FEDERAL RESERVE BOARD

WASHINGTON

ADDRESS OFFICIAL CORRESPONDENCE TO
THE FEDERAL RESERVE BOARD

September 21, 1935

MEMORANDUM ON LOW-COST HOUSING

TO Governor Eccles

FROM J. M. Daiger

This memorandum is in response to your request for an outline of the low-cost-housing program on which I have been working with the FHA people.

You will recall that my first move after you and Mr. McDonald had established a cooperative relationship between the Federal Housing Administration and the Federal Reserve Board was to advise the FHA people to prepare at once a list of the operating changes that it was desired to bring about in the interest of reducing the schedule of charges and simplifying the procedure under Title II. These changes I proceeded to divide into two classes, first those that could be accomplished by regulation, and second those that required legislation. The latter, in turn, I divided into those relating to home mortgages and those relating to low-cost housing.

The regulatory changes in regard to low-cost housing are incorporated in the proofs that I mailed to you from New York two or three weeks ago. These I had worked on with the technical and legal staffs of FHA. The legislative changes, with one exception, are incorporated in the Banking Act of 1935. These relate chiefly to the financing of low-cost housing by means of bond issues rather than single mortgages. The exception referred to is an amendment to Section 77 b -- the so-called corporate reorganization section-- of the Bankruptcy Act.

The effect of the amendment to the Bankruptcy Act is to exempt low-cost-housing projects on which mortgages are insured by FHA from the compulsory reorganization requirements of Section 77 b. This means simply that the holders of a mortgage or bonds on a low-cost-housing project cannot be forced by judicial decree to accept a plan of reorganization in the event of a default and receivership proceedings. In other words, prior to the adoption and signing of this amendment at the same time that the Banking Act was adopted and signed, ~~the effect of Section 77 b of the Bankruptcy Act was to nullify~~ the practical legal effect of Section 77 b of the Bankruptcy Act, in the case of a receivership of a low-cost-housing property on which the mortgage was insured by FHA, would apparently have been to deprive the holders of the mortgage or bonds of the benefits of the governmental guaranty -- an absurd legal situation, since the purpose of Congress in providing the guaranty was to induce private investment and to safeguard it against loss arising from mortgage defaults.

While these various amendments were pending I discussed with Governor Harrison on two or three occasions the possibility that, if the low-cost-housing program of the FHA were developed aggressively, it might in itself result in a considerable volume of new construction and at the same time, because of the amendments that I have here referred to, result in a new type of quasi-governmental bond issue for houses in the Street to underwrite and make a market in. Governor Harrison became very much interested in the matter; and I may say in this connection, parenthetically, that he has always shown a cooperative attitude toward the Housing program and a keen realization of the importance of a reopening of the mortgage market and a revival of construction as essential prerequisites to recovery. I think also that Win Riefler's intimacy with Allan Sproul, who was formerly with the San Francisco bank and who is now Assistant to the Governor at the New York bank, has been very helpful in this respect.

I asked Governor Harrison some weeks before the adoption of the Banking Act with the low-cost-housing amendments if he would tell me who, in his opinion, was the best man in the Street to look into the low-cost-housing set-up from the point of view of bond underwriting and distribution. Several names had been suggested to me by various friends of mine in New York, and I turned these names over to Governor Harrison for consideration. The outcome of this was that he suggested Mr. George N. Lindsay, a partner in the firm of Speyer & Co., as the best man in the Street to look into the matter and as one who also, Governor Harrison found, had some knowledge of the FHA picture in general as a result of his firm's association with Chas. E. Quincey & Co. (the firm that Ted Goldsmith is with). Governor Harrison said that Lindsay had formerly been with Blair, but that this need not be regarded as a detriment, for Lindsay nevertheless had the reputation and the ability in the underwriting and distributing field, was very highly regarded, and had a strong institutional following.

