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September 11, 1935.

F. H. A. Insured Mortgage Program Now Offers Attractive Business to Banks

Recent revision of the Federal Housing Administration program seems to meet the practical needs of our banking system and to measurably improve earning prospects of many banks. Investments in mortgages insured by the F. H. A. offer a relatively higher return than most bank investments. Additionally, considerable income may be derived by trust departments that elect to act as trustees in connection with the servicing of such mortgages.

The National Housing Act, designed to improve methods of real estate financing, was signed by the President on June 27th, 1934. Although it was hailed at that time as a major recovery measure, the results to date have admittedly been disappointing. Only a small portion of the two billion dollars of mortgage insurance, the backbone of the program, authorized under Title II of the Act, has actually been utilized.

The importance of the mutual mortgage insurance program should not be minimized by the small volume achieved to date. The Act embodied a theory of financing hitherto untested in this country and a prolonged period of experimentation proved necessary to draft practicable regulations. Certain clarifying and other amendments to the Act, and certain provisions of the Banking Act of 1935, passed by the last session of Congress, are also calculated to give needed impetus to the program.

Banks which gave careful study to the insured mortgage plan when the Act was first passed and found it impractical, may well wish to reconsider its possibilities from their viewpoint in the light of the recently adopted changes. We feel that the Federal Housing Administration is now in a position to make an important contribution to business recovery and are encouraged to believe that we are on the threshold of a substantial recovery in residential construction.

The following article presents merely a birdseye view of the provisions and objectives of the mortgage insurance feature of this Act. We have available copies of the Administrative Rules and Regulations under Title II, and other data prepared by the Federal Housing Administration which we will be glad to make available upon request to those interested in studying this matter in more detail.

Objectives of F. H. A. Mutual Mortgage Insurance

The purpose of the insured mortgage principle as embodied in Title II of the National Housing Act was to eliminate the ill-advised methods of home financing in vogue prior to this depression. Formerly the cost of money for the construction of a home, to anyone who started with little money of his own and was obliged to borrow most of the funds, was so excessive that it accentuated the wholesale liquidation of real estate and loss of homes during the depression. Under the methods formerly in use, home financing usually involved a temporary construction loan, a first mortgage and a second mortgage. The second mortgage ordinarily was discounted at an excessive cost to the borrower. Additionally, there were charges for commissions and other services, which frequently raised the total cost of the borrowed money to as much as 20%.

First mortgage loans were usually made so conservatively as to defeat themselves. A first mortgage of 40% to 50% of the cost of the property may well have been the limit that was justified under the existing conditions, but it was just this inability to obtain first mortgage loans for a larger proportion of the cost of the property which forced most borrowers to resort to junior money at excessive charges. The resulting total cost of the money was so high that frequently it helped weaken the financial condition of the borrower and therefore defeated the purpose of the conservative first mortgage lender. Another major defect of the old methods of home financing, was that most mortgage loans made no provision for repayment by gradual amortization. Often such loans matured in such a short period that the average borrower never expected to repay the full loan upon maturity and was regularly forced to renew with periodical charges for such renewal.

The insured mortgage plan eradicates these defects in the old system; first, by reducing interest rates; second, by making eligible for insurance first mortgage loans up to 80% of the value of the house and lot; and third, by making amortization of such loans obligatory; and fourth, it eliminates renewal charges.

Mortgages Eligible for Insurance

In brief, the Federal Housing Administration under Title II of the Act, will now insure first mortgages, which do not exceed $16,000, and 80% of the appraised value of the property. These mortgages must mature in not more than 20 years, must be completely amortized by maturity and the interest rate may not exceed 5%. The insurance premium charged by the Federal Housing Administration is ½ of 1% per year of the original face value of the mortgage and a servicing charge up to ½ of 1% may be charged by the servicing institution. An initial service charge may be imposed by the mortgagee to reimburse itself for the cost of closing the transaction. Such charge shall not exceed 1% of the original principal amount of a mortgage covering existing construction and shall not exceed 2½% of the original principal amount of a mortgage covering property under construction or to be constructed.

