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Staff study by Henry Eschwege, Director, Community and Economic Development Div.

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Contact: Community and Economic Development Div.
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Congressional Relevance: House Committee on Banking, Currency and Housing; Senate Committee on Banking, Housing and Urban Affairs.
Authority: Housing and Urban Development Act of 1968 (12 U.S.C. 1717). Emergency Home Finance Act of 1970, title III (12 U.S.C. 1452 et seq.). Housing Act of 1954 (12 U.S.C. 1716 et seq.). Emergency Home Purchase Assistance Act of 1974. Emergency Housing Act of 1975.

The Government National Mortgage Association participates in the buying and selling of mortgages in the secondary mortgage market. Findings/Conclusions: The Association attempts to accomplish its legislatively assigned missions primarily by: issuing to mortgage originators commitments to purchase mortgages with primarily below-market interest rates; purchasing and selling such mortgages; and guaranteeing securities, backed by pools of mortgages, that are issued by approved mortgage originators. Review of the Association's sales activity identified a number of alternatives that warrant study by the Association because they have potential to increase revenues or otherwise improve operations. The sale of Association mortgages directly to the Federal Financing Bank would allow the Association to adhere to the Office of Management and Budget's imposed outlay ceiling, while it would eliminate the need to sell the mortgage in the private market under unfavorable conditions. Recommendations: The Association might be able to receive a better return on the sale of securities if it sold the securities directly to investors rather than by blocks to syndicates which resell them at a profit. The Associations should also consider reducing the amount required for a security issue to an amount less than the present $1 million. (SC)

00552

STUDY BY THE STAFF OF THE UNITED STATES GENERAL ACCOUNTING OFFICE

Government National Mortgage Association's Secondary Mortgage Market Activities

This study develops information on the Government National Mortgage Association's buying and selling of mortgages in the secondary mortgage market. It also discusses GAO's report of November 29, 1976, which recommended that the Secretary of Housing and Urban Development consider the desirability of alternatives to the present mortgage sales practices which might increase revenues or otherwise improve operations.

CED-77-28

MARCH 8,1977

PREFACE

This study was prepared by GAO's Community and Economic Development Division for the Subcommittee on Housing and Urban Affairs, Senate Committee on Banking, Housing and Urban Affairs. The Subcommittee requested that we develop information on the Government National Mortgage Association's buying and selling of mortgages in the secondary mortgage market.

After testimony was provided to the Committee in September 1976, we made arrangements to issue (1) a report to the Secretary of Housing and Urban Development outlining the areas that need improvement in the Association's secondary mortgage market activities (CED-77-16, Nov. 29, 1976), and (2) a staff study describing the Association's role in the secondary mortgage market.

The staff study presents the most current data available at the time of our review but has not been updated to reflect changes that may have taken place since our testimony in September 1976.

Henry Eschwege

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Director, Community and
Economic Development Division

STUDY BY THE STAFF
OF THE UNITED STATES
GENERAL ACCOUNTING OFFICE

THE GOVERNMENT NATIONAL MORTGAGE ASSOCIATION'S SECONDARY MORTGAGE MARKET ACTIVITIES
Department of Housing and Urban Development

D I G E S T

The Housing and Urban Development Act directs the Government National Mortgage Association to participate in the secondary mortgage market for the purpose of:

--Making mortgage financing available for those Americans unable to obtain adequate housing under established financial programs.

--Retarding or stopping declines in homebuilding and mortgage lending.

--Encouraging mortgage originators to expand their allocation of funds for mortgage investments.

--Attracting nontraditional sources of long-term investment capital to the mortgage market.

The Association attempts to accomplish these missions primarily by

--issuing to mortgage originators commitments to purchase mortgages with primarily below-market interest rates;

--purchasing and selling such mortgages; and

--guaranteeing securities, backed by pools of mortgages, that are issued by approved mortgage originators. (See p. 8.)

COMMITMENTS AND PURCHASES

A commitment is an agreement by the Government National Mortgage Association to purchase a specific type of mortgage bearing a specified interest rate at a specified price from a mortgage originator. The interest rate specified in the commitment is usually lower than the market interest rate.

Commitments are intended to encourage mortgage originators to make loan commitments to homebuilders which are intended to make it easier for builders to obtain construction financing. The commitment also insures builders that homebuyers can obtain a mortgage and enables the builders to advertise the availability of below-market interest rates.

Legislation authorizing the Government National Mortgage Association to make commitments and purchase mortgages places a ceiling on the combined amount of commitments and purchases that the Association may have outstanding at any time, which was $20.5 billion as of March 31, 1976. (See p. 10.)

The Office of Management and Budget must approve the Association's use of the legislative authority. The Office of Management and Budget determines timing and amount of authority to be released to the Association based on requests made by the Secretary of Housing and Urban Development and the President. The types of mortgages to be purchased are mutually agreed on by the Office of Management and Budget and the Secretary of Housing and Urban Development with recommendations from the Government National Mortgage Association.

The methods the Association used to satisfy commitments and the amount of commitments each method satisfied during the period July 1, 1972, through March 31, 1976, were:

--The holder of the commitment took action to cancel the commitment or allowed it to expire by not delivering mortgages for purchase by the Association within the specified time period--$.4 billion.

--The obligation under a commitment was assumed by the commitment holder or a third party with the Association paying the difference between the commitment price and current market price at the time of assumption--$6.2 billion.

--The Government National Mortgage Association purchased the mortgages when delivered--$12.1 billion. (See p. 20.)

SALES OF MORTGAGES AND SECURITIES

The Association finances its purchases of mortgages and related operations through borrowings from the Treasury and revenues it receives primarily from proceeds from the sale of mortgages and mortgage-backed securities. During fiscal years 1973-75, the Association had revenues of $5.8 billion, of which 75.1 percent ($4.4 billion) came from mortgage and security sales. Through these sales, the Association minimizes its borrowings from the Treasury by substituting private for Federal funding. (See p. 28.)

Because the Government National Mortgage Association, as intended by its authorizing legislation, generally purchases mortgages with below-market interest rates at a higher price than private investors are willing to pay, it usually suffers a loss when it sells these mortgages on the private market. Consequently, the Association can minimize those losses best by timing its sales to take advantage of the most favorable market conditions. (See p. 29.)

The amount and timing of its sales are heavily influenced by the Office of Management and Budget's ceiling on the Association's net outlays (difference between expenditures and revenues), which affect its Treasury borrowings. This net outlay ceiling can place the Association in the position of having to sell mortgages to stay within the outlay ceiling even though losses could possibly be minimized by delaying sales until market conditions improved. In fiscal year 1975, the Office of Management and Budget allowed the Government National Mortgage Association to exceed the ceiling by $1.9 billion in order to avoid excessive losses. (See p. 33.)

Between July 1, 1972, and March 31, 1976, the Association has used a variety of sales methods to dispose of $9.1 billion worth of single-family mortgages. Two of the sales methods--security auctions and whole loan auctions--were used to sell most of the single-family mortgages--about $7 billion. (See p. 34.)

The Association has had difficulties selling its multifamily mortgages and has tried four different sales methods between July 1, 1972, and March 31, 1976, under which it sold $1.1 billion of such mortgages. Most mortgages--$676 million--were sold by the whole loan method. (See p. 38.)

ATTRACTION OF NONTRADITIONAL INVESTORS

One of the Government National Mortgage Association's missions is to attract new investors into the mortgage market, thereby increasing the amount of investment capital available for mortgage origination. This is accomplished primarily through the sale of securities backed by Association-held mortgages and by guaranteeing securities--backed by pools of mortgages--issued by mortgage originators. As of March 31, 1976, outstanding mortgage-backed securities guaranteed by the Association had a value of $23.3 billion; 35 percent of these securities had been purchased by the category of investors that normally did not invest capital in the mortgage market.

Mortgages sold individually are purchased almost exclusively by traditional investors in the mortgage market, such as mortgage bankers and savings and loan institutions. (See p. 45.)

MORTGAGE SALES ALTERNATIVES

GAO's review of the Association's sales activity identified a number of alternatives that it believes warrant study by the Association because they have potential to increase revenues or otherwise improve operations. In a report to the Secretary of Housing and Urban Development (CED-77-16, November 29, 1976), GAO recommended that the desirability of implementing these alternatives be determined.

The Government National Mortgage Association's ability to hold mortgages during periods when interest rates are relatively high is restricted by the Office of Management and Budget's required end of the fiscal year outlay ceiling. The sale of Association mortgages directly to the Federal Financing Bank would allow the Association to adhere to the Office of Management and Budget's imposed outlay ceiling, while it would eliminate the need to sell the mortgage in the private market under unfavorable conditions, thereby providing a potential opportunity to minimize losses. Negative features of such sales, such as worsening market conditions, must also be considered. (See p. 50.)

When the Association holds a security auction, it offers a block of securities for sale requiring that the potential investor submit a bid for the entire block. As of March 31, 1976, only two large syndicates have submitted bids and purchased securities. The syndicates then resell the securities at a profit. The Association might be able to receive a better return on the sale of securities if it sold the securities directly to investors. (See p. 54.)

The Association requires that a security issue have a minimum value of $1 million. Its officials indicated they could have sold as securities some of the $501.0 million worth of mortgages the Association sold through whole loan auctions since January 1975 if the minimum had been $100,000. The Government National Mortgage Association should consider reducing the amount required for a security issue to an amount less than $1 million because (1) its securities have been sold for a better price than the individual mortgages, and (2) securities' sales have attracted more nontraditional investors than have mortgage sales. (See p. 53.)

Contents

ABBREVIATIONS

FHA	Federal Housing Administration
FHLMC	Federal Home Loan Mortgage Corporation
FNMA	Federal National Mortgage Asscciation
GAO	General Accounting Office
GNMA	Government National Mortgage Association
HUD	Department of Housing and Urban Development
OMB	Office of Management and Budget
VA	Veterans Administration
RFC	Reconstruction Finance Corporation

CHAPTER 1

INTRODUCTION

The Housing and Urban Affairs Subcommittee, Senate Committee on Banking, Housing and Urban Affairs, requested on October 22, 1975, that we review the Government National Mortgage Association's (GNMA's) operations in the secondary mortgage market. This review was to provide the Subcommittee information on the following matters during the period July 1, 1972, through March 31, 1976:

--The role played by GNMA in the secondary mortgage market.

--The nature and level of GNMA activities during the specified period.

--The manner in which GNMA activities are conducted.

--The criteria used by GNMA in its decisions to sell mortgages and in determining sales price.

On September 20, 1976, we presented testimony on GNMA's secondary mortgage market activities before the Senate Committee on Banking, Housing and Urban Affairs.

On October 5, 1976, arrangements were made with the Subcommittee to finalize the request by issuing (1) a report to the Secretary pointing out the need for certain improvements in GNMA's mortgage activities and (2) a staff study presenting additional information on GNMA's mortgage-buying and -selling activities. (See p. 50.)

GNMA was created by the Housing and Urban Development Act of 1968 (12 U.S.C. 1717) as a Government-owned corporation within the Department of Housing and Urban Development (HUD). All GNMA's powers and duties are vested in the Secretary of HUD. The Secretary directs the administration of GNMA and, within limitations of the law, determines the general policies which govern GNMA's operations.

SECONDARY MORTGAGE MARKET

The majority of home mortgages are made by deposit institutions, such as savings and loan associations, mutual savings banks, and commercial banks, which obtain funds from depositors and invest these funds in mortgages as an earning asset. These institutions operate in the primary market where investors normally allot a portion of their available or anticipated funds for permanent investment in residential mortgages.

These primary lenders and investors are supplemented by an independent group of mortgage lenders who originate mortgages primarily for sale to others. This independent group of lenders, known as mortgage bankers, came into being because of the following factors:

--There are significant differences in the supply of mortgage money relative to demand in various parts of the country and there are also differences within a State or major metropolitan area.

--It is not always economical for primary investors to have their offices where there is mortgage demand.

The mortgage banker brings the borrower and primary investor together by originating mortgages for his own account in anticipation of finding a ready market for such loans. Because mortgage bankers do not accept deposits of funds, they usually do not have enough capital to make permanent investments and, therefore, seek to sell the mortgages they have originated. Some primary lenders are also sellers of mortgages because they are located in mortgage markets which do not generate enough savings to satisfy local mortgage demand.

The secondary mortgage market, therefore, consists of sale and purchase transactions between organizations that originate mortgages for their own account but expect to sell all or some of the mortgages they originate, and other institutions (i.e., thrift institutions, insurance companies, and State pension funds) interested in purchasing mortgages as investments.

Although the secondary mortgage market had not been highly organized with a centralized trading facility, recently two significant developments were implemented to improve its operations. The first was the creation of the Automated Mortgage Market Information Network, Inc., in June 1974 by five mortgage trade associations and the Federal Home Loan Mortgage Corporation (FHLMC) (see page 5 for a discussion of FHLMC). The Network is a computerized data bank which allows its subscribers--240 as of October 1976--to list instantly, via computer terminals, mortgage information, such as offers to buy and sell, delivery times, loan-to-value ratios, prices on short-term money market instruments, selected notes and bonds, international money rates, and the daily securities trading summary. The Network's objective is to increase the liquidity of mortgage investments by making it easier to buy and sell them. Actual transactions are not handled through the system but are handled privately by telephone or person-to-person contact.

The second development was establishment of an interest rate futures trading market in GNMA mortgage-backed certificates by the Chicago Board of Trade in October 1975. The development of this market stems from the volatility in the interest rates which recently have been creating new risks and expenses for the mortgage originator and investor. Thus, the purpose of this market, like commodity exchanges, is to allow the risk to be shifted from mortgage originator/investor to speculators. The originator/investor is then able to insulate his profit margin against loss while providing the speculator with the possibility of a profit.

