Form No. 131

Office Correspondence

FEDERAL RESERVE BOARD

Date January 2, 1936

To Miss Egbert

From Miss Morgan

Subject: Attached memorandum

16—852

Mr. Daiger wishes Governor Eccles to have the attached copy of a memorandum, with the explanation that it is not yet completed. The concluding sections are to deal with the insurance of large-scale new building projects and large-scale rehabilitation projects and with Title III. Mr. Daiger expects to complete these sections at home today and to have them here in the morning.

Mr. Daiger says that he talked with Mr. Ferguson about this memorandum on Tuesday and that Mr. Ferguson will be prepared to give him a quick answer on the parts that will require legislation.

Copies of the attached memorandum are being delivered by messenger today to Mr. Ferguson, Mr. McDonald, Mr. Grimm and Mr. Delano, with the explanation that the concluding sections are to follow tomorrow.

Mr. Daiger regrets that he is still unable to return to the office.

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Preliminary and confidential

First draft 12/30/1935 (JMD)

SUGGESTIONS FOR 1936 HOUSING PROGRAM

Briefly defined, a program is a plan of intended action. More specifically, it is a plan of action on which there is an accord among scheduled participants who (1) have a clear understanding of their respective parts and (2) are agreed as to the effect to be aimed at by their acting in concert.

The essential requisite of a program, then--housing program or any other--is that it shall be susceptible of performance. It is this quality of being susceptible of performance, of translation into action, that distinguishes a program from a statement of purposes or objectives, which may be less a plan of intended action than a mere expression of hopes or desires.

To the question, "What is the housing program for 1936?" the appropriate answer is a statement of what we are going to do in 1936. In other words, a 1936 housing program must be susceptible of performance within the brief time-span of the building season that for the country as a whole runs from early spring to late summer. And, since time and feasibility are of the essence of such a program, it must of necessity be projected with full regard to existing condi-

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tions and existing facilities.

For example, there is no gainsaying that housing standards in the United States are deplorably low, or that the construction industry in the United States is deplorably inefficient, or that mortgage financing in the United States is (or at least has been until the past year) deplorably unrealistic and costly. But this is simply to say that in these respects we have long been a backward people. A prudent program for 1936 will recognize that fact and will therefore, as a matter of practical policy, be adapted in the main, or at least readily adaptable, to the following factors:

(a) The existing framework of Federal, State, and local legislation;

(b) The existing operating framework of governmental and private agencies;

(c) The existing cost structure of building materials and building labor;

(d) The existing unintegrated and undercapitalized state of the construction industry;

(e) The existing limited cash accumulation and current income of the main body of potential buyers of houses; and

(f) The existing demand for modern moderate-priced accommodations for rent as well as for sale.

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With these factors in mind, the suggestion is put forward that the Administration's housing program for 1936 might well be concentrated on (1) giving a vigorous impetus to the construction of relatively low-priced houses by both operative builders and prospective owner-occupants, and (2) encouraging the entrance of substantial units of private capital into large-scale construction of relatively low-priced houses and apartments.

The benefits of such a program, it is suggested, would reach a much larger number of persons, and would accomplish a much more widespread raising of housing standards for both the middle and the lower income-groups, than would be possible either by a long-continued revival of private speculative construction of high-priced houses and high-rent apartments, such as was prevalent in the 1920's, or by an experiment in public housing predicated on the inability of private enterprise to supply new modern accommodations at half, or less than half, the actual current cost.

It is further suggested that the kind of housing that will in the long run, as well as in the short run of the 1936 building season, produce the largest number of new modern units, and hence most rapidly accelerate the rate of obsolesence in existing decaying units, is that which can be built at the lowest economic price for the largest potential sale or rental market. In the present state of the construction industry

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in the United States, that price would seem to be approximately $5,000 for a six-room house, or less for a house of smaller size or for an apartment unit; and the market for such housing would seem to be among persons earning from $1,500 to $3,000 a year.

There is apparently no dissent to the assertion, often made contentiously, that new modern housing for the lowest income-groups cannot be produced, on the basis of the existing construction technique and costs, at an economic price. It is to be noted, however, in this connection, that the same assertion might be made without dispute in regard to many non-luxury items of convenience and comfort besides new modern housing. On the other hand, new modern housing for the higher income-groups—i. e., families that can pay from $6,000 to $20,000 or more for a house--is now being supplied in steadily increasing volume by private enterprise, and, in the absence of a sharp recession of business generally, the revival in that field can be expected to continue, if not indeed to overreach itself, without further special inducements in the way of financing terms.

