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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

February 4, 1946.

The Honorable Robert F. Wagner,
Chairman, Banking and Currency Committee,
United States Senate,
Washington 25, D. C.

Dear Senator Wagner:

On behalf of the Board I am enclosing two statements with regard to S. 1592 now pending before your Committee. Because of the Federal Reserve System's responsibilities in the broad field of credit, we desired to set forth the reasons why we feel it would be desirable to reconsider certain provisions, particularly the proposal contained in the legislation to provide easier credit terms on new housing in the lowest price ranges. While the Board is in entire sympathy with the stated objectives of the bill and is in accord with many of its provisions, it is our judgment that its enactment without revision would add to already serious inflationary pressures.

One of the enclosed statements deals with the easy credit proposals. The other statement deals with various provisions of the measure to which we have previously expressed objection. We would appreciate having these statements made a part of the official record of the hearings before your Committee.

Sincerely yours,

(Signed) M. S. Eccles.

M. S. Eccles,
Chairman.

Enclosures 2

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INFLATIONARY DANGERS IN TITLE IV OF S. 1592

Section 402 of S. 1592 would amend Section 203 of the National Housing Act so as to permit the Federal Housing Administration to insure loans for as much as 95 per cent of the value of the property, the loans to run for 32 years, at 4 per cent interest. Such insured mortgages would be available only on houses built under FHA inspection, and would not exceed $5,000.

This section is proposed as part of a long-range Federal housing policy, but its enactment now or in the near future would strengthen the serious inflationary pressures in the housing market. It would not contribute to meeting the immediate need for both an increased supply of houses and better housing for families of low income.

The housing crisis is typical of the inflation problem generally. It is due to the fact that the demand vastly exceeds the supply. There is a large accumulated shortage of housing units. At the same time, incomes have never been so high as in the past few years, and never before has the general public had available such tremendous amounts of cash and readily convertible assets. When credit is required, borrowers have been able to obtain increasingly easy mortgage terms from banks and other lenders who, having ample funds, are eager to supplement their government security holdings with higher yield investments. A ready availability of cash resources has thus combined with the unprecedented need for houses to bring about the inflationary situation in the housing field.

To add to this dangerous pressure at this time by a still further easing of credit terms would make the inflationary danger all the greater without providing any new supplies whatever of houses on the market. The difficulty lies not in credit terms, which have been reduced substantially in the past decade, but in the immediate and prospective shortages of building materials of various kinds and of manpower. Any realistic attack on the problem must look to remedies for these shortages as well as to solutions of the special difficulties created by antiquated building codes, by monopolistic practices affecting building materials as well as the building trades, by jurisdictional conflicts, and by similar restrictions which make for inadequate construction at excessive cost.

Availability of credit is thus not the factor which limits additions to the supply of housing, and may not be for some years to come. While materials and manpower are short, further liberalization of credit terms would merely add to inflationary pressures. Whether further easing of credit terms would be desirable at some future time when the demand for housing is not in excess of the supply of manpower and materials is another question, and one which should be considered in the light of conditions then. Certainly at this time it would be illusory and misleading to the general public to enact legislation which in effect would serve only to intensify the demand factor without adding anything whatsoever to the supply side of the equation. If it is desired to increase the proportion of houses built in the lowest price ranges, action along lines of material allocation would appear to hold more promise.

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COMMENTS REGARDING TITLE III OF S. 1592

Sections 301 and 302

Section 301 would authorize Federal savings and loan associations to lend or invest their funds in any mortgage or obligation which is insured under Title I or Title II of the National Housing Act, as amended. This would change existing law in two important respects. It would permit such an association to make loans on homes located more than fifty miles from its home office, and permit it to participate in the financing of large-scale rental housing, without regard to the limitation which now restricts the aggregate of such loans to 15 per cent of the assets of the association.

These provisions should not be enacted. Savings and loan associations have traditionally been local thrift and home financing institutions, gathering investment funds of individuals from the local community and lending them out to home owners and prospective home owners within the local community. This is clearly the basic function which Congress intended Federal savings and loan associations to perform, although it permitted them, as a matter of operating flexibility and to meet unusual situations, to engage in other lending activities within well-defined limits.

This element of flexibility is proper and useful, but if operations now permitted as exceptions to the rule should become the general rule, the basic function described above would be fundamentally altered. Therefore, the loans made on properties outside the association's locality (i.e., beyond 50 miles) should remain within the 15-per-cent-of-assets limitation.