The F. H. A. also requires that any mortgages to be insured by it must be serviced by an approved institution which will perform this function either on its own behalf or acting as trustee. An institution wishing to become a so-called approved mortgagee must file application with the F. H. A.

Characteristics of an Insured Mortgage From an Investment Viewpoint

This insurance is intended to protect the lender against loss on the loan if the borrower defaults. In the event of default, the lending institution, or the institution acting as trustee for the holder of the mortgage, must through foreclosure or through other means acquire title to the property and then convey good title to the Federal Housing Administration. The latter will, upon conveyance of title satisfactory to the Administrator and upon assignment to him of all claims of the mortgage against the mortgagor arising out of the mortgage transaction or foreclosure proceedings, deliver to the lender a 3% Debenture maturing three years after the first of July following the maturity date of the mortgage. This Debenture will be an obligation of the Mutual Mortgage Insurance Fund, but in the case of all mortgages insured prior to July 1, 1937, these Debentures will be Unconditionally Guaranteed as to Principal and Interest by the United States of America by endorsement on each Debenture by the Secretary of the Treasury. The Administrator will deliver these Debentures in an amount equal to the unpaid principal of the mortgage, plus all taxes and premiums for insurance against fire and other hazards paid by the lender during the period between the date of default and the date title is conveyed to the Administrator, and interest on the unpaid principal from the date foreclosure proceedings were instituted to the date of such delivery, less any amount received on account of interest accrued between such dates. The holder of the mortgage must, however, furnish the necessary foreclosure costs, for which he receives a certificate of claim determined by the Administrator to be sufficient to cover such outlay under which he will be reimbursed for these expenses, only if the Administrator realizes a net amount on the disposition of the property and other claims therewith conveyed to the Administrator sufficient to cover such expenses in addition to the face amount of debentures issued as above, plus all interest paid on such debentures and after deducting all expenses incurred by the Administrator in handling such property.

This brief description of the characteristics of an insured mortgage from an investment viewpoint is obviously inadequate. Those interested should obtain the administrative rules and regulations of the Federal Housing Administration covering mutual mortgage insurance. We have additional copies of these regulations available upon request.

Recent Developments Should Assure Fair Liquidity for F. H. A. Insured Mortgages

Much has been accomplished recently to give institutional investors in F. H. A. insured mortgages basis for the belief that such investments will enjoy a reasonable degree of marketability. The previously existing restriction which made it impossible for a national bank to place real estate loans outside its own Federal Reserve district or farther than 100 miles from the location of the bank, irrespective of district lines, has now been rescinded by an amendment to the Federal Reserve Act passed by the last session of Congress. This provision should greatly increase the mobility of the mortgage market. Moreover, the F. H. A. has recently announced a plan permitting banks that have qualified as approved mortgagees to dispose of mortgages originated by them while retaining the annual service fee of ½%. This should allow institutions in localities where there is a dearth of mortgage money, to induce a flow of funds from money centers. The announcement of the R. F. C. Mortgage Company, quoted below, that it had a revolving fund available for the purchase of insured mortgages to finance new construction should furnish a precedent for other institutions. Furthermore, insured mortgages may now be discounted at the Federal Home Loan banks, irrespective of whether the borrowing institution is a member of this System.

Additionally, the Banking Act of 1935 removes certain restrictions placed upon national banks in connection with real estate loans. Hitherto, the total amount of real estate loans which could be made by a national bank was limited to 25% of capital and surplus or to ½ of the bank's savings deposits. Under the 1935 Act, the proportion of funds has been raised to 100% of capital and surplus or 60% of time and savings deposits, whichever is greater. It has been estimated that this raised the effective limit of mortgage lending by national banks to approximately $4,700,000,000 or an increase of about $1,100,000,000. Currently, the volume of mortgages held by national banks is approximately $1,300,000,000. Numerous states have also passed laws making such insured mortgages eligible for purchase by savings banks, state commercial banks and trust funds. (Upon request, we shall be glad to furnish information as to the eligibility of these insured mortgages under the laws of the several states.)

