TO Chairman Eccles

FROM J. M. Daiger

Fall
1936

1

MEMORANDUM ON THE CONSOLIDATED DRAFT
OF LEGISLATION
PROPOSED BY THE
HOME OWNERS LOAN CORPORATION
FEDERAL HOUSING ADMINISTRATION

The proposed amendments to the National Housing Act and the Home Owners Loan Corporation Act contained in the consolidated draft of the legislation above referred to, are set forth in Sections 2 to 31 and Sections 32 to 42, respectively. The great majority of these amendments are simply technical or clarifying in nature and require no detailed comment.

***** *****************

Taking up first the proposed amendments to the National Housing Act, the following are those which to some degree involve substantive changes in the present statute:

1. Section 6 authorizes the Administrator to insure mortgages in excess of eighty percent (80%) upon properties appraised at not more than forty-five hundred dollars ($4,500) and constructed after January 1, 1936 and before July 1, 1937.

The purpose of this amendment is to meet a possible need for a substantial stimulation of construction of homes for the lower income groups. This is accomplished by enabling the Administrator to reduce the amount of the twenty percent (20%) cash equity now required of the borrower to such extent as may be consistent with sound lending practice. To this end the amendment expressly provides that the Administrator may require the mortgagor to furnish such security in addition to the mortgage as may be deemed adequate to secure that amount by which the mortgage debt exceeds eighty percent (80%) of the appraised value of the property. In many instances, persons with small but steady incomes are not in a position to accumulate twenty percent (20%) of the cost of a home for the down payment although their general credit standing or other collateral resources are ample to secure their loan.

This proposed amendment would enable the Administrator to establish regulations under which each case of this character could be handled upon its merits, thus permitting worthy borrowers, able to meet all requirements except that of a twenty percent (20%) down payment, to buy or build homes, the cost of which is within the scope of their present and reasonably anticipated income.

It is not intended that the amendment should entail the unrestricted financing of small homes; but that in every case, the soundness of the transaction would be carefully scrutinized and a loan in excess of eighty percent (80%) would be approved only where the borrower is in a position to support the excess, either by putting up securities, personal property, or other additional collateral, by obtaining the endorsement or guarantee of his note by some other financially responsible person, or by otherwise complying with regulations designed to make the excess loan secure.

2. Section 10 amends Section 204(b) of the National Housing Act by removing therefrom the date July 1, 1937 upon which the government guarantee of debentures issued by the Administration in exchange for foreclosed property expires.

It is obvious that for the insurance of the Federal Housing Administration to be acceptable in the market, the debentures must be either guaranteed or supported by a capital fund which is sufficient in amount to inspire the confidence of those who purchase insurance. The fund of $10,000,000 appropriated in the National Housing Act for this purpose is far too small in proportion to the volume of business of $2,000,000,000 authorized to accomplish this.

The reinsurance fund is to be built up by transferring to it when group accounts are closed out an amount equivalent to 10 per cent of all premium payments into such group accounts. With an average mortgage life in excess of twelve years, it is obvious that no considerable number of these group accounts can be closed out for a period of fifteen or twenty years. During this time, therefore, the reinsurance fund cannot be built up except through interest on investments.

During this period, the confidence of private lending institutions in the debentures issued by the Federal Housing Administration must be supported either by larger capitalization of the reinsurance fund or by the continuation of the government guarantee. This guarantee must be continued until lending institutions can be induced to look with the same degree of confidence to the Mutual

Mortgage Insurance Fund itself as that with which they now look to the guarantee of the government.

For the government to allow this guarantee to lapse on July 1, 1937 would remove the foundation of the entire Title II program just as that program is commencing to emerge from the initial period of organization and become really effective on a large scale. The result would be not only to render abortive the long-term objectives, for the achievement of which Congress adopted the National Housing Act, but also largely to undo everything already accomplished by the Federal Housing Administration toward the improvement of present housing standards and conditions and the reconstruction on a sound basis of the home mortgage debt of the country.