Furthermore the financing of large-scale rental housing should continue to be subject to the 15-per-cent-of-assets limitation. Such financing is essentially different from the financing of homes for owners and prospective owners. The borrower, in the case of rental housing, is not a home owner. He is an investor in a business enterprise just as is the hotel owner. Thus, the financing of large-scale rental housing is essentially business financing, which it was never contemplated savings and loan associations would undertake. The Federal Home Loan Bank Board has, we think quite properly, recognized this fact because, although the present law would permit Federal savings and loan associations to make any non-home loan within the 15-per-cent-of-assets limitation, the Board, by regulation, has imposed severe restrictions on the rental housing loans which they may make. It has limited such loans to 50 per cent of appraised value, except in the case of small apartments (5 to 12 families) for which the limit is 60 per cent, even though they are insured under the National Housing Act.

For these reasons, the blanket authorization of Federal savings and loan associations to lend any amount anywhere on insured mortgages, which is contemplated by section 301 (and the corresponding provisions in section 302), should not be enacted.

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Section 303

The purpose of section 303 is to increase the amount of money which the Federal Home Loan Banks may borrow in the money market by widening the range of Bank assets on the basis of which debentures may be issued. The law as it now stands restricts the amount of debentures which the System may issue to the amount of advances to members secured by loans of the types prescribed by Congress in section 10(a) of the Federal Home Loan Bank Act. Thus, the power of the Home Loan Banks to obtain funds in the money market is geared to the volume of the advances to the member institutions secured by loans of the best type, namely, loans which qualify under section 10(a). It seems obvious that the present provision furnishes the Home Loan Bank System with borrowing capacity more than adequate to enable member institutions to meet the demand for such loans in communities where share accounts are insufficient. Within the limitation which relates debentures to capital, the Home Loan Banks can now issue debentures on a one-for-one basis for the entire amount of 10(a) loans rediscounted. In what way could a demand arise which could not be met under the present provision? Only if member institutions should wish to rediscount other types of paper (or obtain unsecured advances) in considerable volume. Such other paper would include mortgage loans on business properties, apartment houses, and other non-home properties, as well as loans made on the security of share accounts. It seems apparent that Congress did not intend that such paper should form the basis for obtaining additional funds in the market. With the possible exception of loans on the security of share accounts, this is a type of financing that should be held within the 15-per-cent-of-assets limitation, as already pointed out herein, and therefore that should not be encouraged by giving such paper, when discounted at a Home Loan Bank, the same access to market funds as is enjoyed by 10(a) paper. In fact, the power to include such other paper in the debenture base would have the inevitable effect of eliminating the relative desirability of loans under section 10(a) which are clearly the most appropriate type of loan for mutual thrift and home financing institutions.

The proposed amendment would also include in the debenture base of the System all Government obligations owned directly by the Federal Home Loan Banks. This provision would permit Government obligations, including those held as part of the Banks' reserves, to be counted in the debenture base.

The present law in our opinion is over-generous in providing that required reserves may be invested in earning assets (the reserves of commercial banks and those of the Federal Reserve Banks may not be in earning assets) and the proposed amendment would go even further by allowing the reserves to be again multiplied by forming a base for the issuance of debentures.

There is nothing in the present law which restricts the power of the System to raise money to perform the functions it was established to perform, namely, to provide a reservoir of funds on which member institutions

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can draw when the demand for sound home mortgage loans in their communities exceeds the amount of share investment. Without issuing debentures, the Banks can make advances out of their own capital, as well as from deposits they may have from member institutions which have more share capital than mortgage loans. When demandson the Banks exceed these resources, the System may borrow from the money market the entire amount of section 10(a) advances from the Banks to their members.

Bearing in mind that Federal savings and loan associations are forbidden by law to accept deposits and that the holder of a share in such an institution should not expect the same liquidity as the owner of a deposit in a commercial bank, it seems obvious that the Federal Home Loan Banks should not need to raise funds on the basis of assets other than loans of the types described in section 10(a) of the Federal Home Loan Bank Act. The most likely use for such funds would be to make unsecured advances to member institutions to enable them to meet demands for share withdrawals - an operation which is clearly inconsistent with the nature of share accounts and the uniform charter provisions of Federal associations governing withdrawals.