Trading units, called contracts, are GNMA mortgage-backed certificates with a principal balance of $100,000 and a stated interest rate of 8 percent. Around 114,000 GNMA futures contracts were traded during the first year of operation. Activity in the futures trading market for GNMA futures contracts is regulated by the Commodity Futures Trading Commission.

A basic dilemma of the mortgage market stems from the fact that as interest rates rise, deposits with thrift institutions decline and funds available for mortgage lending also decline. Consequently, mortgage bankers and other originators who rely on the secondary market for the permanent placement of their mortgage loans find their traditional sources unavailable. Under these circumstances, the mortgage bankers have used their available capital to originate mortgages which they are unable to sell and thus they lack the capital for originating new mortgages.

GOVERNMENT PARTICIPATION

The Government's initial participation in the secondary mortgage market was in 1935, when the Reconstruction Finance Corporation (RFC) was authorized to purchase certain Federal Housing Administration (FHA)-insured mortgages covering residential housing. These purchases were authorized to supplement the inadequate level of mortgage funding available in the secondary market. In 1938, in part because RFC purchases were insufficient to meet demands of the housing industry, the Federal National Mortgage Association (FNMA) was created to purchase FHA-insured mortgages. In 1948 FNMA's authority was expanded to allow it also to purchase Veterans Administration (VA)-guaranteed mortgages. The following section discusses the Government's participation in the secondary market relating to the creation of the Government National Mortgage Association (GNMA).

Government participation prior to creation of GNMA

The Housing Act of 1954 (12 U.S.C. 1716, et seq.), entitled "Federal National Mortgage Association Charter Act," amended Title III of the National Housing Act and recast the Federal Government's participation in the secondary market. This was occasioned by the following:

--New types of Government-backed mortgages, such as urban renewal, low-cost and cooperative housing, required assistance to encourage loan origination.

--A danger existed that market forces would result in increased offerings to FNMA of overpriced, less saleable residential and specific purpose mortgages to a point where FNMA's original secondary mortgage function would be adversely affected.

--Several organizations concerned with homebuilding and mortgage lending, such as the National Association of Home Builders and the United States Savings and Loan League, had advocated the formation of a secondary market facility which would ultimately become privately financed and operated.

In recognition of the above, the FNMA Charter Act required FNMA to establish separate accountability for the following three functions:

--The original support program for FHA-insured and VA-guaranteed mortgage financing, including some rural housing loans insured by the Farmers Home Administration, and FHA-insured home improvement loans. Under this function FNMA was authorized to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments. By purchasing mortgages from originators, such as mortgage bankers, FNMA would provide, as needed, a market where the originators could sell their mortgages and obtain funds with which to originate new mortgages.

--Special assistance was to be provided through FNMA's purchase of urban renewal, low-cost and cooperative housing and other new types of Government financing instruments that were not attractive to private investors because of their below-market interest rates. Such assistance was to be provided when either the President of the United States should deem it in the public interest or the Congress should specifically designate special programs. Eligible mortgages had to meet, in general, the purchase standards of private mortgage investors, but specifically were not required to be readily acceptable to private investors.

--The management and liquidation of federally owned mortgages in the existing portfolio. FNMA's responsibilities consisted of managing and liquidating these mortgages with a minimum adverse effect on the home mortgage market and a minimum loss to the Government.

<u>Government participation after the creation of GNMA</u>

The Housing and Urban Development Act of 1968 (12 U.S.C. 1717) was occasioned by the reformation of the Federal budget to a unified basis. Under the unified budget concept, FNMA's expenditures would have been carried as budget outlays even though the purchasing funds were obtained principally through borrowings from the public. It was feared that representation of FNMA's expenditures as budget outlays would have an adverse effect on FNMA's response to home financing demands, so the Congress enacted legislation to partition FNMA into two continuing entities. One entity, the new FNMA, was created to carry out secondary market operations financed entirely by private sources. The other entity, GNMA, was established within the Department of Housing and Urban Development to carry out, as needed, certain of the activities carried out by the old FNMA.

In July 1970, to strengthen and further develop the secondary mortgage market, primarily in conventional mortgages, the Federal Home Loan Mortgage Corporation was created under Title III of the Emergency Home Finance Act of 1970 (12 U.S.C. 1452 et seq.). FHLMC, which is wholly owned by the Federal Home Loan Bank System, was created to buy and sell conventional, FHA-insured and VA-guaranteed mortgages. The same act also amended the Housing and Urban Development Act of 1968 to authorize FNMA to purchase and sell conventional mortgages. Before 1970 there was no secondary market facility for conventional residential mortgages.

FNMA and FHLMC perform similar functions. The primary differences between FNMA and FHLMC are as follows:

--FHLMC was created primarily to purchase conventional mortgages for which there was no secondary market facility. FNMA, on the other hand, was established to purchase FHA-insured and VA-guaranteed mortgages and until July 24, 1970, was not authorized to purchase conventional mortgages.

--FHLMC purchases mortgages primarily from savings and loan organizations, whereas FNMA purchases mortgages primarily from mortgage banker organizations.

Under the 1968 act, GNMA was directed to carry out the following activities that were previously carried out by the old FNMA:

--Perform secondary mortgage market activities funded through Government borrowings.

--Purchase home mortgages as directed by either the President or the Congress.

--Manage and liquidate a portfolio of mortgages formerly held by FNMA.

--Act as trustee for a number of trusts for which FNMA had been the trustee.

The act also authorized GNMA to guarantee securities, backed by pools of mortgages, issued by either the new FNMA or by other GNMA-approved mortgage originators.

GNMA's authority to sell mortgages was changed significantly in 1969, when it was authorized to sell mortgages at a discount (less than the unpaid principal balance).

Before 1974 GNMA was authorized to purchase and sell mortgages that were Government insured or guaranteed. GNMA's authority was broadened by the Emergency Home Purchase Assistance Act of 1974, which authorized GNMA to participate in the single family conventional mortgage market. Subsequently, GNMA was authorized by the Emergency Housing Act of 1975 to purchase and sell conventional multifamily mortgages.

Servicing agreements

GNMA fulfills its legal responsibility by making the major decisions on policy matters, such as the timing, amount, and methods of mortgage purchase and sales. However, the day-to-day operations of GNMA's programs are carried out by FNMA and a portion of one program is carried out by FHLMC.

GNMA is bound to the new FNMA and FHLMC by servicing agreements which provide that these organizations perform certain services to administer and operate GNMA's programs.

The combined services agreement between FNMA and GNMA provides that FNMA administer and operate all GNMA Special Assistance Programs, the GNMA/FNMA Conventional Home Mortgage Program, and perform certain services in connection with the GNMA mortgage-backed security program, as such programs exist and are operated as of June 1, 1975. The mortgage purchase and servicing agreement between FHLMC and GNMA provides that FHLMC perform certain services to administer the GNMA/FHLMC conventional home mortgage program. The agreements among GNMA and FNMA and FHLMC stipulate that FNMA and FHLMC shall provide the necessary personnel, equipment, and facilities to perform their respective services.

Services to be performed under both agreements include approval of sellers, administration of commitments, loan review, purchasing mortgages, supervision of servicing, recordkeeping, mortgage liquidation, and property disposition. Additional services provided under the FNMA/GNMA agreement include servicing FHA project mortgages in GNMA's portfolio, spot checking purchased conventional home mortgages, selling mortgages, and reviewing mortgage-backed securities.

GNMA incurred servicing expenses of $22.5 million--$21.1 million to FNMA and $1.4 million to FHLMC--under both agreements during the 3-1/2 year period from July 1, 1972, to December 31, 1975.

SCOPE OF REVIEW

We conducted our review at GNMA headquarters in Washington, D.C.; interviewed GNMA officials; obtained descriptions of GNMA's activities; identified prices paid and received for mortgages in GNMA's purchasing and selling operations; and evaluated GNMA's criteria regarding the purchase and sale of mortgages. We examined pertinent legislation, administrative regulations, and records of operation.

We also interviewed officials of FNMA and FHLMC concerning their selling practices, officials of organizations that participate in the secondary market for mortgages, and knowledgeable individuals in the field of housing finance. In addition, we obtained statistical data on economic factors, such as housing starts and mortgage interest rates, which affect GNMA's operations.

CHAPTER 2

SECONDARY MARKET OPERATIONS OF THE GOVERNMENT NATIONAL MORTGAGE ASSOCIATION

The Housing and Urban Development Act of 1968 (Act) directs GNMA to participate in the secondary mortgage market to:

--Make mortgage financing available for segments of the population which are unable to obtain adequate housing under established financial programs.

--Retard or stop declines in homebuilding and mortgage lending.

--Encourage originators to expand their allocations for mortgage investments.

--Attract nontraditional sources of long-term investment capital to the mortgage market.

GNMA attempts to accomplish these missions primarily by:

--Issuing to mortgage originators commitments to purchase mortgages with primarily below-market interest rates.

--Purchasing and selling such mortgages.

--Guaranteeing securities, backed by pools of mortgages, that are issued by approved mortgage originators.

In addition the Act directs GNMA to manage and liquidate federally owned mortgages, acquired from FNMA and other Government agencies, with minimal adverse effect on the home mortgage market.

MORTGAGE COMMITMENTS AND PURCHASES

A commitment contract is an agreement by GNMA to purchase, at a pre-established price, mortgages that are made by a mortgage orginator. The commitment stipulates the type of mortgage, dollar amount, mortgage interest rate (generally below-market interest rate), and date by which the commitment must be exercised. For instance, GNMA might make a commitment with a mortgage originator to purchase $5 million worth of conventional mortgages with interest rates of 8 percent within 1 year from the commitment date.

Commitments are directed at stimulating homebuying and home construction by assuring originators that the mortgages they originate may be sold to GNMA if they do not want to hold them. This assurance is intended to (1) encourage originators to make commitments to builders and to make it easier for the builder to obtain construction financing and (2) sell homes because it assures the builder that potential homebuyers will be able to obtain mortgage financing.

Commitments are also intended to make homebuyers' mortgage payments lower than they would be otherwise since the commitments stipulate the interest rate that the mortgages must bear, which is generally below-market interest rates.

Although the availability of below-market interest rates through GNMA's various programs are intended to stimulate homebuying and home construction, studies performed by HUD and an economist on the President's Council of Economic Advisors to ascertain if the programs are meeting their objectives have resulted in different conclusions. Our review of these studies and discussion with financial experts about GNMA's programs disclosed the following reasons for the difficulty in measuring the impact of GNMA's program:

--The program is relatively new, particulary the portion authorized in 1974 and 1975 under emergency legislation.

--Econometric models, which financial experts use as a primary method to measure programs of this type, are not sufficiently developed to measure GNMA's program.

Presently GNMA is authorized to make commitments for FHA, VA, and conventional single and multifamily mortgages. Before September 1974, however, most commitments were for FHA-insured and VA-guaranteed mortgages on single family and multifamily dwellings. On October 18, 1974, GNMA was given authority to make commitments for conventional single family mortgages and on July 2, 1975, for conventional multifamily mortgages.

Commitments to purchase single family mortgages provide a 1-year period during which the mortgages must be made and delivered to GNMA for purchase. A single exention of 3 months can be granted. Multifamily commitments provide periods of 2 years for delivery with the possibility of more than one extension of 30 days each.

If and when an originator delivers mortgages for purchase to GNMA against an outstanding commitment, GNMA pays the originator the price agreed to in the commitment contract and becomes the holder of the mortgages. By selling the mortgages to GNMA, the originator obtains capital which may enable him to make additional mortgages while at the same time continue to service the mortgage for a fee equal to three-eighths of one percent a year of the unpaid principal.

In addition to purchasing mortgages against commitments, GNMA, before fiscal year 1975, purchased mortgages directly from originators through immediate purchase contracts. However, since then GNMA's mortgage purchases have been limited to purchases against outstanding commitments. In a few cases FNMA has been permitted to purchase mortgages against GNMA commitments.

Authority for GNMA commitments and purchases

GNMA's mortgage commitment and purchase activities, referred to as its special assistance functions, are carried out under two separate authorities--traditional special assistance and emergency special assistance.

Traditional special assistance

The Housing and Urban Development Act of 1968 (1968 Act) transferred traditional special assistance authority to GNMA from the predecessor, FNMA. Under this traditional special assistance function, GNMA is authorized to make commitments to purchase and to purchase mortgages of certain types either selected by the President or identified by the legislation.

Section 305(c) of the 1968 Act authorized \$5.6 billion as of March 31, 1976, to make commitments and purchases of specific types of mortgages selected by the President. Under this authority, GNMA can make commitments to purchase and can purchase all types of mortgages, except conventional, when and as directed by the President.

Sections 305(e), (f), and (g) of the 1968 Act provide a total of \$2.2 billion to make commitments to purchase and to purchase specific types of mortgages identified within those sections. A breakdown of the \$2.2 billion by section of the 1963 Act follows.

--Section 305(e)--\$225 million for cooperative housing.

--Section 305(f)--\$224 million for armed services and low- and moderate-income housing.

--Section 305(g)--\$1.75 billion for new low-cost housing.

The amount of GNMA mortgage commitments and purchases under each authority is limited by the legislative ceilings on the total combined amount of commitments outstanding and mortgages held in GNMA's portfolio under each authority at any one time. When the total amount of GNMA commitments and mortgages reaches the ceiling level, GNMA is prohibited from making any new commitments under that authority. However, as it disposes of commitments made or sells mortgages purchased pursuant to that authority, it can then make new commitments up to the amount of the commitments disposed of or mortgages sold. This action is referred to as "rolling over" mortgages and is also applicable to the emergency special assistance programs discussed below.

