Housing
Real Estate
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August 21, 1935

TO Mr. Coolidge

FROM M. S. Eccles

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

Since I may not have the opportunity, before I go on my vacation, to discuss fully with you and Mr. Grimm your memorandum and his on the proposed sale of participating certificates by banks, I am giving you my comments in this memorandum. The subject is one in which I am naturally very much interested, both from the point of view of the Federal Reserve System and the point of view of the Federal Housing Administration.

I think that the proposal is inadvisable and impracticable from both these points of view. Apart from this fact, however, I think that the drawing of small investors into the mortgage market would be a factor of relative unimportance in dealing with the refinancing of existing mortgages and the financing of new construction. In other words, I do not think that participating certificates are the remedy for any of the problems stated in the first part of Mr. Grimm's memorandum.

Frankly, it seems to me that Mr. Grimm has misconceived the purpose of Title II of the National Housing Act and also that

he has misconceived the present situation of the banks with regard to real-estate loans. According to the account recently published in the AMERICAN BANKER--under the heading "U. S. Treasury Studies Plan to Sell FHA Mortgages to Individuals"--"Mr. Grimm stated that he thought it would be advantageous for banks to sell some of their insured FHA mortgages to the public, thereby relieving banks of some of their mortgage load and making additional funds available for mortgages through drawing the public directly into this field."

This is the view that seems to be reflected in his comments on "The Eccles Memorandum." It is a view which implies (1) that banks can derive an advantage from disposing of their insurable mortgages rather than holding them, (2) that banks are overloaded with mortgages and in need of being relieved of at least part of their load, (3) that mortgage insurance was provided under Title II to facilitate the liquidation of mortgages by banks rather than to induce banks to increase their mortgage holdings, and (4) that the current volume of residential construction and the volume of funds available for mortgage financing can be increased by the device of selling participating certificates to individual investors.

These are all, as you are yourself well aware, erroneous assumptions. I have no doubt that Mr. Grimm has heard them voiced by some bankers, but nevertheless, as someone has put it, the first thing to be said about an error is that it is erroneous.

You express in your memorandum, commenting on Mr. Grimm's, the opinion that any pooling of mortgages by banks is entirely impracticable. You then go on to say, however, that "whether banks should be permitted to allocate the participations in a single mortgage is a somewhat different question." I agree with you that the questions are different, but I would point out that the sale of participations in a small mortgage (the FHA average is $4,159 and the maximum $16,000), amortized by equal monthly payments of interest and principal combined, is also entirely impracticable.

You will readily see that the piecemeal payment of interest and principal on participating certificates against such a mortgage would be cumbersome and costly to the bank in its dual role of mortgagee and mortgage dealer, and altogether unsatisfactory to the investor. The latter's interest and principal would come back to him in monthly driblets, his actual investment return would thus be substantially less than the return of interest borne by the mortgage, and either his monthly receipts from his certificate would be spent in driblets or he would be put to the necessity of depositing for slow accumulation the small sums received from month to month as his mortgage investment diminished. In short, this would be a "thrift plan" in reverse.

For an agency of the Federal Government to encourage persons of limited means and limited experience to engage in such an

impracticable pursuit would be, therefore, an unwarrantable imposition; 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 issued against a single monthly-payment-plan mortgage.

The article in the AMERICAN BANKER that I have referred to above says that, "in reply to Mr. Grimm's suggestion for the sale of FHA mortgages to the public," the disadvantages of participating certificates issued against a mortgage that is paid off in monthly installments were pointed out to him, and that there followed the suggestion that "one solution of the problem might lie in pooling groups of mortgages and selling debentures against them." This I take to be the plan that Mr. Grimm is advocating, and this is the plan that I had taken into consideration in writing my previous memorandum.

Now that the Banking Act has been adopted, and with Congress on the eve of adjournment, it seems to me like flogging a dead horse to press at this time a proposal for the adoption of which there is no clear legal authority, but on the contrary a considerable legal doubt. It is true that, as Mr. Grimm states at the outset of his comments on "The Eccles Memorandum," Section 303 (a) of the new Banking Act may be amended if in its present form it does not remove the doubt respecting the power of banks to issue participating certificates. This suggestion, however, is for obvious reasons

one that cannot be availed of until the next session of Congress. Nor could it have been availed of while the Banking Act was in conference, since Section 303 (a) had passed the House and the Senate in identical terms and hence was not subject to amendment in conference.

What Section 303 (a) does in practical effect is to authorize banks to deal in mortgages--to acquire mortgages with a view to their resale "without recourse or agreement to repurchase." It may therefore be held by inference, and has been so held in the past, that the right of a bank to deal in whole mortgages carries with it the right to deal in split mortgages. At any rate, with Section 303 (a) on the statute books, such transactions are no longer prohibited even though they are not expressly authorized.