Until I went to New York for the week of August 23 to 29, inclusive, I had myself not met Mr. Lindsay, but I had been in touch with him by telephone and through Governor Harrison, Dr. Burgess and Ted Goldsmith. Meanwhile, however, Lindsay had his firm's Counsel explore the matter and arranged to work closely with Quincey & Co., Speyer & Co. remaining in the background until the first group of issues (I shall explain this presently) is ready to be underwritten and sold.

In Governor Harrison's absence, Dr. Burgess, with whom Governor Harrison had fully discussed the matter, invited Lindsay, Riefler and myself to luncheon at the New York bank, at which we went into the FHA's low-cost-housing set-up at considerable length. To put the afternoon's discussion in a few words, Lindsay said that he thought the set-up was wholly practicable from the point of view of the Street, that the bonds would be readily taken in large lots by the commercial banks, the savings banks, the trust companies, and the insurance companies, and that there would be no difficulty in maintaining a market in the bonds. His chief regret was that a very large volume of issues was not yet in prospect. He said that his firm's lawyers had raised various questions that would of course have to be answered before any issues were underwritten. I think that we have matters so arranged, however, that the President will ask the Attorney General for whatever opinion may be required to cover these questions and that the opinion will satisfy the bankers.

I have already sent to you a copy of a letter, "Mortgages Insured by F.H.A.", that Quincey & Co. have distributed to a large mailing list of banks, investment houses, etc. I went over the draft of this circular with Goldsmith, who also had some help on it from Don Woodward of Moody's, whom I had previously gotten to write the two Moody letters on the FHA. On this same trip I talked with some of the men I know in Pask & Walbridge, who have been interested in the FHA set-up for some time with a view to acting as brokers in mortgages insured by FHA. This firm has also been seriously considering the set-up of a national mortgage association. I believe that I have previously spoken to you about their plan to act as dealers in FHA mortgages. This firm was also preparing a letter on "F.H.A. Insured Mortgages".

Since my meeting with Mr. Lindsay three weeks ago, the two firms, Speyer and Quincey, have been quietly sounding out the larger institutions in New York as to what their attitude would be toward the proposed bond issues. The plan with regard to offering the bond issues, briefly, is for Speyer and Quincey, probably in association with other houses as a matter of friendly policy, to underwrite at one time issues on low-cost-housing projects in several cities, sell these issues among a number of large institutions, but without a public offering, and then to give a great deal of publicity to a "matter of record only" advertisement. The Speyer and Quincey men say that their inquiries among institutions thus far bear out their own impression that the attitude toward the bond issues will be highly favorable and that the bonds can be sold on about a 4% basis. The Equitable Life and the Prudential, by the way, are among the institutions thus reported as favorable to the plan of financing low-cost housing through bond issues against mortgages insured by FHA.

The Quincey letter was advertised last week in the New York Times and elsewhere, and also received a good deal of publicity through the news columns. I am enclosing some samples for you. Goldsmith told me on Tuesday of this week, when I was again at the New York bank, that eighty-seven inquiries from New York City alone were received by messenger and telephone on the morning the advertisement was published. He tells me that since then the number of persons writing for copies of the circulars, plus the office inquiries, has reached a total of about 350. This is not as large a number as his firm received on a similar instance with regard to HOLC bonds, but Goldsmith thinks that there is in the present instance more real interest as evidenced by persons coming into the office and talking the FHA set-up over after they have read the circular mailed out in response to inquiries. Goldsmith also tells me that, even apart from the proposed bond issues, the Equitable Life, like the New York Life, indicates a willingness to take any FHA mortgages it can get it hands on, and that the Bowery Savings Bank and the Emigrant Industrial Savings Bank are also changing their tone toward FHA as a result of the interest roused in New York by this recent financial publicity.

