Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

# Office Correspondence

Date November 3, 1937.

To Chairman Eccles

From Lauchlin Currie
LBC

Subject: Effect of Reducing Financing Charges on Residential Construction

I think you will be very much interested in the attached note by Mr. Krost and in the suggestions he offers on pages 3 and 4. I wish we could get financing costs lower, at least on 50 and 60 percent mortgages. If we do not, it becomes even more important to secure some actual reductions in construction costs as I am afraid that the equivalent of a reduction of 11 percent proposed will not be enough.

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Date November 3, 1937

To Mr. Currie

From Mr. Krost
MK

Subject: Effect of Reducing Financing Charges on Residential Construction

The following example shows the effect of the proposed plan to change the conditions under which mortgages are guaranteed by the F. H. A. by eliminating the insurance premium, reducing the interest rate by one-half of one percent, and increasing the loan value from 80 to 90 percent on properties valued at $5,000 or less. The change in the annual interest and amortization payment, the change in the down payment, and the equivalent change in construction costs that would be necessary to give the prospective home-buyer the same benefits as he would realize from the proposed plan are shown for two houses, a cheaper house, on which 90 percent can be borrowed, and a more expensive house, on which only 80 percent can be borrowed.

EFFECT ON HOUSE COSTING $5,000

| | Present Conditions | Proposed Plan |
|---|---|---|
| Cost of house | $ 5,000.00 | $ 5,000.00 |
| Construction costs, exclusive of land | 4,000.00 | 4,000.00 |
| Loan value | 4,000.00 | 4,500.00 |
| Down payment | 1,000.00 | 500.00 |
| Rate of interest and insurance premium | 6.25% | 5.00% |
| Annual financing charges | 355.85 | 361.09 |
| Dollar changes in costs | | |
| Down payment | | $ -500.00 |
| Annual financing charges | | + 5.24 |
| Equivalent reduction in construction costs | | 441.00 |
| Percentage changes in costs | | |
| Down payment | | - 50.0% |
| Annual financing charges | | + 1.5 |
| Equivalent reduction in construction costs | | - 11.0 |

EFFECT ON HOUSE COSTING $6,000

| | Present Conditions | Proposed Plan |
|---|---|---|
| Cost of house | $ 6,000.00 | $ 6,000.00 |
| Construction costs, exclusive of land | 4,800.00 | 4,800.00 |
| Loan value | 4,800.00 | 4,800.00 |
| Down payment | 1,200.00 | 1,200.00 |
| Rate of interest and insurance premium | 6.25% | 5.00% |
| Annual financing charges | 427.02 | 385.16 |
| Dollar changes in costs | | |
| Down payment | | 0 |
| Annual financing charges | | -41.86 |
| Equivalent reduction in construction costs | | -471.00 |
| Percentage changes in costs | | |
| Down payment | | 0.0% |
| Annual financing charges | | -9.8 |
| Equivalent reduction in construction costs | | -9.8 |

The prospective buyer of the cheaper house will receive under the proposed plan a reduction of 50 percent in his down payment, but will pay one and one-half percent more in annual interest and amortization charges. To yield an equivalent benefit at the present level of interest rates and loan values, construction costs would have to fall by eleven percent. The prospective buyer of the higher-priced house will receive under the proposed plan a reduction of ten percent in annual interest and amortization charges, but no reduction of the down payment. To yield an equivalent benefit at the present level of interest rates, construction costs would have to fall by ten percent.

For houses costing between $5,000 and $5,625, the maximum loan value under the proposed plan remains constant at $4,500. The effects on the financing costs of such houses will lie between the two examples given. As the cost of the house increases, the saving on the down payment from what it would be under present conditions decreases from 50 percent to zero and the annual interest and amortization payment ranges from one and one-half percent above to ten percent below what it would be under present conditions. The decrease in construction costs necessary to yield equivalent benefits in such cases would be between eleven and ten percent.

There are two features of the proposed plan that make it less valuable than it might otherwise be as an incentive to the home buyer. One is the fact that in the case of lower-priced houses the annual payment which the borrower must make on a 90 percent mortgage at the reduced rate is actually slightly in excess of the payment he must make on an 80 percent mortgage at the present rate. This is attributable to the fact that the reduction in the interest rate is not quite sufficient to offset the effect of the increase in the mortgage on which interest must be paid. This result could be avoided by a reduction of the interest rate to 4.8 percent instead of 5 percent. At this rate the annual payment is slightly lower instead of slightly higher than the payment under present conditions. This change would make the benefits to the borrower equal to those produced by a 13 percent reduction in construction costs in the case of the lower-priced house and an 11 percent reduction in construction costs in the case of the higher-priced house.

The other feature of the proposed plan where a slight alteration might increase its effectiveness is the sharpness of the line drawn between the borrower whose house costs $5,000 and who can borrow 90 percent and the borrower whose house costs slightly more and who can borrow only 80 percent. The device of setting the maximum loan value of houses above the $5,000 level at $4,500 or 80 percent whichever is greater does something to remedy this but it still deprives the man building a house costing as little as $5,625 of the benefit of any reduction in down payment. To such a borrower it will seem anomalous that he can borrow no more than a man whose house costs $5,000 and in fact borrowers who deserve to obtain the benefits of the 90 percent loan value may not be separated from those who do not deserve it by so narrow a margin.

A sliding scale of maximum loan values, which started at 90 percent for houses costing $5,000 or less and decreased by one percentage point for every $200 increase in cost, would make it possible for buyers contemplating the purchase of houses slightly in excess of $5,000 to borrow some part of the increased cost and would extend the benefits of a reduction in the minimum down payment required to houses costing up to $7,000. The following table compares the effects of the two arrangements with the present situation:

| Cost of house | Loan value proposed plan | | Loan value revised plan | | Reduction in down payment from present requirements | |
|---|---|---|---|---|---|---|
| | Percent | Amount | Percent | Amount | Proposed | Revised |
| $5,000 | 90.0 | $4,500 | 90.0 | $4,500 | $500 | $500 |
| 5,200 | 86.5 | 4,500 | 89.0 | 4,628 | 340 | 468 |
| 5,625 | 80.0 | 4,500 | 87.0 | 4,894 | 0 | 394 |
| 6,000 | 80.0 | 4,800 | 85.0 | 5,100 | 0 | 300 |
| 6,800 | 80.0 | 5,440 | 81.0 | 5,508 | 0 | 68 |