FROM: MR. DAIGER'S OFFICE

TO: Mr. Eccles

Enclosed are several copies of the memorandum that I had prepared to use as a basis of discussion at this morning's executive session of the House Banking and Currency Committee.

As you know, Mr. Lubin, Dr. Fisher, and I were on hand as arranged, but we were not called.

J. M. Daiger

Notes for Executive Session
House Committee on Banking and Currency
August 17, 1937

STATEMENT BY J. M. DAIGER ON AMENDMENTS PROPOSED TO STIMULATE

PRIVATE FINANCING AND CONSTRUCTION OF RENTAL HOUSING

MR. CHAIRMAN, I realize that your Committee is considering these proposed amendments on somewhat short notice and that, except for the situation which Dr. Lubin has explained to you, they would have been taken up earlier in this session of Congress or put over until the next. However, we do feel that they are pertinent and important as augmenting both the volume of new housing accommodations and the volume of new employment provided for in the Wagner-Steagall bill, and therefore may properly and wisely be included in that bill.

In describing the nature of the amendments, and what each of them is designed to do, I believe that I can save time for you by being explicit rather than by attempting a quick, off-hand summary. If you will permit me, then, I shall outline the purpose, form, and practical working of the amendments, and then undertake to answer whatever questions the Committee finds that I have left unanswered in this outline.

From studies made by the Brookings Institution, the Federal Reserve Board, and the various housing agencies of the government, it is evident that around 3,000,000 houses or apartments will be needed over the next four years if we are to avert a serious housing shortage and an acute rent crisis. That is an average of 750,000 family units per year. In contrast to this prospective need, we are confronted by the fact that fewer than 400,000 family accommodations, according to the best estimates we can make at the present time, will be built during this current year 1937. If we take, as a moderate estimate, an average cost of $4,000 per dwelling unit, the amount of new housing which ought to be built to meet the prospective demand over these next four years comes to $12,000,000,000.

The crux of the problem, then, is how to increase the volume of housing construction that is being done through private capital and private enterprise, and more particularly how to direct a substantial part of that capital and enterprise into the field of rental housing.

Now the Administration and the Congress have done a great deal over the past three or four years to stimulate the private financing and construction of houses for sale--that is, to promote home ownership. This has been done partly through the enlargement of the Federal Home Loan Bank System, partly through the establishment of the Federal Housing Administration, and partly through the real-estate-loan provisions of the banking legislation that was enacted in 1935. But, notwithstanding the fact that more than 50 per cent of the families in our cities and towns and smaller communities rent the places they live in,

we have done very little up to the present time to give an impetus to the building of more dwellings for rent. The purpose of the proposed amendments to the National Housing Act is to give that impetus.

As the Act now stands, there are two main classes of housing construction carried on under it. One is the construction of single-family houses and other dwellings up to four families, on which mortgages are insurable not in excess of $16,000; the other is the construction of large-scale, limited-dividend rental projects, such as the Colonial Village, Buckingham, and Falkland developments in the suburbs of Washington. In practice, the mortgages in the first of these two classes of operation average around $4,000 or $5,000, and for the most part cover single-family, owner-occupied dwellings. The mortgages in the case of the limited-dividend rental projects, on the other hand, average a little over $800,000 and cover group houses or apartments averaging some 225 family units in each development. The total volume of these rental projects thus far constructed or contracted for, however, is relatively small--something less than $25,000,000. The mortgages on the projects range from something over $200,000 to $1,750,000; the number of family units in each project, from something over 50 to something less than 500.

The proposed amendments are designed for a twofold purpose. In the first place, they are designed to bridge the gap between the 4-family group or unit, on which the insured mortgage cannot exceed $16,000, and the large-scale, limited-dividend type of rental project on which the mortgage has run upward from $200,000. In the second place, the amendments are designed to facilitate and simplify the private financing and construction

of both this smaller type of rental development, which is particularly needed in our smaller communities, and the larger type that is suitable only to our larger communities. In other words, we want to encourage not only the large rental projects, such as are now being built in limited number, but the smaller rental group-housing and small, walk-up apartments that range from $20,000 upward and accommodate from four or five or six to 50 or more families.

Accordingly, the first of the proposed amendments, which is to Section 201(a) of the Act, removes the four-family limitation by striking out the words "not more than four" and inserting the words "one or more".

The second of the proposed amendments, which is to subsection (2) of Section 203(b) of the Act, adds a provision for the insurance of mortgages in excess of $16,000, but not in excess of $200,000 and not in excess of 80 per cent of the appraised value of the property. This change, however, applies only to new construction of multi-family dwellings and the mortgage insurance is limited to $1,000 per room in any family unit. The multi-family dwellings built under these two proposed amendments would be subject to all the other provisions of the Act applicable to dwellings built within the $16,000 and four-family limitations. Since these smaller multi-family rental developments would be more nearly comparable to the one-to-four-family dwellings built for sale, or built by the persons who intend to occupy them, they could be regulated under the Act in the same manner as these other properties, and hence need not be required to be under the ownership of a limited-dividend corporation, rigidly restricted as in the case of the much larger rental projects.

