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Volume Title: The Postwar Residential Mortgage Market

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Volume Publisher: Princeton University Press

Volume ISBN: 0-870-14106-6

Volume URL: http://www.nber.org/books/klam61-1

Publication Date: 1961

Chapter Title: Plan of the Book and Summary of Findings

Chapter Author: Saul B. Klaman

Chapter URL: http://www.nber.org/chapters/c2338

Chapter pages in book: (p. 1 - 24)

THE POSTWAR RESIDENTIAL MORTGAGE MARKET

CHAPTER 1

Plan of the Book and Summary of Findings

In broad terms this report presents analytical materials to meet the dual objective of describing and appraising (1) the flow of residential mortgage funds in the post-World War II decade and the main underlying influences, and (2) the institutional framework of the residential mortgage market in terms of lender policies and practices, and market techniques and characteristics. To the task of meeting these objectives, the study brings evaluations of a variety of information already available and development of new information, both statistical and qualitative.

Plan of the Book

The report is organized around the relatively simple plan of describing at the outset what happened during the first postwar decade in the area under investigation and then appraising the main factors responsible for changes. Chapter 2 sets the stage by describing the special position of mortgage debt in the economy at the end of the war, the record volume of mortgage flows in the succeeding decade, and the resulting marked changes in that debt structure at the end of the period. In Chapter 3 the broad setting in which changes occurred and the main elements underlying mortgage market expansion and restraint are appraised in a time-sequence oriented analysis. The factors include the position of financial institutions, capital market conditions, monetary and fiscal policies, federal mortgage programs, and demands for mortgage funds. Because the yield relationships among capital market securities are such a basic determinant of the flow-of-funds pattern and because so little is known about the postwar movement of mortgage interest rates, both are singled out for separate exploration in Chapter 4. It is left for Chapter 5 to tie more closely together and in considerable detail the changes in postwar mortgage flows, by type of mortgage and type of lender, and their basic underlying causes. There the attempt is to put together the market structure analysis of Chapter 2 and the time-sequence analysis of Chapter 3.

Chapters 6 and 7 shift the emphasis away from the statistical orientation of mortgage flow analysis to the institutional setting of the market place. The analysis in both chapters is more qualitative than quantitative and is concerned basically with differences in mortgage investment policies and practices of the main types of financial institutions, and with the special

organization, techniques, and characteristics that distinguish the mortgage market from other sectors of the capital market. Chapter 7 is directed toward an appraisal of the more interesting new postwar market developments which have sprung up in response to shifting financial conditions, and the basic organizational arrangements of primary and secondary markets including junior mortgage financing. Chapter 8 is a summary of a previously published occasional paper[1] and shows how a new type of financial institution—the modern mortgage company—has developed to meet the needs of new institutional arrangements of the postwar mortgage market.

Within that framework of analysis, the reader will find a considerable body of new quantitative and qualitative information. The statistical orientation towards flow-of-funds accounts is supported by more comprehensive data on net mortgage flows than was previously available, for both time intervals and type of mortgage and lender.[2] Given the well-known limitations of net flows data, the more comprehensive series has facilitated and made more meaningful the analysis of postwar mortgage market developments. The analysis has been aided also by new annual and quarterly series on conventional mortgage interest rates, developed in this study. While not as broadly based as desired, these series illuminate a previously dark area and permit new insights into comparative interest rate movements.

The two chapters on mortgage lending policies and market techniques are founded in large part on evaluation of primary information obtained by direct personal interviews with representatives of a variety of institutions and with individuals associated with the mortgage market. In addition to the broad qualitative information obtained, savings and loan associations supplied some new data through questionnaires that—though subject to qualification—tell us a little more about their lending practices than we knew before. The appraisal of the role of mortgage companies in the postwar residential mortgage market is based entirely on new data developed in this study.

The summary of the study's findings to which we now turn must necessarily be brief. Results will often be reported without supporting evidence or reference to underlying causes. For expanded discussion the reader must rely upon the pertinent chapters which follow. The analysis of "yield differentials and gross mortgage flows," (page 13), is an

[1] Saul B. Klaman, *The Postwar Rise of Mortgage Companies*, Occasional Paper 60, New York, National Bureau of Economic Research, 1959.

[2] Klaman, *The Volume of Mortgage Debt in the Postwar Decade*, Technical Paper 13, New York, NBER, 1958.

exception to the general summary presentations in this chapter. It is discussed more fully than in later chapters because expansion of earlier drafts and development of more recent data could be included here more conveniently.