Pask & Walbridge during the past few weeks have been accumulating some FHA mortgages which they have as brokers taken from various banks to be held by the Manufacturers Trust and the New York Trust pending the sale of the mortgages. In other words, the Manufacturers Trust and New York Trust have the mortgages put in their names as approved mortgagees and carry them for Pask & Walbridge as brokers. On Wednesday of this week Pask & Walbridge advertised in the New York Times $1,250,000 of these FHA mortgages for sale. At the same time they sent out to their mailing list a circular on "F. H. A. Insured Mortgages". McCoy of Pask & Walbridge told me yesterday that the publishing of the advertisement and the mailing of the circular resulted in three of their office men being kept on the telephone all day taking care of inquiries. They had on those two days about two hundred letters and telephone calls from a buying angle and about fifty ~~calls~~ from a selling angle. One of the resulting transactions (I believe this is a matter of confidential information) was a $250,000 purchase by the Yale University Fund.

The Pask & Walbridge activities, of course, do not relate directly to low-cost housing as the Speyer and Quincey activities do; but the news-column publicity and the response to the advertisements nevertheless show the extent of the interest roused among both institutional and individual investors when the FHA set-up, as to home mortgages as well as low-cost housing, is presented in financial terms, as I have been trying to get it presented, instead of in terms of ballyhoo, as the FHA people have unfortunately been doing it heretofore.

Now as to the FHA set-up as clarified and simplified by the recent amendments to the banking act, the housing act, and the bankruptcy act, and by the revised regulations presently to be issued after the legal questions referred to above have been determined by the Attorney General.

Under Section 207 of Title II of the National Housing Act, the Federal Housing Administrator is authorized to insure mortgages not in excess of $10,000,000 each on "low-cost housing" for "persons of low income". Mortgages thus insurable are not limited either as to 80% of appraised value of the property or as to the maximum term of twenty years, both of which restrictions apply to the insurance of urban home mortgages up to $16,000 each. As a practical matter, however, restriction to 80% is necessary owing to that limitation being generally placed by State laws on the investment of trust funds, savings funds, and insurance funds in mortgages insured by FHA. On the other hand, the twenty-years maximum maturity would not be practicable for large-scale operations, so that in practice a mortgage on a low-cost housing project insured by FHA might be made for fifteen years, with amortization down to 50% in that period, or might be made for a correspondingly longer period for full amortization.

The FHA set-up makes it possible for private capital to finance large housing projects that are low-cost properties in fact as well as in name. As ordinarily used, the term "low-cost housing" is made applicable to properties that are designed for occupancy at an uneconomic rent. In other words, such properties should really be referred to as low-rent housing, or subsidized housing, or new modern housing for the very poor, rather than as low-cost housing; for the cost of such properties may be, and in fact usually and inevitably is, very high. They are rented, however, at rates substantially below the economic rent level.] Under the FHA set-up, as compared with the ordinary method of financing large projects, whether groups of individual dwellings or apartment structures, it is possible for private enterprise to effect a material reduction in construction costs, particularly in respect of such items as the usual promotion fee, commission or bonus on first mortgage, heavy discount on second mortgage, subordination of high fees for architect and contractor, and other such carrying charges ordinarily present. The elimination of some of these charges and the reduction of others of them accomplishes a reduction in rent schedules by economic means rather than by artificial means.

A further reduction in the cost of such housing under the FHA set-up, with a corresponding further reduction in rent schedules, is accomplished through the efficient planning, construction, and operation of a group of dwelling units, and through the control of rents, charges, capital structure, rate of return, and methods of operation of the mortgagor during the term of the insured mortgage.

In other words a private enterprise in this case would take the form of a limited-dividend corporation for a period of, say, fifteen years during which the mortgage would run. During these fifteen years this limited dividend corporation would have to conform to the requirements of the Federal Housing Administration. At the end of the fifteen years, when it had paid its insured mortgage down to, say, 50%, it could if it wished refinance its mortgage by whatever other means were available and be relieved of the limited dividend restrictions. The equity interest would be built up meanwhile, however, on terms far more favorable than could possibly be obtained through the methods heretofore prevailing for the financing of large-scale operations.

