Growth Creates Growth: The Secondary Mortgage Market and Sunbelt Suburbs

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"The causes of growth," Houston developer David Wolf told Congress in 1978, "are often in turn caused by the growth itself."[1] Houston was in the midst of a homebuilding boom. Thousands of new homes sprung up in far-flung suburbs—master-planned communities uniform in style and price. Wolf credited the city's "pro-business" atmosphere for allowing the homebuilding industry to capitalize on the area's demand for new homes without the aid of government support. Houston's boom, another developer agreed, was the product of the city's embrace of "free market forces and the entrepreneurial spirit."[2] These developers, however, omitted a key ingredient to Houston's homebuilding boom: Fannie Mae and Freddie Mac, the two "government-sponsored enterprises" (GSEs) which created and sustained an expanding secondary market in mortgages from the 1970s onward. GSE policies drastically reinforced regionally divergent growth trends throughout the country by channeling millions of dollars' worth of mortgage capital to rapidly expanding metropolitan areas like Houston. Growth created more growth, thanks to Fannie Mae and Freddie Mac.

The GSEs facilitated a new era of capital mobility. As policymakers intended, they purchased mortgages from institutions in high-growth regions and sold securities or bonds based on these mortgages to institutions in slow-growth regions. In effect, depositors in cities like Chicago and New York were financing the growth of Los Angeles and Houston. Indeed, during the 1970s, Fannie and Freddie facilitated a massive redistribution of mortgage capital

[1] *Task Force on Homeownership: Hearings Before the House Subcomm. on Housing and Community Development*, 95th Cong. 650 (Jan. 24, 1978) (Statement of David S. Wolf).

from northern and mid-western cities to southern and western cities. In the process, they had a profound effect on the size and shape of suburban growth in the Sunbelt.

In fueling housing booms in places like Southern California and Texas, the GSEs provided vast, new sums of mortgage money that allowed developers to capitalize on economies of scale. Homebuilders raced to take advantage of the influx of capital and the increasing demand for mortgages in growing metropolitan regions like Atlanta, Washington, DC and Houston. The result was large-scale, speculative homebuilding. Ever-larger subdivisions, encompassing hundreds of acres, sprung up on Houston's metropolitan periphery—where builders could purchase and develop large tracts of land at low cost. And economies of scale also incentivized the stylistic and socio-economic homogeneity of these subdivisions.

GSE appraisal and purchasing policies also favored such large-scale suburban developments. In order to easily securitize mortgages, they sought more uniform appraisal criteria that could transform the specificities of an individual mortgage in a particular neighborhood into a commoditized financial instrument that could be purchased by an investor without any knowledge of local real estate markets. Their criteria favored neighborhood homogeneity in style, price and age, allowing appraisers to easily quantify the relationship between home values in a given neighborhood. Lastly, the GSEs could most efficiently securitize mortgages by purchasing them in bulk, which gave preference to large-scale developments.

The complexity of the secondary market shrouded the profound effect of the GSEs. Often, homeowners did not know that their mortgages had been sold on the secondary market because originating institutions continued to service the mortgages they sold. Ignorance of the GSEs' importance fueled free-market explanations of suburban growth. In the late 1970s, however, several urban community groups sought to illuminate the GSEs' growing power to shape

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[2] Ibid., 606 (Statement of Tyler Todd)/

mortgage markets. Their efforts spurred consideration from policymakers such as Senator William Proxmire and President Carter's HUD Secretary, Patricia Harris. Proxmire held hearings and Harris attempted to issue new regulations governing GSE operations. Fannie and Freddie defended their actions by claiming they were only acting according to marketplace demands. The efforts of Proxmire and Harris were mostly unsuccessful. The GSEs wielded immense and growing lobbying power in Congress. Meanwhile, economic conditions conspired against GSE reform. The resumption of significant inflation at the end of the decade followed by the Volcker shock sent interest rates skyrocketing, severely tightened mortgage markets and threw the thrift industry into crisis. With the thrifts failing in record numbers, policymakers increasingly agreed that the secondary market was the only way to supply mortgage capital and maintain the promise of homeownership for the nation's middle-class.

