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Restricting non-farm real

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estate credit

Here is a draft of a memorandum on what can be done by the Federal Government, without further legislation, to restrict the current volume of mortgage lending. There are also some comments on powers needed for more general control.

The discussion here is fairly general, not going into detail about different FHA and VA programs. Even so, there is probably not much of substance that can be added to the discussion of the powers of the Home Loan Bank Board.

The comments on legal problems and issues in the last section are by an economist, and have not been cleared by the legal division.

Attachment

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## RESTRICTING NON-FARM REAL ESTATE CREDIT

Any attempt to restrict the amount of non-farm real estate credit extended must first take account of the Federal agencies which, over the last fifteen years, have been given the responsibility of encouraging the extension of such credit. There are three of these agencies, all of them represented on the National Housing Council established earlier this year to advise the Administrator of the Housing and Home Finance Agency -- the Federal Housing Administration, the Home Loan Bank Board, and the Veterans Administration.

The Federal Housing Administration insures mortgage loans on both houses for owner-occupancy and houses and apartments for rent. It insures mortgages of owner-occupants on both old and new houses. There are three distinct programs under which FHA now operates in insuring mortgages: peacetime Title II; War Housing Title VI, and Veterans' Emergency Housing Title VI. The Veterans Administration insures and guarantees mortgage loans on both old and new houses purchased by veterans. The Federal Home Loan Bank System, governed by the Home Loan Bank Board, charters Federal savings and loan associations, and augments the resources of all members.

The amount of mortgage lending currently being done under the sponsorship of these three agencies is roughly 55 per cent of total mortgage lending. About one-third of the total is lent by private individuals, trust funds and similar groups not subject to any public supervision. Uninsured lending by commercial banks, insurance companies and savings banks accounts for the bulk of the remainder. The volume of real estate mortgage lending would probably be reduced substantially if the Federal Housing Administration and the Veterans Administration were to tighten their present regulations, because undoubtedly a significant part of the loans they are underwriting would not be made by other lenders without the guarantee. If, in addition, commercial bank supervisors were to question all mortgage loans not conforming to the revised regulations of these two agencies, another deterrent would be offered to further expansion of mortgage credit. Individuals and similar lenders, difficult to regulate directly, might make some of the loans which would thus be frowned upon, but there would undoubtedly be a net reduction in loans. There seems to be little that the Home Loan Bank Board can do by direct regulation to restrict lending by savings and loan associations, but it could, perhaps, have a psychological effect by stiffening the terms on which the Federal Home Loan Banks make advances to members.

To be fully effective, restriction of mortgage credit would have to be in the form of general control of all lenders. This would require legislation, however, and offers many legal and administrative

problems. The discussion which follows suggests restrictions which could be imposed by Federal agencies without further legislation. In summary these are:

1. The Federal Housing Agency and the Veterans Administration could adopt regulations, effective during the period of inflationary pressures, so that:
  - a. Mortgages on existing houses may not be insured or guaranteed;
  - b. Mortgages on new construction having a maturity of more than eighteen years may not be insured or guaranteed; and
  - c. Mortgages on new construction representing a higher proportion of the value of the security than would be permitted if the loan were not insured or guaranteed, may not be insured or guaranteed.
2. Bank supervisory agencies could discourage the banks and other lenders under their jurisdiction from making uninsured or unguaranteed loans of the character mentioned above.
3. The Home Loan Bank Administration could tighten the terms under which Federal Home Loan Banks may make advances to member institutions.

Federal Housing Administration. The Federal Housing Administration was probably meant to function with more flexibility than the others. Maximum mortgage amounts, loan-value or loan-cost ratios, maturities, and interest rates are written into law, but the Commissioner has power to vary these items within the statutory limits. In practice, however, as builders and lenders have come to rely on the insurance, the changes made have been in the direction of easing the terms, and no instance comes to mind of a tightening of the regulations under any of these heads.

Legislative changes of recent years have relaxed terms, and, except in the case of interest rates, have thereby increased the range of administrative control. The maximum interest rate which may be charged on a Title II loan is still 5 per cent by statute (4-1/2 per cent by regulation), but the maximum rate on the Veterans' Emergency Housing Title VI loans is only 4 per cent. On the other hand, Title II stipulates that the mortgage amount on a new house may not exceed 90 per cent of value, while Title VI stipulates 90 per cent of "necessary current cost." This widening of the area of control has not been reflected in any apparent willingness of FHA to stiffen

controls, and it is probably true that if FHA were to act alone, it would lose business and thus lose what small anti-inflationary effect it has in the market.

