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Governmental Influence on the Methods of Real Estate Financing

THE concern of government with the establishment and protection of rights in real property gives it a natural interest in the validity and fairness of actions that involve borrowing and lending on the security of real estate. Moreover, being committed to a policy of diffusion of ownership and the maintenance of small ownerships, it is inevitable that government should make its control over financial transactions an instrument for preserving and advancing that policy.

The process of intervention develops somewhat in this manner. First, comes the elementary policing problem: Is the transaction free from coercion or fraud? Next, the question of equity arises: Are the rights and interests of borrower and lender fairly balanced? At this stage other questions arise: In what manner may the protection granted to either party influence the flow of credit and thus affect the state's committed objectives? Finally: What devices may be employed to cause credit to flow in amounts and in directions that will advance the chosen purposes? At this stage financial policy becomes a vital instrument of land policy.

DEVELOPMENT OF MORTGAGE FINANCING

The creation of a nation of small landholders obviously involved the extension of large amounts of credit, for settlement was a costly process. Funds were needed to purchase land, and even after the Homestead Act the choicest lands were rarely in the free category. Funds were also needed to pay for improvements, tools and seed, and to carry the settler until his land was fruitful.¹

For these purposes the device of the mortgage loan was not only available but had peculiar advantages. It permitted the achieve-

¹ See Clarence H. Danhof, "Farm-Making Costs and the 'Safety-Valve': 1850-1860," *Journal of Political Economy*, Vol. 49, No. 3, June 1941.

ment of ownership with a relatively low (and as events developed, a constantly lower) amount of initial cash investment, and it was largely dependent upon the security of the financed property for its repayment.

Both features were important where borrowers were likely to have little resources beyond the property itself. In addition, through successive renewals with curtail, or by regular amortization, the repayment of a mortgage loan might at least be roughly adjusted to the earning capacity of the property—a further advantage under circumstances where the property was the dominant factor in the transaction. As a consequence, mortgage financing has been synonymous with real estate financing.

The mortgage is almost as old as recorded law. For present purposes, however, its ancestry need be traced no further than from the end of the sixteenth century. By that time, the legal background of the mortgage as we know it had been well laid and many of its early crudities had been eliminated. The equity of redemption² had been established, and a procedure for foreclosure devised. As a distinction grew up between legal and equitable rights, title was still held by the mortgagee during the existence of the debt, but actual possession of the premises was generally left in the mortgagor, and an agreed interest payment supplanted the surrender of the yield of the property.³

Because of the predominance of a well-established landed interest (proverbially a debtor interest) with its passion for stability and continuity, the development of the mortgage during the next century was mainly toward the greater protection of the equity holder. Obstacles were put in the way of foreclosure, making it costly and time-consuming; and the rights of the mortgagee in possession were more and more strictly limited. Though the balance of legal opinion favored the borrower, the law in many ways was vague, leaving both parties in some uncertainty as to their rights.⁴ The need for mortgage credit in those precommercial days

² *Equity of redemption* is the right of the mortgagor to satisfy the debt and redeem the property after the date upon which the debt has become due. The time during which this right may be exercised is called the *redemption period*.

³ H. W. Chaplin, "The Story of Mortgage Law," *Harvard Law Review*, Vol. 4, 1890-91, pp. 1-14; Charles A. Keigwin, *Cases on Mortgages With Summaries of Doctrine* (Rochester, New York, 1936).

⁴ Robert H. Skilton, *Government and the Mortgage Debtor*, (Philadelphia, 1944) p. 10.

may not have been great; certainly its expansion was not given official encouragement.

On importation to this continent, mortgage practice faced different conditions. Credit was no longer merely incidental to land ownership—it was the very essence of land acquisition and development. And the settler's need for credit often outweighed his anxiety for protection as a debtor. What the settler wanted was ample funds at a favorable interest rate, and he was willing to chance his ability to handle his part of the bargain. The availability of cheap land on an ever-broadening frontier was, at least in theory, a hedge against disaster not present in England.

In rewriting mortgage law in the colonies, the policy was clearly to induce a flow of credit. More of practice was put into statutory form and less was left to custom, thus removing much of the uncertainty as to rights and duties under the agreement. Foreclosure procedures were simplified and redemption periods were shortened, or, in some cases, eliminated altogether. At the same time, the right of the mortgagor to remain in possession before default was firmly established, and frequently this right extended to the redemption period. With these rights acknowledged, the concept of the mortgage as a lien gradually, and almost wholly, displaced that of the mortgage as a conveyance.⁵

Though the interests of the borrower were not altogether neglected, the balance of benefit was shifted to the lender. The high point in this trend was the contracts clause of the federal Constitution, which asserted the inviolability of contracts. From the available evidence, it seems clear that the provision was designed to prevent debtor relief, and particularly the relief of delinquent mortgagors, through a forced modification of contract terms such as, at times, had been imposed by colonial and state legislatures.⁶

As communities were settled, however, and open land became more difficult to acquire, a shift toward more definite solicitude for the borrower's fate became evident. This was particularly true in the new states where, as a result of national policies, small land holdings were predominant. It was less true of the older states,

⁵ *Ibid.*, p. 11.

