactivating the countercyclical Emergency Mortgage Purchase Assistance program--commonly referred to as the Brooke-Cranston program.

In response to questions raised by the renewed interest in the Brooke-Cranston program, in my testimony today I will:

- Review how the program operated during the last cyclical downturn in construction activity;
- Discuss the implications of several proposed program modifications; and
- Examine the budgetary effects of reinstituting the original or a modified version of the program.

PROGRAM OPERATIONS BETWEEN 1974 AND 1976

The Brooke-Cranston program was established in 1974 to help stabilize housing production by providing mortgage assistance during periods of reduced residential construction and sales activity. The program authorizes the Government National Mortgage Association (GNMA) to issue commitments to purchase privately written below-market-interest-rate mortgages. GNMA

buys these loans at close to face value and subsequently resells them as market-yield instruments, absorbing the price difference as a financing subsidy. The program may be used to aid both single-family and multifamily housing and owner-occupied as well as rental units.

The Brooke-Cranston program was designed to deal with two financial market problems that were causing declines in residential construction and sales. First, the high interest rates for residential loans made the cost prohibitive for many builders and potential homebuyers. Second, funds for these loans were limited, in part, because of large outflows of capital from savings and loan institutions resulting from constraints on the interest payments to depositers.

Between October 1974 and September 1976, GNMA issued commitments to purchase about $7.8 billion of mortgages for one- to four-unit homes and $5 billion of loans on larger multifamily projects. By September 1979, GNMA had purchased approximately $6.4 billion in mortgages on one- to four-unit structures and $2.4 billion in multifamily loans, accounting for 190,000 units in one- to four-family homes and 117,000 units in larger buildings.[1] The interest rates on the one- to four-unit

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1. All remaining single-family loan-purchase commitments have expired. The bulk of the outstanding multifamily loan-purchase commitments are still active and may result in mortgage purchases in the future.

mortgages ranged from 7.5 percent to 8.5 percent, providing interest subsidies of between 1 and 2 percentage points. Nearly all of the mortgages for the smaller structures have now been resold by GNMA at a net cost of $412 million--or an average subsidy of approximately $2,200 per loan. The multifamily loans were all written at 7.5 percent interest rates. The ultimate cost of the multifamily program cannot yet be determined, because many of those mortgages are only now coming into GNMA's possession. Their resale in today's markets will almost certainly involve larger discounts than were required in reselling the single-family loans.

It is difficult to gauge the effect that these mortgage purchases and sales have had on new construction. A recent GAO study estimated that the single-family mortgage assistance program resulted in between 2,000 and 63,000 additional construction starts in the short-run, offset, in part, by reductions in later years. The "best guess" estimates of five housing analysts were that the program resulted in from 18,000 to 35,000 additional construction starts during its two years of operations. No estimates are available of the net construction effect of the multifamily mortgage assistance program.

The Brooke-Cranston program also reduced housing costs for participating homeowners and tenants and increased landlord profits. Savings for participating homebuyers averaged about $40

per month. Renters--or the owners of rental properties--can be expected to benefit by comparable amounts.

CURRENT NEED FOR THE PROGRAM

Current housing-market conditions are both similar and dissimilar to those that created the need for Brooke-Cranston assistance in 1974. Mortgage interest rates are currently very high, in the neighborhood of 13 percent, but the availability of credit is much less a problem now than it was in 1974. Residential construction activity has slowed considerably, but the current projections indicate that the slowdown is likely to be less dramatic than that which occurred in 1974. Whatever the present need for Brooke-Cranston assistance, if the program is reactivated today, one of its effects might be to put renewed upward pressure on housing prices that have been moderating recently as a result of diminished demand.

PROGRAM REDESIGN ISSUES FOR 1980

If the Brooke-Cranston program is again needed, there are three major program redesign issues facing the Congress:

- How large should the interest subsidy be.
- What purchase-price and mortgage limits to establish for eligible units.
- How aid should be apportioned between yet-to-be-built and existing housing and between owner-occupied and rental units.

