Research Department
Federal Reserve
Bank of
San Francisco

February 7, 1975

Flexible Rate?

On the heels of the 1969-70 credit crunch, many housing analysts expressed interest in a mortgage with a flexible interest rate, and the Federal Home Loan Bank Board went so far as to ask Congress to authorize the use of the instrument by the nation's Federally chartered savings-and-loan associations. However, the proposal generated little in the way of political appeal, and meanwhile aroused rather fierce opposition from consumer and labor groups. Generally, the variable rate mortgage found only limited acceptance at that time, and some states even banned its use.

But now, in the wake of another crunch, interest in the VRM has again come to the fore. Recently the Home Loan Bank Board again proposed its adoption, arguing that it would provide considerable aid to S&L's and other mortgage lenders competing for limited supplies of funds in tight-money periods. In California, where earlier efforts to institute variable-rate clauses all failed, four large S&L's have now announced plans for the VRM.

What is a VRM?
As the term implies, a variable-rate mortgage differs from the standard fixed-rate mortgage in that the contract rate may vary over the life of the loan. Thus, the VRM essentially is a form of indexing, an escalator type of agreement such as is used in cost-of-living adjustments to wage and pension agreements, rental-property contracts, and welfare and alimony payments. But whereas many escalator agreements provide only for upward adjustments, the VRM provides for downward movements as well.

In one type of contract, the monthly payment is adjusted to reflect a change in the interest rate, with the loan's maturity remaining unchanged. For example, on a typical $24,000, 25-year loan made in 1973 with an 8-percent mortgage rate, the monthly payment would have been about $185. If that loan had been written with a variable-rate clause, the following year the rate on the outstanding balance would have been raised to 8¾ percent—the average for new 1974 loans—and the monthly payment would have been about $197. Under the second type of VRM, the monthly payment on the original loan would have stayed the same but the loan's maturity would have been extended to accommodate the higher interest rate—in this case to somewhat over 30 years. This flexible-maturity type of contract, unlike the variable payment plan, would not provide the lender with any short-run increase in cash flow.

The VRM of course could make a considerable difference for S&L's if their entire mortgage portfolio consisted of flexible-rate instruments. As it was, they earned almost $18 billion last year on their $242-billion mortgage portfolio, for a 7.35-percent average yield. But at least $3½ billion more—enough to finance over 100,000 additional homes—could have been earned if **all** loans had carried the same average rate and terms as 1974's **new** loans. The

(continued on page 2)

Research Department
Federal Reserve
Bank of
San Francisco

net impact probably would not be that large, of course, because of the impact of higher mortgage payments on savings flows, and other factors. Still, by making lenders' income more responsive to changes in interest rates, it could better enable them to maintain the flow of funds to housing during periods of overall credit restraint.

Sharing the risk

Supporters of the VRM argue that it permits a greater degree of sharing, between borrowers and lenders, of the risks of changes in interest rates. With a fixed-rate mortgage, a borrower bears none of the risks of interest-rate increases—which is to say, the risks of inflation. At the same time, the fixed-rate mortgage usually provides the borrower with the option of refinancing his loan (with some prepayment penalty) if interest rates decline, while the lender cannot call a loan originally made at a low rate and require it to be refinanced when rates are high. Moreover, borrowers who acquire their loans when rates are low in effect are "subsidized" by those who borrow when rates are high—the latter thus bearing a disproportionate burden of efforts to fight inflation.

VRM supporters also claim that borrowers would not be unduly hurt by an increase in their monthly payments (or by an extension of their loan maturities) because rising incomes generally accompany rising interest rates. Consider, for example, a borrower who acquired a $20,000, 25-year mortgage loan at 6.50 percent in 1967, but with a variable-rate clause tieing his contract rate to the average rate charged on new loans each year. Over the entire 1967-74 period, the borrower would have paid out about $1,400 more, and his loan balance would have been about $500 higher, than under the fixed-rate mortgage. However, his interest-and-principal payments in 1967 would have equalled 21 percent of the $7,974 family median income, while his higher (variable) payments in 1974 would have amounted to only 15 percent of that year's median income of $11,357.

To the extent that borrowers faced with rising monthly payments curtail other expenditures, the variable-rate instrument would tend to shift some of the burden of anti-inflationary policies from housing to other sectors. Conversely, during periods of recession and (presumably) falling interest rates, declining monthly mortgage payments would tend to release a greater proportion of household income for the purchase of other goods and services, thereby helping to stimulate the economy.

Problems

The VRM concept has substantial advantages, but it also poses significant problems. Some observers question whether homebuyers who acquire their financing when rates are relatively low should share the risks and burden of future increases. Logically, all borrowers for whatever purpose—not just homeowners—who borrow when rates are low are "subsidized" by those who borrow when rates are high. Protection of mortgage lenders against the risks of rising rates conceivably might persuade other lenders to make similar demands for protection against such risks. If, as a result, public resistance to rising interest rates should intensify, the public might weaken in its support for use of a flexible monetary policy, and inflationary pressures might become even more difficult to contain.

Another problem centers upon the reference rate to which the variable rate mortgage should be tied. In California, S&L's employing variable-rate mortgages must base changes in their lending rates on the weighted average cost of savings, borrowings and advances from the Federal Home Loan Bank of San Francisco. But because of the rising trend in savings rates, this average has increased every year of the last decade—a consideration which potential borrowers may well remember.

Additional problems involve the appropriate timing, frequency and magnitude of mortgage-rate adjustments. In an effort to assure borrowers equitable treatment, several states have placed statutory limitations on the number of rate adjustments which can be made within a year, thereby reducing the VRM's potential advantage to lenders. Doubt concerning the salability of the VRM in secondary markets may pose yet another obstacle to its use. In addition, the lending conditions (including timing) most favored by lenders differ from those most favored by borrowers. Lenders, for example, may be reluctant to adopt the VRM when rates are high—the very time borrowers would be most favorably disposed—because of the possibility of declining returns in future years. However, this consideration may now be less of a constraint, in view of the announced intention of some California S&L's to introduce the VRM while rates are still fairly high.

On balance, the variable-rate mortgage could well be a useful vehicle for smoothing the flow of funds to housing over the business cycle. Still, the instrument is likely to have only a marginal effect in the short run, because its adoption would be limited just to new loans. Moreover, while the VRM would provide lenders with a greater degree of protection against inflation and tight-money conditions, it does not represent an attack on the basic problem of inflation itself—the Number One enemy of housing.

Verle Johnston