Summary of Findings

POSTWAR CHANGES IN THE STRUCTURE OF MORTGAGE DEBT

At the war's end, the relative importance of mortgage debt in the nation's economic and financial structure had declined to a point lower than in almost any year as far back as the turn of the century. The absolute level of mortgage debt, as well as its structure, was little different at the end of World War II than at its beginning. From the relatively depressed postwar starting point, mortgage debt more than quadrupled in the subsequent years through 1956, and that unusually rapid growth was accompanied by marked changes in the structure and organization of mortgage markets. Between 1945 and 1956 major shifts occurred in the relative significance of real estate properties securing mortgage debt, in types of mortgages outstanding (conventional and federally underwritten), in the types of market participants, and in the portfolio composition of major lenders.

The net flow of funds into nonfarm mortgage markets, in the 1946–1956 period, was markedly larger than the flow into any other sector of the money or capital markets. It amounted to one-third of the total net flow of funds into all types of debt instruments, and was greater than the combined flow into corporate and state and local government securities. Within mortgage markets, mortgages on one- to four-family houses absorbed three-fourths of the entire net flow of funds. One-half of the home mortgage flow was in conventional mortgages, the other half in federally underwritten. Of the latter type, the largest part was guaranteed by the Veterans Administration. The rate of expansion in VA-guaranteed mortgages was far greater than in other types of mortgage debt, reflecting in part the small volume outstanding at the end of 1945.[3]

The chief sources of postwar mortgage funds have been the four main types of financial institutions—life insurance companies, savings and loan associations, commercial banks, and mutual savings banks—which together supplied five-sixths of the total volume. The first two types of institutions alone accounted for more than half the total net mortgage flow. Among the four, savings and loan associations dominated the market for conventional home mortgages, mutual savings banks the market for multifamily

[3] The VA mortgage guarantee program had been operating only a short time by the end of 1945, having been authorized by the Servicemen's Readjustment Act in June 1944.

mortgages, and life insurance companies and commercial banks the market for nonresidential mortgages. Of the other types of financial institutions separately identified in the statistics given here, only mortgage companies accounted for as much as 1 per cent of the net mortgage supply. Their role is that of mortgage originators and servicers, however, rather than investors, and is unique among mortgage market participants. Nonfinancial institutions, federal agencies, and individuals together were a relatively minor source of total mortgage funds in the postwar decade, but they were individually significant in particular markets. Nonfinancial institutions were a dominant supplier in the farm mortgage market and were an important source of nonfarm nonresidential mortgage funds as well.

By far the largest demands for mortgage funds, among all identifiable economic groups, were from consumers borrowing chiefly to finance the purchase of new and existing houses. Net mortgage borrowing by that group amounted to more than two-thirds of all mortgage funds borrowed in the first postwar decade, and was two and a half times the amount borrowed by all nonfarm businesses—the second largest group. The postwar demand for mortgage funds from farm businesses and from nonprofit organizations was relatively small.

By the end of 1956, following more than a decade of rapid but uneven expansion in mortgage markets, fundamental changes had occurred in the structure of mortgage debt. Two-thirds of the debt was secured by one- to four-family properties compared with one-half at the end of the war. Accompanying that sharp increase, debt secured by each of the other types of property declined substantially in relative importance. Within the home mortgage sector, VA-guaranteed debt increased extraordinarily, from 1 per cent of the total at the end of 1945 to 28 per cent, while Federal Housing Administration insured mortgage debt was shrinking from 22 to 16 per cent, and conventional loans from 77 to 56 per cent of the total.

Ownership of the mortgage debt, already fairly concentrated at the end of the war, was even more so by the end of 1956, with over three-fourths held by the four main types of financial intermediaries, compared with less than three-fifths eleven years earlier. Savings and loan associations increased their participation in mortgage markets relatively more, and savings banks relatively less, than the other types of institutions.

Postwar changes in mortgage markets were reflected also in the changing composition of mortgage portfolios of major lenders. Savings and loan associations, while continuing to concentrate their activities in conventional home mortgages, markedly increased the proportion of their holdings in VA-guaranteed loans. Life insurance companies and

savings banks sharply increased their holdings of home mortgage loans. Savings banks expanded their VA loans to one-third of their total mortgage portfolio, a larger proportion than any other type of loan. Commercial banks expanded their home mortgage holdings somewhat less sharply than either of the latter two institutions and, unlike them, continued to maintain the same proportion of their loans in nonresidential mortgages.

