August 8, 1935

TO Governor Eccles

FROM J. M. Daiger

SUBJECT: Sale by banks of participating certificates in mortgages insured by FHA.

It appears from Mr. Ferguson's conversation of yesterday afternoon that a New Jersey banker who attended the conference held by Mr. Peter Grimm in Newark, New Jersey, on Monday suggested that banks might insure more mortgages with FHA if they were permitted to pool these mortgages, issue participating certificates against them, and sell the certificates to the investing public.

Mr. Ferguson quoted Mr. Arthur Walsh, former State Director for FHA in New Jersey and now Deputy Administrator of FHA in charge of Title I, to the effect that Mr. Grimm expressed at the Newark conference great enthusiasm for the FHA program, and also expressed himself very strongly in favor of adopting the proposal mentioned above. As I understand it, Mr. Grimm is expected to put the proposal forward at the conference which is to be held at the Treasury this morning.

The purpose of Mr. Ferguson's visit yesterday afternoon was to ask what my understanding was of the legal aspects of the proposed sale of participating certificates by banks, and in general what I thought of the merits of the proposal. Since this is a matter on which I have very positive views, which in recent weeks I have had occasion to express to Mr. Walsh and others at FHA who have been urging the resort to participating certificates as a substitute for the operation of Title III, I suggested to Mr. Ferguson that we also consult your

views, inasmuch as I did not know whether they would be the same as mine. It appears, however, that they are.

I would therefore suggest that you might summarize the objections to the proposal as follows:

1. Whether banks are permitted, under the Banking Act of 1933, to engage as dealers in the sale of mortgages to investors has been held to be doubtful, as I understand it, by the Attorney General, the Comptroller of the Currency, and the Federal Reserve Board. This doubt is removed by Section 303 (a) of the Banking Act of 1935 as far as mortgages are concerned, but whether this would also remove the doubt where participating certificates are concerned is itself doubtful.

2. Though there is no express provision of Federal law, past, present, or future, that either authorizes banks to issue participating certificates, or that prohibits them from doing so, both the Comptroller of the Currency and the Federal Reserve Board have long frowned on the practice and have sought to discourage it.

3. The pooling of mortgages and the issuance of participating certificates against them would be contrary to the whole effort of the past few years to get banks out, and keep them out, of the manufacture and sale of securities.

4. The sale of participating certificates would also be contrary to the spirit, if not actuallyto the letter, of the

National Housing Act itself, which in Title III specifically provides the conditions under which participating certificates may be issued and sold against mortgages insured under Title II. Though there is no specific prohibition against the Administrator's evading or circumventing the provisions of Title III, he would certainly be in an incongruous position if he were to adopt such a course.

5. Both the national bank examiners and the Federal Reserve examiners have found in the past that a great deal of trouble has resulted from the issuance of participating certificates by banks, but this is a kind of trouble that does not become apparent to the public generally until the banks run into difficulties.

6. There appear to be court decisions, notably in Illinois and Ohio, which hold the sale of participating certificates by banks to be outside the charter powers of banks and to be a violation of the first principle of trusteeship, which is to avoid self-dealing. The courts have also held that the banks are guarantors in fact, regardless of supposed sale without recourse, if they undertake to pay a fixed return on participating certificates. In other words, the bank exceeds its trust powers when it undertakes to fix the return that the investor in mortgages is to receive.

7. The only reason urged at this time in favor of authorizing participating certificates, as far as I know, is that it would increase the volume of business under Title II of the Housing Act. This seems to me to be wholly fallacious and to be the result of thinking in terms of banks singly rather than in terms of the money market in general and the mortgage market in particular.

8. There is nothing in the present state of the money market or the mortgage market that makes it necessary for FHA to go out and beat the bushes for individuals to invest in $100, $500, and $1,000 participating certificates. The existing agencies have an abundance of funds available for mortgage lending and they are lending more freely right along. The idea that any more could be made available, or that it could be made available more quickly, by having depositors invest directly instead of indirectly, is one that can be true only of a particular bank in a community and then only so long as that bank can force deposits out of competing institutions.

9. As a practical operating matter, the only banks that would have any incentive to sell participating certificates, even if they could force deposits out of other institutions, would be those that are already up to or approaching their limit on mortgage loans. The banks that have among them the

great bulk of funds available for mortgage lending are paying 2 per cent on such funds and can invest them at 5 per cent net in mortgages insured by FHA. Obviously, therefore, these banks would not themselves entertain the idea of driving funds out of their own savings departments in order to earn the much smaller spread afforded by the sale of participating certificates. Hence the FHA, in promoting the sale of these certificates, would be compelled to place its main reliance on the mortgage companies that it has approved as mortgagees. These companies would of course welcome as a godsend the opportunity thus given to them by FHA to pull savings away from the banks and the building and loan associations, but the result would be suicidal from the standpoint of the FHA's financial and political relations.

10. Even if it is assumed that the sale of the proposed certificates can be popularized through the banks, there nevertheless remains a political danger that I have previously pointed out in connection with the trust plan of selling insured mortgages to individuals—a danger which under the certificate plan would be greatly multiplied. I refer to the fact that the investing public, attracted to

the mortgages by a guarantee that is itself easily susceptible of being misunderstood by laymen, would tend strongly to lay at the doorstep of their Senators and Congressmen, the Federal Housing Administrator, or the President--and not at the doorstep of the trustee bank or the dealer bank--every default and even every delay in the collection of monthly interest and principal. Another serious aspect of this same political problem is that the business of servicing monthly-amortized mortgages is entirely new to most mortgagees and the profit possibilities of it still to be explored. There is thus inherent in both the trust plan and the certificate plan some reason for concern lest many approved mortgagees, when they cast accounts on the servicing of regularly diminishing debit balances, shall become discouraged and lax and in consequence greatly multiply the complaints that the investing public will direct to Washington against what they will inevitably regard as the breakdown of a governmental instrumentality.