⁶ *Ibid.*, pp. 55 ff. Also Edward S. Corwin, *The Constitution and What It Means Today* (Princeton, 1940) pp. 73-74; Charles A. Beard, *An Economic Interpretation of the Constitution of the United States* (New York, 1935) pp. 178-83.

where agriculture had declined in importance, or where large holdings under the plantation system were characteristic.

Thus, in spite of some counter swings in times of prosperity, the trend in the new agricultural states by the middle of the last century was toward the provision of long periods of redemption following foreclosure. At the present time, twenty-seven states, either by legislative or court practice, allow redemption periods of six months to two years.⁷ It is interesting that all of these states were created after the establishment of the Republic and, with the exception of Alabama and Arkansas, are states in which the plantation system was never widely introduced.

UNCERTAINTY OF THE MORTGAGE CONTRACT

The policy of granting increased protection to the mortgagor went beyond merely writing the original contract terms in the mortgagor's favor. It modified the effect of the contract when in times of general distress the mortgagor's interest seemed to require it. Twenty years after the ratification of the Constitution, legislative attempts were made to circumvent the guaranteed sanctity of contracts, and each succeeding depression brought forth new methods for providing debtor relief. To this movement the federal government itself made a contribution by acting to relieve defaulting purchasers of public lands. During the sixteen years prior to 1820, eleven separate relief laws were enacted to extend or modify payments on public land contracts.⁸ With the panic of 1819, the states themselves began to devise means of protecting debtors, particularly those indebted under mortgage.

Many devices were invented over the next sixty years to avoid the constitutional interdiction against statutory modification of

⁷ Alabama, Arkansas, Arizona, California, Colorado, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Michigan, Minnesota, Missouri, Montana, Nebraska, Nevada, New Mexico, North Dakota, Oklahoma, Oregon, South Dakota, Tennessee, Utah, Washington, Wisconsin, and Wyoming. R. H. Skilton, *op. cit.*, pp. 19-24; David A. Bridewell, "The Effects of Defective Mortgage Laws on Home Financing," *Law and Contemporary Problems*, Vol. 5, No. 4 (Autumn, 1938) pp. 547-48; Leonard A. Jones, *A Treatise on the Law of Mortgage of Real Property* (Indianapolis, 1944).

⁸ Benjamin H. Hibbard, *A History of the Public Land Policies* (New York, 1924) pp. 92 ff. Even these moves did not prevent wholesale defaults, "when the panic came in 1819, payments due to the government for public land were in arrears many millions, most of which never were and never would be paid." See also Samuel Eliot Morison and Henry Steele Commager, *The Growth of the American Republic* (New York, 1937), Vol. 1, p. 338.

contractual obligations. According to Robert Skilton:⁹ "The strategy usually adopted was to operate merely upon a creditor's legal remedies. The legislation was ingenious and varied. Some statutes closed the courts to contract suits for a definite or an indefinite period. Some delayed a phase of the suit, such as trial, judgment, or execution. Some created or extended the statutory right of redemption after judicial sale. Some required valuation of property before sale, and forbade sale below a certain percentage of appraised value (at least until a stipulated time had elapsed). Some created or enlarged debtors' property exemptions. All of the law purported to apply to suits on pre-existent contracts."

Judicial history has varied but, in the main, the devices were upheld,¹⁰ although relief was generally provided only to meet a specific, current emergency, and reliance had to be placed on precedent rather than on an active statute when a new emergency arose. The mortgagee could anticipate some modification of his contract with each emergency, even though he could not foretell the precise manner and extent to which his rights would be curtailed.

The climax to this development came in the depression of the 1930's. As that crisis developed, demands for relief grew steadily more insistent. In 1932, federal authorities, and most state authorities, ordered receivers of closed banks under their respective jurisdictions to discontinue foreclosure. By the beginning of 1933, orderly court processes were interrupted in some areas. Before the suspension of banking activities in March 1933, five states had enacted mortgage moratoria. A flood of such legislation followed the bank holiday, with ten states acting during the month of

⁹ R. H. Skilton, *op. cit.*, p. 60.

¹⁰ In two decisions the Supreme Court has indicated the latitude within which debtor relief may operate. In *Sturgis v. Crowninshield*, 4 Wheat. 122, 200 (1819) the Court held: "The distinction between the obligation of a contract and the remedy given by the legislature to enforce that obligation has been taken at the bar, and exists in the nature of things. Without impairing the obligation of the contract, the remedy may certainly be modified as the wisdom of the nation shall direct." In *Van Hoffman v. City of Quincy*, 4 Wall. 535, 553-54 (1866), the language was broadened: "It is competent for the states to change the form of the remedy or to modify it otherwise, as they may see fit provided no substantial right secured by the contract is thereby impaired." Quoted in J. Douglas Poteat, "State Legislative Relief for the Mortgage Debtor During the Depression," *Law and Contemporary Problems*, Vol. 5, No. 4 (Autumn, 1938) p. 519. The temporary nature of the relief granted by the statutes is an important consideration. "Indeed," says Poteat, *ibid.*, p. 521, "it is precisely this feature on which their constitutionality depends." This criterion is established in *Home Building and Loan Association v. Blaisdell*, 290 U. S. 398 (1934).