As to liability for mortgage debt, after a decade of record borrowing consumers owed three-fifths of the total amount of mortgage debt outstanding in 1956, nearly twice that owed by nonfarm businesses. At the end of the war each of these sectors had owed about the same amount of mortgage debt—a little over two-fifths of the total. Farmers and nonprofit organizations continued to owe relatively small amounts of mortgage debt at the end of 1956.

PATTERN OF MORTGAGE FLOWS AND UNDERLYING INFLUENCES

The summary of broad postwar changes in mortgage debt and flows obscures the wide fluctuations within mortgage market sectors and the varying relationships among them. The swings occurred in response to changes in economic and financial activity and in governmental actions. During the first half of the decade the interplay of those factors brought about almost unrestrained expansion in mortgage markets. There were insistent demands for mortgage credit to finance the increasing volume of new construction and real estate transactions at rising prices. Financial institutions with large holdings of government securities were unusually liquid and were actively seeking new and more profitable investment outlets. The Federal Reserve System's policy of supporting government bond prices at par—and therefore at relatively constant and low yields—permitted institutions to sell such securities readily and without penalty. The federal government, moreover, in its efforts to stimulate production of housing, was aggressively pursuing a policy of liberalizing FHA and VA mortgage programs and expanding the secondary market authority of the Federal National Mortgage Association (FNMA). All these elements contributed to the attractiveness to investors of mortgage yields relative to those of other capital market securities through most of the 1946–1950 period. Federally underwritten mortgages had the added advantage of limited risk.

In that setting the flow of funds into mortgages increased almost without interruption, culminating in 1950 in a record volume not exceeded until four years later. In most years of the first half-decade the mortgage flow

was larger than the combined flow into other capital market securities; for the period as a whole it was three-fourths larger than the net issue of corporate securities and three times larger than that of state and municipal securities. All major types of savings institutions—mutual savings banks, life insurance companies, savings and loan associations—invested an increasing proportion of their assets in mortgages from 1946 through 1950.

Commercial banks committed a considerably larger proportion of their investment funds to mortgages in the first three postwar years than in the succeeding two, representing conversion of a heavy share of their extraordinarily large volume of government securities. In 1947 and 1948 the net flow of mortgage funds from commercial banks was larger than from any other type of investor.

Mutual savings banks and life insurance companies were slower than commercial banks to take advantage of favorable investment opportunities. Savings banks were handicapped by legal restrictions limiting mortgage acquisitions generally to their own or adjoining states. Since most savings banks are located in the East where construction and real estate markets were relatively inactive, legally eligible mortgage loans were not plentiful in the immediate postwar years. When state laws were modified to permit acquisition of FHA and VA loans throughout the country, savings banks increased their mortgage lending markedly, absolutely and also in relation to other investments.

The relatively slow pickup of mortgage investments by life insurance companies was due in part to the cautious attitude of some companies remembering the experience of the thirties and in part to problems of market reorganization. It was necessary to re-establish mortgage correspondent or branch office organizations, largely dismantled after many years of reduced mortgage activity during depression and war. As these problems were solved and skepticism towards mortgages faded, life insurance companies devoted a steadily rising share of assets to mortgages. Except for the first two years after the war, when commercial banks took the lead in mortgage lending, the net flow of funds from life insurance companies exceeded the flow from any other type of investor through 1951.

Savings and loan associations liquidated about $1 billion in government securities and placed all their capital investments in mortgages during the 1946–1950 period. Even so, the reduced inflow of savings limited their absolute volume to less than that of commercial banks in the first part of the period, and to less than that of life insurance companies in the latter part.

The total mortgage flow from the four types of financial institutions—comprising the bulk of available mortgage funds in each year of the decade—varied with market conditions from a little over three-fourths to nearly nine-tenths of the total. The low occurred during 1949 following a general rise in bond yields and a slight business recession. As institutional funds were attracted to other markets, support for federally underwritten mortgages was provided by FNMA, whose purchasing authority had been expanded in 1948 to include VA loans and had been generally liberalized by the Housing Act of 1948. This support was not sufficient, however, to prevent a decline in over-all net mortgage flows during 1949—the only year of decline in the first half of the postwar decade. The decrease, reflecting both reduced demand and relatively unfavorable yields, was mainly in the market for one- to four-family mortgage loans, with some drop also in the flow of nonresidential mortgage funds. The 1949 flow of funds into multifamily mortgages, however, increased from earlier very low levels, owing entirely to the stimulation of the FHA Title VI program. Through it, construction and financing of rental housing had become both profitable and riskless.