Interregional Capital Mobility

From the 1970s to 1980s, the GSEs transformed the mortgage finance system from a set of regional markets into a national market. The early postwar system had combined federal subsidies for and regulation of thousands of local financial institutions through government agencies like the Federal Home Loan Bank (FHLB) and the Federal Housing Administration (FHA). These institutions largely relied on local savings deposits to finance local mortgages. Transferring mortgage funds from region to region faced regulatory, cost, risk, and cultural issues.[3] Barriers to interregional capital mobility meant that mortgages in high-growth areas carried higher interest rates. Where demand for mortgages was relatively low and bank and thrift deposits were relatively high (like New York), mortgage rates could be about a percentage point lower than in areas where the opposite was true (like California). And during periods of disintermediation, as in 1966, mortgages were virtually unavailable in high-growth regions like California.

As the secondary market grew, mortgage rates converged across different regions, meaning that homeowners in New York and California, regardless of local demand and supply, paid about the same rate on their mortgages by the end of the 1980s.[4] Increased capital mobility was a central goal of the GSEs. Their stated objective was to transform the secondary market from a small, disparate set of local and personal relationships into a standardized, national and fluid network of capital. When asked to list its "most important functions, in order or priority," Freddie Mac listed its regional redistribution of mortgage funds first, followed by its ability to attract mortgage investment from "non-traditional" sources of capital.[5] Third and fourth were, respectively, the standardization of the mortgage process and the general promotion of the secondary mortgage market.

However, the complexity and secrecy surrounding the secondary mortgage market obscured the specific ways in which it redistributed mortgage funds. Fannie and Freddie were, and are, exempt from FOIA and they vigorously protected their right to corporate privacy as privately owned, profit-seeking businesses. Because of this, it is difficult to obtain detailed, consistently published data on Fannie and Freddie operations. A 1976 Congressional hearing on the secondary mortgage, however, offers a glimpse of how their mortgage purchases were broken down by region. Material submitted by the GSEs showed that their purchases were heavily concentrated in high-growth areas, particularly California and Texas but also Washington, DC, Atlanta, and Seattle. During the first three quarters of 1976, for example, four of the top ten

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[3] Roth, "Volatile Mortgage Rates," Fed. Reserve Bank of Kansas City, March 1988, 22.
[4] Ibid.

metro areas in terms of Fannie's mortgage purchases were in California. Houston ranked second. Fannie's mortgage purchases there were four times the amount of mortgages it purchased in the Chicago metro area, which was three times the size of the Houston metro area. The contrast with New York was even starker. Fannie's New York purchases were a sixteenth of Houston's even though New York was more than six times the size of Houston.

Table 1: Fannie Mae conventional mortgage purchases in top thirty metro areas, first nine months of 1976 :[6]

Metro Area	Mortgage purchases (in millions $)
1. Washington, DC	77.3
2. Houston	69.5
3. LA/Long Beach	48.4
4. Atlanta	42.9
5. Seattle/Everett	40.6
6. San Francisco/Oakland	36.9
7. Detroit	30.1
8. Anaheim	29.2
9. Philadelphia/Camden	27.8

[5] *Secondary Market Operations of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs*, 94th Cong. 347 (Dec. 13, 1976).
[6] Ibid., 447-448.

10. San Jose	23.8
11. Denver	21.4
12. Dallas	20.4
13. Chicago	16.5
…	
23. New York	4.3
…	
26. Cleveland	1.1
27. Pittsburgh	0.6
28. Patterson/Clifton (NJ)	0.6
29. Buffalo/Niagara	0.5
30. Boston	0.3

Through the late 1970s and early 1980s, Fannie Mae continued to purchase large quantities of mortgages in California and Texas. During the height of Houston's boom in the late 1970s, the association drastically increased its Houston mortgage purchases. In the second quarter of 1979, for example, Houston ranked first and Los Angeles second as the number one metro region for Fannie purchases. During the quarter, Fannie Mae purchased almost $200 million of mortgages in Houston and $167 million in Los Angeles. Together, these two metro areas represented almost fourteen percent of all of Fannie's mortgage purchases.[7] The trend would continue with Los Angeles and Houston consistently ranking as the top metro areas for Fannie purchases during the late 1970s and early 1980s.[8] Cities like Anaheim, San Jose, Dallas, Atlanta and Washington ,DC also consistently ranked near the top during the period.