If FHA were to decide to tighten its terms, there are two distinct approaches open to it. One is to change its regulations; the other is to issue instructions to its field offices setting conditions beyond those in the regulations. The regulations which could be made stronger are: (1) The maximum loan-value or loan-cost ratio could be reduced for selected types of loans, for selected builders in each area who are either building shoddily or overcharging, and for different borrowers, depending on the prospect of their being able to fulfill their obligations. (2) Maturities could be reduced. The present maximum of twenty-five years for new construction could be reduced to twenty, eighteen, or fifteen years with perhaps some well-defined exceptions. Maturities might also be made selective in the same way as loan-value ratios. (3) Interest rates might be specified at the maxima, rather than being left to the market. (4) All the foregoing regulations could be made still tighter for mortgages on old houses.

Instructions to the field could make the stiffer regulations highly selective. These instructions could range all the way from setting maximum amounts of insurance to be written each month in each insuring office to revision of locality rating standards, cost adjustment factors, and criteria for borrowers' incomes.

Veterans Administration. The Veterans Administration probably does not have the broad flexibility in its operations that FHA has, but it undoubtedly has greater powers than it has shown any disposition to use. In effect, it seems to take the position that the regulations must give as much as the law allows, as witness its recent castigating of lenders who demand down-payments. Beyond requiring that the amount paid by the veteran for his house shall not exceed "reasonable value," VA seems to be concerned mainly with the form of the loan documents. Probably the first steps that would have to be taken here are to convince VA that it has some responsibility for real estate inflation and that the Act under which it operates permits some flexibility of regulations.

Veterans Administration can do several things to control mortgage lending. It could make use of the FHA appraisal procedure either by having FHA appraise properties or by having its own appraisers use the FHA procedures; in many cases this would undoubtedly reduce the "reasonable value" of properties being mortgaged. It could introduce flexible maturities instead of permitting every loan to be for twenty-five years; it could exercise much greater discretion about the insurance of second mortgages, that is, mortgages not exceeding 20 per cent of "reasonable value" where FHA has insured the first mortgage; it could insist on stronger criteria of the ability of veterans to carry their obligations; and it might also be able to

rewrite its regulations concerning the paying of insurance so as to place some of the risk, even if only a small part, on the lender. Furthermore it could probably adopt regulations requiring that its permission be obtained before mortgages are sold or bought.

Home Loan Bank Board. The power of the Home Loan Bank Board to tighten lending practices of savings and loan associations is very small, and this is undoubtedly the area of Federally sponsored mortgage lending which is least amenable to Federal control. The Board sets the terms of lending by Federal savings and loan associations in the charters which it issues, but these charters, once issued, cannot be changed easily, except in the direction of relaxation. The Board's power over state-chartered associations extends only to those which are insured by the Federal Savings and Loan Insurance Corporation, or are members of the Home Loan Bank System. Here the primary means of control is through examinations, and the effectiveness of this control is markedly diminished by the need to consider the feelings of state supervisory agencies. Even in the case of Federal associations it is doubtful that examinations could be made an instrument of control, and if this were attempted, there would be several years of litigation before the power of the Board could be determined. A small degree of control can be exercised through the discounting policies of the Federal Home Loan Banks, but although the advances of these Banks to member associations have increased appreciably in recent months, associations still hold very large amounts of Government securities so that discount policy will not have any appreciable effect until either mortgage loans by savings and loan associations have increased very much further or share holders withdraw their share accounts in large volume. Discounting terms should probably be tightened, however, for whatever effect this will produce.

General control of mortgage credit. General mortgage credit control by the Federal Government appears to be most difficult for several reasons: Constitutional objections can be raised, and whether such a control would be upheld remains to be tested. There are also great administrative difficulties. If, as in the case of Regulation W, the regulation applies only to "those in the business," a very substantial part of current mortgage lending would escape regulation. Whether this part would increase appreciably with regulation, however, is open to question. Enforcement would also be difficult, the difficulties ranging all the way from devising an equitable base against which compliance is to be judged, through the ease of concealment of parts of transactions, to the possible impairment of the validity of legal titles involved in transactions which violated the regulation.

If a regulation is to be recommended, it seems desirable that it should cover all those engaged in the business of extending, or arranging for the extension of, credit on the security of real estate mortgages or for the purpose of acquiring or carrying real estate. Real estate here should probably be defined to cover all residential properties not located on farms, and vacant or improved land acquired for the purpose of being converted into residential real estate as here defined. The regulation should establish the maximum amount of credit which may be extended for the purposes covered by the regulation, the maximum maturities of the credits and the terms of repayment. The regulation should probably provide maximum ratios of loan to value; value should be defined, in the case of properties being transferred, as the bona fide purchase price, and, in the case of re-financing and similar transactions, the value should be established perhaps by appraisals, or by appraisals in the first instance and the last bona fide purchase price for those properties changing hands after the date of the regulation. In addition, the regulation would have to take care of trades. The regulation should be careful to supersede statutes such as those under which FHA, VA, and the Home Loan Bank Board operate, to the extent necessary to accomplish its purposes.