Section 303 is therefore open to objection on the following principal grounds: first, because it would broaden the base for debentures in such a manner as to encourage lending by member institutions of types which are inappropriate for local mutual thrift and home financing institutions; second, because, by including paper not conforming to section 10(a) as well as Government obligations owned directly by the Federal Home Loan Banks, whether as part of their reserves or not, it would make available to the Banks far more funds than they need in order to perform their functions; and third, because it is desirable that the reserves of the Federal Home Loan Banks, which are already invested in earning assets, should not be used as a basis for further generation of credit.

The argument which has been advanced that the Federal Home Loan Banks have not participated as fully in the financing of the war as they would if Government obligations could be included in the debenture base, is not convincing. The Treasury has said repeatedly that it does not want institutions to borrow money in order to purchase Government bonds.

Section 306

The reserve which Congress has said should some day reach 5 per cent of the Federal Savings and Loan Insurance Corporation's insured risk was, on June 30, 1944, after 10 years of operation, only 0.57 per cent of the insured risk. Section 306 would reduce the insurance premium due from insured institutions by one-third, and would consequently slow down the rate at which the reserve is accumulated. In a period when losses were high, the reserve would be sadly deficient.

It might be argued that the right to assess insured institutions for losses and operating expenses could be used to meet larger losses, but

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apart from the fact that the Corporation has never yet used this power of assessment, it is doubtful that assessments after large losses have started would be effective in yielding the amount of revenue that would be required (since the amount of assessment for any one year is limited) or could, in such a period of widespread strain, be conveniently paid by the institutions. Indeed, it is contrary to all insurance principles to attempt to assess the insured after the risk insured against has materialized.

One of the arguments advanced in support of this proposal in previous years was that the risk insured by the Federal Savings and Loan Insurance Corporation is about the same as that insured by the Federal Deposit Insurance Corporation, and that therefore the premiums should be similar. However, the risk is far from being the same.

In the first place, banks insured by the FDIC as of June 30, 1945, had cash and United States Government securities totaling $112 billion as against total deposits of $134 billion, leaving a balance of $22 billion as the only part of their deposits involving risk of loss to the FDIC. Capital accounts (capital, surplus, undivided-profits and reserves) totaled $8 billion. The ratio of capital accounts to these remaining deposits was therefore 1 to 2.7. By comparison, institutions insured by the Federal Savings and Loan Insurance Corporation, as of December 31, 1944, had cash and United States Government securities totaling $1.5 billion as against total private repurchasable capital (shares), including deposits and investment certificates of $4 billion, leaving a balance of $3 billion. The undivided profits and reserves of the insured institutions amounted to approximately $0.36 billion, a ratio of 1 to 8. On this basis, the cushion provided by the capital accounts of institutions insured by the FDIC is three times as great as that provided in the case of accounts insured by the Federal Savings and Loan Insurance Corporation.

In the second place, the comparison of the risks should be on the basis of the insured accounts of the institutions and not their total assets. The capital accounts of institutions insured by the FDIC amounted, in 1943, to 20 per cent of the insured deposits, while the capital accounts of institutions insured by the Federal Savings and Loan Insurance Corporation amounted to only about 9 per cent of its insured accounts. In other words, a comparison on this basis, without taking into account the cash and United States Government securities which would tend to reduce the risk, would show that the cushion in the case of the FDIC is over twice as great as in the case of the Federal Savings and Loan Insurance Corporation.

Finally, the difference is further accentuated by the fact that, whereas virtually all of the share accounts and deposits of the institutions insured by the Federal Savings and Loan Insurance Corporation are covered by insurance, only about 38 per cent of the total deposit liabilities of insured banks are insured by the FDIC (its Annual Report for 1943 indicates that 36 billion are insured out of a total of 94 billion). This means that the effective premium rate of the FDIC is approximately 1/5 of one per cent of insured deposits. Consequently, even if the other factors were equal,

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the rate for the Federal Savings and Loan Insurance Corporation should be raised instead of lowered in order to make it comparable with that of the FDIC.

The Federal Savings and Loan Insurance Corporation has 100 million dollars of Government-furnished money. This is, in effect, a subsidy. At the present time, when the national debt is so great and such earnest efforts are being made to increase Government receipts it would be more prudent to permit the rate to remain where it is with the ultimate view of repaying this 100 million dollars to the Treasury when possible, rather than to reduce the rate in the face of all the factors outlined above.

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