FORESTA FACTORS INC.
233 BROADWAY, NEW YORK

OFFICE OF THE PRESIDENT
HENRY J. ECKSTEIN

March 8, 1939

Mr. Marriner Eccles,
Federal Reserve Bank,
Washington, D. C.

Dear Mr. Eccles:

I have for a long time been interested in and studied the problem of the possibility of the growth of housing for low income groups, and particularly for large scale rental projects undertaken by private industry. The headway in this direction that has been made the last year or so, though percentagewise considerable, is, in relation to the need, unimpressive. This lag is largely due to the respective problems of cost and the lack of initiative and encouragement for private equity capital, particularly of an investment nature.

The soundest and the most promising suggestion towards meeting this latter problem is the yield insurance plan devised by Mr. Frederick Babcock, Assistant Administrator of the FHA, and covered by the enclosed preliminary presentation. I believe it will be of interest to you, and it will be very helpful to Mr. Babcock and myself if you will be good enough to let us have your reaction to it.

Yours sincerely,

HJE:LE
encl.

March 10, 1939.

Mr. Henry J. Eckstein, President,
Foresta Factors, Inc.,
233 Broadway,
New York, New York.

Dear Mr. Eckstein:

This is to acknowledge receipt of your letter of March 8, 1939, enclosing a copy of the Yield Insurance Plan for Financing Rental Housing Projects.

I was interested to have your comments on Mr. Babcock's plan, with which I am somewhat familiar, but not sufficiently so to venture to give you an opinion. I would prefer to defer that until such time as I have had an opportunity to give you an opinion. I would prefer to defer that until such time as I have had an opportunity to discuss the proposal more fully with the F. H. A. people.

However, I wanted you to know that I appreciate your courtesy and interest in the subject.

Very truly yours,

M. S. Eccles,
Chairman.

ET:h

HENRY J. ECKSTEIN
233 BROADWAY, NEW YORK CITY

March 11th, 1939.

Mr. Marriner S. Eccles,
Chairman, Federal Reserve Board,
Washington, D. C.,

Dear Mr. Eccles:

It was good of you so promptly to answer my letter of the 8th.

After you have had an opportunity further to consider the Yield Insurance Plan and discuss it, it would be very helpful if you would have me advised of your reaction thereto, if you consistently can.

Cordially yours,

HJE:M

FORESTA FACTORS INC.
233 BROADWAY, NEW YORK
OFFICE OF THE PRESIDENT
HENRY J. ECKSTEIN

April 26, 1939.

Mr. Marriner Eccles,
Federal Reserve Bank,
Washington, D. C.

Dear Mr. Eccles:

I am wondering if you have as yet had opportunity to examine the Yield Insurance Plan proposed by Mr. Frederick M. Babcock, which I sent you some time ago. The interest the plan has aroused is considerable. Its furtherance would be greatly assisted by your opinion, criticism and suggestions. Both Mr. Babcock and I would greatly appreciate hearing from you.

Sincerely,

HJE:LE

YIELD INSURANCE PLAN

for

Financing Rental Housing Projects

February 15, 1939

YIELD INSURANCE PLAN

for

FINANCING RENTAL HOUSING PROJECTS

This memorandum presents the Yield Insurance Plan for the creation and permanent operation of rental housing projects. The plan provides for the financing of projects by private capital, without the use of mortgages, and with provision for a guarantee of a minimum rate of return.

Two plans are offered, one generally applicable to the financing of rental housing, the other applicable solely to projects which involve slum clearance or the rehabilitation of blighted areas.

PLAN A

Plan A is designed to provide for moderate rental housing in both urban and suburban locations where the costs of production and the rentals available bear a reasonable relationship.

1. The plan contemplates the investment of funds of responsible investors in the direct ownership of real estate by permitting them to acquire sites, plan rental housing projects, erect structures, and own and manage them thereafter. Such investors may include conservative investment groups or associates and the trustee custodians of investment funds such as savings banks, trust estates, and life insurance companies. Such ownership may be accomplished, if desirable in particular cases or states, by the ownership of the common stock shares of subsidiary realty corporations. Such shares, however, may be owned only by such qualified responsible investors.