The marked economic expansion of 1950, accompanied by further liberalization of government mortgage programs and declines in yields on competitive securities, brought forth a sharply increased flow of mortgage funds. Evidence of the renewed attractiveness of mortgages to financial intermediaries was their provision of a larger proportion of the increased net flow of mortgage funds in 1950—87 per cent—than in any other year on record. All types of financial institutions increased their participation in mortgage markets during that unusually active year of business and mortgage activity.

Within home mortgage markets, the composition of mortgage flows fluctuated widely. In the first half-decade, the flow of funds into federally underwritten mortgages exceeded that into conventional; in the latter half, the reverse was true. Within the federally underwritten sector, the movements of VA and FHA mortgage flows often diverged because of the effects of basic differences in federal programs and of lender reactions to them. In general, VA financing has tended to fluctuate more widely and irregularly than that of FHA, and both have been far less stable than conventional financing. The relative stability of conventional mortgage flows has been due largely to the flexibility of conventional interest rates compared with relatively rigid maximum interest rates on federally underwritten loans. During the 1948–1949 rise in bond yields, for example, VA mortgage flows declined rapidly, accounting for nearly all of the drop in home mortgage

flows. A sharp rise followed in 1950–1951, accompanying the easing in bond yields and the general economic expansion. FHA mortgage flows showed little change during most of that period, however. The markedly different behavior of the VA and FHA loan programs in those years is explained by differences in contract interest rates, in amounts of loan guarantee and insurance, in mortgage terms, in secondary market support, and in availability of special incentive programs for builders and lenders. The influence of these and other factors is evaluated in Chapters 3 to 5.

Underlying the changing composition of home mortgage flows were shifts in the participation of both private financial institutions and FNMA in the various markets. The main shifts among participants occurred in the market for VA loans. In the market for FHA loans, life insurance companies were the dominant lenders throughout the first half-decade; and in the conventional loan market, savings and loan associations led. In the second half-decade, life insurance companies relinquished their dominance of the FHA market to commercial banks and mutual savings banks. In the VA loan market, savings and loan associations and commercial banks were the leading lenders in the immediate postwar years, as life insurance companies and mutual savings banks delayed entering it, for reasons previously noted. In the 1950–1951 mortgage expansion, however, life insurance companies accounted for almost the entire VA loan growth, having firmly established their correspondent organizations and finding these loans attractive relative to other investments.

The strong support provided for the VA loan market by FNMA, following the expansion of its authority in 1948 to include that sector, is indicated by the fact that the Association provided funds for more than one-third of all VA mortgage flows in 1949, a larger proportion than any private lender. Strong FNMA support continued in 1950 even after many private lenders expanded their participation in VA markets. The Association's role in FHA loan markets, though important, was relatively far less significant than in VA loan markets.

Following the outbreak of war in Korea in mid-1950 and the Federal Reserve-Treasury "accord" in March 1951, there was an abrupt change in the capital market setting. This resulted in marked shifts in the flow of mortgage funds relative to other financial flows and within the various mortgage market sectors. Direct post-Korean federal controls tended to restrain mortgage lending activity for nearly three years. Though not measurable, these restraints probably were not as great as those resulting from restrictive monetary policies, alternative investment opportunities,

and reduced liquidity of financial institutions. In any case, direct federal restrictions were removed by mid-1953, and mortgage markets alternately expanded and contracted in response to shifting monetary policies, changes in general capital market demands, and federal legislative and administrative actions. The alternate expansion and contraction in the 1951–1956 period was in marked contrast to the almost uninterrupted expansion of the preceding five years.

Notwithstanding the introduction of important restraining forces, the net flow of mortgage funds in each year of the 1951–1956 period continued to exceed other individual capital market flows by a wide margin. The margin narrowed considerably during the 1951–1953 period of credit restraint, widened thereafter through 1955, and declined again in 1956 as restraining forces once again became dominant. During periods of general contraction the four main types of financial institutions reduced their mortgage market participation relatively more than other lenders did, while in periods of expansion they increased their mortgage activity relatively more than other lenders did.