By what means, then--by what practicable means--might the Federal Government give a vigorous impetus to the building by private enterprise of relatively low-priced housing?

From the point of view of conservative fiscal policy, the most economical means would seem to be for the Government to underwrite

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the marginal risks involved in giving a quick stimulus to construction financing and mortgage financing in this field of housing. Such risks are in the main, as experience has shown, social risks--i. e., arising from causes beyond the control of any one lending institution or other investor, and hence too great for such institutions and other investors to assume individually, especially in a period of emergence from severe depression and capital impairment.

When pooled in insurance funds, however, under prudent conditions and limitations, the risks take on a different aspect. If they are largely confined, as proposed to the class of housing for which there is the widest market whatever the prevailing economic conditions, the aggregate cost in relation to the volume of construction stimulated should be very small--say $\frac{1}{4}$ of 1 per cent per annum over the mortgage term.

The following detailed suggestions proceed, then, (a) from the fundamental principle of having the Government underwrite the social risks of giving a quick stimulus to the building of relatively low-priced housing, and (b) from the practical policy of further implementing existing governmental and private agencies that are in a position to aid and encourage private building enterprise:

1. Title I of the Housing Act might be extended from April 1, 1936 to July 1, 1937. In that event, however, the total insurance

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liability which the Administrator may incur might be reduced to $100,000,000 (experience now shows such a fund to be ample) and the insurance, furthermore, might be confined strictly to loans for improvements to real estate.

2. The maximum rate of interest authorized on Title I loans might be reduced from the present discount basis of 5 per cent to 4 per cent on the annual initial debit. This would give, at true interest, approximately 7 3/4 per cent, with the Government in practical effect underwriting the entire risk.

3. In the case of Title I loans for structural changes (as distinguished from papering, painting, repairs, etc.) the maximum authorized amount on residential property might be increased from the present $2,000 to $10,000, and the maximum authorized term from the present 5 years to 10 years; provided that in the event of such larger sum or longer term the maximum rate of interest authorized shall not exceed a discount basis of 3 per cent on the annual initial debit.

4. Of the $200,000,000 now appropriated as an insurance fund for repair-and-improvement loans under Title I, $100,000,000 might be authorized for use by the Administrator up to July 1, 1937, as a revolving fund to insure construction loans (exclusive of loans under Section 207) up to 20 per cent of the total amount of such loans

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by an approved mortgagee; provided that any such loan shall not exceed $4,500 per dwelling unit; provided further that the construction loan is supplemented by a commitment for a mortgage loan under the provisions of Title II; provided further that the charge for servicing such construction loan shall not exceed 2 per cent and that the rate of interest, exclusive of such service charge, shall not exceed 5 per cent per annum.

5. The maximum authorized interest on mortgages eligible to insurance under Title II might be reduced to 5 per cent net per annum, or 4½ per cent interest, plus a service charge of ½ of 1 per cent per annum, both interest and service charge being calculated on decreasing balances. This would be in conformity with the original purpose and intent of the Housing Act and with the prevailing public interpretation of the President's statement in regard thereto, and hence should remove a source of much misunderstanding and criticism on the part of both borrowers and lending agencies.

6. In the case of mortgages on new construction, the present limitation of $1,000,000,000 on the amount to be insured might be increased to $5,000,000,000, and the present limitation of the Government guaranty to debentures issued prior to July 1, 1937, might be removed altogether. These limitations in Sections 203 and 204 respectively of Title II would in themselves be enough to render Title III of the

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Housing Act utterly impracticable, since their effect is to preclude private enterprise from subscribing the permanent capital and supplying the personnel required for the type of long-term, large-scale operations contemplated in Title III. The two limitations referred to, together with another that will be mentioned presently (paragraph below), are fatal as far as any public benefits that might be derived from Title III are concerned. Apart from this hampering aspect of the limitations, however, is the still more serious fact that they fail to take into realistic account the enormous volume of private residential building that must be induced if, on the one hand, housing construction is to play an important part in raising the national income and bringing the budget into balance, and if, on the other hand, the social and economic repercussions of an acute housing shortage, a consequent rent crisis, and, inevitably in turn, widespread rent legislation that would quickly paralyze housing construction, are to be averted. Not even the most sanguine optimism would lead one to anticipate an effective solution of these problems by July 1, 1937, nor to assume that the insurance of $1,000,000,000 of mortgages on new construction--less than half an ordinary year's production of housing--would go far toward hastening such a solution. If the ultimate net cost of insuring $5,000,000,000 of mortgages on new construction should be as much as $250,000,000 (which is a high estimate) and if the Government should sustain all the realized losses

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from year to year over the mortgage term (which is not contemplated in these proposals), the cost should still be small in comparison with the social and economic gains at stake. The gains in employment alone, and the resultant savings in unemployment relief, should far more than justify any actual loss that might ultimately devolve on the Treasury.