2. The total costs incurred up to the completion of a project are ascertained and if approved become the "Established Investment". Allowable costs include all actual outlays. They do not include interest during construction.

3. Project owners are not permitted to mortgage properties or to create any form of funded indebtedness.

4. The Federal Housing Administration, after amendment of the National Housing Act, will accept such projects any time prior to commencing construction for "Yield Insurance", provided defined minimum standards are complied with.

5. "Yield Insurance", for this purpose, consists of a guarantee of a minimum yield of $2\frac{1}{2}\%$ per annum on the amount of the "Established Investment" which remains invested in any year. If a project, in any year, earns less than $2\frac{1}{2}\%$, the FHA will pay, in cash, immediately upon verification of the validity of the claim, the difference between $2\frac{1}{2}\%$ and the amount actually earned.

6. Accounting for this purpose will reduce the original "Established

Investment" on a straight-line basis at the rate of 2% per year of the depreciable portion of the original investment (i.e., total investment exclusive of the land). It will also reduce the "Established Investment" in an additional amount equal to the earnings in excess of 5% per year.

7. Properties may be sold but if sold shall not continue to receive the benefits of yield insurance unless the purchaser would have been eligible for such insurance at the inception of the project.

8. The total benefits collectible under the plan are limited to 10% of the original established investment. That is, when the aggregate amount of paid claims equals 10% of the original established investment, additional claims cannot be collected from the FHA and the insurance ceases. No claims are collectible after 20 years from original date of insurance.

9. The Federal Housing Administration collects an annual premium amounting to 1/8th of 1% of the portion of the established investment remaining unrecaptured in each year. That is, the premium amounts to 5% of the coverage (1/8th of 1% divided by 2½%).

PLAN B

Plan B is designed to provide for low-rental housing in slum and blighted areas of cities where the costs of land acquisition and rebuilding and the rentals available tend to be disproportionate.

1. The plan contemplates the creation of local corporations to acquire sites in slum or blighted areas, demolish existing structures, plan rental housing projects, erect new structures, rehabilitate old structures, and own and manage the properties thereafter. Under defined conditions, such corporations are to have the power of condemnation.

2. Such corporations may secure capital by the sale of common stock shares only, to the public and to trustee investors. Corporations are not permitted to mortgage properties or to create any form of funded indebtedness.

3. The total costs incurred up to the completion of a project are ascertained and if approved become the "Established Investment". Allowable costs embrace all actual outlays, including actual interest paid during construction provided such interest is at a rate not in excess of 3½% per year.

4. The Federal Housing Administration, after amendment of the National Housing Act, will accept such projects any time prior to commencing construction or rehabilitation for "Yield Insurance", provided defined minimum standards are complied with.

5. "Yield Insurance", for this purpose, consists of a guarantee of a yield of 3½% per annum on the amount of the "Established Investment" which

remains invested in any year. If a project, in any year, earns less than $3\frac{1}{2}\%$, the FHA will pay, in cash, immediately upon verification of the validity of the claim, the difference between $3\frac{1}{2}\%$ and the amount actually earned.

6. Accounting for this purpose will reduce the original "Established Investment" on a straight-line basis at the rate of 2% per year of the depreciable portion of the original investment (i.e., the total investment exclusive of land).

7. Earnings in excess of $4\frac{1}{2}\%$ shall be devoted, in the order named, to (1) Expenditures for needed or desirable improvements, repairs, maintenance, and alterations, (2) Accumulations in a reserve for the foregoing purposes, the total of such reserve not to be allowed to accumulate to more than $7\frac{1}{2}\%$ of the original established investment, (3) Payments to the FHA as additional premiums (really a penalty for failure to reduce rents).