It was a similar story for Freddie Mac. By 1976, California and Texas mortgages made up a third of Freddie Mac's conventional mortgage portfolio. Freddie Mac also provided data on the source of its funds for its mortgage participation (PC) program. Illinois, home the the largest number of S&Ls in the country, held $168 million of Freddie mortgages, or 11.5% of its total holdings. New York was just behind with $165 million. Ohio, Indiana, Minnesota, Michigan, Missouri, Pennsylvania, New Jersey and Kentucky rounded out the top ten, in order. By contrast, Illinois was the home to 2.25% of Freddie's conventional mortgages, New York just 0.4%. Together, these top ten states in terms of financing accounted for under fourteen percent of Freddie's conventional mortgage purchases even though they held more than two-thirds of its mortgage portfolio. By contrast, California and Texas together held less than six percent of Freddie's portfolio.[9]

The Secondary Market and Suburban Growth

GSE appraisal criteria reflected an assumption that neighborhoods almost always deteriorated in value with age. Appraisers estimated "the remaining economic life" of the property based on the age of the neighborhood's housing stock, its social and economic characteristics, land use

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[7] "L.A. second in Fannie Mae Buy List," *LAT*, Aug. 19, 1979.
[8] "L.A. Area, California Top Fannie Mae Buy List," *LAT*, Nov 4, 1979; "Fannie MaeIssues Report on Mortgage Purchases," *LAT*, May 11, 1980; "FNMA Buys $188.6 Million in State Mortgages During Quarter," *LAT*, Aug 29, 1982.
[9] Congressional Research Service, *The Role of the Federal Home Loan Mortgage Corporation in the Secondary Mortgage Market*, Dec. 8, 1976, 11-12.

patterns, and the degree that surrounding land had been developed.[10] "No matter how good an individual property is, it alone cannot overcome generally prevailing economic obsolescence in a neighborhood," Freddie Mac guidelines warned. In the case that "the sum of the age of the property plus the term of the loan exceed 60 years," the guidelines stated, "the property should be considered for inspection prior to purchase by FHLMC."[11] In other words, a typical thirty year mortgage on a home older than thirty years received heightened scrutiny from Freddie Mac—something lenders would wish to avoid wherever possible.

Similarly, Fannie Mae and Freddie Mac valued social and economic homogeneity, especially in terms of the age and price of the homes in a given neighborhood. GSE appraisers noted the homogeneity of the neighborhood's property values, type of occupancy (owner vs. Renter), architectural style, land use and the age of the buildings. Properties which did not "conform" to their surrounding neighborhoods were considered to be higher risk and subject to inspection. Freddie Mac determined new or "over-improved" homes in older neighborhoods were unlikely to be good investments. "A property which falls out of the general age group should receive special consideration," Freddie Mac guidelines stated.[12]

GSE purchasing methods also favored new, large-scale suburban developments. Fannie and Freddie purchased most of their conventional mortgages through the "forward commitment" system, whereby they agreed in advance to buy mortgages that were not yet originated. Almost always, these purchases were done in bulk. With a commitment in hand, mortgage companies, S&Ls and banks were able to offer homebuilders financing for vast new subdivisions, favoring outlying suburbs where developers could build large, new tracts of single-family homes on a scale that could not be matched in already-existing urban and inner-suburban neighborhoods. As

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[10] *Secondary Market Operations,* 43.
[11] Ibid, 44. Because of pressure from Congress, Freddie Mac removed this requirement in 1976.

Mary Lou Wolff, president of Chicago's Citizen Action Program, noted in 1975, forward commitments facilitated systematic urban disinvestment and multiplied far-flung suburban growth. According to financial institutions, geographic lending policies did not amount to "redlining unless a person is told point blank that he cannot get a mortgage because of the geographic area in which he wishes to buy," Wolf said. "In fact," she went on:

> the system of forward commitments itself means that the suburbs and lakefront are much more likely to get mortgage money than older city neighborhoods. The relationship between large developers and S&L's implicit in the forward commitment prevents the free functioning of competition for mortgage money… this system leads inevitably to the disinvestment of mortgage funds from the older neighborhoods. And this would be true even if the S&L industry never consciously redlined any areas—which of course they do also.[13]