It should be pointed out that the guarantee of Federal Housing Administration debentures by the government represents only a contingent liability upon which there is little likelihood of the government's ever having to pay. While this contingent liability technically is represented by the outstanding amount due on insured mortgages, one would have to assume defaults and foreclosures on practically every home in the country and the total loss of all the value in the property transferred to the Federal Housing Administration after foreclosure, in order to arrive at an actual liability of the Treasury even approximating anything like the amount represented by the outstanding balances on insured mortgages.

Actuarial calculations, based on the most conservative assumptions, indicate that each group account may suffer as high as 20 per cent foreclosures of mortgages and still have sufficient funds through premium income to meet all losses. The liability of the Treasury is, therefore, very remote and contingent, and any possible losses that the Treasury might sustain because of this guarantee would be so small as to be negligible compared with the advantages to the country of the program of the Federal Housing Administration.

It would accordingly appear to be a policy of very doubtful wisdom for the government to sacrifice the entire National Housing Act program just as it begins to demonstrate its success, for the immediate and insubstantial purpose of eliminating from the books of the Treasury so remote and contingent a liability as that involved in the government guarantee of Federal Housing Administration debentures.

3. Section 19 amends Section 207 of the present Act by providing in lieu thereof a statutory framework adequate for the proper carrying out of the functions which Congress, in adopting the original Section 207, clearly intended the Administration to perform.

It was recognized from the outset that Section 207, as adopted, was too brief and incomplete to serve as a law under which large scale housing operations for persons of low income could be properly handled through the insurance feature of Title II, and the primary purpose of this amendment is simply to cover, in sufficient legal detail, the intention expressed by Congress in a condensed and general form in enacting such section.

In only two respects of any importance does the amendment differ from the original Section 207. They are as follows:

(a) An insurance fund separate and distinct from the Mutual Mortgage Insurance Fund is set up for large mortgages upon low cost housing projects.

The National Housing Act created a system of mutual mortgage insurance. Mutual insurance is in essence the grouping of similar risks. There is no similarity of risk and hence no mutuality between a $1,000,000, corporate mortgage and a $16,000 home mortgage; yet these risks are grouped together in one fund as the Act now stands. The proposed amendment takes the large mortgages out of the small mortgage fund. Thus a condition preventing true mutuality among the small mortgages is removed and the original intent of Congress as shown by the Committee Reports, can be realized.

(b) Provision is made for the insurance of debentures upon assignment of the mortgage to the Administrator after default instead of upon conveyance of the property after foreclosure.

The wisdom of putting the Government in the business of foreclosing mortgages against home owners has been seriously questioned. With this in mind the Congress authorized the payment of mortgage insurance only after the mortgagee had completed foreclosure against the home owner and was in possession of the property. This method of settlement as the Act now stands also applies to large corporate mortgages under Section 207, but the considerations prompting this method of settlement obviously do not apply to large corporate mortgages. There is no reason, therefore, why mortgage insurance should not be paid upon assignment of the mortgage in the case of corporate mortgages.

In addition, this method would induce private capital to finance large-scale housing at lower interest rates because it assures the certain and speedy collection of the insurance. The certainty of the insurance improves the mortgage security and lowers the money cost. Low money cost is vital in housing low income groups. The government is also better protected because it can obtain possession of the property more promptly and thus maintain the project as a going concern, safeguarding earning power and property values by eliminating the possibility of waste and milking.

> The proposed amendment also clarifies the Administrator's right to insure mortgages covering housing for sale as well as for rent.

The statute as it now stands, leaves some doubt upon this point. Under the amendment, the Administrator is given the right to supervise an operation leading to a result already easily obtainable through indirect methods. For, even assuming that the Administrator may only insure mortgages covering housing for rent, the mortgagor in a given case may by the simple expedient of refinancing the mortgage without the insurance, proceed to sell off the property.

It is felt that under the amendment, wide use will be made of the insured mortgage device in the development of new subdivisions and garden apartments. These developments, however, in order to obtain mortgage insurance must be planned according to sound real estate and housing practices, and the limited dividend corporations or other agencies, public or private, undertaking the projects, must submit to strict supervision designed to protect the public as well as the risk which the government assumes. In this way the unbridled speculative practices of the past may be largely avoided.