The third of the proposed amendments, which is to Section 207 of the Act, is solely for the purpose of legal clarification. Section 207 contains the provisions applicable to the insurance of loans on limited-dividend housing projects and public-housing projects.

One of the present provisions of this section is that limited-dividend corporations whose mortgages are insured shall be "formed for the purpose of providing housing for persons of low income." The term "persons of low income" has been found difficult of interpretation from a legal point of view, because it is not susceptible of exact definition. Furthermore, the term is commonly identified with the type of families for whom subsidized public-housing is designed. This confusion of meaning arises notwithstanding the fact that housing built under the provisions of Section 207, however economically financed and constructed, and however low in cost when compared with housing provided by other means, must be self-sustaining in order to comply with the requirements of the Act. In these circumstances, there has been a divergence of opinion among counsel of lending institutions as to how the term "persons of low income" should be interpreted.

It is to remove doubt and hesitancy that the amendment as proposed would strike out the words "persons of low income" and add to Section 207 a specific provision that the mortgage on limited-dividend projects shall not exceed $1,300 per room on any family unit. In practice, the mortgages on these projects have averaged something less than $1,000 per room, including both land and improvements, but the $1,300 figure is used in the amendment

in order to cover the exceptional cases of large cities where higher land costs and the greater costs of fireproof and elevator construction have to be met.

Another legal question as to which there has been a divergence of opinion among counsel of lending institutions is whether separate units of a limited-dividend housing project insured under Section 207 may be sold off, released from the blanket mortgage, and the insurance applicable to the remainder of the project continued, or whether all the insurance would be voided if any part of the project were sold. In order that doubt and hesitancy may be removed on this point, the proposed amendment to Section 207 makes it clear that all or any part of a limited-dividend housing project may be sold as well as rented without voiding the insurance, but requires the Administrator to regulate the conditions of sale in the same manner in which he is now required to regulate rents, charges, capital structure, rate of return, etc.

Another change made by the third amendment clarifies in the Act what has been true all along in practice--namely, that the insurance of mortgages on limited-dividend projects is limited to 80 per cent of the estimated value of these projects.

Finally, the fourth and fifth of the proposed amendments, which are to Section 301(a) and Section 302 of the Act, are designed for the purpose of making private capital more easily available for loans on the large-scale, limited-dividend projects constructed under the provisions of Section 207. Because of the size of the loans on these projects, the present source of funds is for the most part limited to large insurance

companies. In the case of some such companies there is a reluctance or an unwillingness to make these loans because of self-interest in existing properties--properties that would naturally benefit from a housing shortage and a continued rise in rents. But in any event the number of these large loans that can be made even by the largest insurance companies is necessarily limited.

The amendment to Section 301(a) authorizes the national mortgage associations provided for in the Act to make loans that are secured by mortgages insured under the provisions of Section 207. This authorization applies only to loans on limited-dividend or public-housing projects insured under this section. It does not permit a national mortgage association to compete with building and loan associations, banks, mortgage companies, life insurance companies, etc., in making any other kind of mortgage loan.

The fact that no national mortgage association has yet been organized is due in the main to two hampering limitations in the Act. In the first place, a national mortgage association is restricted under the present language of the Act to the purchase and sale of mortgages made by other institutions; it is given no authority to originate loans. This would be remedied by the amendment authorizing the association to make loans on limited-dividend or public-housing projects insured under Section 207. In the second place, the authority of the national mortgage association to issue debentures is limited under the present language of the Act to 12 times the capital of the association.

The proposed amendment to Section 302 would increase the authorized ratio of debentures to capital from 12 to 20. Now inasmuch as the

association is permitted to issue debentures only to the extent of its holdings of mortgages insured under the Act, government securities, and cash, the proposed increase in the ratio of debentures to capital is neither excessive nor unsound. On the contrary, the quality of these three limited classes of assets behind the debentures, in addition to the capital of the association, assures investors in the debentures all the protection that is required.

The proposed increase in the ratio of debentures to capital is necessary as a practical matter because of the small spread between interest paid and income received upon which a national mortgage association would have to operate. In no instance to date has an insured mortgage loan on a limited-dividend project carried an interest rate in excess of 4½ per cent. An association holding a large amount of these mortgages in its portfolio would therefore have to sell its debentures at a very narrow spread, and consequently ought to be permitted to have a reasonably large turnover of business in order to cover expenses and make a fair profit.