8. There will be no direct regulation of rents by the FHA but management supervision is contemplated.

9. The total benefits collectible under the plan are limited to 14% of the original established investment. That is, when the aggregate amount of paid claims equals 14% of the original established investment, additional claims cannot be collected from the FHA and the insurance ceases. No claims are collectible after 20 years from original date of insurance.

10. The Federal Housing Administration collects an annual premium amounting to 1/4th of 1% of the portion of the established investment remaining unrecaptured in each year. That is, the premium amounts to 7.1% of the coverage (1/4th of 1% divided by $3\frac{1}{2}\%$).

<u>OBJECTIVES OF THE PLAN</u>

The objectives of the Yield Insurance Plan are set out as follows:

1. To make private capital available to housing. The present mortgage system operates with difficulty because there is a dearth of funds available for equity investment except at rates which compensate for highly speculative risks. This situation invites the creation of apparent equities by deliberate overvaluation.

2. To provide an investment outlet for funds of investors. It is presumed that the competition for investments, especially mortgage investments, has and will result in a condition where reasonably safe investment of available funds is and will be increasingly difficult. It is to be noted that the only alternatives in the residential mortgage field are withdrawing from the field or making and purchasing very high percentage mortgages.

3. To secure the erection of housing where most needed: in slum areas, for lower-income groups, in smaller as well as larger cities.

4. To produce real estate facilities at lower costs of construction. This purpose is desirable as a safeguard against cyclical fluctuations.

5. To stimulate the construction of good properties. It is evident that, in the recent periods of building activity, principally 1920 to 1929, speculative building with the support given by competition between lenders produced a quality of physical security behind mortgage investments which was not of a sufficiently high standard. One objective of the proposed program is to make certain that investment is made in better properties, surrounded by better community environments. The social benefits of the program, namely, improved health, life extension, and improved social environments, need not be considered as the major objective but are accomplished as a natural accompaniment of the program.

6. To remove the speculative motive, insofar as possible, from real estate operations. The program proposes that the ownership of real estate be placed in strong hands, interested primarily in the rate of return over a long period rather than in rapid speculative gains. The stabilizing effect on realty rentals and values, implied by such strong ownership, is of major significance.

7. To prevent the unnecessary further extension of governmental ownership of housing and housing investments.

8. To provide the major investor in real estate (today, the mortgage lender) with real control over his investments. This should lead to better maintenance, lower rehabilitation costs, and longer effective economic lives of properties.

9. To provide a relatively safe investment which embraces a hedge against diminished purchasing power of the dollar.

10. To create a condition in which construction activities are more attractive in times of recession, less attractive in boom times. If this purpose can be achieved it will mean a partial lessening of the intensity of conditions in depressed periods and an automatic brake on speculation in boom times.

NEEDED LEGISLATION

State legislation will be required to permit trustee investors to invest in real estate or in the shares of realty corporations. Similar legislation has already been provided by the New York State Legislature. Such legislation should be modeled on the proposed Federal legislation.

State legislation to provide for the creation and control of the housing corporations in Plan B will also be required.

Federal legislation should provide for "Yield Insurance" and should take the form of an amendment to the National Housing Act. Provisions should include:

1. Projects to be submitted to the Federal Housing Administration

prior to completion of construction for approval for yield insurance.

2. Definition of eligible projects including neighborhood and structural standards, verification of reasonableness of costs and economic soundness, and what constitutes a "slum" (Plan B).

3. Provisions defining rights of the investors, eligibility of realty corporations, contracts of insurance (non-cancellable), methods of accounting, etc.

4. Definition of types and qualifications of investors eligible for such insurance coverage.

5. Provisions covering the computation of claims, the payment of premiums, and the expiration or lapsing of coverage.

The state legislation would be so drawn that it limits the percentage of the total assets of trustee investors which may be invested in the direct ownership of real estate. Other restrictions might be necessary including the consent of State Insurance Commissioners, etc.