The Banking Act of 1935 also provides that a Federal Reserve Bank, under rules and regulations prescribed by the Board of Governors of the Federal Reserve System, "may make advances to any member bank on its time or demand funds having maturities of not more than four months" and which "are secured to the satisfaction" of the Federal Reserve Bank. It has been pointed out that the effect is to make virtually the entire portfolios of banks "eligible," thereby rendering the majority of loans "liquid". This provision is of direct interest here since insured mortgages may be made eligible for Reserve advances to member banks. It may permit many banks to place less emphasis upon the liquidity of their assets and more importance on their return.

The RFC Mortgage Company Announces Available Funds for Investment in Insured Mortgages

Under Date of August 27th, 1935, Jesse H. Jones, chairman of the Reconstruction Finance Corporation, wrote the following letter to Mr. Stewart McDonald, Administrator of the Federal Housing Administration, to the effect that the R. F. C. Mortgage Company had funds available for investment in insured mortgages. Financial institutions which have been approved by the F. H. A. as mortgagees who wish to sell insured mortgages in this manner, should contact the Washington office of the Reconstruction Finance Corporation.

August 27, 1935

Dear Stewart:

For the purpose of encouraging the construction of new homes and to assist in creating a more general market for mortgages insured under the National Housing Act, the RFC Mortgage Company, will, until further notice and to the extent hereinafter named, buy and sell these insured mortgages.

For the present it will buy the mortgages at par and accrued interest, less a discount of ½ of 1%, but will only buy from reputable financial institutions originally making the loans, who agree to look after servicing them.

Any mortgages that we buy will be available for sale and when sold through qualified brokers and distributors, we will allow an over-all commission of ½ of 1% to cover their compensation and cost of distribution.

Under the new Banking Act banks may invest in these mortgages, and such investments will not be regarded as real estate loans. We feel that these mortgages also offer a desirable form of investment for institutions and fiduciary trust. The greater their distribution, the more home building we will have, and the more we will contribute to national recovery.

Commitments for the purchase of these mortgages will be considered by the RFC Mortgage Company at the 32 RFC Loan Agencies throughout the country, as soon as regulations can be issued.

$10,000,000 has been made available to the RFC Mortgage Company by the Reconstruction Finance Corporation as a revolving fund for this purpose.

Very truly yours,
(*signed*) JESSE H. JONES,
Chairman.

Mr. Stewart McDonald
Acting Administrator
Federal Housing Administration
Washington, D. C.

Trust Departments May Derive Income from This Program Without Permanent Investment in Insured Mortgages

Until July 30th last, no provision had been made for the distribution of insured mortgages to the general public. On that date, the F. H. A. approved a plan whereby trust departments of banks that have qualified as approved mortgagees of the F. H. A. may act as trustees for holders of mortgages and obtain a service charge not to exceed ½ of 1% per annum for their work in this connection. This is in addition to initial service charges which may be imposed by the mortgagee to reimburse itself for the cost of closing the transaction. Such charge shall not exceed 1% of the original principal amount of a mortgage covering existing construction and shall not exceed 2½% of the original principal amount of a mortgage covering property under construction or to be constructed. The F. H. A. has tentatively approved a form of living trust agreement that may be used for this purpose. This new plan may prove to be of major importance in making adequate funds available. It is a known fact that in many localities where a distinct housing shortage now exists, there is not sufficient capital in local banks and other financial institutions to provide the necessary funds. On the other hand, many institutions in the money centers are meeting difficulty in finding sufficient investments at an adequate return. This living trust arrangement should now make it possible for those institutions located in centers where additional mortgage money is required to originate and service such insured mortgages and to resell them to institutions in the money centers, as well as to some of their individual clients.

The following is a letter addressed by Robert M. Catharine, Deputy Administrator of the Federal Housing Administration, to banks and trust companies approved as mortgagees under the Housing Act:

July 30, 1935

To Banking Institutions and Trust Companies subject to governmental supervision approved as mortgagees under the National Housing Act:

Inquiries have reached the Federal Housing Administration concerning the possible purchase of insured mortgages by individual private investors. These inquiries originate from a recognition of the large amount of private capital which thus could be made available for investment, with entire safety of principal and at a satisfactory income yield.