The greater volatility in the one- to four-family than in other mortgage sectors, clearly revealed in this study, is due entirely to the impact of shifting market forces on the flow of federally underwritten mortgage funds. As in the first half-decade, the fluctuation of the flow of VA funds was considerably greater than that of FHA funds, but more in degree than in direction of change. During the 1951–1953 period of Regulation X and associated federal controls, restrictive monetary policy, rising bond yields, and reduced FNMA authority, the drop in the flow of VA mortgage funds was sharper than in FHA funds. Subsequently, in the changed capital market environment of 1953–1955—mortgage credit restrictions removed, monetary policy eased, bond yields in decline, FHA and VA contract interest rates raised, and FNMA's purchasing authority increased—VA mortgage flows expanded much more sharply than FHA flows. Again, the return to restraint in 1955–1956 had a greater impact on VA markets. All of this suggests that investors find the quality and terms of VA loans less attractive than those of FHA loans; that, in comparison with their reaction to FHA markets, they withdraw from VA markets faster when other investment opportunities are favorable and return with more volume when other opportunities diminish.

Quarterly data developed in this study clearly reveal that changes in mortgage market activity lag behind the events that induce or influence them. The increase in VA lending activity, for example, did not start until mid-1954 following the return of expansionary forces in late 1953.

VA flows continued sharply upward through 1955 after restraining forces had already become dominant; the reaction to restraint was not evident in VA mortgage flows until early 1956. The lag in the upturn of FHA mortgage flows was somewhat longer than in VA flows, and the lag in the downturn was about the same. Quarterly data on conventional mortgage flows must be used more carefully in drawing inferences because of recurring and fluctuating movements that stem principally from seasonal activity of savings and loan associations. Nevertheless, time lags are still evident, with the upturn during 1954 sharper and longer than usual to a third-quarter peak, and the downturn in late 1955 greater than usual to a fourth-quarter low. Earlier, during 1952 and 1953, when federally underwritten mortgage flows were declining, conventional mortgage flows increased, as interest rates were free to rise with those on other capital market securities.

PATTERN OF MORTGAGE INTEREST RATES

Lack of comprehensive data has limited empirical evidence on the course of mortgage interest rates and yields in the postwar decade. The development in this study of quarterly contract interest rate series on conventional home and income property mortgage loans closed by life insurance companies permits us now to draw some general conclusions on the movement of conventional mortgage interest rates. First, the amplitude of home mortgage interest rate movements has been considerably narrower than rate movements of other capital market securities. Second, changes in home mortgage interest rates have consistently lagged by about four quarters behind changes in bond yields. Third, broad movements in mortgage interest rates and bond yields have been in general conformity reflecting the pervasive influence of conditions in financial markets. Fourth, interest rates on conventional mortgages secured by income properties have been generally lower and somewhat more volatile than rates on conventional home mortgages. The summary findings, which tend to confirm those reported in earlier National Bureau studies of the first half of this century, are supported and evaluated in Chapter 4.

As for FHA and VA interest rates, their inflexibility has been an important factor in the volatility of federally underwritten mortgage flows. The technique of market discounts has been only partially effective during periods of credit stringency in adjusting maximum rates on these loans—established by law or regulation—to yields competitive with other capital market securities. The failure of that expedient reflects the legal restrictions and complexities associated with the use of discounts and also strong

Congressional criticism, particularly when discounts are large and increasing. As a result, many financial institutions have become unwilling to lend on federally underwritten mortgages when yields on competitive securities are rising.