The following chart presents the status of GNMA's commitments, purchases, and authorization balance, as of March 31, 1976, for each section of the Act.

Section of the Act	Total authorization	Purchases outstanding	Commitments outstanding	Net authorization balance
	(millions)			
305(c)	$5,551.2	$3,385.4	$1,801.5	$ 364.3
305(e)	225.0	112.5	-	112.5
305(f)	224.0	170.8	-	53.2
305(g)	1,750.0	408.4	202.1	1,139.5
Total	$7,750.2	$4,077.1	$2,003.6	$1,669.5

GNMA's fiscal year 1977 budget request indicates it does not intend to issue commitments during that fiscal year under any of the above programs.

Emergency special assistance

Emergency special assistance was authorized by the Emergency Home Purchase Assistance Act of 1974 (12 U.S.C. 1723), approved October 18, 1974, and the Emergency Housing Act of 1975 (12 U.S.C. 2701), approved July 2, 1975. These acts authorized $7.75 billion and $10 billion, respectively, in new mortgage commitment and purchase authority over and above GNMA's traditional special assistance authority. This authority was granted for a limited, specified period.

The 1974 Emergency Act (1974 Act) amended the Housing and Urban Development Act of 1968 by providing that the authority could be utilized whenever the Secretary of HUD finds inflationary conditions are having a severely disproportionate effect on the housing industry, and that a resulting reduction in the volume of home construction or acquisition threatens to affect the economy and to delay the orderly achievement of national housing goals. The 1974 Act broadened GNMA's authority by authorizing the commitment and purchase of conventional single family mortgages as well as FHA and VA mortgages. The 1974 Act stipulated that the total amount of outstanding commitments and purchases under this new authority should not exceed $7.75 billion outstanding at any one time. The total commitment authorization was fully released by June 24, 1975, and fully committed by August 11, 1975.

The 1975 Emergency Act extended GNMA's purchase authority under the 1974 Act to July 1, 1976, and authorized an additional $10 billion, but provided that funds authorized under the 1975 Emergency Act were subject to release in an appropriation act. GNMA's authority was broadened further to include conventional mortgages on multifamily structures and condominium units. The 1976 Appropriation Act only released mortgage purchase authority of $5 billion, which was available for commitment through July 1, 1976. Only $3 billion of the $5 billion authority provided by the 1976 Appropriation Act was actually made available to GNMA for commitments in fiscal year 1976.

Mortgage commitment and purchase programs

GNMA classifies specific commitments and purchases of mortgages by various programs. As of December 31, 1975, GNMA had a total of 16 programs under which it had issued commitments or purchased mortgages since July 1, 1972. The following are examples of 2 of the 16 programs.

Program Number 19--FHA and VA single and multifamily mortgages for prefabricated housing and housing which represents the development of new and better construction methods.

Program Number 20--Purchase of FHA and VA single and multifamily mortgages on properties in Guam.

Each program represents a specific authorization to make commitments and purchases of certain types of mortgages usually at a stipulated interest rate.

Timing and amount of commitments

The decision to make commitments to purchase and the total amount to be committed is determined by a combination of actions by the Congress, the President, the Office of

Management and Budget (OMB), and the Secretary of HUD. GNMA's input in the decisionmaking process consists of suggestions to the Secretary concerning the status of the housing market and the need for governmental intervention, including the type and amount of mortgages to be purchased.

The actual timing and amount of funding authority apportioned to GNMA is determined by OMB based on requests made by HUD and the President. HUD's requests are based on a combination of economic indicators, including national housing starts, interest rates, feedback from builders and lenders on their willingness to participate in a GNMA program, and analyses indicating the effects of various funding levels on GNMA's outlay ceiling. The amount initially requested from and apportioned by OMB may be substantially less than the congressional authorization. For example, the Congress authorized $5 billion of emergency special assistance authority for conventional, FHA, and VA housing under the 1976 Appropriation Act, pursuant to the Secretary of HUD's finding that inflationary conditions are having a severely disproportionate effect on the housing industry, as discussed on page 11 of this report. However, HUD made only $3 billion available for commitment during fiscal year 1976.

Determination of mortgage interest rates

GNMA determines the interest rates of mortgages for which it makes commitments or purchases under traditional special assistance based on recommendations from the Administrator of the VA for VA-guaranteed mortgages and from the Secretary of HUD for FHA-insured mortgages. The specified mortgage interest rates vary among traditional programs. For instance:

--Four of GNMA's programs specify that the mortgages have interest rates equivalent to the maximum FHA rate prevailing at the date of commitment.

--Another program permits interest rates to vary from between 7 percent to the maximum allowed FHA rate.

--Two other programs specify a rate of 8 percent.

The interest rates of mortgages for which GNMA makes commitments and purchases under emergency special assistance are specified in the legislation. The law now limits the rate specified in commitments to the lesser of 7.5 percent or the rate set by the Secretary of HUD for mortgages insured under Section 203(b) of the National Housing Act.

Determination of purchase price

The commitment to purchase mortgages specifies the price that GNMA agrees to pay the originator when GNMA purchases mortgages against the commitment issued under both the traditional and emergency programs. For example, the commitment states that GNMA will purchase the mortgages at 98. This means that GNMA will pay the originator 98 percent of the loan's unpaid balance at the time it is delivered for purchase. In effect then, GNMA is purchasing the mortgages at a 2-percent discount. GNMA has made commitments at purchase prices ranging from 96 to 100 under its current programs.

According to GNMA officials, the purchase prices are determined subjectively. In establishing the purchase price the primary consideration is given to providing for a discount that will cover GNMA's costs to the extent feasible under prevailing market conditions. However, according to GNMA officials, when commitments are being made concurrently under several programs with different interest rates, the above consideration may be waived in favor of setting a purchase price that will maintain a comparable effective interest rate (combination of purchase price and mortgage interest rate) among different programs. This is done to maintain a competitive balance among GNMA's programs so that commitments under one program do not become more attractive than commitments under its other programs.

GNMA usually purchases mortgages at a discount. However, in a few instances, because of a desire to stimulate the origination of a certain type of mortgage, GNMA has made commitments with a purchase price of 100, which means that no discount is involved. In these instances, GNMA agrees to purchase the mortgage at a price equivalent to 100 percent of the loan's unpaid balance at the time it is delivered for purchase.

Fees charged on commitments and purchases

In issuing commitments and purchasing mortgages, GNMA generally imposes certain fees on the originator in addition to the discount. These fees are:

- --A commitment fee, varying from one-half of 1 percent to 2 percent of the commitment amount depending on the program, imposed at issuance of the commitment.
- --A processing fee of one-one hundredth of 1 percent of the commitment imposed at issuance of the commitment.

--A purchase and marketing fee or a loss reserve and marketing fee varying from one-half of 1 percent to 1.5 percent of the unpaid principal balance depending on the program, which is deducted from the amount GNMA pays for the mortgage.

GNMA's Sellers Guide permits the originator to pass these fees on to the builder and homebuyer.

Effect of discount and fees on builders and homebuyers

GNMA's commitment generally requires the mortgage originator, if he elects to exercise the commitment, to sell the mortgage to GNMA at a discount. In order to compensate for this discount, the originator will generally receive a premium from the builder and homebuyer when originating the mortgage. For instance, if the purchase price under a commitment is 96, the originator is discounting the purchase price of the mortgage to GNMA by 4 percent. In order to recover this discount, the originator in making the mortgage will charge the borrower 4 points (1 point is equivalent to 1 percent) as a premium for making the loan. A premium of 4 points on a $30,000 mortgage is $1,200. In this case, the builder and the borrower, usually in combination, pay the originator the premium of $1,200 when the mortgage is originated. Because GNMA limits the points that can be paid by the homebuyer to 1.5 percent of the mortgage amount, the bulk of the premium ($750 in the example) is paid by the builder.

Illustrative chronology of a commitment

Presented below is a description and chronology of actions that occur from the time GNMA is directed to issue commitments to the time GNMA purchases the mortgages. To simplify the illustration we narrow the scope from the total amount available for commitment to GNMA's purchase of a single mortgage.

In the fall of 1974 the Secretary of HUD decided that GNMA should supplement the construction of homes by making commitments and purchases of conventional, FHA-insured and VA-guaranteed single family mortgages. Pursuant to authority assigned by the Emergency Home Purchase Assistance Act of 1974, the Secretary requested OMB to release authority of $3 billion to GNMA. OMB released authority to GNMA in October 1974.

GNMA announced the offering of $3 billion worth of commitments to purchase conventional single family mortgages. In accordance with the Emergency Home Purchase Assistance Act of 1974, GNMA limited the maximum mortgage amount to $42,000, except for properties in Alaska, Hawaii, and Guam, which had higher mortgage limits, and required mortgages to bear interest at 8 percent. The commitments guaranteed GNMA would purchase eligible mortgages at 98 percent of their unpaid principal amount at the time of delivery.

A builder of single family homes saw the announcement and contacted a savings and loan (originator) requesting a GNMA commitment to purchase $5 million worth of mortgages. The savings and loan contacted GNMA and requested a GNMA commitment to purchase $5 million worth of conventional single family mortgages.

Upon GNMA's approval of the commitment request, a notice signifying a commitment contract was sent to the savings and loan. The notice stated

--the amount of the commitment, $5 million;

--the interest rate the mortgages must bear, 8 percent;

--the expiration date of the commitment, 12 months after approval date; and

--other pertinent information, such as fees due.

Upon receipt of the notice the savings and loan paid GNMA a commitment fee of 1 percent, $50,000 (1 percent of $5 million), and a processing fee of one-one hundredth of 1 percent, $500 (one-one hundredth of 1 percent of $5 million), for a total of $50,500.

The savings and loan issued commitments to the builder for the amount it requested. The commitment allowed the builder to advertise the availability of financing at 8 percent interest rates.

A buyer agreed to purchase a home and obtained an 8 percent mortgage for $42,000 from the originator. GNMA expects originators to charge builders and buyers only such fees as are necessary to cover the costs of originating the mortgages and participating in GNMA's program (GNMA program fees and discounts). The originator would charge 3-1/2 points, 1 to be paid by the buyer and 2-1/2 by the builder to cover the following: origination fee (1 percent); GNMA discount (2 percent); and GNMA purchase and marketing fee (one-half of 1 percent).

After settlement of the mortgage, the savings and loan delivered the $42,000 mortgage and additional documentation, such as the certificate of mortgage insurance, to a FNMA regional office. Upon approval of the mortgage's documentation by the regional office, GNMA paid the savings and loan $40,950 (97.5 percent of the $42,000), deducting a 2 percent discount plus one-half of 1 percent purchase and marketing fee. In addition, GNMA allowed the savings and loan to keep the servicing contract on the mortgage from which the originator annually receives three-eighths of 1 percent of the unpaid principal.

DISPOSITION OF COMMITMENTS VIA METHODS OTHER THAN PURCHASE

All commitment contracts GNMA issues do not result in mortgage purchases. From July 1, 1972, through March 31, 1976, commitments totaling about $6.6 billion have been satisfied by other than the purchase of mortgages in the following ways:

--The originator canceled his commitment contract or allowed it to expire.

--The originator or other private investor assumed the commitment contract.

These actions release GNMA from its obligation to purchase mortgages and have the advantage of not increasing FNMA's borrowing from Treasury. This in turn reduces the amount of mortgages GNMA must sell to remain within the OMB outlay ceiling, discussed on page 33.

Further, since rolling over of mortgages is permitted, eliminating commitments enables GNMA to make additional commitments up to the same amount as those commitments it eliminated.

Cancellation

GNMA's single family and multifamily commitments to purchase mortgages expire after 12 months and 24 months, respectively. Extensions to these time periods can be obtained before the commitment expiration date. According to GNMA officials, commitments are not used primarily because the originators are not able to make enough mortgages to utilize their full commitment amount because the builders are not able to complete construction. In fiscal year 1975 under a one-time arrangement, commitments worth $395.6 million were canceled. By canceling its commitment contract before expiration, the originator received a refund of one-half of the commitment fee paid to GNMA. If the commitment was not canceled, GNMA would have retained the entire commitment fee.

Assumption of commitment by originator or private investor

The assumption of a GNMA commitment by the mortgage originator holding the commitment releases GNMA from its obligation to purchase mortgages made under the commitment. Under an assumption, also referred to as "buy-back", the originator agrees to assume the commitment and to retain the mortgages at the commitment price provided that GNMA pays at the time the mortgage is fully disbursed a price differential equal to the excess of the commitment price over the market price. According to testimony by a GNMA official at hearings in September 1975 before the Subcommittee on Housing and Urban Affairs of the Senate Committee on Banking, Housing and Urban Affairs, the price differential payable on each mortgage results in the same effect on GNMA as if the mortgage had been purchased by GNMA and sold in the marketplace. For example, GNMA issued a commitment to purchase a conventional mortgage, bearing an interest rate of 7.5 percent, from an originator at 96 and the published GNMA repurchase price was 92. The originator may (1) assume or "buy-back" the commitment contract, keep the mortgage, and receive the 4 percent (96-92) differential from GNMA or (2) sell the mortgage to GNMA at the agreed upon price of 96 and then GNMA could resell it at 92. To effect an assumption, the mortgage is not submitted for purchase pursuant to the commitment contract, but instead presented for validation.

A GNMA official told us that the advantages of the assumption or buy-back of the commitment to GNMA as compared to the purchase and subsequent resale of mortgages by GNMA under the commitment were:

- --Saving administrative expenses, such as transferring title to the mortgage to GNMA and carrying the mortgage in inventory.
- --Eliminate selling expenses associated with disposing of mortgages at auctions.
- --Reduce the amount of GNMA borrowing from the Treasury.

