BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date February 12, 1947

To Mr. Musgrave

From Ramsay Wood

Subject: RFC purchase of loans insured under the Servicemen's Readjustment Act

The Budget of the United States for the fiscal year 1948 "authorizes" the Reconstruction Finance Corporation to spend 450 million dollars for the purchase of loans guaranteed or insured under the Servicemen's Readjustment Act of 1944. This amount is provided to carry out Public Law 656 of the 79th Congress which authorizes the RFC to "furnish a market" for such loans. Since Public Law 656 does not limit the amount of loans RFC may buy, however, the 450 million dollar authorization in the Budget estimate is not a restriction, but merely an estimate of the maximum amount which will be required.

The purchase of these loans is not part of the process of payment of the insurance or guarantee of loans in default, which is provided for in the budget of the Veterans' Administration. It seems reasonable, therefore, not to give this responsibility to the Home Owners' Loan Corporation whose function was to aid distressed debtors and lenders, and which is now in process of liquidation. The regulations governing purchases, issued by the RFC Mortgage Company, provide not only that loans purchased must not be delinquent, but also that the sellers must certify that they have no reason to believe that the loans will become delinquent.

This program of loan purchase fits logically into the policy followed by the Federal Government in recent years of increasing the liquidity of mortgage debt held by private lenders. Even in the fact that a double protection against loss is provided, it is similar in principle to the RFC's purchase of mortgages insured by the Federal Housing Administration.

Although it may be sound policy for the Federal Government to support the market for obligations which it underwrites, some question may be raised about the regulations covering the present program. For example, RFC engages to buy the loans at a price representing outstanding principal plus accrued interest, which implies that it will not adjust to market conditions either by paying premiums or by accepting discounts. This would seem to prevent RFC from "making a market" in the ordinary sense, but may be intended to assure lenders that they will not suffer from a rise in mortgage interest rates.

A further limitation on "making a market" seems to be the provision in the regulations that RFC will not buy except from the originator of the loan, and only then if the seller has owned the loan since it was made. This provision will limit the market that RFC provides since a particular loan can go through its portfolio only once; furthermore, if lenders regard RFC as the market of last resort, this regulation may also inhibit trading in these loans by private parties and thus both reduce the mobility of the loans and increase the demands on RFC when lenders want to obtain cash.

Perhaps it should be mentioned here that the Federal Home Loan Bank Administration is considering a similar plan under which the Federal Home Loan Banks would buy from their members loans guaranteed or insured by the Veterans' Administration. The fact that such a plan is under consideration has been announced, but it is expected that the plan will not be in operation for about two more months.

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