March. During the remainder of 1933 and in 1934, twelve additional states enacted moratoria, making twenty-seven in all.¹¹

On the whole, this legislation went much further in its effort to protect and salvage the mortgagor than any previous enactments. In most cases farm and residential property was covered irrespective of its homestead character and in some states benefits were given to corporate owners as well as to individuals. In some states the owners of commercial property, as well as of farm and residential property, obtained protection.¹²

The usual effect of the moratoria was to prohibit or impede foreclosure during the applicable period of the acts. Sometimes interest and taxes had to be paid, but in many instances payments of a fair rent on the property (which might be less than interest charges) were permitted in lieu of interest. A few of the states offered relief to all defaulting mortgagors irrespective of the nature of, or reason for, default, but more commonly a wide range of judicial discretion was permitted. The actual extent of relief granted, and the reasons for which relief was extended varied, therefore, not only from state to state but from court to court. Originally, the moratoria applied only to pre-existent contracts, but in several instances subsequent mortgages were also made subject to their provisions.¹³ Questions of constitutionality arose but they were usually dealt with on the principle that the *status quo* might be maintained where an emergency prevailed and where the creditor continued to receive proper compensation.¹⁴

Moratoria were repeatedly extended during the decade but, with the assumption by federal agencies of a large part of the mortgage debt on farms and homes, and the gradual return of more prosperous conditions, the pressure for continued relief subsided. By the beginning of World War II, they were for all practical purposes abandoned except in New York State, where the moratorium (modified to require a 1 percent annual payment on principal) was still in force in 1947.¹⁵

¹¹ R. H. Skilton, *op. cit.*, pp. 73-78.

¹² *Ibid.*, Chapter 5.

¹³ *Ibid.*, Chapter 6.

¹⁴ *Ibid.*, Chapter 6; E. S. Corwin, *op. cit.*, p. 74; J. D. Poteat, *op. cit.*, pp. 520-25. The term "proper" was liberally interpreted from the mortgagor's point of view.

¹⁵ Under the amended moratorium law of 1941 (Laws of New York, 1941, c. 782). See R. H. Skilton, *op. cit.*, p. 94, and *Journal of Housing*, March 1947, p. 66.

Abandonment, however, generally came through the gradual process of limiting the nature of the remedy and the classes of properties considered, rather than by outright repeal. Louisiana is probably the only state where a clear-cut repeal was enacted.¹⁶ The aftermath was more than a mere retention of partial remedies. So widespread was the practice of granting relief from the rigidity of the mortgage contract that it may be said to have become embodied in legal usage, to be invoked with little debate whenever a new need for it might arise. In Iowa, at least, the issue has been squarely faced with a permanent statute, under which a mortgagor is entitled to petition the court for relief from foreclosure where default occurs by reason of crop failure due to climatic conditions or infestation of pests, "or when the Governor of Iowa by reason of a depression shall have by proclamation declared a state of emergency to exist in this state."¹⁷

State legislatures were not alone in their intervention in the mortgagor-mortgagee relationship. As early as 1931, in the last days of the Hoover Administration, an effort was made to relieve mortgage debtors through the invocation of the bankruptcy law.¹⁸ This first attempt proved on the whole to be ineffectual. Further amendments, under the second Frazier-Lemke Act of 1935¹⁹ and the Chandler Act of 1938,²⁰ provided the means for eliminating the priority of the mortgage lien and for placing mortgage obligations in approximately the same standing as other obligations in bankruptcy proceedings. These changes in the bankruptcy statute were particularly effective in dealing with farm mortgage debt and with urban mortgage bond issues.²¹ By successive extensions the Frazier-Lemke Act was kept in force until 1949.²²

After the United States entered the war, a new type of moratorium came into existence with the passage of amendments (Octo-

¹⁶ Louisiana General Statutes Annotated (Dart Supplement 1942) §§ 5002.14-.29; R. H. Skilton, *op. cit.*, p. 94.

¹⁷ Iowa Code (Reichmann, 1939) § 12383.3, quoted in R. H. Skilton, *op. cit.*, p. 95.

¹⁸ 47 Stat. 1467 (1933); 11 U.S.C. § 201 *et seq.*

¹⁹ 49 Stat. 943 (1935); 11 U.S.C. § 203 (s).

²⁰ 52 Stat. 840 (1938); 11 U.S.C. § 201 *et seq.*

²¹ R. H. Skilton, *op. cit.*, pp. 137-44.

²² 62 Stat. 198 (1948) provided extension to March 1, 1949. Although bills for the extension of these provisions beyond March 1, 1949 were pending at the close of the 1st Session, 81st Congress, no action had been taken. At least temporarily, therefore, the Frazier-Lemke statute was allowed to lapse.

ber 1942) to the Soldiers' and Sailors' Civil Relief Act of 1940.²³ This federal statute barred creditors from exercising their remedies during the period of the borrower's military service.

DECLINE OF THE DEFICIENCY JUDGMENT

The moratorium met only one phase of the defaulted debtor's problem. It gave him time in which to repair his fortunes, or to negotiate for modified terms with his creditor, but it could not lighten his personal liability under a deficiency judgment.