As you are aware, the Rules and Regulations of the Insured Mortgage Plan, under Title II of the National Housing Act, do not authorize direct investment by the public in insured mortgages. However, it is possible by means of an appropriate trust instrument for an individual to participate directly in the insured mortgage program, and the Legal Division of the Federal Housing Administration has drafted two suggested forms of trust instruments tentatively setting forth an approved procedure.

One of these instruments is designed to cover the situation where an individual desires to invest in an individual mortgage and contains provisions for servicing the mortgage satisfactory to the Federal Housing Administration. In fact, this document can be used in such a manner that it is in effect no more than a servicing contract.

The other document covers the situation where an individual wishes to turn over to an approved mortgagee a larger amount of money to be held in a living trust, with power to invest in one or more insured mortgages. This instrument also contains provisions for servicing that are satisfactory to the Federal Housing Administration.

It is the feeling of this Administration that the trust procedure embodied in these two documents makes the insured mortgage available as an investment to all individuals for whom an amortized mortgage is a proper and desirable form of investment while at the same time safeguarding both the insured mortgage program and individual investors.

If you are interested in either or both of these plans, the Federal Housing Administration will be glad to furnish you copies of the above documents, together with suggestions as to their use. Please address communications on this subject to Mr. Leslie S. Baker, Manager Financial Relations, Field Division, Federal Housing Administration, Washington, D. C.

Very truly yours,
(*signed*) R. M. CATHARINE,
Deputy Administrator.

Revival of Residential Construction May Create Substantial Volume of Insured Mortgages

Competent students of the housing situation seem to believe that there is a real possibility for a substantial revival of residential construction. If this were to be the case, insured mortgages might soon prove to be one of the important types of investment for institutions. A study by Moody's Investors Service entitled "Residential Building — One of the Main Recovery Hopes," issued under date of July 18th, 1935, contains a well balanced analysis of the outlook. We quote the following summary from the study but suggest that those interested in estimating the possible volume of future mortgage business. Read the full text.

> "Residential construction has shown considerable improvement in recent months compared with last year, the gain to date being nearly 60 per cent. Such a large percentage is somewhat illusory due to the extreme depression which prevailed in this field in 1934; present activity is still about one-fifth of the average for 1923-25.
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> "The gains this year raise the question, however, whether a real change in trend is occurring or whether current activity is but a flash in the pan. This question is important not alone for the industry itself, but as well from the point of view of the outlook for general business. If continued and important gains can be expected in so large and so depressed a field of business as residential building, then the outlook for general business revival can be viewed with much greater confidence. If on the other hand a recovery of important proportions cannot be expected in residential building, the possibilities for general business gains are more restricted. Herein we have sought to examine all of the important factors, and to arrive at conclusions regarding them.
>
> "Residential building seems definitely to have reversed a down trend which started in 1928. Improvement of several years duration may reasonably be expected and this improvement *could* occur quite rapidly, though the speed of improvement is of course unpredictable."

Moody's Investors Service draws together a summary of several important clues to the building outlook, as follows:

> "1. The supply and condition of housing in relation to the population is as low if not lower than it has been any time in this century. The previous time when this condition existed, following the World War, a building boom resulted which covered ten years.
>
> "2. Distress conditions in the real estate market are disappearing, with the accompaniment of higher prices for existing structures.
>
> "3. Housing rentals have turned upward for the first time in ten years, and in view of the above facts should be expected to continue to rise for some time, though at what rate is not discernible.
>
> "4. Building costs continue relatively high in many regions, but not sufficiently so to strangle construction. Furthermore, increased attractiveness of the present type of construction adds a lure to new building at least partly offsetting relatively high cost.
>
> "5. Incomes and confidence in jobs are both rising.

To this may be added the estimate of a responsible national organization that vacancies now average less than 5 per cent as contrasted with the 7 per cent shown last year by the government survey. In addition, a shift from poorer to better residences is under way, which should continue for a time with the trend of incomes and thus accentuate the rise in rentals and values in all except the very poorest housing."

This Bulletin is compiled from sources which we believe reliable, but we cannot vouch for the accuracy of the facts or of the opinions contained therein.