



TREASURY DEPARTMENT

WASHINGTON

August 13, 1935

RE: SALE OF PARTICIPATING CERTIFICATES BY BANKS.

A digest of Governor Eccles' memorandum may best be made against an appraisal of the normal effect of the FHA program under Title II.

Our observations point to a housing shortage which, if the industrial up-swing continues, should become acute in 1937-8. Such a shortage is historically marked by - *I pray, earlier!*

1. Sharp advances in rents and property values.
2. Re-occupation of abandoned sub-standard housing.
3. Extraordinary construction activities followed by an over-supply of housing, depressed rents and values, and foreclosures.

FHA activities bring into the construction field somewhat in advance of actual demand funds which would otherwise be withheld until the shortage is upon us.

This tends to flatten out the shortage, and the rise in rents and values, minimizes re-occupation of abandoned facilities, discourages quantity production of flimsy housing, spreads construction activity over a longer period and retards over-supply.

At present the demand for new housing, which has been hibernating for several years, shows signs of life but is weak. Contributing factors are:

1. Assumption that credit facilities are not available.
2. Lack of immediate economic pressure for additional space.

The opening up of credit facilities and advertising of the approaching shortage should decidedly stimulate the demand.

The Eccles Memorandum

1. "Section 303 (a) of the Banking Act does not remove doubt respecting the power of banks to issue participating mortgage certificates."

If it does not, it may be amended to authorize such power, should such power be deemed wise.

2. "The Comptroller of the Currency has long frowned on the practice."

Inasmuch as Federally insured mortgages have not been heretofore available for such business, it may be well to re-appraise the practice.

3. "The practice is inconsistent with the trend to keep banks out of the manufacture and sale of securities."

Federally insured mortgages on real estate are hardly in the same class of security as that from dealing in which banks are intended to be excluded. Especially in smaller communities people look to banks for mortgage money. By broadening the market for sound mortgages, borrowers can be better served and private investors better accommodated, all with profit to the banks, there would appear to be no serious objection to such activity.

4. "The practice is inconsistent with the spirit, if not the letter of Title III."

The NMA is an additional device and not an exclusive instrument to provide liquidity. The spirit of Title III dramatizes the need for getting the funds of private investors into this field, and not merely the mechanics.

5. "The practice breeds trouble not apparent until the bank runs into difficulties."

The nature of trouble is not stated in the memorandum.
No comment.

- 6a. "Illinois and Ohio decisions hold the practice a violation of trusteeship because of self dealing."

- 6b. "Banks are guarantors in fact regardless of sale without recourse, when they undertake fixed return on participating certificates."

In states where it is held improper for banks to sell mortgages to their own trust funds, (procedure is undesirable everywhere) there can be no objection to the trust fund ~~making and paying for the~~ bank's facilities in making and servicing the mortgage.

The bank's guaranty is coupled with Federal insurance and exposes the bank to no risk of loss, particularly if the guaranty is limited to exchange of MMIF debentures for certificates.

7. "The impelling motive for advocating the practice is to increase b the volume of business under Title II. The fallacy consists in thinking in terms of banks singly rather than in terms of the money market in general and the mortgage market in particular."

Reference is made to preliminary comment.

8. "Existence of available funds in lending institutions deprives effort to stir up a market among private investors of any point."

Reference is made to preliminary comment.

9. "The only banks which would wish to sell certificates would be those approaching their mortgage limit. Until that limit is reached banks pay 2% for funds and invest at 5% net in FHA mortgages. The spread from sale of certificates is less. Only Mortgage Companies would profit and would do so by draining off savings in banks."

The spread in certificate sales is smaller. But the volume would produce greater profit.

Banks desiring the privilege have not indicated fear of mortgage company competition.

10a. "Political dangers inherent in popular misunderstanding of the insurance plan. Pressure to convert debentures into cash may be effective."

10b. "Monthly servicing is new and costs have yet to be explored. There may be laxity in collection of diminishing credit balances causing breakdown all along the line and direct popular appeal to Washington."

These contingencies are, of course, possible. Proper education, the transformation of the mortgage structure into a long term, steady amortization and monthly service plan, and the profit motive should make such contingencies highly improbable.