Another potential advantage, according to a GNMA official, is that if mortgage market conditions deteriorate (see page 33) GNMA's loss on the sale of mortgages could exceed the amount of the price differential that it would have paid if the mortgage had been assumed.

The use of assumptions was initiated in 1969, under the "tandem plan" agreement between GNMA and FNMA. Before August 1971, assumption transactions were exclusively between GNMA and FNMA. Since August 1971, GNMA has entered into assumption transactions with the commitment holders and other investors in addition to FNMA. From July 1, 1972, through March 31, 1976, FNMA assumed $42.8 million of GNMA commitments. Initially, the term "tandem plan" referred specifically to assumptions by FNMA. However, since August 1971 the term has been used to refer to any transaction by which originators, because they pay a price differential, retain their mortgages rather than deliver them for purchase by GNMA under commitment contracts. The terms also refers to programs for the sale of mortgages from GNMA's portfolio to other investors, such as savings and loans and mortgage bankers.

From July 1, 1972, to March 31, 1976, commitments to purchase FHA and VA mortgages in the amount of $5.4 billion have been satisfied by assumptions.

The assumption of commitments, 1/ also referred to as buy-back, for conventional mortgages was initiated in October 197[illegible].

GNMA experienced difficulties in selling conventional mortgages. In September 1975, GNMA decided to sell single family conventional mortgages worth $350 million through an auction; however, by contacting savings and loans, mortgage bankers, and other market representatives, GNMA found there was not demand for such mortgages and, therefore, canceled the auction.

A GNMA official told us that, in his opinion, the main problem with selling conventional mortgages is that GNMA does not guarantee the payment of principal and interest on these mortgages to investors, and the cost and time involved for investors to review each mortgage to determine if it is a

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1/ The GNMA/FNMA Conventional Home Mortgage Guide refers to the assumption of commitments for conventional mortgages as repurchase option, but to facilitate our discussion we use the term assumption of commitment.

good risk is prohibitive. According to a GNMA official, OMB believes the Government should not furnish a guarantee because of the contingent liability associated with a Government guarantee. To eliminate the problem of investors lacking sufficient knowledge of the mortgages, GNMA decided to allow the originators to buy-back their commitments. GNMA had disposed of 23,081 conventional commitment contracts worth $783.1 million by this method as of March 31, 1976.

Statistics on GNMA commitments, purchases and other methods of disposition

The following table summarizes GNMA's commitment and purchase activity from July 1, 1972, through March 31, 1976.

Committing and Purchasing Activity By Dollar Amount

	FY 1973	FY 1974	FY 1975	FY 1976	Total
	(millions)				
Commitments					
Traditional authority	$4,785.6	$3,028.4	$5,844.6	$ 361.5	$14,020.1
Emergency authority					
Conventional	-	-	4,935.6	2,000.0	6,935.6
Other	-	-	998.6	280.2	1,278.8
Total	-	-	5,934.2	2,280.2	8,214.4
Total commitments	$4,785.6	$3,028.4	$11,778.8	$2,641.7	$22,234.5
Purchases					
Traditional authority	$1,414.7	$1,542.2	$3,056.2	$2,320.9	$8,334.0
Emergency authority					
Conventional	-	-	422.1	2,557.0	2,979.1
Other	-	-	185.3	605.4	790.7
Total	-	-	607.4	3,162.4	3,769.8
Total purchases	$1,414.7	$1,542.2	$3,663.6	$5,483.3	$12,103.8
Other transactions					
Cancellations and expirations	$ -	$ -	$ 395.6	$ -	$ 395.6
Assumptions	2,324.4	1,341.0	1,721.5	783.1	6,170.0
Total	$2,324.4	$1,341.0	$2,117.1	$783.1	$6,565.6

GUARANTEES OF MORTGAGE-BACKED SECURITIES

The National Housing Act (12 U.S.C. 1721) authorizes GNMA to guarantee mortgage-backed securities issued to the public by the new FNMA or by any other GNMA-approved issuer. The full faith and credit of the United States is pledged to the payment of all amounts which may be required to be paid under any such guarantees. The purpose and effect of the GNMA guarantee is to encourage established mortgage originators to expand their allocations for mortgage investment and to attract nonmortgage-oriented sources of long-term investment capital into the field of housing finance. The results of the latter are discussed in Chapter 3.

Application fees, guarantees, and other charges are assessed issuers of guaranteed securities to cover costs incurred by GNMA in connection with the guarantees and to help offset possible future payments of claims under the guarantee. Funds received from these fees and charges are used to finance GNMA expenditures and, when possible, to reduce GNMA's outstanding borrowings. When necessary, GNMA borrows from the Treasury to meet requirements of claims under the guarantee.

The issuer is responsible for administering the mortgage pools backing the securities, including the collection of the principal and interest on the mortgages. In the event that the issuer defaults in making timely payment of principal and/or interest to the owner of the guaranteed security, GNMA may make the payment and take title to the mortgages backing the security.

Under regulations promulgated by the Secretary of HUD in May 1970 (24 F.R. 1665), the securities may be issued as a pass-through or a bond. On pass-through securities, principal and interest are paid monthly to the security owners. On bond securities, interest is paid semiannually and principal is paid at maturity. FNMA and FHLMC have been the only issuers of bond securities.

GNMA had guarantees outstanding at March 31, 1976, of $23.3 billion, of which $19.5 billion was insured from the beginning of fiscal year 1973 through March 31, 1976.

All securities to date have been backed by FHA-insured and VA-guaranteed mortgages; however, the Emergency Home Purchase Assistance Act of 1974 authorizes the guarantee of securities backed by conventional mortgages which are purchased or eligible for purchase by GNMA. GNMA's risk through guaranteeing securities backed by FHA or VA mortgages is limited to the excess of interest expense, attorneys' fees, and other costs involved in foreclosure, and uninsured property damage, over and above amounts allowable by FHA or VA in the settlement of mortgage insurance and guarantee claims. The risk increases when the securities are backed by conventional mortgages, since the guarantee of the securities is tantamount to a guarantee of the mortgages themselves. As of March 31, 1976, GNMA had not guaranteed any conventional mortgages.

COMPARISON OF COMMITMENTS TO HOUSING STARTS AND INTEREST RATES

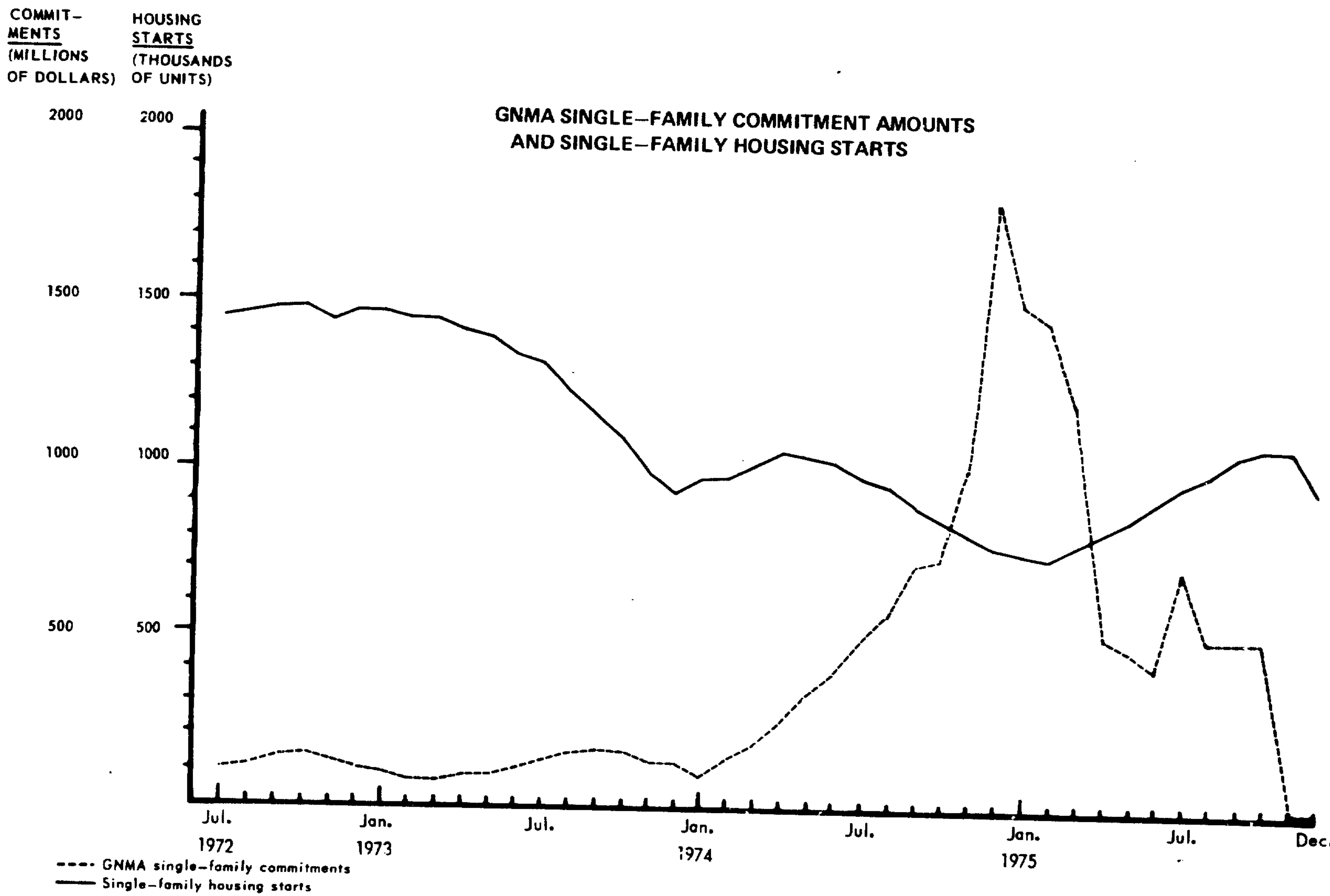
GNMA attempts to retard or stop declines in housing construction and mortgage lending, and to provide suitable financing for low- and middle-income segments of the population by issuing commitments to purchase home mortgages. The number of housing starts and mortgage interest rates are two of the most important indicators of the conditions of the housing industry according to officials at HUD. The Secretary of HUD continually receives information concerning housing starts, mortgage interest rates, and other economic indicators from her advisors, including GNMA. This information is also available to the President and the Congress for determining when GNMA should be directed to make commitments.

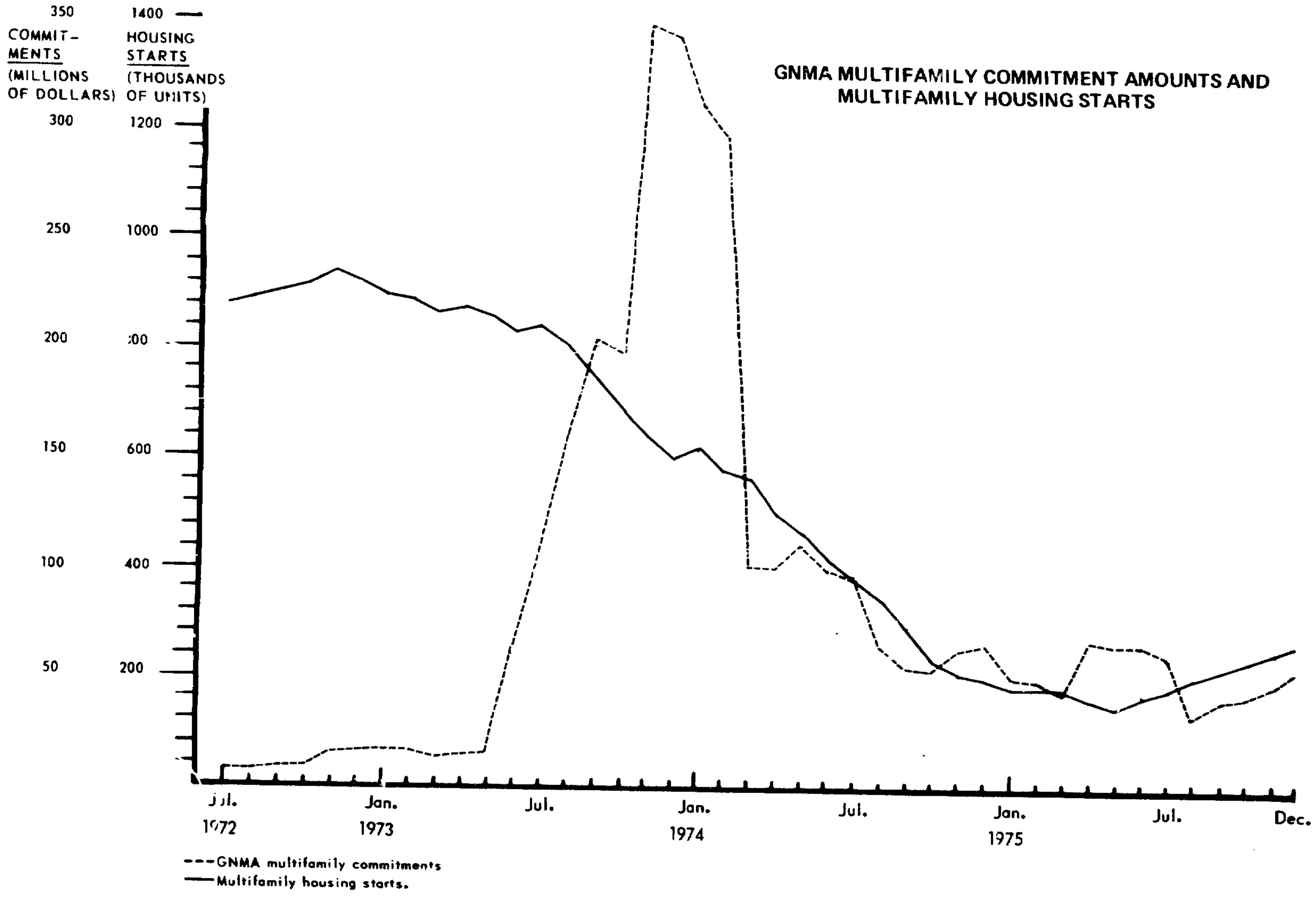
GAO observed single and multifamily housing starts as an indicator of GNMA's responsiveness to declines in home construction. One of GNMA's goals is to issue commitments in reaction to declines in housing starts. The generally below-market interest rate mortgages originators made pursuant to the commitments are intended to stimulate demand for more housing. Also the commitments obtained by builders from the originators enables them to obtain construction financing.

