Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date June 4, 1936.

To Mr. Daiger.

From Mr. Thurston.

Subject: Letter from Mr. Edward E. Brown, President, The First National Bank of Chicago.

GPO 16—852

The Chairman asked me to get you to prepare a learned and devastating reply to the attached.

He wants to stress the big volume of savings; the fact that people do not have the equity to borrow on such restricted terms as this bank is offering; that the reason bank earnings are poor is because of the failure of the banks to respond to demands for mortgage credit on the liberalized basis made possible under the law; that the second mortgage type of financing is cockeyed and caused a lot of the trouble in the recent painful past; that if the banks are going to sit back waiting for second mortgages to come back, then they are sunk; that Ned Brown has failed to grasp the opportunity now presented; that it is dismaying to have ~~as~~ enlightened a banker as he really is still operating on Model T theories; that other big banks are now beginning to respond very aggressively in the mortgage field and are helping to bring about the financing which means more business and employment and hence recovery and a balanced budget and everybody living happily ever after.

In case you have any ideas of your own, you might put those into the letter too !

Attachment.
ET:b

June 24, 1936

Dear Elliott:

The letter to Mr. Brown of the First National in Chicago will be typed in my absence. I wish that you would look it over, therefore, before it is passed on to Mr. Eccles for his signature.

With thanks,

June 25, 1936

Dear Ned:

Since receiving your letter of May 28 expressing your views and those of your bank on real-estate loans in general and FHA insured mortgages in particular, I have been intending to write to you further in this matter, but preliminary to doing so I have been making some inquiry as to the extent to which other banks are now using the insured mortgage both for their own account and for their trust estates.

Of course, I am fully aware that the pursuit of a given policy by a large number of banks is not necessarily to be taken as conclusive evidence that the policy is sound. It is to be taken, however, as prima facie evidence of soundness; for it reflects the judgment arrived at independently by a great many bankers who have found good and sufficient reasons for putting the policy into practice.

In the present instance one of these reasons, presumably, is that the policy is profitable as well as sound--certainly a compelling reason at a time when bank earnings are hard to come by. And so I am led to wonder, after seeing the latest figures on bank activity in insured mortgages, whether you and the First National and the other non-participants are not passing up good business simply because you have failed to look into it as fully as the several thousand participating banks have.

It appears from the information given to me by the FHA that 6,470 banks have qualified as approved mortgagees under Title II of the Housing Act, and that of this number 3,424 are now listed as active. In the earlier period of FHA operation the number of banks approved as mortgagees from week to week was considerably greater than the number that went on the active list during those same weeks. More recently, the number of banks becoming active from week to week has been considerably larger than the number added during those same weeks to the list of approved mortgagees.

Thus it is evident that a good many banks which at first went through the formality of obtaining the approved status simply as a polite gesture are now really getting down to business. The extent of this activity among the participating banks is shown by some additional figures. Of the volume of mortgages accepted for insurance by the FHA to the end of last month, $196,234,348, or approximately 70 per cent of the total, came from banks. The number of mortgages insured for banks at that date was 49,153. This puts the average insured mortgage handled by banks at about $4,000, which would appear to be a pretty safe average for the country as a whole and well within the limit of "not more than $20,000" that you specify for a mortgage on a single-family house.

Furthermore, the current business in insured mortgages is at a considerably higher rate than the aggregate volume for the nineteen months of Title II operation would indicate. The total for all groups of lending institutions in March was approximately $23,000,000, in April approximately $28,000,000, and in May approximately $35,000,000. The total for June to date is in excess of $35,000,000. In other words, the volume is running currently well over $1,000,000 a day, with the banks still accounting for approximately 70 per cent of it.

Now I am frank to say that it is disturbing to me when I find a banker as enlightened as you are, and as influential as you are, taking the position that you do notwithstanding the mortgage experience of the past five years. I mean specifically the position of sitting back in the expectation that a market for second mortgages will eventually develop if only you wait long enough, and that you will then be able to satisfy the demand of your bank and the demand of your trust estates for mortgages on a 50 per cent basis, or at least on a 60 per cent basis.

You say in your letter that you cannot now get enough mortgages, and you indicate that the reason is that there is practically no second-mortgage money available in Chicago. But you also say that, though there is very little residential building activity within the city proper, there is a very considerable amount of building going on in the suburbs, where houses are being put up in large numbers by builders who intend to sell them when completed.

In short, there is a demand for mortgage credit in your area that you are not meeting, and the reason you are not meeting it is that no one is willing to hold the second-mortgage bag for you.