American mortgage laws in most states make two significant departures from English foreclosure practice. In England, the mortgagee may obtain title by taking and holding possession beyond the limitation on the right of redemption, or by proceeding to obtain title under strict foreclosure.²⁴ If either course is adopted the debt is considered to be discharged and all claims canceled. Or, a public sale, in which the mortgagee may not participate, may be required by court decree. In the latter case, the mortgagee may lay claim on the debtor for any deficiency in the amount received from sale. In this country, the method of obtaining title has generally been limited to public sale under the jurisdiction of the court, although the mortgagee is permitted to bid at the sale and at the same time to retain his right to sue for a deficiency judgment.²⁵

The first departure—the requirement of sale—by avoiding the possibility that the creditor might obtain property greater in value than the amount of the debt was undoubtedly taken in the mortgagor's interest. But the second—permitting the mortgagee to bid and, at the same time, to sue on the covenant—was clearly in the lender's interest. Particularly in times of distress, when values were low and purchasers few, nominal bidding by a mortgagee might, and often did, leave the mortgagor with a burden from which there was no escape but bankruptcy.²⁶

In the course of a century, various means were used to escape

²³ 54 Stat. 1179 (1940), as amended by 56 Stat. 769 (1942).

²⁴ Strict foreclosure "is an action in which a decree is rendered barring the mortgagor's equity, and vesting the absolute estate in the mortgagee, if the debt is not paid within a certain time after the rendition of the decree." Christopher Gustavus Tiedeman, *The American Law of Real Property* (St. Louis, 1924) p. 272.

²⁵ R. H. Skilton, *op. cit.*, pp. 11-12, 116-17.

²⁶ D. A. Bridewell, *op. cit.*, p. 558.

this contingency. Sometimes a substantial minimum limit was put on the amount of the price bid at a foreclosure sale. Another method was to permit redemption at the amount of the sales price (plus interest and costs). But the real drive on the deficiency judgment came with the depression of the 1930's. The approach usually was to prevent nominal bidding by postponing sales, by establishing minimum sales prices, by relating the deficiency to an appraisal of "fair value" rather than sales price, and limiting the time during which an appraisal might be sought and a suit be brought, or by limiting the time within which a judgment could be enforced. In seven states the effect of the statutes is to eliminate the possibility of a deficiency judgment.²⁷

Unlike the state moratorium laws, deficiency judgment legislation has generally been applicable to the future as well as to the past, and consequently results in a permanent modification in mortgage procedure. Difficulties with constitutionality seem on the whole to have been overcome.²⁸

SHORTCOMINGS OF THE MORTGAGE DEVICE

In spite of its apparent adaptability to the requirements of realty finance, the mortgage has revealed serious weaknesses in its adaptability to the requirements of a fluid, expanding society. A number of these weaknesses resulted from practices which, due either to legal requirements or to custom, became characteristic of the mortgage lending system; others are more deeply imbedded in the mortgage device itself.

Of the first class of weaknesses, Horace Russell lists eight, which he considers to have been major contributors to the debacle of the thirties (and which, indeed, were present in all previous disasters): "First was the general use of short-term mortgage loans, which had to be refinanced every few years with high commissions and financing charges. Second was the general practice of lending only a small amount on the security of the first mortgage, which necessitated junior financing with all the hazards to the borrower which that practice involved. Third was the general use of lump-sum rather than amortized mortgages, which necessitated the borrower repaying the entire amount of the mortgage at one time or refinanc-

²⁷ Arizona, Arkansas, California, Louisiana, Montana, Nebraska, South Dakota.

²⁸ R. H. Skilton, *op. cit.*, pp. 121-34; J. D. Poteat, *op. cit.*, pp. 529-36.

ing it. Fourth was the prevailing high interest rates generally charged on all such mortgage loans in contradistinction to the low interest rates charged on railroad, public utility, and other types of long-term loans. Fifth was the absence of a steady market for mortgages as a preferred type of investment, due to the lack of facilities for insuring the repayment of mortgage loans and to the lack of a sufficient number of sound mortgage associations operating on a national basis, which would create a market for this type of investment. Sixth was the lack of any credit facilities for home-financing institutions, from which such institutions could borrow in order to meet reasonable withdrawal requests of their investors during times of emergency and to meet the usual requirements of their borrowers. Seventh was the lack of any insurance facilities whereby shareholders and depositors in home-financing institutions might be assured of the repayment of their invested funds. Eighth was the absence of proper lending and appraisal practices and procedure and the impossibility of obtaining uniform, cooperative action among thousands of widely scattered local home-financing institutions." ²⁹

Many of these reputed defects have, in part at least, been remedied by legislation to be discussed below. Many, however, persist because of the unsolved problems arising from the variety, rigidity, cumbrousness, and costliness of mortgage procedures. As is true with all the substantive law of real property, mortgage law lies in the province of the states; and the states have well expressed their separate sovereignties in the variety of their legislation. Diversity in the proffered remedies and the stipulated procedure impedes the flow of funds on a national basis and tends to maintain localism in mortgage lending. Efforts at uniform mortgage legislation (corresponding to the universally adopted Negotiable Instruments Act) have so far borne little fruit.