Buying in bulk through the forward commitment system allowed the GSEs to quickly transact millions in mortgage dollars over vast distances with a small staff. In 1985, Rep. Harry Barlettt, who hailed from Dallas' quickly growing northeast suburbs, praised the efficiency of Freddie Mac's operations. He described his tour of the corporation's facilities:

> There's a small room in Freddie Mac's basement where a staff of nor more than six or seven talk to lenders all over the country to let them know what prices Freddie Mac can buy mortgages for each day. This staff also commits Freddie Mac to buy the mortgages that lenders want to sell… approximately 3 hours and 100 calls later, a tape of all the transactions for that day are taken by a messenger from the commitment room to the trading room 3 floors up. The traders there call 15 Wall Street Firms simultaneously and the firms bid on the mortgages Freddie Mac has committed to purchase that day.[14]

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The forward commitment system, along with GSE appraisal criteria, helped to shape the size and homogeneity of the new suburbs built during the 1970s and 1980s. In Houston, the GSE-fueled housing boom produced huge, master-planned communities often encompassing hundreds

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[12] Ibid, 44-45.
[13] "Greenlining Drive: Phase II," Box 2, "Greenlining- Mortgage Industry/Regulation 1973-1975," Citizens Action Program Dubi, Chicago History Museum.
[14] 131 Cong. Rec. H E3460 (July 23, 1985).

of acres.[15] Most of these subdivisions were on the metropolitan fringe where developers could acquire vast tracts of land on a relatively cheap basis. In 1978, the fastest growth was on the city's far northwest side, which alone accounted for a quarter of the area's new detached, single-family homes.[16] Master planning on a large scale helped to achieve the socio-economic and architectural homogeneity that the GSEs demanded. Often, individual subdivisions were part of a larger development. Each subdivision was delineated by home price and architectural style. In its annual report, for instance, the Friendswood Development Corporation, which was a subsidiary of Exxon, described its vast Houston communities as a series of "small villages… each with its own identity, and it is this identity which has so much sociological significance."[17] Such a landscape, the company said, offered residents the "orderliness" that older, urban neighborhoods lacked.

Both Fannie and Freddie repeatedly claimed they could not provide data on how many of their mortgages were suburban, urban or rural. In 1977, however, HUD estimated that seventy percent of Fannie Mae's conventional mortgage purchases were suburban.[18] Lorraine Legg, a former Fannie Mae officer, corroborated HUD's estimate of Fannie Mae's suburban purchases. Fannie Mae had neglected its mandate to provide low and moderate income housing in favor of upper-class, suburban developments, she said. According to her, the association's "attitude has been "let's have all the benefits of Government backing and none of the responsibilities."[19] She claimed that "FNMA has abandoned the cities and small towns and now competes with other institutions in the suburbs rather than complementing the activities of those institutions." Legg

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[15] *Homeownership Task Force*, 608, 651.
[16] Ibid., 597, (Statement of Michael H. Inselmann, Urban Research Corp.).
[17] Friendswood, 1974 Hi Lites, 3, Box 11, Folder 11, Y. Frank Jungman Collection, Houston Metropolitan Research Center.
[18] *Federal National Mortgage Association Charter Act: Hearings Before the Sen. Comm. on Banking, Housing and Urban Affairs,* 95th Cong. 13 (Jun. 7, 1977).

did not deny that Fannie Mae owed its stockholders a fair return on their investment but "American taxpayers are also entitled to a return on their investment." Fannie Mae had failed to fulfill the promise of the 1968 Housing Act, according to Legg: "Urban blight and the flight to the suburbs has accelerated instead of being stemmed."[20]

Mortgages and the "Free Market"

Under the early postwar system, financial institutions had responded to claims of redlining by arguing that their decisions were a product of market logic. But, with the growth of the secondary market, these institutions received a much less-debatable defense—not one of market logic but rather market dictate set by Fannie Mae and Freddie Mac. Financial institutions increasingly made decisions about where to lend based on fulfilling the criteria used by the GSEs. As Freddie Mac's president noted in 1976 "regardless of the selling intentions of any particular primary lender… our underwriting standards [have] become a minimum standard of quality for mortgages generally. The term 'Mortgage Corporation quality' is becoming a designation in the market for mortgages of a particular tradeable grade."[21]