The manner in which these issues are resolved will affect program costs and will necessarily involve tradeoffs among often-competing program objectives. For example, many of the actions that could be taken to target assistance in various ways might slow the pace of outlays. However, it is not clear that simply the rate at which loans are purchased is essential to the program achieving its primary goal.

Interest-Rate Limits

Under current law, GNMA may fix the interest rate on mortgage-purchase commitments at any level not to exceed the lesser of 7.5 percent or the maximum interest rate applicable under the FHA single-family mortgage insurance program--now set at 11.5 percent. Two bills now pending before this Committee would amend these limits. S. 2177 would remove the 7.5 percent cap entirely, limiting mortgage-purchase commitments to loans with interest rates no greater than the FHA maximum. S. 2178 would allow the Secretary of HUD complete discretion in setting the rate on one- to four-unit mortgages but would leave the 7.5 percent maximum in effect for multifamily loans.

The difference between the interest rate on mortgages bought and the prevailing market rate will affect program costs, benefits to homebuyers, tenants, and landlords, and the impact of the program on new construction. Lower interest rates on the mortgages purchased will require larger discounts in reselling the loans, but lower rates will provide greater savings to property owners. With effective yields on privately traded, single-family mortgages now hovering around 13 percent, reselling an 11.5 percent, $50,000 mortgage on an owner-occupied home would cost GNMA about $2,900 (see Table 1). The monthly savings to the homebuyer would amount to approximately $60 (see Table 2). Lowering the interest rate to 9.5 percent--or about 3.5 percentage points below the current market--would increase the government's costs to $8,700 and the size of the benefit to about $135 per month. Providing the deeper multifamily subsidies mandated under S. 2178, and permissible under S. 2177, would be still more costly to the government. The actual cost of any loan transaction, however, would depend on prevailing interest rates when the mortgage is sold. GNMA retains the option of delaying sales whenever it is advantageous to do so, however, for the period that the agency holds the loans it must pay any interest differential between the mortgages in its portfolio and funds borrowed from the Treasury to finance the loan purchases.

TABLE 1. ESTIMATED NET COST TO THE GOVERNMENT FOR A $50,000 SINGLE-FAMILY LOAN PURCHASED UNDER THE BROOKE-CRANSTON PROGRAM (In dollars)[a]

Effective Yield When Loan is Sold	Interest Rate on Loan Purchased		
	11.5 Percent	9.5 Percent	7.5 Percent
13.0 Percent	2,900	8,700	14,300
12.5 Percent	1,500	7,500	13,200
12.0 Percent		6,100	12,000
11.5 Percent		4,800	10,800

SOURCE: CBO estimates.

a. Loan costs are assumed to be offset by commitment, marketing, and servicing fees, paid to GNMA by lenders, averaging 3 percent of the value of the mortgages. The discount at resale is calculated assuming a 30-year loan and a 12-year prepayment period.

TABLE 2. REDUCTION IN MONTHLY MORTGAGE PAYMENT FOR A $50,000, SINGLE-FAMILY LOAN ASSISTED UNDER THE BROOKE-CRANSTON PROGRAM BY SIZE OF INTEREST SUBSIDY (In dollars)[a]

	Size of Interest Subsidy (In percentage points)				
	1.5	2.5	3.5	4.5	5.5
Reduction in Monthly Payment	60	95	135	170	205

SOURCE: CBO estimates.

a. Savings are relative to the payments due on a 30-year self-amortizing loan at a 13 percent annual interest rate and do not reflect any offsetting increases in monthly expenses as a result of fees charged by GNMA to the lender and passed on to the homebuyer.

The relationship between the size of the interest subsidy and the amount of additional single-family, owner-occupied housing built will depend on the factors constraining demand. To the extent that credit availability is the constraining factor, additional mortgage funds at prevailing interest rates may have some stimulative effect. If the cost of credit is the greater problem--as appears to be the case today--an interest subsidy is necessary to stimulate demand. Under such circumstances, a fairly shallow subsidy might be sufficient to attract potential homebuyers who are temporarily priced out of the market by the most recent run-up in interest rates. Deeper subsidies would be needed to attract persons who were out of the market before the downturn in sales and construction activity.