The rigidity of the mortgage contract creates another deterrent to the flow of funds. The now general practice of regularly amortizing mortgage loans is at best only a partial remedy. It does prevent the hazard of large payments to be made under uncertain future conditions, and it does, very roughly, reduce the outstanding

²⁹ Horace Russell, "Private Housing Legal Problems," *Housing, the Continuing Problem* (National Resources Planning Board, Washington, December 1940) pp. 41-42.

obligation in some relationship with the probable ultimate decline in the value of the security. But the amortization arrangements are themselves usually fixed and inflexible and, if combined with interest in one payment of constant amount, they prevent (except by special arrangement with the lender) any adjustment to a varying rental or personal income. Moreover, the dangers of inflexibility are increased with the reduction of down payments and the extension of the repayment period.³⁰

In contrast to the ordinary collateral loan of commercial banking, the mortgage contract does not (perhaps for good reason) provide either for increasing the amount of security or for quickly calling the loan in a period of falling value. Consequently, mortgage lending practice commonly requires that the amount loaned be limited to a figure considered to be not more than the lowest value to which the security may fall during the term of the loan. The decline in the availability of the deficiency judgment emphasizes the importance of this principle. Yet, as we shall find, the exercise of the principle runs counter to a public policy that seeks to liberalize lending terms, irrespective of the peculiar characteristics of the transaction.

The slowness and costliness of the foreclosure procedures which the mortgagee must follow in most states, even when unimpeded by a moratorium, are notorious.³¹ These procedures add to the initial charges and cost of money to the borrower, and they add to the risk of the lender. They tend to reduce the relative availability of mortgage funds in states where foreclosure procedures are the most onerous, and they particularly increase the cost of hazard on loans of small amounts. These conditions have often made it difficult for private institutions to comply with an expansionist credit policy and consequently have evoked measures to compensate for the impediments introduced by state law. Indeed, the later history

³⁰ Recently, some institutions have adopted the practice of writing into the mortgage loan agreement conditions under which the amortization payment might be modified to meet temporary hardship on the part of the borrower. This practice, however, appears not to be widespread. Effort has also been made to include such provisions in Federal Housing Administration procedure.

³¹ H. Russell, *op. cit.*, pp. 45-52; D. A. Bridewell, *op. cit.*, pp. 549-58. In this connection it may be noted that long redemption periods, characteristic of farm mortgage credits, become particularly burdensome and hazardous to the lender on urban property.

of federal intervention is concerned in large part with efforts in this direction.

In addition to the problems just discussed, two special questions arise concerning the adaptability of the mortgage device to current real estate and construction requirements. These questions center on "fixtures" and construction loans.

THE PROBLEM OF "FIXTURES"

The distinction between movable and real property, while never wholly clear, was in early times usually not difficult to draw. What was fixed to the land was a "fixture" and thus part of the real estate and eligible as security for a real estate mortgage loan. In the course of time, however, many fixtures have become less fixed; new elements of uncertain status have been added to the structure; and the structure itself in some respects has become less definite in its affixation. Electrical equipment (such as ranges, refrigerators, laundry machines, and ventilating fans) which is affixed only by a plug-in device, certain easily-removed gas-fired equipment, certain classes of furniture, partially affixed (such as folding beds and removable partitions)—these are only a few in a long list of questionable items. With the increasing use of prefabricated building methods, the list may be greatly extended.

The traditional tests for determining whether or not an article is a fixture are the following: (1) the manner of its annexation to the land or to the structure; (2) its adaptability to the use and purpose for which the realty is used, or its essentiality to the realization of that use; (3) the intention of the parties making the annexation; and (4) the specific agreement as between buyer and seller, landlord and tenant, mortgagor and mortgagee as to what is, or is not, real estate.³²

With an increase in the number of disputable items, tests (2), (3), and (4) have become more important. State law, however, varies widely on this point and custom and court decisions within states have added to the range of variation. The wide use of conditional sales contracts, and of chattel mortgages, complicates the situation by introducing additional parties into the process of acquiring a complete and usable property.

³² C. G. Tiedeman, *op. cit.*, Chapter 2; L. A. Jones, *op. cit.*, Vol. 1, Chapter 11.

The mortgagee has several problems because of this situation. On foreclosure, he may find the security stripped and unusable without additional expense. Legal definitions may prevent his blanketing certain items under the mortgage to the detriment of his security and of his ability to include their value in estimating the legal limit of the loan. Finally, the extensive use of instalment credit for financing equipment that cannot be classed as real property may seriously affect the mortgagor's ability to carry the total debt.