Financial executives claimed that their lending decisions were increasingly determined by GSE policy. For example, Alan E. Rothenberg, a vice-president at Bank of America, argued before a HUD meeting in 1976 that "if FNMA and FHLMC revised their lending criteria to show a willingness to buy urban loans, reasonably underwritten, you would see a substantial number of traditional mortgage lenders re-devoting their efforts to providing these loans to the secondary market. Many a private lender feels he cannot justify making loans in urban areas when he

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[19] *Secondary Market Operations*, 65.
[20] Ibid 66.
[21] Ibid., 317.

knows the federal government, through its credit agencies or its insurance programs, will have no part of any of these loans because they are considered too risky."[22]

Of course, Rothenberg had a vested interest in displacing blame for urban disinvestment but his claims were corroborated by critics of GSE policies, including HUD Secretary Patricia Harris. Fannie Mae, she argued, held the power to reverse patterns of urban disinvestment. If they were to purchase more mortgages for lower-class, urban, minority residents, she said, financial institutions would originate such mortgages at a much higher level.[23] Community leaders also accused Fannie and Freddie of redlining older, poorer urban neighborhoods with large minority populations. Nick Licata, a member of the Seattle Coalition on Redlining, noted how underwriting and appraisal guidelines used by the GSEs established a "dogma" that all neighborhoods inevitably declined with age.[24]

Q.V. Williamson, the chairman of the National Association of Real Estate Brokers (the national organization of African American real estate professionals), joined the assault on Fannie Mae, arguing that the GSEs favored suburban investment at the expense of the "inner city" and especially minority residents. Williamson had become the first black Atlanta alderman since Reconstruction in 1965. Williamson compared Fannie Mae, as a government-sponsored corporation, to utility companies. "They can't tell you you can't have a telephone because you live in a certain area," Williamson said. Fannie Mae, he said, operated as if it wasn't "responsible to anyone… They just do what they want to do and treat citizens the way they think they ought to be treated, and not as a [sic] public citizen of this country."[25]

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[22] Ibid., 34.
[23] *Federal National Mortgage Association Charter Act*, 17-18.
[24] Ibid. 59.
[25] Ibid., 77.

Darel Grothaus, director of Seattle Department of Community Development, testified that the growth of the secondary market brought with it "the increasingly universal" application of appraisal standards that disadvantaged older, racially and economically diverse urban neighborhoods. Fannie and Freddie, Grothaus said "appear to be giving public sanction to lending policies that redline older neighborhoods."[26] Even when lenders did not immediately sell their mortgages on the secondary market, he noted, they wished to preserve this option. And so they applied the same, universal criteria on all loans they made.

Fannie Mae's chairman, Allen Oakley Hunter claimed that there was only so much Fannie Mae could do to overturn the systematic suburban favoritism of the housing industry. "The underwriting fraternity, the lending fraternity, the housing industry, the entire complex for many years, since shortly after World War II, has been suburban oriented," Hunter noted. Fannie Mae was "far from perfect" in its urban lending programs, he said, but, as a profit-seeking, privately owned corporation it could only do so much to promote urban lending against prevailing market norms[27]. As evidence of its attempt to support urban lending, Fannie Mae cited its purchase of nearly half of all FHA Section 235 loans.[28] Section 235 was designed to support urban, low-income lending by directly subsidizing such loans but the program was racked by corruption and high foreclosure rates because they involved little risk for the financial institutions originating the loans.[29] Fannie Mae purchased few conventional loans in these neighborhoods. "By taking FHA loans in these areas but not accepting conventional loans," Chairman Proxmire said, "FNMA is helping FHA become the vehicle for blockbusting, racial and economic turnover, and

[26] *Secondary Market Operations*, 49.
[27] Ibid 415.
[28] Ibid.
[29] Andrew Highsmith, "Prelude to the Subprime Crash: Beecher, Michigan, and the Origins of the Suburban Crisis," *Journal of Policy History* 24:4 (Oct. 2012), 572-611.

rapid deterioration in these areas."[30] When Fannie did make conventional loans in the city, they were most often to white gentrifiers, Proxmire charged.

