April 22, 1939

Honorable John J. Cochran
House Office Building
Washington, D. C.

My dear Mr. Cochran:

In compliance with your request to me of April 21, I submit herewith my comments in reference to the Amendment to Section 207 of the National Housing Act proposed by the Banking and Currency Committee of the Senate.

The Senate Amendment to Section 207 restates, amplifies, and strengthens the controls which now regulate the insurance of mortgages on rental properties.

Under this Amendment, four distinct and mutually interacting controls are established, as follows:

(1) The setting of a maximum limit to the amount of any one mortgage.

(2) The limiting of the amount of any mortgage to a percentage of value based upon methods accepted by leading lending institutions, and by courts in valuation and condemnation cases.

(3) The further limiting of the mortgage proceeds in relation to the estimated replacement cost of the improvements.

(4) The restricting of the mortgage amount on the basis of a maximum amount per room.

These controls, all of which must be applied to every case, are designed to protect the FHA against the possibilities of error which might arise if any one method of determining eligible mortgages were used by itself.

Under this method, now to be included in the law, an appraisal both on an income producing and on a replacement cost basis is called for. Thus, unless ample earning power can be demonstrated, no mortgage as high as 80 per cent of value can be accepted no matter how great an amount might have been expended in

the land and improvements. This is an essential limitation in sound lending.

As a check, however, against an error in a calculation of net income, and as a preventative against excessive borrowing in cases where an unusually favorable income situation prevails, no mortgage can now be allowed to exceed the estimated cost of the structures. It should be noted that such estimate specifically excludes any amounts expended for public utilities, street extensions and all miscellaneous costs such as interest, taxes and insurance during construction and all legal, financial and organization expenses, which must be paid out of the sponsors' own funds and cannot be covered by the mortgage proceeds.

As a further check on cost estimates an over-all limitation on the mortgage amount is placed in terms of a maximum amount of $1,350 per room.

By requiring the sponsor of a development to provide with his own funds a fully improved parcel of land free and clear of any incumbrance, the Amendment removes an advantage which might otherwise accrue to the developer of unimproved as against improved land. By requiring this and other specific equity contributions on the part of the sponsor, the tendency to endeavor to create equity by overcapitalizing land value through exaggerated assumptions of income or on a basis of prices established through past speculation is counteracted.

Since the miscellaneous costs, which are required by the Amendment to be paid out of the sponsors' own funds, will average about 5 per cent of the total valuation, the maximum amount that could be attributed to fully improved land where an 80 per cent loan was possible would be 15 per cent of the total. In few such cases, however, could a project be developed without an expenditure for streets and utilities which would not further bring the land proportion down to a figure varying probably between 6 and 10 per cent of the total valuation. Under such circumstances it is hard to imagine how any unusual or unwarranted "write-ups" of land value could take place.

The methods stipulated by the Amendment should assure that no mortgage can be insured in respect to a project in which there is not a substantial investment on the part of the borrower. They do, moreover, provide that this end may be accomplished in a manner that is comparatively simple to administer and difficult to circumvent.

I feel confident therefore that your purpose of preventing the likelihood of unwarranted profits through land or mortgage manipulation will be achieved.

I believe also that under the provisions of this Amendment, the maximum benefits of the Act will go only to projects on land valued sufficiently low to permit the lowest rents consistent with the operations of private enterprise. This, of course, has been and remains the primary objective of this section of the Act; and the results of the short time of its operation show noteworthy progress toward this aim.

On the other hand, the Amendment in the House Bill defeats this very purpose. By requiring no specific equity on the part of the sponsor, it extends its maximum benefits only to sponsors who can claim so high a value to their land that no other equity need be required. In fact, it creates a situation in which part of the mortgage proceeds could be used to reimburse the borrower for part of such claimed land value. The results would be that the inducement would be held out only to projects on high priced land, requiring high rentals for successful operation.

Thus, not only does the House Amendment decrease the possibilities of building modern rental dwellings for families of modest incomes, which is the obvious purpose of this section of the Act, but, it fails in its own objective of preventing the possibility of land value manipulation. In the first place, it may be easily circumvented. There are many ways of concealing the actual price paid for land, as is well known to anyone familiar with real estate operations; and there are many ways of producing evidences of price which may be out of line with any real considerations of the earning power of the land. The House Amendment would invoke the use of such practices and would reduce the appraisal operation to a guessing game as to the sort of deal the developer had probably made.

In the second place, the House Amendment robs the appraiser of the universally accepted method of appraising land on the basis of its highest and best use. In so doing it actually exposes the appraiser to the danger of over-appraisal, particularly in areas where values have been built up out of false speculative hopes, or where costs have been built up from payments of mortgage and tax arrears which have nothing whatever to do with real value. In such circumstances the House Amendment would only make the FHA the victim of past speculation.

That the method of appraisal which is set forth in the Senate Amendment is a valid one is attested by its acceptance by respon-

sible lending institutions and by courts in condemnation cases. It is in fact, impossible to arrive at a fair and proper determination of land value without taking into consideration the various uses to which it might be put, and, in accordance with theories accepted by appraisal authorities, that use which on valid market data promises the maximum return from development, will be the determining one in arriving at a valuation. It must follow that in considering a definite use, such as a housing project, the returns to be conservatively estimated as arising from such use, will provide a sound and reasonable basis for land value appraisal.

The House Amendment contradicts this approach, and at the same time establishes no other definite criterion. It would, therefore, create such confusion in the mind of the appraiser as to make the section inoperative.

The procedure followed by the FHA in the examination of rental housing mortgages has been developed slowly and cautiously over a period of nearly five years. It was begun under a law, which, aside from the limited dividend provisions, required no restraints and provided no administrative guides. The amendments to the Housing Act passed in 1938, while liberalizing many other provisions, introduced for the first time any controlling features as to mortgage amount so far as rental housing loans were concerned. Since then, as before, the FHA has been alert to possible abuses and has constantly endeavored to expand and improve the safeguards which are thrown about these operations. This process, which has been under my direct supervision since its beginning, will not, I assure you, cease with the adoption of the present Amendment.

The high opinion which has been unreservedly given by lending institutions familiar with the established procedure testifies to the fact that the FHA has made noteworthy contributions to sound lending practice in respect to income residential properties, and that its procedure comprises more extensive and effective safety factors than have ever before been applied to this field.

Since the controversy over this matter has arisen, several officials of lending institutions have expressed to me their willingness to come to Washington to present directly to you their testimony as to the effectiveness of FHA procedure and the soundness of the techniques upon which it is based.

I am confident that a close scrutiny of our operations in the rental housing field would convince you that a careful and conscientious job is being done, that the Administration has itself

been always alert to develop its procedure to the end that the purpose of the Act may be achieved with a minimum of risk to the government.

Respectfully yours,

Miles L. Colean
Assistant Administrator