FEDERAL RESERVE BOARD

WASHINGTON

ADDRESS OFFICIAL CORRESPONDENCE TO
THE FEDERAL RESERVE BOARD

August 15, 1935

COMMENTS ON MEMORANDA OF MR. COOLIDGE (AUGUST 14)

AND MR. GRIMM (AUGUST 13)

These memoranda, both dealing with the proposed sale by banks of participating certificates in home mortgages insured by the Federal Housing Administration, really involve separate and distinct proposals. Mr. Coolidge, apparently rejecting as entirely impracticable any pooling of mortgages, thinks that whether banks should be permitted to allocate participations in a single mortgage is a somewhat different question. Mr. Grimm, on the other hand, evidently contemplates the pooling of mortgages and the issuance of certificates against the pool. This would appear to follow, at least, from the nature of his suggestions, which seem to look toward whatever legislative or administrative authority may be required to create an instrument readily salable to small investors.

Leaving aside for the moment any legal questions involved in the two proposals, it may be pointed out that it is the sale of participations in a single mortgage that in the present instance is entirely impracticable. This is of course not the case with the ordinary three-year or five-year mortgage hitherto split up and sold by a number of banks to their customers, since these mortgages have a principal that is constant to maturity and the interest on this constant principal is ordinarily payable semi-annually or annually.

The most fundamental principle of the National Housing Act, however, is that of complete amortization by periodic payments. In practice, as the result of the overwhelming advice of men of seasoned judgment and experience in mortgage matters, the Federal Housing Administration, by regulation, requires these payments to be made monthly. The operation of this practice has been found to be eminently satisfactory to both lenders and borrowers, and it is the consensus of bankers who have been questioned in regard to it that the risk of default would be greatly increased if it were departed from.

But in any event—and this is the essential point—the piecemeal payment of interest and principal on participating certificates of small amount would be cumbersome and costly to the bank in its dual role of mortgagee and mortgage dealer, and altogether unsatisfactory to the small investor. The latter's interest and principal would come back to him in monthly driblets, his actual investment return would be substantially less than the rate of interest borne by the mortgage, and either his monthly receipts from his certificate would be gradually dissipated or he would be put to the necessity of depositing for slow accumulation at still less interest the small sums received from month to month as his mortgage investment diminished. In short, this is a "thrift plan" in reverse.

It would be an unwarrantable imposition, therefore, for an agency of the Federal Government to encourage persons of limited means and limited experience to engage in such an impracticable pursuit, and especially so when governmental protection is available in a variety of other investments which have none of the disadvantages that would be inherent in participating certificates in a monthly-installment mortgage.

From the standpoint of the larger investor, there is no occasion for the participating certificate as distinct from the whole mortgage. Only the very large investor can actually afford to carry monthly-installment mortgages, and the whole mortgage rather than the participating certificate is plainly the logical outlet for his funds. The practical course for him is to use the trust arrangement sanctioned by the Federal Housing Administration or, if his mortgage investments are of institutional proportions ($100,000 or more), to form a corporation eligible under FHA regulations to approval as a mortgagee.

As to the law in the matter of the sale by banks of participations in a single mortgage, it would appear that, upon the adoption of Section 303 (a) of the Banking Act, such sale would no longer be prohibited even though not expressly authorized. It may therefore be held by inference that the right of the banks to deal in mortgages, which Section 303 (a) is designed to clarify, carries with it the right to sell part of a mortgage. If this is the case, however, the implied legal sanction would be general in respect of all classes of mortgages, and action by the Federal Housing Administration predicated thereon in respect of insured mortgages would as a matter of course tend to encourage also the resort by banks to the use of participating certificates in the sale of uninsured mortgages. What the competitive result might be would thus become a moot question.

It may be noted, parenthetically, that this matter of split mortgages may come within the regulatory powers of the Federal Reserve Board if authority to regulate real-estate loans is given to the Board in accordance with one of the measures now pending with the conferees on the Banking Act. Otherwise, granted the adoption of Section 303 (a), there would appear to be no restriction, except such as the Federal Housing Administrator may impose in the case of mortgages insured under Title II of the National Housing Act, on the sale by banks of participations in any single mortgage. The banks engaging in such sale, however, would be proceeding without clearly defined authority of law. Furthermore, unless the policy of the Comptroller of the Currency and the Federal Reserve Board were altered, the sale would be in contravention of the long-standing advice of the examining authorities. The banks would also, in the case of mortgages not insured by the Federal Housing Administration, be flying in the face of a disastrous experience, as the records of the Comptroller's office and the Federal Reserve examiners will abundantly testify.

Since it would be manifestly impossible, as a matter of governmental policy, for the Federal Housing Administration to rely on an inference from Section 303 (a) that would in the very nature of the inference open wide the sale by banks of participations in all types of single mortgages, and since the sale of certificates against monthly-installment single mortgages is impracticable in any event, the real question raised by Mr. Grimm can be put in terms of very practical concreteness. It is whether Mr. McDonald shall ask Senator Bulkley to introduce in the Senate, and Congressman Steagall in the House, immediately on the adoption of the Banking Act of 1935, an amendment to Section 303 (a) expressly prohibiting the sale of any form of participating certificate against mortgages, with an exception in the case of certificates issued against pools of mortgages when the mortgages are insured under Title II of the Housing Act.