The proposed amendment to Section 207 does not change the classification of eligible mortgagors; the size or character of eligible mortgages; the character or kind of eligible properties or the premium rate for insurance. In short, the proposed amendment merely perfects a vehicle for carrying out a policy to which the Congress is already clearly committed.

4. Sections 22, 23 and 24 provide for the following amendments to Title III of the National Housing Act:

a. Section 22 increases the power of National Mortgage Associations by allowing them to make loans and advances upon mortgages insured under Section 207 of Title II of the Act, that is for large scale housing projects.

The purpose of this amendment is to make additional funds available for the financing of large scale private housing projects contemplated by Section 207 and the proposed amendments. In addition, the powers proposed by this legislation would enable these associations to finance the underlying mortgages in public housing projects as well, by making insured loans on such properties and selling their debentures to the public to cover such loans.

b. Section 22 also increases the powers of National Mortgage Associations by enabling them to act as trustee under mortgages.

The purpose of giving national mortgage Associations these powers is to enable them to facilitate the financing of large scale housing operations when such financing must be carried on through a bond issue. It is not designed to give wide and general trust powers and if the proposed amendments to Section 207 are effectuated the Administration is willing to delete this proposed part of the section.

c. Section 23 permits the Administrator to authorize an association to commence business when 25% of its capital has been paid in, in cash or government securities.

Under the present Act, capital stock must be paid for in full before an association can begin business. When a National Mortgage Association is organized, there must necessarily elapse a considerable period of time after substantial payments have been made on capital stock before the association can acquire insured mortgages in an amount representing the total capitalization. During this period of building up its portfolio, therefore, a substantial amount of its capital would have to remain idle and unproductive. This fact may readily deter the investment of private funds in the capital of a National Mortgage Association. The proposed amendment merely mitigates this situation by enabling an association to being to build up its portfolio when 25% of its capital has been actually paid in, but all the capital stock subscribed. During this period, however, the association cannot issue debentures, notes, or other evidences of indebtedness. The public, therefore, can have no interest at stake in these early operations of the association. The capital stock must be paid in full before debentures, notes, or any other obligations can be issued to the public.

The amendment thus simply removes an unnecessary restriction on the part of private capital in the National Mortgage Association field.

d. <u>Section 24</u> increases the ratio between the amount of debentures which may be issued by an association and the amount of its capital and surplus from 12 to 1 to 20 to 1.

National Mortgage Associations must operate on a very narrow spread between the yield of mortgages in their portfolio and interest rate on their debentures. To show a legitimate profit on the basis of a narrow spread, it is essential that the volume of business which may be done by the association be increased as much as possible.

In view of the safeguards thrown about the operations of National Mortgage Associations, there is no reason why a 20 to 1 ratio should be inherently any less sound than a ratio of 12 to 1. For judging this matter in practice, the only evidence available is that presented by the operations of certain European and South American institutions of a similar nature. These have operated soundly and conservatively over a period of many years with ratios as high as 50 to 1 and without any guarantee of underlying collateral.

Since every issue of debentures must be approved by the Administrator and the total amount of all such debentures must be supported by an equivalent amount of insured mortgages, cash, or government securities, it is difficult to understand how the increase of this ratio from 20 to 1 can be attacked as an unsound financial practice.

The purpose of capital stock in an institution selling its obligations to the public is to enable that institution to absorb losses sustained on account of assets held as collateral to its public obligations. When such collateral is restricted to cash, government securities, and insured mortgages which are eventually guaranteed by the government, no severe losses on account of collateral can be sustained by the association. Any losses actually sustained can, furthermore, be offset by earnings. A cushion represented by a capitalization of 1 to 20 represents an adequate safeguard against losses on collateral which cannot be met out of operating revenue.

5. Section 29 amends Section 5136 of the revised statutes, as amended, by providing that national banks may subscribe or invest not exceeding 6 percent of their paid up net capital stock and surplus of national mortgage associations.

