

Rough Draft
March 13, 1936

MEMORANDUM ON HOLC'S SECOND-MORTGAGE PROPOSAL

Among various legislative proposals which Mr. Fahey has submitted to the Director of the Budget for review is one which would authorize the Home Owners' Loan Corporation to make loans to individuals "to buy, build, or improve homes not exceeding \$5,000 for their own occupancy." Provision is made (a) that the loans shall not exceed 20 per cent of the appraised value of the property and (b) that the loans may be made "as part of or subject to loans by other lenders." Further provision is made to authorize the HOLC to sell \$200,000,000 of its obligations for the purpose of making these subordinate loans.

It is to be noted, in the first place, that this is not a proposal for the specific purpose of stimulating the construction of new homes. The funds could be used for that purpose, but the bill as drafted expressly provides that the funds may also be used for two other purposes--namely, to supply part of the purchase money on existing homes and to provide improvement loans on existing homes.

In the second place, it is to be noted that the proposal is not for the specific purpose of enabling small homes to be purchased on a down payment of 10 per cent. Here, too, the funds could be used for that purpose, but they could also be used under the express pro-

visions of the bill for a quite different purpose--namely, to supplement any mortgage on a property valued up to \$5,000 regardless of the ratio of first mortgage to appraised value. For example, under the express provisions of the bill a first mortgage of \$2,500, representing 50 per cent of appraised value, could be supplemented by an HOLC loan of \$1,000. In this case the Federal Government would be supplying the borrower with nearly 30 per cent of the purchase money, while at the same time in practical effect supplying the "other lender" with a high-yield prime investment that would otherwise be unobtainable under the conditions now prevailing in the investment market.

There is certainly no existing or prospective credit stringency that would give the Federal Government any reasonable excuse or justification for embarking in the business of making second-mortgage loans on existing properties and second-mortgage loans for home-improvement purposes. Nor would there be any reasonable excuse or justification for the Federal Government's embarking in the business of making second-mortgage loans to finance new construction that can be financed by private lending agencies under the terms of existing State and Federal legislation governing first-mortgage loans. That would put the Federal Government in direct competition with active private lenders.

For another thing, the proposal makes no specific provision as to the terms of either the first or second mortgage financing con-

templated in the bill. If it is assumed that the interest rate on the second mortgage would be the 5 per cent rate charged by the HOLC on its distress loans, the Federal Government would be in the anomalous position--notably with regard to building and loan associations--of providing cheap capital funds to the institutions and cheap second-mortgage money to their borrowers without limitation on the interest rate and commissions charged on the first-mortgage loans. The result would be in practical effect a governmental guaranty of well-secured first mortgage loans on which the borrowers are charged 6, 7, and 8 per cent, plus commissions.

The principal argument advanced for the second-mortgage proposal is that many institutions are still unwilling or reluctant to make loans in excess of 50 or 60 per cent--at the very most 70 per cent--of the appraised value of the property, and that a second-mortgage loan is therefore necessary to stimulate lending and to make available to borrowers loans up to 70, or 80, or 90 per cent. With almost equal vigor, however, the proponents of second-mortgage lending by the Government argue that to authorize FHA to insure first mortgages on small homes up to 90 per cent would place many institutions at a competitive disadvantage because of the lack of enabling legislation in a number of States for loans above 80 per cent.

The second of these arguments is not absolutely incompatible with the first, but it does severely strain the logic of the case, for what it contends is that institutions would be at a competitive disadvantage in being unable to do something that they do not want to do in any event. It might have been argued with equal force in 1934 that the 80 per cent loans authorized in the Housing Act put certain classes of institutions at a temporary competitive disadvantage. That kind of temporary situation is inevitable under our dual form of government.

But it is on the ground of its conflict with clearly defined Administration policies that the second-mortgage proposal is most objectionable. To begin with, it would place the Administration in the absurd position of facing two ways in the matter of first-mortgage loans. If there is one contribution more notable than others which the Administration has made toward the improvement and strengthening of mortgage-lending practices, it is to be found in the increasing acceptance by private institutions of the long-term, monthly-payment first mortgage made at a low rate of interest and for a substantial proportion of the appraised value of the property. Certainly this tendency on the part of private institutions is to be encouraged in the interest of home-buyers and in the interest of long-range stability in the mortgage market. It would be as certainly discouraged, however, if not

actually halted, by a sudden reversal of policy in which the Federal Government not only encouraged second mortgages, but actually made them with public funds.

The second-mortgage proposal also runs directly counter to the avowed fiscal and banking policy of the Administration. For two years the Administration has been directing its efforts toward getting the Federal Government out of the business of direct lending and toward inducing a revival of construction by private enterprise and private capital. These efforts have been fruitful, and the good faith of the Administration with respect to them has been thus far demonstrated by its record. The expectation that the direct-lending activities of the Government would continue to diminish, rather than be increased, is widely held--and rightly so--because spokesmen of the Administration have repeatedly asserted that this was its intention and determination.

It is undoubtedly true that, if the Federal Government were to make funds available for second mortgages, some new construction would result that might not otherwise be undertaken. But anyone who knows the temper of the business and financial community as a whole, as distinguished from the small part of it that might stand to gain directly from this new governmental lending or largesse, must be apprehensive, to say the least, of the ridicule and resentment that would

accompany the launching of the HOLC into an activity so utterly unrelated to the relief of home owners in distress.

In short, though the move would perhaps enhance the prestige of the HOLC among the building and loan associations that might naturally be expected to be the chief users of its second-mortgage facilities, it would embarrass and hamper the activities of other governmental agencies and would impair the prestige of the Administration as a whole.