You recognize the fact that people do not have a sufficient equity to borrow on the restricted terms that you are willing to offer, for you say that no means are available for financing the difference between a 50 per cent or 60 per cent loan and the sale price. You do have the means, however, of financing an 80 per cent loan; but you will not do this because in your opinion the whole theory of the Housing Act is "fundamentally unsound."

My own view is that it is your position on second mortgages that is fundamentally unsound. I think that the mortgage experience of the past five years has demonstrated, as forcibly as any financial fact can be demonstrated, that the second mortgage is unsound from the point of view of the borrower, unsound from the point of view of the first-mortgage lender, and unsound from the point of view of the mortgage system as a whole. The fundamental conception of the Housing Act, insofar as the insurance of mortgages is concerned, is to eliminate the hazards of the second mortgage and all the unsound first-mortgage practices that the second mortgage made possible and encouraged.

The existence of the second mortgage gave the holder of the first mortgage an utterly false sense of security--a security that was found not to exist at all when put to the practical test in a large way. In the first place, it added unduly, and more often than not exorbitantly, to the initial cost of the property, and thus gave it a fictitious value. What was nominally, therefore, a 50 per cent or 60 per cent first mortgage was frequently, in reality, a mortgage of considerably larger proportion because of the hidden charges for secondary financing loaded into the selling price.

In the second place, the illusory security of the second mortgage was responsible more than any other factor for the failure to require regular periodic curtailment of the first mortgage. In practice this meant that, although the holder of the first mortgage had a prior lien on the property of the borrower, the holder of the second mortgage had a prior lien on his income. Whether the charges for the second-mortgage money were excessive and burdensome was a question with which the first-mortgage lender did not concern himself. Since he looked primarily to the property for his security, he rarely made any effort to determine the ability of the borrower actually to pay for the property.

For another thing, the illusory security of the second mortgage encouraged the legal fiction of the short-term first mortgage--a three-year or five-year obligation that neither the borrower nor the lender expected to be paid when it fell due. The multiplication of these misnamed "renewal" loans, which tended in practice to become perpetual debts, led to a situation in which virtually every mortgage loan in the portfolio of many institutions fell due and became payable in a period when borrowers were least able to meet the demands made upon them. Thus the persistence of the legal fiction of the short-term mortgage brought about a widespread condition of default that the more prudent and more realistic long-term amortized mortgage could have averted.

Yet you say that the whole theory of the Act by which the effort is made to do away with these costly and misguided practices is fundamentally unsound. I must say that I do not know how you arrive at any such conclusion, and much less why you think it would be a good thing for your bank and its borrowers if the second-mortgage market were to be revived. Even if the revival of the second-mortgage market that you are waiting for were possible--and there certainly seems to be no early prospect of it--your borrowers would simply have to pay through the nose for money that your own bank can now make available at a profit to itself and with the full protection of FHA insurance.

Why, then, turn the business away? And what are banks going to do with the huge volume of savings they hold if they do not get into the largest market that is developing as an outlet for savings funds in their communities? I think it is plain enough that, if banks do not respond to demands for credit on the liberalized terms that the Housing Act and the Banking Act make possible, either they will have to yield up a large part of their savings business to other institutions that will take a practical view of the matter, or else the Government will have to get farther into the mortgage business instead of getting out of it.

So it seems to me fortunate that all bankers do not have the attitude toward the insured mortgage that you have; and so also I wish that you would try to look into the FHA set-up again, first putting aside whatever preconceptions you have in order that you may approach the question with an open mind. I do not say that the set-up is perfect; I do say that it is soundly conceived and that in my judgment it is an immense improvement over any other system of mortgage lending that you and I have ever known in the past. If you want me to send one of our men who is thoroughly familiar with it out to see you, or to talk with the men in your real-estate-loan department, I shall be glad to do it, for I think it would be a good thing for the bank and a good thing for the community if the First National were active in extending this kind of credit.

In view of your remark that the Continental is the only important bank in Chicago handling mortgages insured by the FHA, I think you will be interested in knowing that six banks in Chicago have among them thus far approximately $2,500,000 of mortgages that the FHA has insured. Three of the large trust companies in New York and three of the large banks in Boston also have each taken a very substantial amount of this business. There are some fifteen banks in other cities that have insured more than $1,000,000 each, including five that have insured more than $2,000,000 each.

I really think that you are neglecting a good thing.

With kindest regards, I am

Sincerely yours,

M. S. Eccles,
Chairman

Mr. Edward E. Brown, President
The First National Bank
Chicago, Illinois

JMD