DISCUSSION OF FEASIBILITY OF PLAN

A limited number of persons have expressed views and cited problems which the yield insurance plan presents. These are discussed below:

1. Rental Housing vs. Home Ownership: The Yield Insurance Plan relates to rental housing only. Whether the principle is applicable, through some sort of modification or adaptation, to owner-occupied housing has not been explored. In fact, the success of the insured mortgage under Section 203 of the National Housing Act leads to the conclusion that the examination of the yield insurance plan in that field of housing is either unnecessary or premature. There can be no serious debate on the question whether rental housing or home ownership should be promoted. Both types of housing are necessary in our urban ecology. Most commentators point out that individual home ownership is more desirable than rental housing and that the latter should be provided only to the extent that individual home ownership cannot be achieved.

2. Mortgages vs. Ownership of Real Estate: The basis for the suggestion that the ownership of unencumbered real estate is superior to the use of mortgages is indicated in the objectives outlined above. It is felt that past experience has demonstrated that high percentage mortgages with rigid amortization schedules cannot withstand ordinary rent fluctuations and that they invite dangerous overfinancing. In addition, they place the construction and management of properties in speculative hands to the detriment of mortgagees and tenants.

A recent report of the Twentieth Century Fund and the views expressed by a number of prominent economists indicate that a greater stability of our economic structure would be achieved if there were less investment in evidences of debt and greater direct ownership through stock shares. The application of this principle to realty investments implies the direct ownership of real estate as opposed to the purchase of mortgages.

A very practical argument closely related to this question is that alternative forms of investment are rather limited at the present time. This is discussed elsewhere.

3. Does the Plan Provide for Rent Limitation? Neither Plan A nor Plan B provides directly for rent limitation, but does provide strong motivations for establishing reasonable rentals and, in the case of Plan B especially, for the progressive reduction of rents.

4. Serious Effect on Existing Properties? Some interests point out that the Yield Insurance Plan will result in the construction of many new properties and will reduce, through competition, the earnings and value of existing properties. However, it would seem that considerable new construction, either through private or subsidized means or both, is inevitable and that the effect on existing properties is the same whether the Yield Insurance Plan is used or not.

5. Will the Plan be Attractive to Trustee Investors? The purchase of mortgages, even with margins of safety represented by equities, carries with it the chance of loss but not a chance of compensating enhancement. While mortgage insurance offsets this difficulty to some degree, it has been pointed out that the rate of return on well-selected real estate owned outright is greater than on mortgages. Yield Insurance replaces the insurance protection in another form.

Trustee investors may be expected to want to invest in types of real estate other than rental housing, such as office buildings, stores, etc. The opportunities to own the real estate now owned by chain stores is a case in point. If yield insurance is provided to induce such companies to enter the housing field, it will have enabled them to establish the principle of direct ownership, which principle will require establishment before the wider field of real estate investments is likely to be open to them.

6. Trustee Investors require Such a Plan. Custodians of trusteed funds complain of the lack of adequate outlets for investment. They have placed large sums in low-yield government bonds. They feel that the legislative restrictions on their fields of investment require revision. They point out that a plan which permits them to make investments in real estate would reestablish a desirable flexibility in their portfolios and that the mere fact that this is a new departure is an inadequate argument against such a scheme.

In any event, most real estate brokers say it will be far better to have housing owned and managed by large investors than by municipalities under the program of the United States Housing Authority.

The pressure for suitable new investment outlets is indicated by the fact that it is claimed that in the life insurance companies alone, over $2\frac{1}{2}$ billions of dollars would be released for this type of investment if such companies were permitted to invest only 10% of their assets in directly-owned real estate.

The limitations on investment outlets are more evident today than at any previous time. It therefore appears that the time is ripe for the examination of a plan such as Yield Insurance.

7. Is owned real estate Sufficiently Liquid? It has been suggested that real estate owned will not constitute a sufficiently liquid form of investment for a trustee investor. Experience will indicate that mortgages are really no more liquid, especially high-percentage mortgages.