The reason that the removal of the two present hampering limitations on the operation of the national mortgage associations would in all probability lead to the formation of one or more of these associations--and thereby make funds more easily available for loans on limited-dividend projects and public-housing projects--is that ample Federal and State legislation already exists to assure a wide market for the national mortgage association debentures provided for in the Act. The existing Federal banking laws cover investments in these debentures by national banks, and during the past three years State enabling legislation has been enacted

authorizing investments in these debentures by building and loan associations in 34 States, by savings banks in 37 States, by trustees in 41 States, by life insurance companies in 42 States, by trust companies in 46 States, and by commercial banks in 47 States.

Since all classes of mortgage-lending institutions would be able, under the proposed amendments, to make insured mortgage loans up to 80 per cent on the smaller multi-family projects ranging from $20,000 upward, and since the national mortgage association debentures secured by mortgages on limited-dividend or public-housing projects would be readily salable under existing law to all types of investors, the construction of a much larger supply of moderate-priced rental housing than is now in prospect would be assured by the adoption of the amendments. Thus the amendments would supplement and round out a program of government stimulation of rental housing by encouraging and facilitating the operations of private enterprise at the same time the new program of public housing goes forward. But the amendments are needed in order to get this additional private construction, because at the present time an effective financial mechanism for handling rental-housing projects does not exist.

The long-term amortized mortgage is the ideal instrument for sound lending on residential properties. By reason, however, of the small monthly payments of principal and interest, the long-term amortized mortgage is ill adapted to the investment needs of the average individual or small institution in which real-estate lending constitutes only part of the business. For this reason it is not feasible at the present time for the individual or the small institution to acquire even a small portfolio

of these mortgages, and, in fact, there has never existed in this country a proper financial mechanism through which the individual and small institution could channel their savings and surplus funds directly into long-term amortized mortgages.

The nearest approach to such a financial mechanism was the guaranteed-mortgage and certificate companies, which reached the zenith of their operations in the late 1920's. That the securities issued by these companies were attractive to the individual and corporate investor by reason of their convenient denominations and maturities and attractive yields, is best evidenced by the fact that upward of ten billion dollars of such securities was marketed. The subsequent collapse of these securities was not brought about by any inherent defect in the mechanism itself, but must be attributed rather to a failure to incorporate in that mechanism the principle of long-term amortization and the additional safeguards that Congress has incorporated in the National Housing Act. The collapse of these securities, nevertheless, closed the primary source of funds for large rental-housing operations and at the same time there disappeared from the financial markets a type of investment peculiarly adapted to the needs of many individual and institutional investors.

The enactment of the proposed amendments would therefore make it possible to create under proper statutory and regulatory supervision a sound security through which the investment funds of individuals and institutions could be made available to meet at least part of the acute need for more rental housing.

It must be obvious that, however necessary it may be for government to finance in whole or in part the cost of providing shelter for the lowest income groups, just as it provides food and clothing for them, the financial burden itself prohibits any extension of the public-housing principle beyond the relief classes. Private capital, however, given the essential financial mechanisms, is in a position to finance the additional housing needed for families that can afford to pay a moderate economic rent.

The insured mortgage provided for in the National Housing Act requires the payment by the mortgagor of an annual insurance premium. This premium, together with other charges incident to the insurance of the mortgage, is calculated by actuarial authorities to be sufficient not only to pay the entire cost of administering the mortgage insurance, but also to maintain the integrity and solvency of the mutual mortgage insurance fund, which fund is the primary guarantee of payment to the mortgagee. Furthermore, the insurance itself is not payable in cash, but in debentures which constitute a primary obligation of the fund and do not mature until three years after the original maturity date of the mortgage. The insured mortgage also requires constant amortization of the borrowed principal.

These two requirements--the building up of the insurance fund and the constant reduction of the mortgage loans--alone make it extremely improbable that the Treasury will ever be called upon to meet its contingent obligation in the guarantee of the insurance debentures. In addition, the property upon which the insured mortgage is placed must meet definite

appraisal standards, pass construction inspections, and fulfill the other requirements provided in the law and regulations. When a default occurs and a mortgage is foreclosed, all the proceeds from the sale of the property, up to the amount of the mortgage indebtedness, is payable into the insurance fund.

In short, the private lender is encouraged to better housing standards and conditions through the persuasive influence of his financial resources, and he must do so in order to obtain the benefits of the insurance. The person ultimately benefited is the home owner or tenant who pays directly or indirectly the small cost incident to the protection he receives.

The safeguards thrown about the mutual mortgage insurance fund have been mentioned and the source of its income explained. There is every reason to believe in its enduring solvency. If, however, a situation should arise whereby the ultimate guarantee of the Treasury would come into operation, the extent of its participation would manifestly be small. By comparison with the volume of new housing and employment obtained, the cost would be inconsequential. Measured in terms of the reduction of relief rolls and of budgetary deficits, the maximum Treasury outlay that could possibly occur under the insured mortgage system is the cheapest employment assurance and budget-balancing assurance imaginable.