The kinds of properties that may be financed under the FHA set-up may comprise individual dwellings, moderate-sized multiple dwellings, large apartment structures, or any practicable combination of these. Up to the present time

142 applications for the insurance of mortgages on low-cost housing have been received by the FHA, and of these 66 have been found to warrant serious consideration. These 66 projects involve an estimated cost of approximately $175,000,000. They range from a $150,000 mortgage on a row-house development in a Chicago suburb to a $5,500,000 mortgage on a strictly urban apartment development in Brooklyn. These two projects mentioned, by the way, are among those which have been approved. There are thus far 12 projects, involving a total cost of $27,867,000, on which the FHA has issued tentative commitments to insure mortgages, the mortgages amounting altogether to $21,286,000. The others are still under examination or negotiation with the sponsors, in which connection the FHA is trying to help the sponsors get the projects into such shape that they will be economically sound and eligible for mortgage insurance.

¶ The first of the projects approved for mortgage insurance was that of Colonial Village, which is suburban to Washington on the Virginia side of the Potomac and within quick access of the downtown section of Washington. The application for insurance on this project was submitted January 12, and less than a month later had been examined and worked into such shape that a commitment to insure could be and was issued. Shortly thereafter the sponsors, who are the owners of the Westchester

Apartments, a very large and successful development in Washington, arranged the financing of the insured mortgage with the New York Life Insurance Company. In less than eight months after the first application was submitted, families began to move into the completed dwellings, of which there are between 250 and 300 units. Long before this, however, the property was 100% rented from the blue prints and an enormous surplus of applications was accumulated. Two similar developments on adjacent sites are now projected; the plans on the first of these two have been completed and approved for mortgage insurance, and negotiations for the mortgage financing have now been initiated.

I can say from my own knowledge and observation of Washington real estate over the past fifteen years that Colonial Village, under the FHA set-up, represents the best rental value that has been offered in Washington within this period, and that it is probably by far the most soundly financed large-scale project that has been undertaken in Washington within that period. The institutional mortgagee is well satisfied with its 80% mortgage investment, the owners of the equity are well satisfied, and the facts that I have related with regard to the rental applications certainly make it evident that the "white-collar workers" are well satisfied. Any interested person who may entertain a doubt as to whether the low-cost housing program of the FHA is feasible would be amply repaid by a visit to Washington to inspect this completed project at first hand and to inquire directly into the nature of its capital structure and plan of operation.

Financing has been arranged for two or three other approved projects and on one of them, at Meadville, Pennsylvania, work is practically ready to start. I believe that this is the one on which the funds for the first-mortgage financing are being supplied by one of the State pension funds -- an illustration of how such funds can be put to a use which will have results that are both economically and socially beneficial. The Brooklyn project, of $5,500,000, is being financed by the New York Life Insurance Company, and this project is also nearly ready to start.

The only real obstacle to a very much more rapid progress in this low-cost-housing program has been the problem of obtaining mortgage money at interest rates low enough to assure sound economic operation. The financing thus far approved carries a rate of 4½%. Up to the present time, however, the sponsors of these projects have had to rely mainly on life insurance funds, since the insurance companies are virtually the only institutions large enough to finance large-scale operations. The amendments in the Banking Act open this type of financing to other classes of institutions, first by providing for bond issues, second by allowing such bonds to be classified as investment securities rather than as real estate loans, and third by authorizing banks to go joint account in making mortgage loans. The bonds or the mortgages, as the case may be, will be legal investments for savings banks, insurance companies, and trust funds in practically all States. The advantages of the bond form over the mortgage form from the standpoint of marketability are obvious; the character of market that may be anticipated for the bonds I have already indicated above. I should say that the result of the statutory amendments and regulatory amendments, therefore, will be to greatly facilitate the financing of low-cost-housing projects as soon as the opportunities in this field are fully realized by construction interests, material interests, and banking interests. When these opportunities are realized, the life insurance companies will no longer have a virtual monopoly as they have had up to the present time, and the carrying out of the program will no longer be dependent solely on the attitude of a few large insurance companies toward the National Housing Act.