This power has already been conferred upon commercial banks operating under state laws in thirty-six states, upon savings banks in thirty states and upon trust companies in thirty-seven states, as a result of amendments to their applicable laws passed since the adoption of the National Housing Act. Banks have been the chief source of the funds advanced to date under mortgages insured under Title II, and their relationship to the entire insured mortgage program is perhaps more fundamentally important than that of any other class of private lending institution.

The purpose of the proposed amendment is simply to complete the integration of the functions of national banks and the Federal Housing Administration of mortgage financing by according to national banks the right already possessed by state banking institutions.

National banks comprise a substantial portion of the institutions already approved and active as mortgagees under Title II and their direct interest in giving to insured mortgages as high a degree of liquidity or shiftability as possible is obvious, and national mortgage associations were provided for by Congress for this express purpose. It is felt, therefore, that national mortgage associations in which national banks have a financial interest would be assured the most competent and responsible management that it is possible to give them.

In view of the close governmental supervision to which both national banks and national mortgage associations are subject by law, it is submitted that the authorization of national banks to invest in the stock of national mortgage associations cannot be attacked as an unsound or unwise innovation in banking and financial practice.

With respect to the proposed amendments to the Home Owners Loan Corporation Act, we submit the following comments:

1. <u>Section 33</u> authorizes the Home Owners Loan Corporation "to make loans to individuals to enable them to build homes after this Act takes effect, or to buy homes built after this Act takes effect, or to improve homes. Properties dealt with under this section should not exceed $5,000 in value and shall be for the occupancy of the persons securing such loans. Such loans shall not exceed 20% of the appraised value . . . . but <u>may</u> be made as a part of or subject to loans by other lenders on such properties." The terms and conditions under which such loans are to be made are to be prescribed by the corporation, and the corporation is authorized to expend $200,000,000 for the purposes of this sub-section.

To this proposal the Federal Housing Administration is in opposition for the following reasons:

a. The Home Owners Loan Corporation was created as an emergency organization to perform a specific task. This task has been admirably performed and is essentially complete. If ever the government expects to withdraw from this type of direct lending operation it should do so now. The effect of this proposed legislation would be to perpetuate the Home Owners Loan Corporation organization consisting of some 282 offices with nearly 20,000 employees. It would project a paternalistic form of government financial practice indefinitely into the future.

b. The wording of the proposed legislation is so broad and general that it is difficult precisely to understand the type of operations which would be authorized. As drawn, the language could certainly be interpreted to include the making of direct loans by the government for the purposes of modernizing and repairing existing properties. This type of loan is now being made by private financing institutions insured by the Federal Housing Administration under Title I of the National Housing Act. The average volume of loans insured for this purpose during the past 6 months has been over $26,000,000 per month through more than 6,000 private financial institutions.

The direct lending of government funds for this purpose would be a serious duplication and create direct competition on the part of the government with these private lending institutions. This legislation proposes to put the government into business at a time when many representatives of the administration have been indicating that every effort would be made to take the government out of business and out of competition with private business wherever possible. From a political point of view, therefore, this would seem to be an unwise proposal.

c. There is nothing in the proposed legislation to indicate the nature of the security to be taken on these loans or whether any security would be required. It may be assumed, however, that some type of mortgage security such as a second or junior mortgage would be required. If such advances are made on mortgage security, some sort of inspection and appraisal of the collateral would be required. Without them the operations would be impossibly hazardous. If the loans were made in any considerable volume, these operations would necessitate the creation or retention of an organization large enough to handle all these inspections and appraisals. Such an organization would be exactly duplicating the functions of the Federal Housing Administration.