Mortgage assistance for multifamily rental housing would affect construction activity principally by increasing the expected return for potential developers. Although every reduction in interest costs increases expected returns, the marginal effect of any given interest savings in stimulating additional construction is uncertain. The fairly slow rate at which previous multifamily mortgage-purchase commitments were taken up suggests that the shallow subsidies provided then might not have been adequate to sway many investors to undertake projects that would not have gone forward without the subsidy. However, this slow take-up rate could have been due, in part, to other factors. For example the higher vacancy

rates that existed at the time were probably a deterrent to investment. Relatively shallow financing subsidies might be more effective in generating additional construction in today's tighter rental markets. The slow take-up rate may also have resulted from delays attributable to the processing time for FHA insurance.

The two bills pending before the Committee take different approaches in dealing with the uncertainty concerning the likely effects of different interest subsidies. S. 2177 would grant wide discretion to the Secretary of HUD in setting the interest subsidy for all types of housing. S. 2178 would grant even greater discretion in the case of one- to four-family mortgages but would require that multifamily loans be subsidized at an interest rate of 7.5 percent. Neither bill would place a cap on the level of interest subsidies.

As an alternative to either of these approaches, the Congress could limit the size of the interest subsidies. This could be done either by specifying that the interest rate on mortgage-purchase commitments not be more than a set number of percentage points below the prevailing market rate or by establishing some absolute minimum interest rate for mortgages bought. Setting a maximum depth of subsidy without also fixing a minimum interest rate could, however, create undesirable incentives for persons to delay development or purchase decisions in the hope of acquiring a still lower subsidized rate in the

future. A minimum interest rate would limit these incentives and would assure that the assistance was phased out as the prevailing market rate approached whatever floor was established.

Purchase-Price and Mortgage Limits

Setting purchase-price and mortgage limits presents the Congress with a different set of tradeoffs. On the one hand, lower limits would direct the aid to homebuyers with lower incomes and would allow a greater number of homes to be assisted for the same level of funding. Lower limits might also increase the likelihood that purchasers would represent net additions to demand. On the other hand, higher limits would allow the money to be used more rapidly and would increase the portion of any local market that could use the aid.

Both S. 2177 and S. 2178 would tie purchase-price and mortgage limits for principal residences to the FHA maximum mortgage amount. S. 2177 would limit sale prices to 105 percent of the FHA loan ceiling, with a 10 percent adjustment for high cost areas. The resulting price ceilings would be $70,875 in most areas and nearly $78,000 in expensive markets. S. 2177 would limit mortgages to 110 percent of the FHA maximum. The S. 2177 price ceiling for non-high-cost areas would allow approximately one-half of all new single-family homes and about two-thirds of all existing homes to be eligible for assistance.

S. 2178 would limit sale prices to 120 percent of the FHA mortgage ceiling, with a 25 percent adjustment for high cost areas. The resulting price limits would be $81,000 in most markets and over $101,000 in high-cost areas. The limit for non-high-cost areas would allow about two-thirds of all new single-family homes and three-quarters of the existing homes to qualify for assistance.

As an alternative to the approach taken in the two pending bills, the Congress could express the purchase-price limit as some fixed percent of the median sale price for all newly built or existing homes, permitting the absolute dollar amounts to rise and fall with market fluctuations. HUD might also be directed to use market-specific sales-price data, when available, in setting limits for individual localities.

Allocation of Assistance

A third issue facing the Congress concerns how assistance should be allocated between new and existing homes and between owner-occupied and rental housing.

New Construction versus Existing Housing. Although the authorizing legislation for the Brooke-Cranston program permits assistance to be used for housing at all stages of production--from units on which construction has not yet begun to existing, previously occupied homes--the present statutory focus

is on aiding yet-to-be-built or newly built homes.[2] In re-examining the program, the Congress could retain the flexibility that now exists or could target aid differently.