In addition to the GSEs suburban favoritism, the regional preferences of Fannie and Freddie drew criticism as in an exchange between GSE executives and Senator Proxmire. "It somehow seems California just dominates everything in this area," Proxmire complained, pointing out that while California was home to ten percent of the nation's population, it was home to almost a quarter of the GSEs' mortgages. During the first nine months of 1976, Proxmire noted, almost seventy percent of Freddie Mac's purchases were in West Coast states. By contrast, Proxmire said, his home state of Wisconsin, which had two percent of the nation's population, was home to just eight tenths of a percent of Fannie's mortgage portfolio.[31]

The GSEs argued that their lending decisions were shaped by market forces that were outside of their control. The interregional transfer of capital from north and east to south and west was a product of simple laws of supply and demand, they said. Fannie Mae's chairman, Allen Oakley Hunter, claimed that the regional imbalance was the product of a "market over which no one has control." Higher mortgage rates in high-growth areas like California promised higher returns to investors. Proxmire was unimpressed, arguing that the GSEs were "rewarding" higher interest rates and favoring California homeowners and financial institutions. Freddie Mac vice-president Philip Brinkerhoff responded brusquely, "that is the law of supply and demand. If people in other segments of the country were demanding mortgages to the same extent, our facilities are open to them the same as they are in California." Proxmire offered a pithy response to Brinkerhoff: "That explanation would satisfy me completely if I were a Senator from

[30] *Federal National Mortgage Association Charter Act,* 99.
[31] *Secondary Market Operations*, 438.

California."[32] Brinkerhoff's claim that there was little demand for mortgages in "other segments of the country" was refuted by the testimony of Grothaus, Williamson and others. But these were not the type of mortgages that the GSEs desired. They were in older, urban communities and did not provide the same high interest rates as California or Texas mortgages.

The GSEs' claim that they were merely acting according to marketplace demands over which they had no control obscured their central role in creating this market in the first place. Without them, there would be no national secondary market. Their dominance over this market, sustained by their government support, provided them with immense power to shape its distribution of mortgage capital. Even bankers admitted that the private sector couldn't create a secondary mortgage market on its own. Kennon V. Rothchild, the president of the Mortgage Bankers Association, a strong proponent of "competition and the free market," told Congress in 1976 that the GSEs were essential to the development of the secondary market as a "source of new technology." The cost and risk was too much for private capital to "undertake similar ventures."[33]

Conclusion

Interest rate deregulation and the Volcker shock of the early 1980s endangered the S&L industry and sent mortgage rates skyrocketing. "The greatest dilemma of the housing industry is where tomorrow's source of mortgage money will come from," Rep. Henry B. Gonzalez told his Committee on Banking, Finance and Urban Affairs in 1982.[34] Philip R. Brinkerhoff, president of Freddie Mac, was blunt in his testimony before the committee: "With the scheduled

[32] Ibid, 439.
[33] Ibid., 159.
[34] *To Expand and Reorganize the Federal Home Loan Mortgage Corporation: Hearings Before the House Subcomm. on Housing and Community Development,* 97th Cong. 1 (Apr. 21, 1982).

elimination of Regulation Q and the evolving realities of inflation, lending institutions, whether they are thrift institutions or commercial banks, will never again finance on a broad basis long-term fixed rate mortgage loans with short-term deposit funds." Volatile interest rates, he said, would force financial institutions to lend on shorter terms. In terms of mortgage lending, lenders would only be able to directly finance short-term and/or adjustable-rate mortgages with higher rates, a reality, Brinkerhoff noted, that would especially disadvantage middle and lower-class homebuyers. The only way for fixed-rate mortgages to survive, he claimed, was through the growth of the secondary market.[35]

During the 1980s, policymakers and lobbyists would engage in numerous battles over the specifics of the secondary market but the comments of Gonzalez and Brinkerhoff reflected an emerging consensus in Washington that the secondary market was the best replacement for the failing thrift system. With middle-class homeownership under threat, liberal policymakers' attention shifted away from the issues of financial equity raised during the 1976-77 Senate hearings. Instead, their focus turned to the effect of inflation on middle-class homebuyers and financial consumers—President Carter's "small savers." Liberal policymakers were increasingly inclined to support Fannie, Freddie and the secondary market in general in order to preserve mortgaged homeownership as a central policy objective. Preserving this goal overshadowed criticism of the GSEs' lending policies and once again obscured the centrality of the secondary market to the growth of Sunbelt suburbs.

[35] Ibid, 58.