There does not appear to be any alternative that can be relied on, unless it is found possible to have such an amendment added in the pending conference to some section of the Banking Act in which there is a difference between the Senate and the House provisions. The provisions of the Senate and House measures are identical in respect of Section 303 (a), and the section is therefore not subject to amendment in conference. Even if the amendment were nevertheless made in conference by unanimous consent of the conferees—an utterly improbable eventuality—it would still be subject to a point of order on the floor and could be thrown out by a single objection in either the Senate or the House.

That there would be no lack of objectors, either among the conferees and on the floor, goes without saying; for the proposal touches an extremely sore spot with the "small thrift institutions"—the building and loan associations—and it would not have a parliamentary chance where unanimous consent was called for. The bitter fight over Title III of the Housing Bill last year grew out of the vigorous opposition of the building-and-loan people to any investment instrument that might exert a pull on potential purchasers of their shares. The proposal to authorize banks to sell certificates against pools of FHA-insured mortgages would invite not only this opposition, formidable in itself, but likewise the opposition of the large group in Congress that does not want the banks to go back into the business of manufacturing and selling securities of any kind.

In these circumstances, therefore, the suggestion in paragraph 1 of Mr. Grimm's comments on "The Eccles Memorandum"—namely, that Section 303 (a) of the Banking Act may be amended to authorize the proposed sale of participating certificates—does not seem to be one that can be availed of at the session of Congress now moving rapidly toward adjournment. And if this is the case, as it would certainly appear to be to persons intimately familiar with the course of the housing and the banking legislation, the other points raised by Mr. Grimm might be left to a later and more detailed memorandum or, preferably, to fuller discussion with various persons in Washington and elsewhere who have been called on to deal with these same matters at considerable length in the past. There are a great many of these persons, and Mr. Grimm would doubtless find a cross-section of their experience and views of practical use in the work that he is now undertaking.

It need not be supposed, however, that the lack of legislative authority for banks to sell certificates against pools of mortgages—which could at best reach only a fringe of the total mortgage market—will impede the progress residential construction or arrest the impetus that the Federal Housing Administration is giving to home-mortgage financing. In the present investment position of life insurance companies, building and loan associations, commercial banks, savings banks, trust companies and other trustees, and also of individual buyers of whole mortgages, there is an unprecedented volume of funds available for mortgage investment, and there is increasingly evident a pressure of these funds for investment.

From Mr. Grimm's memorandum, it would appear that he is of the impression that the demand for new housing is weak at present because of "assumption that credit facilities are not available," and because of "lack of immediate economic pressure for additional space." The latter factor is evident enough and the explanation of it is readily to be found in the depleted state of the national income (which is of course decisive in itself) and in the continuing disparity between rents and construction costs. These factors must of necessity be further remedied before a materially greater effective demand for additional space can assert itself.

But it is difficult to account for Mr. Grimm's evident impression that there is a widespread assumption on the part of prospective builders of new housing that credit facilities are not now available. Virtually every issue of the daily newspapers bears evidence in the advertising columns that mortgage money is being offered to home owners and home builders on more liberal terms than it has ever previously been available. During the past six months, and more particularly during the second quarter of the year, commercial and savings banks have been lending more freely, insurance companies have been lending more freely, building and loan associations have been lending more freely, the clients of mortgage brokers have been lending more freely; and there has been a universal complaint among these several classes of lenders that they cannot find enough borrowers. It is true that the more speculative types of real-estate loans which characterized the last boom period are not being made, and that facilities for making them are lacking; but there is certainly no impressive evidence or complaint in the lending community that good borrowers are holding back new housing because of an assumption on their part that credit facilities are not to be had.

There is of course no questioning the essential conclusion of Mr. Grimm's observations, which is that a housing shortage impends if the industrial upswing continues and that a boom with all its mischievous potentialities is therefore incipient. It should also be observed, however, that there is a reciprocal action between the industrial upswing and residential construction, and that an increasing proportion of the industrial upswing has become attributable in recent months to the marked upswing in new housing. Both these phenomena are evidences of the opening up of credit facilities.

Among these facilities are to be included those of Title II of the National Housing Act. They are facilities that have been available in really workable form, however, only over a period of some 60 or 90 days. In the light of this latter fact the volume of mortgages being currently offered to the Federal Housing Administration for insurance may reasonably be regarded as both notable and encouraging, and any concern over its rate of increase in relation to the limited period of practical operation of Title II would therefore seem to be premature. The test of the real effectiveness of Title II to date is not in the present volume of insurance applications, but in the impetus and direction that the FHA has given to residential construction and to the mortgage market as a whole in the way of easier money, lower interest rates, long-term loans, and the widespread trend toward amortization. The test of FHA's efforts in the insurance of mortgages will come with the evidence of whether or not the rate of progress attained in the past 60 or 90 days can be substantially accelerated.