7. To simplify administrative procedure for both the Federal Housing Administration and its approved mortgagees, and to reduce to a minimum the hazards of excessive appraisals and of fraud and collusion in the making of appraisals, the eligibility requirements for mortgage insurance might, in one important particular, be more clearly specified in Section 203(b) of Title II. That is, the mortgagor might be required to make a down payment of 20 per cent in cash or its equivalent--e.g., real estate or securities--and the mortgage thereby made insurable up to 80 per cent of the appraised value of the property, but not in any event for more than the appraised value of the improvements exclusive of the appraised value of the land. (This was the original conception of the insurable mortgage risk, the complement of which was the borrower's reasonable ability to pay in periodic installments.) In the case of refunding mortgages on "old" construction, provision might be made in Section 203(b) for insurance up to the aggregate mortgage indebtedness on the property as of a certain date, say July 1, 1935; provided, however, that the insurance shall not exceed 80 per cent of the appraised value of the property, and shall not in any event exceed

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the appraised value of the improvements exclusive of the appraised value of the land. There seems to be a concensus of opinion among mortgage-lending institutions that the Federal Housing Administration has surpassed private agencies in devising a sound appraisal system. That the standards established are observed in practice, however--i.e., that borrowers and lenders are actually given the protective benefits of a thorough and exacting inspection and appraisal service--seems to be seriously questioned, and doubt is thus cast on the equitable apportionment of the mortgage risks and on the ultimate value of the insurance funds. Yet it is only fair to assume that the Federal Housing Administration is neither lax nor unduly "liberal" in its appraisals and that the great bulk of these appraisals conform to the established standards. The fact remains, however, that the present wide variability of the down-payment makes exceptionable appraisals the more likely to occur and renders the agency vulnerable to sharp practice, loose practice, and criticism by outsiders, besides subjecting many of its employees, unnecessarily, to pressure and temptation. Statutory provisions of the kind here proposed, coupled with severe criminal penalties for their wilful violation by misrepresentation, fraud, or collusion, should not only remedy these defects, but bring to Title II a larger measure of conservative institutional support. Inclusion in the Home Loan Bank Act of similar restrictions with respect to uninsured loans

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of, say, 70 per cent or more by Federal savings and loan associations, or by any member agencies of the Federal Home Loan Bank System henceforth receiving advances of capital funds from the Home Owners' Loan Corporation, should similarly protect the various parties at interest in these institutions and allay the criticism (a) that the governmental advances are carelessly re-loaned and (b) that Federal savings and loan associations in particular are loose in their appraisal and lending practices. In this whole connection, it is to be noted that the central, regional, and local offices of the Federal Housing Administration and the Federal Home Loan Bank Board appear to be given to mutual suspicion and distrust, and to criticising each other even more severely than they are themselves criticised by various private agencies. To an impartial observer, acquainted with much of the operating personnel of both agencies and friendly to both, there can be no doubt that each group is quite sincere in regarding the other as a contaminating influence in the mortgage field, winking at dubious practices if not actually encouraging them. Since this attitude is detrimental to the interests of the Administration of which both agencies are a part, and detrimental as well to the housing program and to the two agencies themselves, it is suggested that a rapprochement between them be sought through an early meeting and frank exchange of views among their principal operating officers.