Therefore, the problem relates not only to the precautions necessary for the protection of the security but to the ability of the lender to offer a financing device that will economically and completely meet the borrower's requirements. Recent modifications providing for a more flexible definition of fixtures have been made in many state laws, and, though custom may lag in some jurisdictions, these changes do demonstrate the adaptability of mortgage law to new conditions.³³

THE PROBLEM OF CONSTRUCTION LOANS

The adaptability of law and custom to modern requirements appears less satisfactory in the case of construction loans. The mortgage, according to its original conception, is a conveyance of, or a lien on, an existing property—land, or land with structures on it. The purpose to which the proceeds of a mortgage loan are put—purchase, debt refunding, or personal convenience—plays no part in the legal concepts involved. One of the important needs for credit, however, is for development and construction. In this case, the basis of the loan is not the value of existing real property but a value that will exist only when the proposed improvements have been completed. In this case the success of the loan transaction will be determined by a number of conditions, each of which can be estimated only roughly at the time the terms of credit are agreed upon. These conditions are the eventual utility and earning power of the improvements, the probability of completion within an estimated limit of cost, the likelihood of substitution of long-term

³³ Another evidence of adaptability is the apparently increasing popularity of the so-called "open-end" mortgage, which permits successive loans to be made with the same instrument for the purpose of financing structural repairs, replacing or adding equipment, etc. See *Fortune Magazine*, Vol. 40, No. 3 (September 1949) p. 18.

financing on completion, and the ability of the borrower to carry out his commitments.

Despite these differences between developmental and long-term real estate finance, the mortgage loan, characteristically designed for the latter, is also the principal medium for the former. Two methods are generally followed: (1) a single loan agreement may be made, with amounts disbursed during the developmental period until, at completion, the entire amount has been advanced; or (2) two agreements may be entered into, usually with separate lenders, one of whom provides the entire amount of the loan on the completion of the improvements and the other, limited to the construction period, advances funds as the work proceeds. In both instances, however, the mortgage instrument is ordinarily used. The property, as it exists and as it is to be, provides the security for the loan.

Historically, the owner (or purchaser) of the property rather than the builder or developer arranged the financing, usually through a pledge of the property, and he made progress payments to the builder. The builder, therefore, needed only to carry himself from payment to payment, either out of his own resources or with the proceeds of a short-term bank loan. This system permitted builders to operate with little or no capital and gave rise to an industry unusually lacking in internal financial resources.

Arrangements of this kind have prevailed in spite of the growing importance of the merchant builder who constructs houses for future sale. Such a builder is essentially a manufacturer producing for a market rather than for specific, precontracted purchasers and he has financial requirements similar to those of other producers. For this type of operation, mortgage financing is often especially cumbersome, restrictive, and costly. The land may be covered with a blanket mortgage subject to release clauses; a number of lots may be released under a new mortgage contract to provide funds for construction; a third transaction providing funds for the individual purchaser is necessary on sale of the completed house. Each of these transactions involves negotiation, delay, title search, and expense characteristic of no other form of business finance.

Another method is to arrange separate mortgages on the prospective dwellings, to obtain advances on each mortgage as the work proceeds, and to assign each mortgage, or substitute another, on completion and sale of the property. This method, while simpler

in some ways, is still exceedingly clumsy and is ill-adapted to a mass operation. Moreover, the lender, being skeptical of the market and even more skeptical of the borrower's capacity to repay, except on a basis of quick sale, is disinclined to extend credit except for a small number of units. In a few centers the merchant builder, on the basis of commitments from a mortgage lending institution to make mortgage loans on completion and sale of property, can obtain a bank loan to finance construction. This practice is generally less complex and less costly than the other procedures outlined, but it appears to be not widely employed.

Whatever the method used, the finished product is a paramount consideration in the transaction. The situation is much as if, in automobile manufacture, each car, or group of cars, either had been sold to individual purchasers or had purchaser-financing provided for before the first item had been placed on the assembly line. Such a fusion of producer and consumer credit would be an impossibility in the mass production industries. It is undoubtedly one of the influences retarding the industrialization of house-building.

The situation has become even more crucial with the development of factory fabrication, in which the bulk of the structure may be produced apart from the land. As the prefabricating industry was evolving before World War II, production was in large part limited by orders in hand. Dealers were required to pay cash on delivery, and orders were usually not placed until the purchaser was found and his financing arranged, thus making production contingent on the flow of credit to the consumer.

The difficulties discussed above have led to a number of interventionary steps: the granting of "firm commitments"⁸⁴ to builders by the Federal Housing Administration; the insurance, by that same agency, of construction advances on rental housing mortgages and on mortgages securing single family houses with clauses permitting release of separate parcels upon sale; the provision of direct government loans to manufacturers of prefabricated houses to meet interim working capital requirements; the insurance of loans by FHA for the same purpose.⁸⁵ Some of these actions have had con-

⁸⁴ Agreements entered into prior to construction to insure loans on completion, with the builder as mortgagor, irrespective of the builder evidencing sales contracts.

⁸⁵ See Chapters 6 and 7.

siderable success, others have failed and been abandoned, still others proceed in an experimental fashion. But the problem remains.