The attitude of the banking conferees toward the split mortgage was plainly indicated, however, in the provision which they incorporated in Section 208 for the specific purpose of preventing national banks from purchasing split mortgages in any form. Under Section 208 a national bank may participate with others in the making of a real-estate loan in the first instance, but having acquired part of a mortgage in this manner it cannot, as I understand the new provision, dispose of that participation to another national bank. The conferees were plainly aiming at keeping the split mortgage out of national banks except in the kind of transactions that Mr. Jones had proposed as a means of two or more banks

joining in the making of real-estate loans that were too large for one bank to handle.

What legal authorization, then, could the Federal Housing Administrator rely on if he undertook to authorize banks, as approved mortgagees and acting as their own trustees, to issue participating certificates against pools of mortgages? As I see it, he would have only the implication that such certificates are not investment securities but are mortgages within the meaning of Section 303 (a). If this legal sanction does so exist, however, it is general in respect of all classes of mortgages, and action by the Federal Housing Administrator predicated thereon in respect of insured mortgages would as a matter of course tend to encourage also the resort by banks to the pooling of uninsured mortgages and the sale of participating certificates against these pools.

What the competitive result of this might be on the FHA program is of course a moot question, but my own view is that the Federal Housing Administrator would be opening a Pandora's box, that the FHA program would suffer, and that his action would rightfully be protested by the Comptroller of the Currency and the Federal Reserve Board. The banks engaging in the sale of participating certificates against pools of mortgages would be proceeding without clearly defined authority of law as to either insured or uninsured mortgages, while at the same time neither the Comptroller of the Currency nor the Federal Reserve Board would have the administrative authority

either to authorize the sale of one and prohibit the sale of the other or to prohibit the sale altogether.

I think I have said enough to make it evident that the Federal Housing Administrator would be under the necessity of obtaining the express authorization of Congress before he could as a practical administrative matter promulgate a regulation designed to bring about the sale by banks of participating certificates against pools of mortgages. Furthermore, I think it is obvious that the banks themselves, even if any considerable number of them might be willing to engage in the sale of such certificates, would insist upon knowing beyond all reasonable doubt that they were not subjecting themselves to the penalties of the Securities Act. Only Congress or the courts can give them that definite assurance.

It is pointless for me, then, to discuss further than I have done in my previous memorandum the matters referred to in the paragraphs numbered from 2 to 6b, inclusive, in Mr. Grimm's memorandum. If Congress itself authorizes the sale of participating certificates against pools of mortgages in the manner proposed by Mr. Grimm, the questions of law and policy that I raised in my previous memorandum in regard to these several matters (2 to 6b) would be sufficiently answered.

With regard to Mr. Grimm's comment (paragraph 4) on Title III of the Housing Act, however, I may say it is quite plain that he has been misinformed as to the purposes which the authors of this title

had in mind. They did intend it to supplant or discourage the old type of participating certificate and they did not design it to "dramatize the need for getting the funds of private investors into this field." I do not wish to go into a detailed discussion of Title III here, but I would suggest that, if Mr. Grimm is interested in learning the background of this title, he discuss it with Mr. Charles A. Miller, Mr. Winfield W. Riefler, and Mr. J. M. Daiger, who were its chief proponents. I myself have never been altogether in accord with their views on Title III, but I nevertheless recognize that it cannot be put to the test of practical operation until operations under Title II have progressed much farther than they have up to the present time.

As to Mr. Grimm's statement (paragraph 9) that the volume of certificate sales by banks would produce a greater profit than the banks could earn on the mortgages themselves, I would say that he is simply mistaken both in his arithmetic and in his estimate of the marketing probabilities. What he argues is theoretically possible in the case of banks individually, and actually attainable for a certain number of them, but it is not possible for the banking system as a whole and could not in the situation now existing alter the total result. The error here is the same as that mentioned in my previous memorandum with reference to the matters now referred to again in paragraphs 7 and 8 of Mr. Grimm's memorandum.

In regard to these matters, and also in regard to the matters referred to in paragraphs 10a and 10b, I can only reiterate what I said before, with the further suggestion, however, that if Mr. Grimm

desires additional information on these several points--or, for that matter, on any aspect of this whole question from the bankers' point of view--he obtain the considered judgment of the Administrative Committee of the American Bankers Association.

It need not be supposed, however, that the inability of 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 of residential construction or arrest the impetus that the Federal Housing Administration is giving to home-mortgage financing generally. 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.

Furthermore, the volume of funds potentially available for mortgage investment has been augmented to the extent of $1,100,000,000 by the adoption of the Banking Act of 1935. Prior to the adoption of this Act, the effective limit of mortgage lending by national banks was $3,600,000,000; it is now $4,700,000,000. Since the present volume of mortgages held by national banks is $1,300,000,000, there is thus potentially available from this source alone $3,400,000,000. Incidentally, it should be noted that the Banking Act contains several amendments designed to facilitate the financing of low-cost housing, under the provision of Section 207 of the National Housing Act, by means of bond

issues. These bonds would of course be available to individuals as well as to institutions, and would provide an even more convenient form of security for investors than would the proposed participating certificates.

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 associa-

tions 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 acceptable 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 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 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.