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8. The limitation of mortgage insurance to 80 per cent of the appraised value of the property might be changed to 90 per cent in the case of mortgages on new construction where the loan does not exceed $4,500; provided that the mortgagor makes a down-payment of 10 per cent under the revised eligibility provisions proposed in paragraph 7 immediately above; and provided further that payment of an additional 10 per cent of the purchase price is guaranteed by the operative builder or the building contractor, as the case may be, or in agreed several parts by such builder or contractor and two or more building-material manufacturers, until the mortgage has been reduced to 75 per cent of the original purchase price. Inasmuch as this is an adaptation of British practice, it should be noted, parenthetically, that, whereas in Great Britain the bulk of small-house construction is done on a large scale by a few building companies of considerable substance, in the United States housing construction is done largely at haphazard, with little or no coordination, by thousands of land developers and operative builders whose financial resources are as a rule extremely limited. The largest factors in the American construction industry are the manufacturers of building materials--American Radiator, Johns-Manville, Atlas Cement (subsidiary of U. S. Steel), Weyerhauser, Westinghouse, National Lead, Pittsburgh Plate Glass, etc. Hence it may more often be preferable, as a matter of practical credit policy

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to induce "90 per cent loans," to tie in the material manufacturers rather than place much reliance on the willingness of lending institutions to accept the guarantee of the operative builder or building contractor. (Lumber, brick, plumbing, concrete, and heating supplies are, in the order named, the principal materials entering into American residential construction, and account for more than 75 per cent of the total cost of all materials so used.) If the insurance of loans up to 90 per cent of the appraised value of the property is authorized under the conditions here suggested, the term authorized for loans in excess of 80 per cent might be extended to 25 years, since the hazard of shoddy construction would be minimized, or at least substantially reduced, by having a responsible guarantor or guarantors over the period in which defects in construction might ordinarily be expected to appear. In the event that the insurance of loans up to 90 per cent and up to 25 years is authorized, appropriate supplementary legislation should be provided to authorize national banks and Federal savings and loan associations to make, purchase, and sell loans so insured, and to authorize national mortgage associations to purchase and sell loans so insured. State legislation would be required to authorize such loans by other classes of lending agencies. This might be attainable early in 1936 in 11 States whose legislatures are scheduled to meet during the winter months. Among these is New York State, where the Governor and the General Assembly have thus far manifested a wholly cooperative

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attitude in furthering enabling legislation to give effect within the State to the National Housing Act. Early action by Congress would of course be an essential prerequisite to State enabling legislation this winter.

9. As a further means of stimulating the construction of relatively low-priced housing, provision might be made by Congress for the Federal Government to absorb the cost of insurance, including retroactively that already in effect, on mortgages up to $4,500 when such mortgages are insured under Title II prior to July 1, 1937, and on mortgages covering large-scale operations under Section 207 of Title II and insured prior to July 1, 1937. This would be in effect a nominal subsidy that would result in a lowering of monthly carrying charges or rentals and that might accordingly still further accelerate and broaden the market for new construction. On the basis of a total volume to July 1, 1937, of $1,000,000,000 of the class of construction to which the proposal would apply--a high estimate for the period contemplated--the gross cost of absorbing the insurance would be approximately $5,000,000 a year for 20 years, or $100,000,000, and the ultimate net cost probably about $50,000,000. Since the mortgages would represent at most from 80 per cent to 90 per cent of the total private expenditure involved, the ultimate net cost of the mortgage-insurance premiums paid by the Government instead of by the borrowers might be expected to fall below 5 per cent of the

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total private expenditure for this class of construction in the period ending July 1, 1937. No lump-sum appropriation would be required to give effect to this provision, and the annual disbursement to be authorized in any event would be very small.

10. The insurance of mortgages on construction existing prior to the passage of the Housing Act might be discontinued, either as of July 1, 1937, as now provided, or at an earlier date, say as of April 1, 1936. This is recognized as debatable ground, however, especially in view of the action of Congress in putting existing construction on a par with new construction when the Act was passed (the Housing Bill as introduced limited insurance of mortgages on existing construction to 60 per cent as against 80 per cent on new construction). Furthermore, the process of converting existing mortgages to a long-term, amortized basis at the rates currently prevailing for mortgage money is far from complete. Hence to foreclose the opportunity for such conversion by premature termination of half the operations contemplated in the existing form of Title II might provoke widespread misunderstanding and resentment, and, what is of more practical economic consequence, might place the refinancing of mortgages under some handicap and thus disturb the orderly progress which the mortgage market has been making since last spring. It is of course true that the risks involved in "80 per cent loans" on old houses are greater than in the case of such loans on new houses; but the adoption of the suggestions made in paragraph 7 above

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(regulation of down-payment and provision against insuring increased indebtedness) would go far toward reducing this disparity and at the same time preserve to mortgagors the economic benefits of a single long-term mortgage at a low rate of interest.

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