The costs of making the necessary inspections and appraisals would be the same as those involved in making any mortgage loan on properties, and there would be no source of income to offset these costs. When the average size of these loans is considered the costs of making them would certainly be exorbitant. All the operations would have to be carried out directly with all expenses paid by the government. In contrast, the Federal Housing Administration carries on no direct lending operations but utilizes 8,000 private institutions which absorb these expenses and enables the Federal Housing Administration to maintain a low expense ratio.

d. If the purpose is to make second mortgages, we believe that it represents unsound financing, the perpetuation by direct government activity of one of the most iniquitous features of home financing practice, that the policy represented would be diametrically opposed to one of the basic features of the

National Housing Act, and that as a precedent it would be difficult if not impossible to discontinue this activity.

If the government made a loan on a mortgage junior to a prior lien, in case of default on the first mortgage it would either forfeit its loan or would be obliged to assume the liability of the prior lien. Assuming an average advance of $1,000, or 20% of the appraised value on a $5,000 house, and an underlying mortgage of 70% of $3,500, the total amount advanced and the total contingent liability of the government would be approximately $900,000,000.

If the government abandoned its claim against the property in case of default on the first lien, the advance of funds represents a bonus on which government losses might be very great.

The abandonment of these claims would result in the holder of the first mortgage obtaining properties at a price which would represent at least 20% less than the total loans against the property.

No interest rates or other limitations are proposed in this legislation. It may be assumed that the interest rate would not be in excess of the 5% now charged by the Home Owners Loan Corporation. In many cases the interest rate on underlying mortgages would be in excess of 5%. The government would thus be placed in the anomalous position of guaranteeing in effect the first mortgage which bore a higher interest rate than its second.

Even though the Act restricted the interest rate on advances on prior liens to say 4%, the advance of government funds on second mortgages would be tantamount to a guarantee of the prior lien and would create a great deal of confusion with respect to the government program in connection with the guarantee of mortgages.

The government would be placed in the ridiculous position of operating two programs of mortgage guarantee, one of which required the payment of a premium and the other did not.

e. The government is now authorized to subscribe to 75% of the stock in Federal Building and Loan Associations. This proposed legislation would authorize the government to advance 20% directly above mortgages made by these associations. Of the total amount lent in such an operation, government funds would represent 76.2% of the entire loan. Thus of every $1000 advanced to the borrower, $762 would be government funds.

This program would be in direct competition with that of national banks, state banks, members of the Federal Reserve System, savings banks, life insurance companies, and building and loan associations which are cooperating in the program of the Federal Housing Administration. Under this program private lending institutions have advanced during the past six months an average of over $22,500,000 per month and have reached a level of $7,000,000 per week with a present rate of increase of nearly $1,000,000 per week. These private lending institutions cannot compete with the kind of program proposed. The effect, therefore, would be to drive these institutions out of the type of operation now represented by the program of the Federal Housing Administration.

f. The effect of this proposal would be to give an unfair competitive advantage to the building and loan associations in connection with their mortgage lending operations.

Federal building and loan associations can now lend up to 75% of the value of the property without mortgage insurance. If a 20% loan is obtained under the proposed program, the total amount borrowed would represent 95% of the value of the property. State building and loan associations can lend up to 66 or 67%; and thus a borrower could secure through them and through the government loan up to 86 or 87% of the value of the property. But national banks, state banks, members of the Federal Reserve System and life insurance companies are limited to loans of 50 to 60% on uninsured mortgages. This amount plus a 20% loan of government funds constitutes considerably less than the percentage of property value which can be covered by loans from Federal and other types of building and loan associations under this program.

g. The program would be exceedingly difficult to administer in such a way as not to expose both the government and borrowers to extraordinary risk due to shoddy construction, over-selling, padded construction costs, and all the other bad practices which are associated with second mortgage lending. In the program of the Federal Housing Administration provision is made and an organization is trained to enforce regulations designed for the protection of both borrowers and lenders against these practices.

h. The proposal, though made as a temporary or emergency measure, would have the effect of confirming private lending institutions in the ancient practice of lending only 50% or 60% of the value of the property on first liens. The government would be in a position of perpetuating mortgage practices by lending institutions which would encourage and almost compel the use of sedondary financing. This type of financing practice was vigorously condemned by the Chairman of the Home Loan Bank Board in his testimony before the Senate Banking and Currency Committee in May 1934 in the following words:

