Answers to Mortgage Discount Queries

MORTGAGE DISCOUNTS

In recent years the Federal Housing Administration has received an increasing number of questions concerning mortgage lenders' practices of charging discounts or, as they are sometimes called, "points" of finance "fees." Because of the widespread interest in this matter, this informational statement has been prepared.

WHAT ARE DISCOUNTS?

Discounts come into existence because of the problems investors face in choosing ways of investing their money. Everyone who has a savings account with a bank, a savings and loan association, a building and loan association, or has a life insurance policy or a share in a retirement or pension fund probably is an investor to some degree.

Most investors attempt to place their money in loans or investments which will produce the greatest amount of income, usually called "yield." In addition to a high yield, investors are concerned about the safety and liquidity of investments. Notwithstanding the fact that the yield from mortgages may be lower than the yield from other investments, investors usually want to keep a considerable portion of their money in home mortgages.

At the same time, they attempt to match the yield which may be received from other investments such as high-grade corporate bonds. When the interest rates on home mortgages drop, investors will, to protect their depositors or policy holders, channel funds into loans which produce higher yields than low interest rate mortgages.

For example, assume that an investor has a choice of investing $10,000 in a high-grade corporate bond which will earn 6-½% or of investing $10,000 in a mortgage having an interest rate of 5¾%. The investor would favor the bond unless it is possible to buy the mortgage at a reduced price so that the 5¾% interest and the repayment of the $10,000 will give the same yield as the 6½% interest on the bond.

(In computing yield, lenders generally assume that the average home mortgage will be paid in full in 12 years rather than the full term of the mortgage which may be 30 years or more.) Standard investment tables show that 5-¼% interest and the principal repayment will give a 6% return if the $10,000 mortgage can be purchased for $9,400, or 6% less than the amount of the mortgage. This difference is called discount or "points."

CAN DISCOUNTS BE PROHIBITED?

On two occasions Congress has required FHA to prohibit or control discounts on FHA insured mortgages. The primary effect of these controls has appeared to be to reduce the availability of mortgage money for persons who desire to buy homes, rather than to reduce financing expenses for the borrower.

In both cases, Congress repealed the law in order to encourage an increased flow of money to mortgage investments to stimulate construction of homes and to make home buying easier.

WHAT IS BEING DONE TO REDUCE DISCOUNTS?

In order to keep discounts to a practicable minimum, consistent with reasonable interest rates to borrowers and an adequate flow of money to FHA-insured mortgages, the federal government has taken a number of important actions in recent months.

Among these actions have been successive increases by the Federal National Mortgage Association in prices offered in secondary market purchases of home mortgages; reduction in the stock purchase requirements in connection with sales of mortgages to FNMA; easing of regulations governing loans by Home Loan Banks to member institutions; and Federal Reserve System purchases of longer term Treasury issues in open market operations.

All of these actions serve to increase the supply of money available in the private money market for long-term investments, including home mortgages and thus discourages the charging of discounts or reduces the size of discounts.

WHAT DOES FHA DO ABOUT DISCOUNTS

The law requires FHA to set ceilings on interest rates for FHA-insured mortgages. The current rate is 5¾% plus ½% which goes to the Federal Housing Administration to insure the mortgage.

Discounts are not set by or received by FHA. Any "points" that are charged, as well as the mortgage interest, are retained by the investor and not by FHA. FHA regulations permit charges to the mortgagor for appraisals, title insurance, recording, surveys and other charges which are customary in a locality.

The regulations also permit an initial service charge not to exceed 1% or 2-1/2% if the lender makes advances during construction. These charges are intended to cover the lender's expenses in originating the loan.

FHA prohibits the collection of discounts from home buyers since such charges would circumvent the purpose of interest rate regulations. On the other hand, there is no prohibition against payment of discounts by builders of new homes, sellers of existing homes, mortgagees, or others having an interest in the transaction.

Whether discounts are paid and in what amount are matters for negotiation between lenders and these other parties to the trans-

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