OTHER METHODS OF REALTY FINANCE

The typical mortgage loan is, and has been, made by a single lender. Prior to the 1930's, mortgage participations under a trust agreement (often accompanied by a guarantee of payment) were common, and, along with the real estate mortgage bond issue, had a great but ephemeral vogue in the financing of apartment houses, office buildings, and hotels. Discredited by abuses, later made impracticable by securities regulations, and rendered at least temporarily unnecessary by the recent abundance of institutional mortgage funds, mortgage participation and bond issues have never been revived for private operations.³⁶

In a few of the states, ground rents, long-term leases, and land-trust certificates have served as important auxiliary devices in financing the improvement of real property.³⁷ But the general desire for fee ownership, combined with the widespread disfavor in which leasehold mortgages are held by state laws regulating institutional investment, has prevented any important extension of the ground rent system.

The financing device most commonly used as an alternative to the mortgage loan is the land contract, or contract for deed. Under this instrument, the buyer is granted possession but is not given title until the conditions of the contract are fulfilled. Upon default, repossession may be obtained by the vendor, at least theoretically, without recourse to foreclosure.³⁸ Probably the greatest use of land

³⁶ Louis S. Posner, "The Lesson of Guaranteed Mortgage Certificates," *Harvard Business Review*, Vol. 21, No. 5 (September 1948).

For further treatment of this subject, see Ernest M. Fisher, *Urban Real Estate Markets and Their Financing Needs* (National Bureau of Economic Research, Financial Research Program, mimeo. 1950) Chapter 2. Housing properties owned by municipal housing authorities have recently been financed by bond issues. The possibility also exists legally of financing real estate operations by the issuance to a lending institution, or institutions, of bonds secured by all the assets of the developing corporation. A mortgage may be involved but it will not be the sole consideration in making the loan. Financing of this type is not limited by the loan-to-value ratio of the customary mortgage loan, but, as with other bond financing, rests almost wholly on the discretion of the lender.

³⁷ R. H. Skilton, *op. cit.*, p. 36. E. M. Fisher, *op. cit.*, Chapter 2.

³⁸ Herbert Thorndike Tiffany, *A Treatise on the Modern Law of Real Property* (new abridged ed., Chicago, 1940) p. 1024.

contracts in this country was in connection with the sale of public lands. Under the federal system, the entryman was required to make a partial payment on obtaining possession, and to pay the remainder in annual instalments.³⁹ Failure to make a payment resulted in the forfeiture of all previous payments, as well as of improvements made by the settler. Nothing like an equity of redemption was recognized, although the relief acts, particularly those passed from 1821 to 1832, in effect provided a period of redemption by extending the payment period. For practical purposes, this device recognized an equitable right of the settler in the land for which he had contracted.⁴⁰

In later years, the land contract has been extensively used in the sale of urban lots and houses, especially where the initial cash payment was less than necessary to permit financing by a conventional mortgage loan. In this case the land contract might be the sole financial device, or a device supplemental to a mortgage loan. In many jurisdictions, the courts have considered the buyer under a land contract as having an equitable interest in the property to the extent of his payments or improvements and have consequently granted the right of redemption after default.⁴¹ Where this has occurred, the distinction between the contract and the mortgage is largely erased, and the advantage to the lender or vendor of unimpeded repossession after default is lost. Because of this, and because of the increasing availability of mortgage funds on a high ratio of loan to value, the land contract has declined in popularity since the twenties.

The use of equity funds in the form of stock or trust participations has been of relatively minor importance in realty finance. A serious effort to substitute these methods of finance for debt financing was made in connection with cooperative apartments during the building boom of the twenties, and on commercial structures

³⁹ The law of 1796 provided for final payment at the end of one year. The law of 1800 extended the payment period to four years. The public credit system was abandoned in 1820, all subsequent sales being financed by cash or private loan. B. H. Hibbard, *op. cit.*, pp. 82, 83, and 94.

⁴⁰ *Ibid.*, pp. 95-96.

⁴¹ H. T. Tiffany, *op. cit.*, pp. 1024-25. Land contracts appear also to have been frequently used by insurance companies and banks, particularly mutual savings banks, in selling foreclosed properties.

late in that era, as mortgage funds began to be less plentiful.⁴² Even in these instances, it was rare indeed that the substitution was so complete as to eliminate the need for mortgage loans.

Recently, financing through the direct acquisition of income property by financial institutions has grown into a promise of importance, but the weight of governmental policy has been on the side of discouragement rather than incentive to equity investment. Corporate income taxes, for instance, produce both a deterrent to equity investment and an inducement to debt financing in real estate corporations. The property tax often produces a risk that is likely to give pause to the most venturesome investor.⁴³ At the same time, the reduction of mortgage interest rates and the increase in loan-to-value ratios and aggressive competition among mortgage lenders have reduced alike the need and the incentive to invest venture funds. On the whole, the dependence of real estate financing on the mortgage instrument is today probably greater than at any time in history and is so largely as the outgrowth of governmental influences.

AREAS OF CONFLICT

Glancing back over the course of governmental policy, a number of conflicts and inconsistencies are evident. There have been, and still remain, serious conflicts between state and federal viewpoints, inconsistencies among the laws of the states and between an expansionist federal policy on the one hand and a cumbersome financial instrument on the other. Perhaps the most far-reaching area of conflict develops from the effort made, since the early days of the Republic, to increase the protection of the borrower under a mortgage agreement and at the same time to satisfy increasing demands for more extensive and more liberal credit.