The following graphs show the relationship of the amount of GNMA's commitments for both single and multifamily mortgages to the number of single and multifamily housing starts 1/ each month from July 1972 through December 1975.

1/ Housing starts, representing new privately owned housing, seasonally adjusted were obtained from the U.S. Department of Commerce, Bureau of the Census, publication "Housing Starts."

GNMA SINGLE–FAMILY COMMITMENT AMOUNTS
AND SINGLE–FAMILY HOUSING STARTS



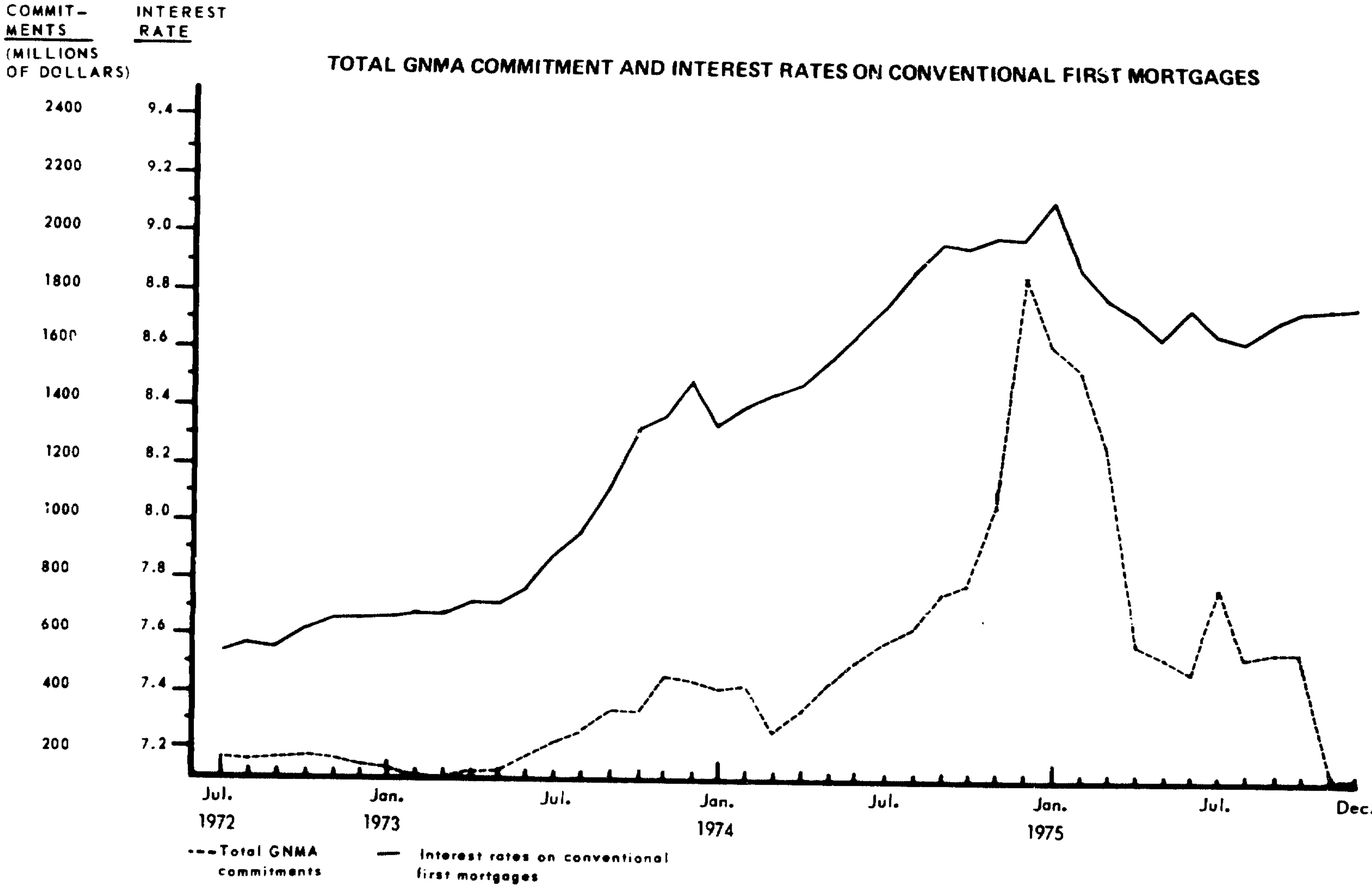

GNMA MULTIFAMILY COMMITMENT AMOUNTS AND MULTIFAMILY HOUSING STARTS
COMMITMENTS (MILLIONS OF DOLLARS)
HOUSING STARTS (THOUSANDS OF UNITS)
350
300
250
200
150
100
50
1400
1200
1000
600
400
200
Jul. 1972
Jan. 1973
Jul.
Jan. 1974
Jul.
Jan. 1975
Jul.
Dec.
GNMA multifamily commitments
Multifamily housing starts.

GNMA believes that as mortgage interest rates increase, certain segments of the population are prohibited from purchasing homes because the increasing interest rate results in higher mortgage payments, which are too costly for some segments of the population. By encouraging originators to make mortgages at below-market interest rates through commitments to purchase those mortgages, GNMA intends to enable these marginal borrowers to purchase homes.

In addition to observing the timeliness of GNMA's commitments in response to declines in housing starts, we compared the timing and amounts of GNMA commitments for single and multifamily mortgages issued with the interest rates for conventional mortgages, which financial experts consider to be a reasonable indicator of mortgage interest rates, from July 1, 1972, through December 31, 1975.

The following graph presents the amounts of commitments GNMA issued in relation to the average monthly interest rates for conventional mortgages. Interest rates are the average percentage for the month indicated.

TOTAL GNMA COMMITMENT AND INTEREST RATES ON CONVENTIONAL FIRST MORTGAGES



Based on the information reviewed and presented in the graphs, it appears GNMA usually responded to declines in housing starts and increases in mortgage interest rates by increasing the amount of commitments issued, therefore making available below-market interest rate mortgages. This appears to be in concert with GNMA's missions of retarding or stopping declines in home construction and mortgage lending, and providing financing for segments of the population which may be unable to purchase housing due to the relatively high interest rates.

CHAPTER 3

SALE OF MORTGAGES AND MORTGAGE-BACKED SECURITIES

GNMA sells mortgages and mortgage-backed securities to obtain revenues to finance additional mortgage purchases and to attract additional investment capital to the mortgage market.

The amount of mortgages and securities which GNMA sells and the price received for them are influenced primarily by OMB-established expenditure ceilings and the condition of the mortgage market at the time of sale.

This chapter discusses the amount and source of GNMA's revenues, factors influencing the sale of mortgages and securities, methods of disposition of single and multifamily mortgages, and the relative success of the various instruments sold by GNMA in attracting additional investment capital to the mortgage market.

GNMA finances the purchase of mortgages and related operations through borrowings from the Treasury and revenues it receives primarily from the following:

--Proceeds from the sale of mortgages and mortgage-backed securities.

--Payments of principal and interest received on the mortgages in its portfolio.

--Various fees and charges.

GNMA's revenues are used to pay current expenditures, such as mortgage purchases or administrative expenses. Revenues in excess of those needed to pay current expenses are paid to the U.S. Treasury to reduce the level of GNMA's outstanding borrowings.

The following table summarizes, by activity, GNMA's revenues used to make mortgage commitments and purchases during fiscal years 1972-75.

	Fiscal year 1973	1974	1975	Total	Percent of total
	------(millions)------				
Receipts from:					
Mortgage loan repayments and other credits	$ 293.6	$ 253.5	$ 313.2	$ 860.3	14.74
Interest on mortgage loans	164.5	149.0	225.2	538.7	9.23
Mortgage sales	1,583.0	1,502.8	1,296.2	4,382.0	75.07
Commitment fees	1.8	1.1	4.8	7.7	.13
Other revenues (see note a)	15.4	16.1	16.8	48.3	.83
Total receipts	$2,058.3	$1,922.5	$1,856.2	$5,837.0	100.0

a/ Includes purchase and marketing fees, recovery of prior years expenses, etc.

As can be seen in the previous table, more than 75 percent of GNMA's revenues during the period of fiscal years 1972-75 resulted from the sale of mortgages and mortgage-backed securities. Like all other revenues the proceeds from the sale are used to pay expenses and to reduce the amount of GNMA's outstanding borrowings from the Treasury. The sale of the mortgages and securities also enables GNMA to substitute private for Government financing.

FACTORS INFLUENCING THE SALE OF MORTGAGES AND SECURITIES

Timing sales to market conditions

GNMA generally purchases mortgages with interest rates below the prevailing market rate for a higher price than private investors would be willing to pay. Therefore, in the absence of a significant decrease in prevailing market interest rates, when GNMA offers mortgages and mortgage-backed securities for sale to private investors, they are generally purchased at a lower price than GNMA paid to acquire the mortgage, which results in a loss to GNMA. The degree of loss GNMA suffers can be reduced by timing sales to take advantage of favorable market conditions. GNMA mortgages and securities must compete for investors with other financial instruments. As a result, the price GNMA receives from the sale of its mortgages and securities is greatly influenced by the effective rate of return (yield) of competing financial instruments.

Prevailing market interest rates for mortgages reflect the yield that an investor would realize through the origination of a mortgage. An investor interested in investing his money in mortgages has the option of originating a new mortgage or purchasing an existing mortgage in the secondary mortgage market. If the existing mortgage was made at an interest rate higher than the prevailing market rate, the purchaser will generally have to pay a premium to acquire the existing mortgage because it offers a higher rate of return than could be realized from originating a new mortgage. Conversely, when an existing mortgage carries an interest rate below the prevailing market rate, the purchaser will generally purchase the existing mortgage only if the price is discounted to provide a rate of return comparable to that available through the origination of a new mortgage.

GNMA mortgages and the opportunity to originate mortgages must compete for investors with other market instruments. Thus, all mortgages, both new and existing, must provide yields comparable to other market instruments if they are to attract investors. Prevailing mortgage interest rates generally reflect the yield necessary for mortgages to be competitive.

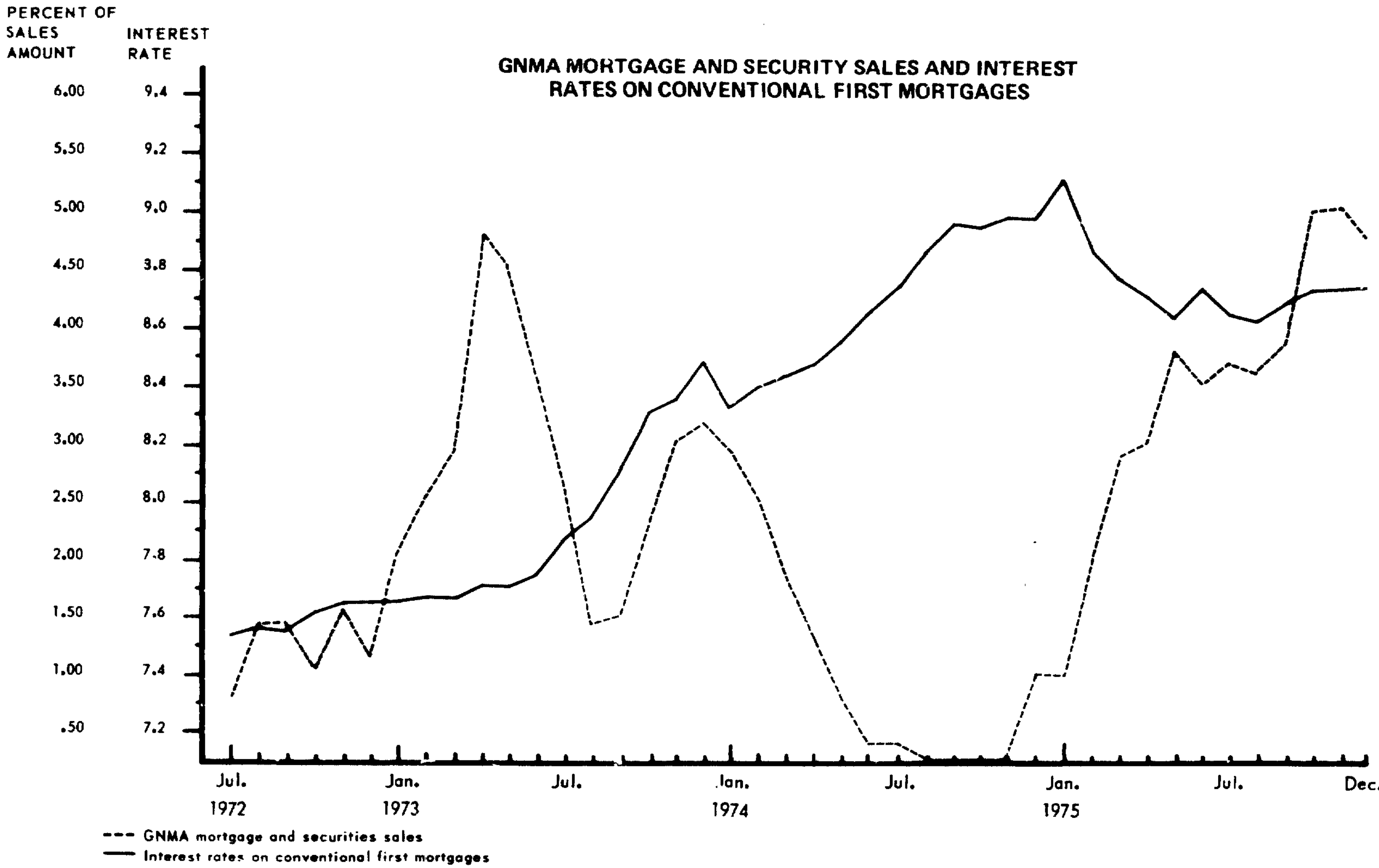
The difference, therefore, between the interest rate of GNMA mortgages and the prevailing market rate is a major determinant of the price that GNMA will receive from the sale of mortgages and securities. The greater the difference (prevailing rate exceeding GNMA mortgage interest rate), the greater the loss that GNMA will incur from the sale. This is illustrated in the following table by showing the discount required to sell $1 million worth of 7.5 percent mortgages with 12-year maturities under different market interest rates.