> "But so far as it is humanly possible in the future to eliminate secondary financing of that character it ought to be done. It has been done in other countries to a very large extent and there is no reason why it cannot be done here."

i. It is doubtful whether the proposed program would result, as suggested, in the stimulation of construction. It is more likely that it would result in merely changing the channels through which funds are made available for construction. While these funds are now coming from private sources in an increasing volume, the effect of this proposal would be to substitute government funds on second mortgage and reduce the amount of private funds lent on first mortgage. When a borrower or prospective builder requires, say 80% of the purchase price or the cost of his property, on a loan, a private financial institution and the borrower himself would naturally prefer a 60% mortgage and a 20% government second mortgage to an 80% first mortgage from a private lender.

The result would be that in connection with every home under $5,000 that is in contemplation, application would be made for this government loan. The $200,000,000 fund would thus probably be quickly used up in connection with projects which will undoubtedly proceed without such financing, and additional funds would be required to continue the program.

j. Finally and in summary no proposal could be made that would more successfully defeat many of the major objectives of the program of the Federal Housing Administration.

2. Section 34 authorizes the Home Owners Loan Corporation to expend $3,000,000 "to promote cooperative thrift and home building, to assist in the rehabilitation of mortgage lending institutions and generally aid in the development of a sound home building and home ownership program throughout the United States."

It is difficult to formulate a precise judgment with respect to this proposal because of the general terms in which the legislation is drawn. Insofar as the purposes of this legislation are to enable the corporation to promote the establishment and development of federal savings and loan associations we feel that it is superfluous.

There is certainly no dearth of funds available for investment in mortgages nor any general lack of financing facilities throughout the country as a whole. If it be conceded that there are isolated spots in which funds are not available, Federal Savings and Loan Associations can be created in those isolated cases without the expenditure of any fund comparable to $3,000,000.

The Federal Housing Administration doubts the advisability of the government's actively promoting the organization of additional Federal Savings and Loan Associations. During a period in which the Board of Governors of the Federal Reserve System, the Reconstruction Finance Corporation and the Federal Housing Administration have been seeking to reduce interest rates, many of these Federal Savings and Loan Associations are charging high rates, notwithstanding the fact that government funds may be invested in these institutions up to a maximum of 75 percent of their total capitalization.

Although the general policy of the Administration as established in the National Housing Act is to insure mortgages up to 80 percent of the value of the property, these associations have not yet been authorized to make loans in excess of 75 percent.

This could be accomplished by amendment of charters by the Federal Home Loan Bank Board, but this Board has never taken any action in that direction.

While the type of function performed by both the Federal and non-Federal Savings and Loan Associations is recognized by the Federal Housing Administration as important, at the same time it must be remembered that both these types of institutions, according to estimates by the Federal Home Loan Bank Board, hold only approximately 23 percent of the home mortgages of the country. We do not see the wisdom of the government's expending $3,000,000 in the rehabilitation of this type of institution and in the establishment of additional Federal associations.

Insofar as the purposes of this amendment are "to aid in the development of a sound home building and home ownership program" it obviously duplicates almost verbatim the functions of the Federal Housing Administration provided in the National Housing Act. It would seem undesirable for the government to duplicate the expenditures and organization to accomplish these identical purposes.

3. Section 42 provides for the establishment of a National Housing Commission.

On this we are for the most part neutral. Attention is called to the fact, however, that there exists at the present time a Senate Committee and a President's Commission established for the purpose of studying the methods of coordinating activities in the Executive Departments of the government. We assume that these committees will study the problem of coordinating housing agencies. It seems a duplication of the functions of these committees to propose the establishment of a National Housing Commission as suggested in this draft.

We believe, furthermore, that the establishment of such a commission can be accomplished by Executive Order or by a Senate or House resolution without the formality of legislation. The Federal Housing Administration, however, would support legislation designed to establish a Housing Coordination Board consisting of the heads of housing agencies, with power to take such action as they deem advisable to consolidate all the housing activities of the government under such agency or agencies as seemed advisable.