At the same time the plan does provide for a degree of liquidity in that it permits an owner to sell. As for the overall effect on the institution, it is not contemplated that it be permitted to place more than 10% of its assets in real estate.

8. Is it wise to have Life Insurance Companies Dominate Realty Ownership? This question assumes that the Yield Insurance Plan is designed solely to provide an investment outlet for life insurance companies. The plan proposes to attract all classes of investment funds except those which demand or require high rates of return or unusual opportunities for capital increment. In fact, some commentators have felt that the real estate investments of life insurance companies should be confined to the ownership of the shares of realty corporations and that no single life insurance company should be permitted to own more than 49% of the shares of any particular realty corporation.

This argument presupposes that life insurance companies would become powerful to such a degree that the general welfare would be adversely affected. It is difficult to imagine how the strong ownership of real estate is anti-social. It appears much more likely that the treatment of tenants and the general public would be much better than it is in the hands of speculative owners of small equities.

It is also pertinent to mention that trustee investors in European countries are permitted to own real estate on a vast scale and that social, rather than anti-social, effects are reported.

In any event, it is certain that life insurance companies should not be excluded from participation in the plan.

9. Can Trustee Investors Manage Real Estate? The Plan requires trustee investors to adopt a new concept: the ownership and management of real estate. Can they do this properly? As a result of the depression these companies have obtained a most liberal education in such matters. Most of such institutions are in close contact with competent management firms throughout the country.

10. Why not Insure Yields on 20% Equity Investments? One idea that has been advanced is that, at least during a transition period, there be a plan providing for the insurance of a mortgage of 80% under Section 207 of the National Housing Act and for yield insurance guaranteeing a minimum rate of return on a 20% equity. This plan serves no purpose and is, itself, unsound and inexpedient: (1) It is illogical to have both mortgage and equity owned by an institution. It amounts to a fiction of lending money to one's self. (2) Insurance of a yield on the equity automatically guarantees the mortgage, making mortgage insurance superfluous. (3) The risk in equity investment is relatively great resulting in the necessity for a high premium for the insurance - so high, in fact, that it would be a material factor in the establishment of rentals. (4) The investor would, through this device, avoid none of the responsibilities of ownership and management. (5) If the statement that even yield insurance is superfluous to induce investors to invest directly in real estate is true, there would not need to be a transitional period.

11. Place of Yield Insurance in the Plan. Several comments have indicated that the direct ownership of real estate by institutions or by subsidiary corporations does not require more than state legislation permitting such ownership and that the guarantee of a rate of return through yield insurance is superfluous - at least in Plan A. The purposes directly served by the provision for yield insurance include the following: (a) The presence of Federal legislation providing for yield insurance will aid in securing the needed state legislation which would then be of the enabling character, (b) Policyholders, savings depositors, and stockholders will find little or no criticism to bring when ownership of real estate is introduced, if the guarantee of yield is used, (c) Yield Insurance provides a degree of Federal influence which should offset general criticism of institutions for changing to the new form of investment, (d) Without yield insurance, the slum-clearance plan, Plan B, would probably be inoperative because investors would not elect to take such deals in the absence of the guarantee, (f) Yield insurance is yield insurance and is intrinsically worthwhile. While many investing corporations will operate on a scale which might provide adequate self-insurance, other institutions would have a definite insurable risk to cover, (g) Yield insurance will tend to carry the benefits of the program to more remote localities and smaller cities than might be reached without insurance of yield.

12. Minimum Rate to be Guaranteed? As presented above, Plan A provides for an insured yield of 2½% and Plan B for 3½%. If money rates were to change in some future market, might not the provision for specific rates result in an excessive guarantee or an inability to attract investment funds? The answer to the problem would appear to be to give the FHA Administrator certain powers with respect to the setting of minimum limits in relation to rates on government securities. However, this power should not include the right to change the contracted rates in previously insured projects.