Despite endeavors to meet these problems, the rigidity of the mortgage contract and the variety, slowness, and costliness of mortgage procedures have on the whole been allowed to remain. Taking into account the depreciability of the security over the customarily long period of loan repayment, the possibility that the security may

⁴² Miles L. Colean, *American Housing* (The Twentieth Century Fund, New York, 1944) pp. 233-34.

⁴³ See Chapter 9, for a more extended discussion of the effects of tax policy on equity investment.

be willfully destroyed before the lender's eyes but beyond his control, and the increasing dubiety of his recourse to deficiency judgments, the characteristics of the mortgage tend to make it relatively unattractive, from the lender's point of view. The natural reaction is to temper the availability of mortgage funds at times when a choice of investment outlets is present and to stiffen the terms of mortgage loans by comparison with other types of borrowing. The difficulties of creating a consistent and equitable policy are tremendous. At the same time we may note the intrusion of a new complication.

Throughout financial history, the basis for extending credit has been the prospect of repayment. The greater the resources of the borrower, the better the terms he might exact from the lender. Where, however, the transaction is made an instrument of public policy, the strict application of this principle meets with difficulties. If, for instance, it is determined to have a nation of individual landholders, the question arises whether the ability to pay can be the sole, or even the compelling, criterion. In the pursuance of such a policy it may be considered desirable to extend credit to persons who can pay very little, and who consequently require credit on such generous terms as to create risks beyond the limits of both prudent lending practice and supervisory policy. The requirements for credit, from this point of view, may be in an exactly reverse ratio to the borrower's resources.⁴⁴

The individual states have never been able to clear the areas of conflict between a rigid financial instrument and a variable economic situation, between the need for borrowed funds and the ability to repay, and between expanded demands for funds and restrictions that reduce the volume of funds. In fact, by the trend of their relief legislation and the future uncertainty engendered by it, the states have undoubtedly aggravated the conflicts. They have, moreover, created an additional complexity by the variety of the courses they have followed, so that confusion has been added to inconsistency. The high interest rates on real estate loans, and particularly on farm loans, that were prevalent (especially in the southern and western states) prior to the era of federal intervention offered evidence that debtor relief did not in the long run contribute to a sound or an adequate mortgage credit system.

⁴⁴ See Chapter 5 for further discussion of this question.

The multiplicity of jurisdictions plainly offered difficulties to the formulation and advancement of a national real estate credit policy. While public land was plentiful, the influence of the federal government was fairly direct, since it was at least in a position to offer new land to those dispossessed of their property. Because, however, the central government lacked power to touch the substantive law of real property, the federal influence became increasingly remote as the land passed from its control.

Yet, having encouraged the creation of small ownerships through every available means, the federal government, after the post-Civil War disillusionment, was certain to be subjected to pressure from the recipients of free land for protection against the calamities to which the great expansion of cultivation and credit had subjected them. Nevertheless, this movement was surprisingly slow in developing. The populist agitation of the eighties and nineties, for instance, was only slightly concerned with the credit system; and its efforts to invoke the federal power were directed at freight and warehouse rate legislation and general monetary legislation rather than specifically toward mortgage credit.⁴⁵

By the 1930's, however, faith both in the necessity for, and the efficacy of, federal intervention had vastly increased. By that time the federal government had already moved far into the field of credit control through the Federal Reserve System and the Land Bank System. Against the growth of federal power, the ability of the states to provide relief seemed slow, piecemeal, and insufficient. General opinion accepted the premises that the underlying weaknesses of the realty economy were beyond the capacity of the states to correct, and that relief on the scale demanded by the times and the restoration of a flow of credit required to meet future needs must come mainly from the federal authority.

The condition of urban real estate in the late twenties was no less precarious than that of farmland. As farm values were swollen by confidence in foreign markets, so urban values had been inflated by a belief in endless city growth. In both areas, credit had been expanded, equities had been stretched thin, and, in its diffusion, ownership had in many instances been weakened. With the collapse, the demands upon the federal government became irresistible.

⁴⁵ S. E. Morison and H. S. Commager, *op. cit.*, Vol. 2, pp. 119, 211, 241-65, and 435.

Subsequent federal intervention took five main directions: (1) a series of broad economic measures involving heavy federal expenditure designed to restore and maintain the farm economy and hence farm values; (2) the use of federal credit and subsidies to halt rural and urban foreclosures and to salvage ownerships; (3) the creation of new mortgage credit institutions, usually supported by government capital, and sometimes resulting in a wholly governmental operation; (4) the creation of a number of devices for restoring public confidence in private credit institutions and for renewing and expanding their lending activity; and (5) the direct use of federal funds for the alleviation of urban tenancy and the expansion of farm ownership.

Through these actions the federal government was able to halt liquidation by a wholesale assumption of private contracts, revising them as necessary to meet the realities of the situation. It then moved to commit its own funds, to encourage lenders to make commitments in a falling and disordered market, and to permit purchasers to borrow without loss of liquidity. The specific means chosen will be discussed below. Here it need only be noted that the national land policy created a credit problem that strained the capacity of traditional devices and methods. In the end, the federal government, which had laid down the policy, was called upon to salvage and restore what it had created.