The allocation of assistance among units at different stages of production will affect the program's impact on construction, the speed with which loans are purchased, and the distribution of assistance among developers and between developers and owners. At one extreme, aid could be targeted exclusively on units on which construction has not yet begun. Although subsidizing existing homes and ones under construction might indirectly stimulate additional building, targeting assistance exclusively on yet-to-be-started homes might have a greater impact on production. On the other hand, restricting aid in this manner could dampen demand for the unsold inventory by holding out the promise of reduced-interest mortgages to buyers willing to wait for the completion of yet-to-be-started homes. This would impose

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2. During the last round of emergency mortgage assistance, rental housing aid was administratively limited to units on which construction had not yet begun. Lenders were permitted to use single-family assistance for newly built but unsold homes and existing, previously occupied homes as well, but the latter were administratively limited to no more than 10 percent of all single-family mortgage purchases. About 35 percent of all single-family mortgages purchased during the last round of Brooke-Cranston assistance were for homes on which construction had not yet begun, 24 percent were for units under construction, 37 percent were for newly built but unsold homes, and 4 percent covered existing, previously occupied units.

costs on builders with unsold homes who would have to reduce prices in order to compete with the newer units that would qualify for aid. Such a restriction would also slow the pace of loan purchases by GNMA. Widening the program to include a larger number of existing homes, by contrast, would speed expenditures but would diminish the impact of the program on new construction.

Owner-Occupied versus Rental Housing. The allocation of aid between owner-occupied and rental housing also involves tradeoffs. On the one hand, several analysts have argued that there is currently a serious shortage of rental housing. On the other, the large number of preconstruction commitments outstanding under federal lower-income rental assistance programs may partially insulate the multifamily market from future downturns. Furthermore, serious questions exist concerning the effectiveness of shallow financing subsidies in stimulating additional multifamily construction. Whatever multifamily construction activity is generated would be felt more slowly because of the lengthier preconstruction delays. The longer construction period would also slow outlays.

BUDGET IMPLICATIONS

Reactivating the Brooke-Cranston program would involve outlays and offsetting collections over a period of several years, with program costs dependent on numerous factors. Specifically, the cost of any new round of assistance would depend on the amount of loan-purchase authority released through

appropriations and the volume of loans actually bought as well as the interest rate on the mortgages purchased, the effective yields at which they were sold, the size of any offsetting fees that GNMA might charge lenders, and the net intrest costs during the period that GNMA holds the loans. Providing interest subsidies of from 1 to 5 percentage points would cost the government between $28 million and $275 million per $1 billion in mortgages assisted (see Table 3).

TABLE 3. ESTIMATED NET COST TO THE GOVERNMENT PER $1 BILLION IN LOANS SUBSIDIZED UNDER THE BROOKE-CRANSTON PROGRAM, BY SIZE OF INTEREST SUBSIDY (In millions of dollars)[a]

	Average Interest Subsidy (In percentage points)				
	1.0	2.0	3.0	4.0	5.0
Estimated Net Cost	28	91	153	215	275

SOURCE: CBO estimates.

a. Estimated costs are for a mix of 60 percent single-family loans and 40 percent multifamily mortgages. Figures are net of commitment, marketing, and servicing fees collected by GNMA but do not include administrative costs or net interest costs for the period that the loans are held.

Some persons have suggested that the $10 billion in loan-purchase authority recaptured from the last round of Brooke-Cranston assistance be appropriated for a reactivated program. It that were done, and if aid for single-family and multifamily loans were apportioned as it was in the previous period, total costs could range from $600 million to well over twice that amount for providing interest subsidies roughly comparable to those offered before. The deeper multifamily housing subsidies mandated under S. 2178--and permissible under S. 2177--could add substantially to these costs.

CONCLUSION

The current decline in residential construction activity presents the Congress with a difficult set of questions regarding the Brooke-Cranston program. First, does the present outlook for housing warrant special efforts to stimulate additional construction. Second, would the Brooke-Cranston program effectively address today's problems? Third, how could the program's effectiveness be improved? The answers to these questions are, regrettably, uncertain.