	Prevailing market interest rates (percent)			
	8	8.5	9	9.5
Value of GNMA mortgages	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Interest rate - GNMA mortgage	7.5	7.5	7.5	7.5
Percent discount required to provide comparable yield on mortgages at the prevailing market rate	3.8	7.4	10.9	14.1
Amount of discount	$38,000	$74,000	$109,000	$141,000
Selling price	$962,000	$926,000	$891,000	$859,000

Therefore, in order to minimize its losses, it is extremely important that GNMA avoid selling mortgages at times when prevailing market interest rates, and thus, yields sought by investors, are excessively high in comparison to the interest rates of mortgages in the GNMA portfolio.

To observe GNMA's sales activity in relation to the prevailing market interest rate for mortgages, we developed the following graph. The graph presents GNMA sales by month and the average monthly interest rates on conventional first mortgages covering the period July 1972 through December 1975.

GNMA MORTGAGE AND SECURITY SALES AND INTEREST RATES ON CONVENTIONAL FIRST MORTGAGES



Generally the graph indicates that GNMA increased its sales of mortgages and securities when mortgage interest rates were relatively stable or declining and decreased its sales when mortgage interest rates were increasing. Therefore, within the confines of the OMB outlay ceiling, GNMA appears to have timed its mortgage and security sales relatively well.

OMB outlay ceiling

The sale of mortgages and mortgage-backed securities is heavily influenced by OMB-imposed limitations on GNMA's net outlays for the fiscal year. Net outlays represent the difference between GNMA's expenditures (i.e., mortgage purchases, interest on Treasury borrowings, and operating costs), and revenues (i.e., mortgage portfolio revenues and proceeds from sales). The level of GNMA's outstanding borrowings will be increased by the amount that its expenditures exceed its revenues and these net outlays add to the national debt.

GNMA, in developing its budget request, estimates its expenditures for the fiscal year, its anticipated revenues from sources other than sales, the level of sales revenues, and its total outlay ceiling. Important factors in GNMA's estimate of sales revenues are the prices it can expect to receive for mortgages and securities sold and the knowledge that OMB expects GNMA to sell as many mortgages as is feasible.

GNMA's budget request is reviewed by the Secretary of HUD and incorporated into the total HUD budget. OMB reviews the GNMA budget considering its appropriateness given the current economic conditions, such as housing starts and the impact of GNMA's outlays on the national debt, and approves a total outlay ceiling.

Once OMB approves the total outlay ceiling, GNMA attempts to sell to meet that ceiling. GNMA continually attempts to identify a demand for its mortgages and sells when a demand is identified.

While it is impossible to predict that interest rates will eventually decrease, past history (see chart of interest rates on page 32) shows that there have been periods where decreases in interest rates have occurred.

GNMA's flexibility to hold mortgages during periods when interest rates are relatively high is restricted, however, by OMB's required end of the fiscal year outlay ceiling. If the outlay ceiling remains firm, GNMA may be forced to sell mortgages at excessively high yields to attract investors in a high interest rate market. During fiscal year 1975 a critical situation developed whereby adherence to the outlay ceiling would have required GNMA to sell substantial amounts of mortgages or securities during periods of unfavorable market conditions.

During the fiscal year GNMA's expenditures exceeded their initial budget estimates due to substantial purchases made pursuant to the Emergency Home Purchase Assistance Act of 1974. Therefore, GNMA needed to sell about $3.2 billion worth of mortgages during the fiscal year to stay within the budgeted outlay ceiling. However, prevailing market interest rates during fiscal year 1975 were generally in excess of 8.75 percent. To avoid the potential large losses that would result from GNMA mortgage sales, OMB allowed GNMA to increase its budget outlay ceiling by $1.9 billion. GNMA, therefore, only had to sell mortgages totaling $1.4 billion in fiscal year 1975 for which it received revenues of $1.3 billion.

FNMA and FHLMC sell mortgages in the secondary mortgage market and exercise complete control over their sales operations. According to FNMA and FHLMC officials, they generally do not sell when the yields of mortgages in their portfolios are less than the yields required by investors.

DISPOSITION OF MORTGAGES

GNMA disposed of single and multifamily mortgages for total revenues of $9.1 billion during the period July 1, 1972, through March 31, 1976. These mortgages had an unpaid principal balance of $10.2 billion. However, the amount for which the mortgages were sold should not be deducted from the unpaid principal balance of the mortgage to arrive at the loss to GNMA because GNMA generally acquired the mortgages at a discount. A discussion of the sales of single and multifamily mortgages follows.

Disposition of single family mortgages

During the period July 1, 1972, through March 31, 1976, GNMA's sale of single family mortgages produced revenues of $8.2 billion. The sale of these mortgages was made under a variety of methods. The following table shows the unpaid principal balance of mortgages sold by method of sale for fiscal years 1973 through March 31, 1976.

GNMA SALES OF SINGLE FAMILY MORTGAGES AND SECURITIES

Method of sales	FY 1973	FY 1974	FY 1975	FY 1976 through 3/31/76	Total sales by method 7/1/72-3/31/76	Percent of total sales
	(millions)					
FHA/VA:						
Whole loan auction	$2,267.5	$1,302.0		$ 501.8	$4,071.3	44.94
Tandem with FNMA	27.5	1.7			29.2	.32
Mortgage-backed (Security auctions)			$1,282.6	1,761.5	3,044.1	33.60
Conventional:						
Portfolio repurchase				1,139.2	1,139.2	12.58
Negotiated with FNMA				775.5	775.5	8.56
Total sales	$2,295.0	$1,303.7	$1,282.6	$4,178.0	$9,059.3	100.00

During fiscal year 1976 single family mortgage dispositions have been made by

--whole loan auctions,
--security auctions,
--portfolio repurchases, and
--negotiated sale to FNMA.

Security auctions

GNMA currently disposes of single family FHA and VA mortgages primarily through security auctions. Under the security auction method, GNMA selects a number of mortgages, referred to as a block, bearing the same interest rate from its portfolio. Each block must contain mortgages with a minimum aggregate unpaid principal balance of $1.1 million and must be serviced by only one mortgage servicer. The titles of mortgages in each block are transferred back to the originator and GNMA issues securities that are backed by portions of blocks and/or blocks of mortgages. Each issue of securities has a face value equivalent to the aggregate unpaid principal of the block of mortgages backing it.

When it holds a security auction, GNMA generally offers a number of security issues for sale and requires the bidders to submit bids for the total amount of the security issues being offered. Bids on individual security issues are not accepted. GNMA sells on an all-or-nothing basis to save the administrative costs of handling numerous bids and to assure the sale of all the security issues.

GNMA began holding security auctions in January 1975, and through March 31, 1976, it has sold $3 billion through this method producing revenues of $2.8 billion. Although the amount of securities sold and the revenues resulting from the sale are shown, the loss cannot be computed from these two figures because of the varying discounts at which GNMA obtained the mortgages. The amount of securities is the unpaid principal balance that the securities represent, which is generally not the cost to GNMA of the mortgages since most mortgage purchases involve a discount and fees, as discussed on page 14. The foregoing also relates to the other instances in the report where we show the amount of a sale of GNMA mortgages and the revenues received in the sale. This represents 42.6 percent of all FHA and VA single family mortgages sold between July 1, 1972, and March 31, 1976, and 85.9 percent of all FHA and VA single family mortgages sold since January 1, 1975. All of these securities were purchased by two large syndicates and immediately offered for sale by the syndicates as individual securities.

GNMA officials told us that the securities auction has the following advantages over whole mortgage sales:

--It provides GNMA greater assurance that it is achieving a yield on its investment which more accurately reflects current market conditions than is possible through the administratively set price.

--It provides GNMA with a higher yield because securities are tradeable and are, therefore, more attractive than mortgages.

Whole loan auctions

In certain situations, GNMA is unable to dispose of single family FHA and VA mortgages through security auctions. This can occur when GNMA does not hold a sufficient amount of mortgages from a single originator at the same interest rate to put together a block of these mortgages with the required minimum aggregated unpaid balance of $1 million. Another situation is when GNMA wants to sell mortgages through a security auction but the mortgage originator elects not to participate.

When either of these situations exists, GNMA will generally sell these mortgages through whole loan auctions to the highest bidders. A whole loan auction provides for the submission of bids for the immediate purchase of a mortgage or package of mortgages. The investor's bid is the maximum price he will pay for the mortgage(s). GNMA will sell the mortgage(s) to the highest bidder provided that the highest bid will produce the minimum yield acceptable to GNMA.

During the period July 1, 1972, through March 31, 1976, single family mortgages worth $4.1 billion were sold by this method producing revenues of $3.7 billion. This accounts for 44.9 percent of the value of all single family mortgages sold during this period.

Mortgage repurchases from portfolio

As discussed in chapter 2, GNMA experienced difficulty in selling conventional mortgages to private investors. GNMA's optional repurchase program (assumption of commitments) has substantially reduced the number of conventional mortgages GNMA must purchase; however, GNMA had still purchased conventional mortgages totaling $3 billion as of March 31, 1976. To reduce its portfolio of conventional mortgages, GNMA offered these mortgages back to their originators at current market prices determined by GNMA during January and February 1976. Since GNMA had purchased the mortgages at prices close to par (100) from the originators, the repurchase by the originators of the mortgages at current market rates, which were below par, resulted in the originators paying less to GNMA for the mortgages than GNMA paid to the originators. As of March 31, 1976, GNMA had sold mortgages totaling $1.1 billion by this method, producing revenues of $1 billion.

Negotiated sale to FNMA

In March 1976 GNMA sold conventional single family mortgages to FNMA totaling about $775.5 million for revenues of $715.8 million. GNMA and FNMA negotiated the price for conventional mortgages which originators had delivered to GNMA but which GNMA had not completely reviewed.

GNMA made the sale because, according to GNMA officials, FNMA paid a better price for the mortgages than repurchasers were paying. GNMA officials used a comparison of the yield based on FNMA's price with the yield paid by repurchasers for conventional mortgages.

Disposition of multifamily mortgages

GNMA has had difficulty in selling its multifamily mortgages. A GNMA official suggested the reasons for this were the 40-year maturities of the mortgages and the high yield required by savings and loans on such mortgages. In attempts to sell multifamily mortgages, GNMA has tried four different methods: whole loan auctions; tandem; option sales; and an option auction. The methods that GNMA used to dispose of mortgages in 1975 and 1976 are discussed in the following.

The following table shows the unpaid principal balance of multifamily mortgages sold by method of sale and fiscal year for the period July 1, 1972, through March 31, 1976. GNMA received revenues of $897.3 million for these mortgages; however, as discussed on page 34, the revenues received should not be deducted from the unpaid principal balance to arrive at a loss to GNMA.

GNMA SALES OF MULTIFAMILY MORTGAGES

Methods of sale	FY 1973	FY 1974	FY 1975	FY 1976 through 3/31/76	Total sales by method 7/1/72-3/31/76	Percent of total sales
	(millions)					
Multifamily mortgages						
Whole loan auction	$ 92.5	$267.0	$153.4	$163.2	$676.1	61.54
Tandem with FNMA	8.5	5.1			13.6	1.24
Option sales				220.8	220.8	20.10
Option auction	—	—	—	188.1	188.1	17.12
Total sales	$101.0	$272.1	$153.4	$572.1	$1,098.6	100.00

Whole loan auction

Before October 1975 GNMA sold its multifamily mortgages primarily through the whole loan auction method. Through October 1975 a GNMA official estimated GNMA had been able to sell only about 35 percent of the total multifamily mortgages it had purchased. Between July 1, 1972, and March 31, 1976, a total of 373 multifamily mortgages worth $676.1 million had been sold by this method producing revenues of $561.4 million.

Option sales

In October 1975 GNMA initiated the sale of FHA multifamily mortgages by the option sales method. Under this method GNMA administratively set a price at which an investor could immediately purchase a multifamily mortgage or, for a fee, obtain a project mortgage purchase option. The option extended the investor's right to purchase the subject mortgage within 60 days at the established price.