From present indications, I should say that within a month or two several of these bond issues will be ready for issue on a 4% basis. A large bank, of course, might very well wish to make an entire mortgage loan on a low-cost-housing project, or a group of banks might wish to combine to advance the money on a large project, setting up a bond issue for private sale, with each bank agreeing in advance to take a certain part of the issue for its investment account.

Thus, by taking bonds offerred by underwriting syndicates in New York or elsewhere or by direct loans in either of the methods that I have indicated, the banks of the country can do a great deal to foster a low-cost-housing program of projects entirely owned and financed by private capital. Moreover, they can do this without serious apprehension on the score of governmental competition. The volume of construction accomplished to date by PWA is inconsequential and but a small fraction of the total long since made available for PWA housing. A recent announcement from Hyde Park would indicate that out of the $4,800,000,000 work-relief fund a total of only $100,000,000 will be made available to PWA for low-cost housing. This is but a drop in the construction bucket, and may be regarded as sufficient only for a very limited experiment in the effort to provide new modern housing for persons who cannot be reached at all by new private construction. At any rate, I think it would be reasonable to infer that banks and other private lending agencies have been given a breathing spell which puts them in a position to assume a greatly increased responsibility in meeting the requirements of the country for low-cost-housing development.

No one is in a better position than the bankers and other mortgage lenders to know that in the last period of construction activity the luxury or relatively high-rent type of residential construction was the kind that was mainly overdone. There was during that period relatively little construction that the white-collar population could occupy except under boom conditions. In the FHA set-up for low-cost housing, emphasis is put on the necessity of economic soundness of the project and, where limited-dividend corporations are involved, on the fact that the financing must come entirely from private funds. The chief element in what is here meant by economic soundness is the use of planning, financing, and construction methods far in advance of practices heretofore prevalent. Particular emphasis is laid on neighborhood and community planning, with every practical safeguard against depreciation of the investment in future years for lack of prudent foresight. Criteria are also laid down for the planning of the buildings themselves, with particular reference to adequate light and air and open spaces in contrast to the previous common practice of overcrowding the land.

If projects submitted to the FHA for low-cost-housing insurance obviously fall within the luxury class, or are obliged to compete for a tenancy by offering extraordinary facilities and services, they will not be held to constitute low-cost housing and the insurance will be refused. If the accommodations projected are incompatible with the general character of the community or neighborhood, and would thus impair the economic soundness of the undertaking, the insurance will be refused.

If a reasonable choice of accommodations is already available in a neighborhood at a rental which persons of relatively low income can afford to pay, or if such accommodations can be provided in a given community by new housing constructed and financed in the ordinary way, no additional housing for persons in these low-income groups will be considered as low-cost housing within the meaning of Section 207 of Title II.

The FHA is authorized to insure low-cost-housing projects submitted by Federal, State, or municipal agencies that receive public grants, subsidies, or other advantages not available to private limited-dividend corporations. If such projects are submitted, however, they must be designed for persons of lower income than can be served by wholly private operation, and the accommodations must be designed for and restricted to such lower income groups, so that the projects may not be directly competitive with private operations. Even in these cases, however, part of the funds -- that is, the part represented by the insured mortgage -- would be provided by private capital. The extent to which this provision of the Housing Act might be used, therefore, would depend on the willingness of private enterprise to effect a sort of partnership with the various types of public agencies concerned with low-cost housing.

I should add that in my opinion the Low-Cost Housing Division of FHA is the most competently organized and managed part of the Federal Housing Administration. It has a level-headed director (Miles Colean of Chicago) and an able staff of architects, engineers, and other technicians. The division seems to me to be free of the promotional spirit that permeates the other divisions handling Title II and free also of the delusive dreams and emotionalism that permeate the Housing Division of PWA.