The option sale lasted only 1 week. GNMA closed sales when market interest rates began declining. Because of the uncertain market situation, the continued sale of the mortgages at an administratively set price could have resulted in the sale of mortgages at unreasonably large discounts. Ninety-four mortgages worth $220.8 million were sold by this method producing revenues of $167.0 million.

Option auction

On March 4, 1976, GNMA began selling multifamily mortgages through an auction method which it terms an "option auction." Announcements of such auctions provide invitations by GNMA to submit mortgage bids and mortgage option applications. When accepted, a mortgage option application extends to the bidder the right to purchase the mortgages at the price specified on the option application within 2 months. By accepting both types of bids GNMA hopes to increase the competition between investors, thus providing GNMA with higher prices for its mortgages.

All bids and option applications are evaluated on an open competitive basis, but GNMA reserves the right of rejection. Bids and options are evaluated in competition with each other; however, a bid for a specific mortgage might be accepted in preference to an option application which specifies the same mortgage and a higher purchase price. For the mortgages receiving both bids and option applications, GNMA administratively determined that the option applications would be accepted when the option bids exceeded the purchase bids by at least 1.85 percentage points. For example, for one project mortgage GNMA received an option application bid of 82.4000 and a mortgage bid of 81.0100. (By a bid of 82.4000, the bidder is agreeing to pay 82.4 percent of the unpaid principal.) Since the option application exceeded the mortgage bid by only 1.3900, the mortgage bid was accepted over the option application.

GNMA was pleased with the results of the March 4, 1976, auction in which it accepted $156.2 million worth of purchase bids for 116 mortgages worth $188.1 million and option bids for 49 mortgages totaling $115.9 million.

DETERMINATION OF SALES PRICE

All of GNMA's methods of selling mortgages or securities involve its estimation of the current market price. For mortgage-backed securities, whole loan, option auctions, and the negotiated sale to FNMA the estimated current market price is used as a guideline in determining the minimum acceptable bid. The actual selling price for those methods is determined by the bids received. However, for the remaining two methods of disposition--the single family conventional repurchase method and the multifamily option sale method, the selling price is determined by GNMA's estimation of the current market price rather than by competitive bid.

GNMA estimates the current market price by reviewing mortgages, securities, and other instruments comparable to those it is offering for sale. For example, when GNMA decides to sell mortgage-backed securities it reviews the current yields being offered by GNMA securities trading in the secondary market, Treasury bonds, mortgages sold by FNMA, and FHLMC's participation certificates. These instruments are similar to GNMA's securities in that they provide limited risk and are highly marketable.

In analyzing the yields of other comparable instruments, GNMA officials weigh the yields' significance on the basis of their knowledge of market conditions, including the desires of active investors. An additional factor which impacts on the establishment of the price is GNMA's desire to sell a sufficient amount of mortgages or securities to meet OMB's outlay ceiling at year end. Based on the aforementioned factors, GNMA subjectively sets the minimum acceptable price or sales price. GNMA officials told us that there is no set formula for establishing the exact price. Similarily, an official at FNMA advised us that FNMA does not have a set formula for establishing prices of mortgages it plans to sell.

FHLMC officials, however, stated that FHLMC does have set formulae based on the yields of mortgages in its portfolio plus a guarantee and management fee.

YIELDS ON GNMA'S AND OTHER FINANCIAL INSTRUMENTS

Many variables and subjective considerations enter into a comparison of the reasonableness of the yields of financial instruments. Because of these variables, we were not able to answer the question: Are the yields on GNMA mortgages and securities reasonable?

To provide some indication of the reasonableness of the prices GNMA is receiving from its sales of mortgages and securities, we compared the yields provided by GNMA mortgages and securities with the yields provided by other selected financial instruments.

Each instrument we identified has its own characteristics (i.e., low risk, highly marketable, monthly payments, etc.), the combination of which make the instrument distinct from other instruments. We were unable to identify any instruments with exactly the same characteristics as GNMA's conventional single family mortgages, FHA multifamily mortgages, or mortgage-backed securities. (FHA and VA single family mortgages are not presented because of the limited number of such sales since the implementation of security auctions.) The yield an investor requires to purchase an instrument varies depending on his perception of the advantages and disadvantages of the instrument's characteristics. Thus, different types of instruments attract different types of investors.

According to our discussions with financial experts, to determine a range of reasonable yields for GNMA's mortgages and securities would be extremely difficult, and at best only an estimate. Each instrument's characteristics which differ from those of GNMA's instruments would have to be weighted to establish comparability. Assigning weights to an instrument's characteristics is extremely subjective; for example, statements by several financial authorities on the value of a Government guarantee to an investor vary from zero to one-half of 1 percent, depending on the status of the economy and the investors involved.

Although we were unable to make an unqualified conclusion as to the reasonableness of GNMA's yields, we did select several instruments with some characteristics similar to those of GNMA's mortgages and securities and generally found their yields to average within 50 basis points 1/ of GNMA's mortgages and securities yields.

Because GNMA's conventional single family mortgages, FHA multifamily mortgages, and mortgage-backed securities (FHA or VA single family mortgages) have some significantly different characteristics, we compared each one separately with other instruments having similar characteristics. The yields discussed in the remainder of this section represent monthly averages for all issues sold during the month and represent instruments with various face interest rates and maturities of 10 years or more.

GNMA mortgage-backed securities

Mortgage-backed securities sold by GNMA were compared to (1) Treasury Bonds, (2) mortgage-backed securities guaranteed by GNMA but sold by originators, and (3) the composite of Federal Insured Securities (insured securities issued by various Federal agencies) for the period January 1975 through March 1976. These securities were selected because they all have at least the following similar characteristics:

--Guaranteed by the Government.

--Marketability (are easily resold to other investors).

--Payments of principal and interest are made monthly.

Mortgage-backed securities sold by GNMA provided yields to investors similar to those of mortgage-backed securities guaranteed by GNMA and sold by originators, and the composite of long-term Government securities in that they averaged only 10.3 and 30.9 basis points higher respectively. GNMA securities' yields, however, were significantly higher than U.S. Treasury Bond yields, averaging 154.7 basis points monthly for the period reviewed. A GNMA official and a private economist suggested several reasons for this. They stated GNMA securities

--are relatively new to the market, thus investors are not as comfortable with them;

--are subject to fluctuating payments caused by lump sum payments on defaulted or repaid mortgages within the pool; and

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1/ A basis point is equal to .01 percent.

--have inconsistent maturities due to defaults and early repayments.

On the other hand the GNMA official said that Treasury bonds are subject to none of these restrictions yet have the Government guarantee and other attractive characteristics of GNMA securities.

GNMA's multifamily mortgages

FHA multifamily mortgages sold by GNMA were compared to FHLMC's Participation Certificates and the composite of Federal Insured Securities for the period May 1975 to March 1976. FHLMC's Participation Certificates are not guaranteed by the Government but are guaranteed by FHLMC and are similar to GNMA's mortgages in their low degrees of marketability and monthly repayments of principal and interest. The composite is similar to GNMA's mortgages in that both represent instruments insured by the Government.

GNMA's multifamily mortgages provided yields which range from 25 to 115 basis points higher than FHLMC's Participation Certificates and 28 to 159 basis points more than the composite of long-term Government securities. A GNMA official and an economist suggested that GNMA mortgages require higher yields because they

--have varying maturity dates due to defaults and early repayments,

--require evaluation by a knowledgeable staff to assess their soundness, and

--are difficult to resell and thus provide little liquidity.

These officials said that the impact of these and other factors on selling price is a subjective determination and, therefore, difficult to quantify. Also, only eight sales were conducted, thus providing limited experience.

GNMA's conventional single family mortgages

GNMA's conventional mortgages' yields to investors were compared to the yields of FHLMC's Participation Certificates and Aaa corporate securities 1/ for the 6 months such sales

1/ These are securities of companies that specialists in the financial community consider to be the most credit worthy.

had been made at March 31, 1976. All three instruments lack a Government guarantee, which means there is some risk involved to the investor. FHLMC's Participation Certificates are similar to GNMA's conventional mortgages in that both make payments monthly which include principal and interest, the mortgages involved are primarily conventional, and the instruments are considered difficult to market. Some Aaa corporate securities make monthly payments but others are paid quarterly or annually.

GNMA's conventional mortgages provide yields which average 26.0 basis points more each month than FHLMC's Participation Certificates and 27.8 basis points more than Aaa corporate securities.

ATTRACTION OF NONTRADITIONAL INVESTORS

An additional objective of GNMA is to attract new capital into the mortgage market. One way this is accomplished is by encouraging new (nontraditional) investors to invest in the mortgage market.

Traditional mortgage investors are organizations which regularly originate and/or purchase mortgages, such as savings and loans, mortgage bankers, and FNMA. Participation by these members does not assume the addition of any new capital into the mortgage market since they are already active in mortgage financing.

Nontraditional mortgage investors are organizations such as pension and State retirement funds, which do not normally invest in home mortgages because of legal and/or policy restrictions. These restrictions vary by organization but generally require instruments purchased to have

--a high degree of marketability,

--limited risk, and

--limited servicing and management requirements.

To determine the success of various GNMA instruments in attracting nontraditional sources of mortgage investment capital, we identified initial investors by type and degree of participation for GNMA securities and mortgages sold from July 1, 1972, through March 31, 1976. However, any conclusions drawn from the results of our survey must be qualified because some of these traditional organizations, such as mortgage bankers, may resell the mortgages they purchase to nontraditional investors. Conversely, some nontraditional investors sell to traditional investors. Our analysis showed that GNMA has been more successful in attracting nontraditional investment capital through the sale of securities backed by GNMA-held mortgages and by guaranteeing securities issued by mortgage originators than through the sale of individual mortgages. The results of our analysis are presented in the following.

GNMA securities

A GNMA official said that various regulations and rulings permit GNMA securities to qualify as legal investments for pension and retirement funds, Federal credit unions, national banks and other members of the Federal Reserve System, and many State-chartered banks and insurance companies. All such institutions, together with corporations, partnerships, trusts, and individuals, are investors in the securities. In addition, GNMA securities are guaranteed by the Federal Government, are treated as a mortgage for tax purposes, and are highly marketable--three characteristics which nontraditional investors find attractive and in some cases require.

The syndicates which sell GNMA securities backed by GNMA-held mortgages furnished the amounts of securities they sold by class of purchaser for three sales totaling $457.7 million, which was 15.0 percent of total mortgage-backed securities sold from January 1, 1975, through March 31, 1976. The following table lists percentages of the three offerings purchased by initial investors.

Types of investors	Percent purchased
Traditional mortgage investors:	
Thrift institutions (i.e., savings and loans)	23.91
Commercial banks	14.32
Total	38.23
Nontraditional mortgage investors:	
Insurance companies (note a)	5.05
Pension and State Retirement Funds	52.72
Credit Unions	1.14
All others (i.e., bond funds, investment firms)	2.86
Total	61.77
Grand total	100.00

a/ Insurance companies are traditional investors in multifamily mortgages but invest in a few single family mortgages.

GNMA identified the initial investors in pass-through securities 1/ sold by issuers and guaranteed by GNMA for the $23.3 billion worth of mortgage-backed securities outstanding as of March 31, 1976. The following table lists the percentage of securities purchased by initial investors.

Types of investors	Percent purchased
Traditional mortgage investors:	
Thrift institutions (i.e., savings and loans)	41.17
Commercial banks	4.52
Mortgage bankers	19.58
Total	65.27
Nontraditional mortgage investors:	
Pensions and State Retirement Funds	8.29
Individuals	1.19
Credit Unions	3.08
All others (i.e., bond funds, investment firms)	22.17
Total	34.73
Grand total	100.00

GNMA mortgages

GNMA does not attract nontraditional mortgage investors through either its auctions of FHA-insured or VA-guaranteed mortgages or its sale of nonguaranteed conventional mortgages.

Our analysis of a statistical sample 2/ of FHA and VA mortgage sales totaling about $4 billion made between July 1, 1972, and June 30, 1974, showed that mortgage bankers purchased 89 percent of such mortgages and FNMA purchased 11 percent. Our analysis of five sales totaling $511.3 million made between July 1, 1974, and March 31, 1976, showed that mortgage bankers and thrift institutions purchased about 91 and 9 percent, respectively.

Investors in conventional mortgages were either FNMA or originators who bought back their mortgages through

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1/ Investors in GNMA securities sold as bonds could not be identified by GNMA.

2/ The sample has a confidence level of 95 percent.

repurchases from GNMA's portfolio (GNMA's Repurchase Program). Of all sales of conventional mortgages totaling $1.8 billion made through March 31, 1976, FNMA purchased about 41 percent, with thrift institutions (i.e., savings and loans), mortgage bankers, and commercial banks purchasing the remaining 59 percent.

MANAGEMENT AND LIQUIDATION OF ACQUIRED MORTGAGES

GNMA is also responsible for managing and liquidating certain federally owned mortgages with a minimum adverse effect on the home mortgage market and a minimum loss to the Government. These mortgages were originally owned by the dissolved Reconstruction Finance Corporation and HUD, and were transferred to GNMA upon its creation.

Liquidation of the mortgages is accomplished through regular principal repayments, by sales of mortgages to private investors, and by prepayments and foreclosures. GNMA has not purchased or sold any mortgages under this function since fiscal year 1973 when 68,558 mortgages with a principal value of $716.6 million were sold at a discount of $93.9 million. The mortgage portfolio under the management and liquidating function had an outstanding balance of $340.9 million on March 31, 1976.

TRUSTEE OPERATIONS

GNMA manages the assets and liabilities of three trusts and is the guarantor of payments on the participation certificates the trusts issued. The three trusts are the Government Mortgage Liquidation Trust, the Federal Assets Liquidation Trust, and the Federal Assets Financing Trust.

The agencies participating with GNMA as trustors in one or more of the three trusts are (1) the Farmers Home Administration, (2) the Department of Health, Education, and Welfare, (3) the Department of Housing and Urban Development, (4) the Veterans Administration and (5) the Small Business Administration.

These participating agencies conveyed title to assets (mortgages and housing-related debt instruments) to the three trusts for which the GNMA is trustee; however, the agencies retained control and administration of these assets. Then the trustee issued and sold to private investors participation certificates backed by these assets. The last sales were in 1968. The agencies used the proceeds from these sales to reduce funds borrowed from the Treasury and to reduce the use of Government funds for their programs. Certificates outstanding at June 30, 1975, totaled $4.2 billion.

As trustee, GNMA receives from the trustor agencies the principal and interest collected on the assets, less the agencies' service charges. These funds are used to pay interest on the participation certificates, pay trust expenses, and retire participation certificates at maturity. If these funds are not adequate, GNMA requests additional funds from the trustor agencies. Specific appropriations are available to the trustor agencies for payment of participation sales insufficiencies.

In the Government Mortgage Liquidation Trust, five issues of participation certificates, totaling $1.8 billion, have been sold since the trust was established. The last issue was sold in 1966. During fiscal year 1975 certificates totaling $110 million were redeemed. The outstanding balance of the certificates was $770 million at June 30, 1975. The certificates will mature at various times through 1981. Collections received during the fiscal year were sufficient to cover interest due on the certificates.

In the Federal Assets Liquidation Trust, four issues of participation certificates, totaling $3.2 billion, have been sold since it was established. The last issue was sold in 1968. During fiscal year 1975, no certificate redemptions were made. The outstanding balance of the certificates was $1 billion at June 30, 1975. The certificates mature at various times through 1987. Because net interest earned on the assets and cash deposits held for the trustors were less than the interest expense incurred on the certificates, additional contributions of $7.6 million were made to the trust by the trustors.

In the Federal Assets Financing Trust, four issues of participation certificates, totaling $4.3 billion, have been sold since the trust was established. The last issue was sold in 1968. The certificates will mature at various times through 1988. During fiscal year 1975, certificates totaling $12.4 million were reacquired. The outstanding balance of the certificates was $2.4 billion at June 30, 1975. Because net interest earned on the assets and cash deposits held for the trustors were less than the interest expense incurred on the certificates, additional contributions of $31.1 million were made to the trust by the trustors.

CHAPTER 4

ALTERNATIVES TO PRESENT MORTGAGE SALES PRACTICES

This chapter discusses several alternatives for improving GNMA's present practices of disposing of mortgages and mortgage-backed securities. They are

--selling the Association's mortgages directly to the Federal Financing Bank, and

--obtaining greater benefit from mortgage-backed securities by (1) permitting investors to bid on individual security issues rather than on all of the security issues offered and (2) reducing the minimum amount of the security issue to some amount less than $1 million.

These alternatives were discussed in our testimony on September 20, 1976, before the Senate Committee on Banking, Housing and Urban Affairs. In a report dated November 29, 1976, (CED-77-16) to the Secretary of HUD, we recommended that the desirability of implementing the alternatives be determined.

AN ALTERNATIVE TO PRIVATE MARKET SALES

The sale of GNMA mortgages to the Federal Financing Bank would allow GNMA to adhere to the OMB-imposed outlay ceiling while at the same time eliminate the need to sell the mortgage in the private market under unfavorable conditions, thereby providing a potential opportunity to minimize losses.

The Federal Financing Bank was created by the Federal Financing Bank Act of 1973 (P.L. 93-224), as part of the Department of the Treasury. It is authorized to purchase and sell, on its own terms, any obligations or guarantees issued by any executive department, independent Federal establishment, corporation, or other entity created by the Congress, which is owned in whole or in part by the United States and authorized to sell obligations. Its purpose is to lower the cost of borrowing for those Federal agencies that raise funds in the private market by selling various financial instruments directly to private investors. This is possible because the Bank is able to pay a better price for these securities than could be received in the financial markets. Participation by eligible agencies is voluntary.

The Bank funds its purchases either by issuing its own obligations or by selling its securities directly to the

Treasury, which, in turn, would sell its own obligations to raise the funds. Because the Bank is a part of the Treasury its obligations are expected to sell at close to the rates obtained on Treasury offerings, which are the most attractive Federal financial instruments and the least costly form of Federal borrowing. For the most part, the Bank's purchases have been funded through the sale of its own securities directly to the Treasury.

GNMA was authorized to sell mortgages and mortgage-backed securities to the Federal Financing Bank by amendments in 1974 and 1975 to the National Housing Act.

The Emergency Home Purchase Assistance Act of 1974 added a new section to the National Housing Act authorizing GNMA to sell mortgage-backed securities to the Bank. The Emergency Housing Act of 1975 further amended the National Housing Act by authorizing GNMA to sell mortgages and securities to the Bank and by directing the Bank to purchase any such mortgages or securities offered by GNMA. The 1975 amendment follows:

> "* * * The Association may offer and sell any mortgages purchased or securities guaranteed under this section to the Federal Financing Bank, and such Bank is authorized and directed to purchase any such mortgages or securities offered by the Association."

However, through the end of fiscal year 1976 GNMA had not sold any mortgages or securities to the Bank. Officials at the Bank and GNMA advised us that during early 1975 GNMA and Bank officials held several meetings with respect to the details of such sales. However, GNMA and Bank officials disagreed on how long the Bank would hold the mortgages. GNMA favored a sale to the Bank which would then resell the mortgages to the private market in the near future while the Bank favored long-term holding of the mortgages. According to correspondence between GNMA and OMB in July 1975, OMB made the decision that mortgages would not be sold to the Bank at that time. Instead OMB increased HUD's outlay ceiling so that GNMA would not be forced to sell the mortgages at that time.

In a memorandum dated June 27, 1975, from OMB to HUD approving the increase in HUD's outlay ceiling by $1.9 billion for fiscal year 1975, OMB stated that

> "Unfortunately, an increase in the allowance is necessary because of GNMA's inability to dispose of the mortgages purchased under the FHA-VA and conventional tandem plans as originally planned."

The memorandum also stated that OMB did not learn of GNMA's inability to sell these mortgages until May 27, 1975, and that options available to dispose of mortgages were unattractive which made an increase in the outlay ceiling necessary.

Because of the OMB-imposed outlay ceiling, GNMA may find it necessary to sell mortgages in the private financial market even though market conditions might not be particularly favorable at the time of the proposed sale (i.e., interest rates increasing). By selling its mortgages and mortgage-backed securities directly to the Federal Financing Bank rather than to private investors, GNMA could get a better price for the mortgages and securities, and the Bank could hold them and wait for more favorable market conditions before selling.

In addition to the opportunity of minimizing the Federal Government's loss, the use of this alternative could have a positive influence on GNMA's efforts to encourage more mortgage originations. Generally, GNMA needs to sell mortgages to finance its mortgage commitment and purchase activities which are undertaken to stimulate mortgage originations. However, the majority of GNMA mortgages offered for sale are purchased by mortgage bankers and savings and loans who are the principal mortgage originators. (See p. 47.) Consequently, at approximately the same time GNMA is making commitments and purchasing mortgages to stimulate mortgage originations, it is selling existing mortgages to the principle mortgage investors. The net result is that the sale of existing GNMA mortgages to mortgage originators reduces the amount of capital available for mortgage originations and may very well be counterproductive. The sale of the mortgages directly to the Federal Financing Bank provides the opportunity to delay and possibly preclude the sale of mortgages so that they would not be in competition with GNMA's market stimulation efforts.

Two possible negative features of the sale of mortgages to the Federal Financing Bank are:

--Because the Bank finances its purchases by Treasury borrowings, the purchases of mortgages by the Bank would result in a direct increase in the public debt.

--If market conditions continued to worsen (i.e., interest rates continued to rise), the Federal Financing Bank might be forced to sell the mortgages at a greater loss than GNMA would have incurred in order to avoid long-term losses.

In our letter dated May 25, 1976, to the Chairman, Senate Subcommittee on Housing and Urban Affairs, we discussed the matter of indirect costs as a result of Federal financing of certain housing programs. We pointed out that financial experts at several Federal agencies told us that there were no techniques or models that could measure the indirect costs to the Federal Government as a result of direct borrowing. They said that much more study and research remained to be done on the development of economic analytical techniques concerning indirect costs.

OPPORTUNITY TO OBTAIN MORE COMPETITION IN SALES ACTIVITIES

The sale of securities backed by GNMA held mortgages is preferred by GNMA to the sale of individual mortgages because they

--are more marketable and, thus, easier to sell;

--attract a higher price than would the mortgages themselves; and

--attract nontraditional mortgage investors.

GNMA sells its securities through closed bid auctions. Since January 1975, GNMA has held 17 such auctions by which it sold $3 billion worth of securities for $2.8 billion (a discount of 9.1 percent).

On the other hand, during the same period, GNMA sold $501.8 million worth of single family mortgages through whole loan auction sales, for which it received $455.1 million (a discount of 9.3 percent). GNMA officials cited two reasons for not selling these mortgages as mortgage-backed securities. They said that their procedure requires that issued securities have a minimum face value of $1 million and that

--issuers net worth, in assets acceptable to GNMA, is sufficient to meet specified Government regulations,

--the mortgages are insured by FHA or guaranteed by VA,

--the issuers provide for servicing and timely payment of interest, and

--issuers comply with other similar regulations.

GNMA holds mortgages from many different originators but not always in sufficient quantity to satisfy the $1 million minimum requirement. In addition, GNMA officials said that some originators elect not to participate in a security issue.

According to a GNMA official, the most commonly traded mortgage-backed securities, issued by mortgage originators and guaranteed by GNMA, are securities valued at $100,000 and $1 million. Thus, if GNMA were able to sell securities valued at $100,000 it might be able to dispose of more of its mortgages through security sales and reduce the number of mortgages that it had to sell. The benefits of reducing the minimum value would be twofold: GNMA should be able to get a better price by disposing of the mortgages as securities; and by selling them as securities it makes them attractive to nontraditional mortgage investors. GNMA oficials indicated that GNMA could have sold as securities some of the $501.8 million worth of mortgages it sold through whole loan auctions since January 1975 if the minimum value requirement was $100,000.

POTENTIAL SAVINGS THROUGH THE DIRECT SALE OF SECURITIES TO PRIVATE INVESTORS

When GNMA holds a security auction, it is offering a number of security issues for sale with the requirement that the potential investor must submit a bid for the entire block. As of March 31, 1976, this requirement has had the effect of limiting competition on security auctions to two large syndicates. At this date only two large syndicates have submitted bids at GNMA security auctions and thus all of the securities offered were purchased by the two syndicates. The blocks of securities sold at these auctions have ranged from $69.0 million to $305.0 million. The purchasing syndicates resold the securities in smaller amounts to private investors, acting in effect as middlemen between GNMA and the private investors. In most cases, according to GNMA officials, the syndicates had obtained commitments from the private investors for the purchase of the securities before the sydicates' purchase of the securities from GNMA. For all security sales through March 31, 1976, the syndicates paid GNMA $2.8 billion for the securities and resold them for a gross profit of $15.5 million (.56 percent of the purchase price), or an average gross profit of $912,000 per auction.

According to GNMA officials, GNMA intends to continue selling its securities in the above manner because it feels that through the syndicates marketing efforts it (1) can reach investors at a reasonable cost with minimal administrative effort on GNMA's part, (2) is assured of receiving a fair market price for its securities, and (3) receives a higher price by selling all the securities together.

The opportunity exists for GNMA to increase its revenues on the sale of mortgage-backed securities if it revises its bidding procedures to permit potential investors to bid on individual security issues rather than requiring the individual investor to bid on the entire block of security issues.

This contention is based upon the following factors:

--Mortgage-backed securities guaranteed by GNMA have become well known and are readily marketable in the financial market. As of March 31, 1976, GNMA was guaranteeing approximately $23 billion worth of such securities held by investors.

--The additional administrative cost to GNMA would be minimal. The acceptance of bids on individual security issues should result in a larger number of bids to be evaluated; however, the only factor to be considered is the bid price, which should require only a minimal additional effort by GNMA. In addition GNMA already prints and issues the securities to the investors who purchase the securities from the syndicates.

--According to a GNMA official, the prices received for GNMA-guaranteed securities are generally the same regardless of the seller involved (i.e., GNMA, mortgage investor, or syndicate). This is because prior issues of GNMA securities are constantly sold in the financial market and investors can choose the best yielding securities. Thus, it is highly probable that GNMA could obtain the same prices that the syndicates obtain when they sell the GNMA securities.

We recognize a possible negative effect of GNMA conducting such sales could be the failure to attract nontraditional lenders. As discussed on page 46, it appears to us that the syndicates have been more successful selling to nontraditional lenders, such as State pension and retirement funds, than have the originators in GNMA's guaranteed mortgage-backed securities program. This could be accounted for by the fact that the State retirement funds prefer to purchase securities in large amounts ($50 million to $80 million in some cases), something individual originators cannot offer but the syndicates can offer. In this regard, GNMA could tailor the size of its offerings to take advantage of individual investor preferences.

According to several GNMA officials, GNMA has never attempted to determine the cost and feasibility of permitting investors to bid on individual security issues. In view of the fact that the syndicates' average gross profit per auction has been about $912,000, GNMA should determine the feasibility of permitting investors to bid on individual security issues.