Yield Differentials and Gross Mortgage Flows

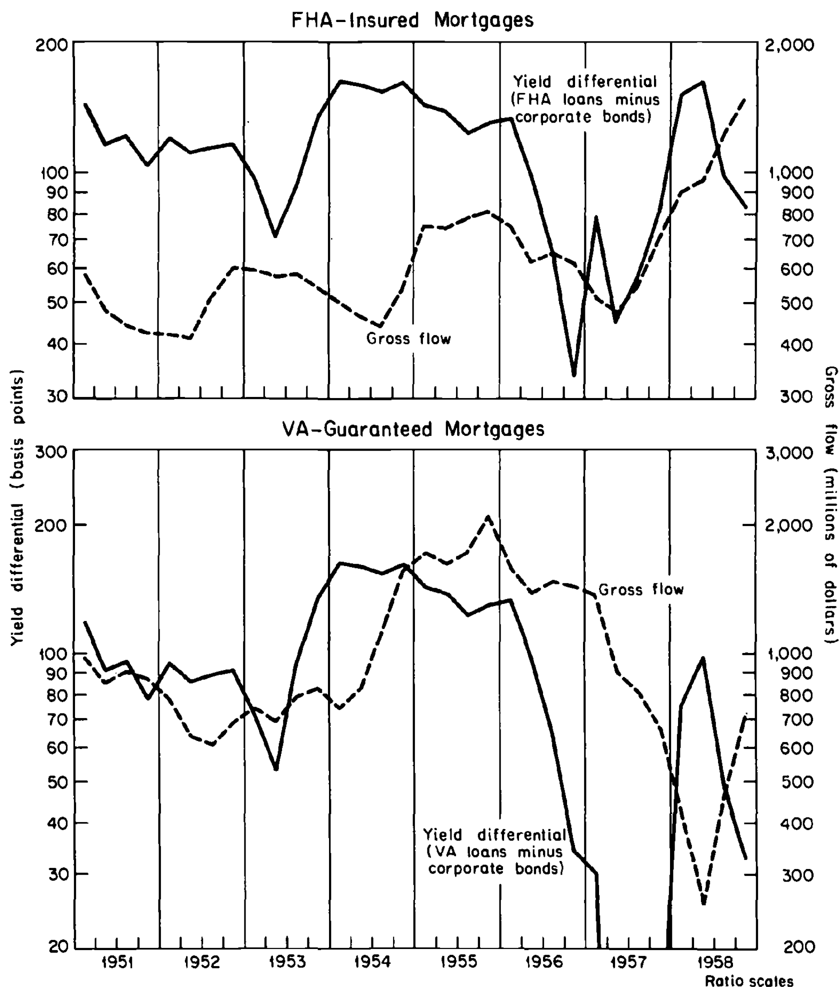
There is a clear relationship between changing capital market yields and FHA and VA mortgage flows. This relationship is reflected in Chart 1, which compares gross VA and FHA mortgage flows with differentials between yields on new high-grade corporate bond issues and VA and FHA contract interest rates. It is apparent that changes in both VA and FHA gross flows generally lag behind changes in yield differentials, and that VA loans are somewhat more responsive than FHA loans to such changes. The lack of close conformity between gross flows and yield spreads in each year is explained partly by the influence of other factors appraised in Chapter 3 and partly by imperfections in the data.

The influence of yield spreads on gross flows has been particularly evident since mid-1953, which marked the end of selective control of real estate credit through Regulation X and associated regulations. Thereafter, the ebb and flow of VA and FHA mortgage funds followed the diminishing and increasing spreads between federally underwritten contract interest rates and flexible yields on directly competitive new Aaa corporate bond issues. A similar pattern emerges when the comparison is made between government bond yields and FHA and VA interest rates. The sharp rise in yield spreads to a postwar high in 1954 was followed by a rapid rise in VA mortgage flows to a record peak in late 1955. The subsequent almost uninterrupted decline in yield spreads from the end of 1954 through late 1957, as corporate yields advanced sharply, was followed by a precipitous drop in VA flows to a postwar low by mid-1958. The turnaround and marked rise in VA flows thereafter reflected the earlier easing in financial markets and the significant widening in the differential between new bond yields and VA contract rates (Chart 1).

It was the FHA market that responded quickly to yield changes in 1957–1958 as contract interest rates on FHA loans were increased from 5 to 5¼ per cent in August 1957. The rate on VA loans, meanwhile, was maintained at 4½ per cent, until the spring of 1958 when it was raised to 4¾ per cent. The more attractive rate on FHA loans relative to corporate bonds, evident from Chart 1, was largely responsible for the marked upturn in FHA mortgage flows after mid-1957 while VA flows continued to decline for about a year thereafter. In earlier years, when

CHART I

Comparison of FHA and VA Gross Mortgage Flows with Differentials between Contract Interest Rates on FHA and VA Mortgages and Yields on New Aaa Corporate Bond Issues, Quarterly, 1951–1958



Data on gross mortgage flow are quarterly averages of monthly figures from the Federal Housing Administration and Veterans Administration. The series on average yields of new corporate bond issues used for comparison with FHA and VA loans is from the First National City Bank of New York; it begins in 1951 and is adjusted to an Aaa basis. This yield series was used because it pertains to securities competitive with FHA and VA loans and because it is more responsive to market change than yield series on outstanding corporate bonds. By the same token, data on gross rather than net mortgage flows were used because they reflect more quickly the response of lenders to changes in financial markets.

A similar comparison with conventional mortgage loans is precluded because of the lack of quarterly data on gross mortgage flows. Comparison of yield differentials with estimated annual conventional mortgage flows reveals much narrower changes than in the FHA and VA loan series, as noted in several places in the text. See Table A-1 below.

FHA and VA contract interest rates were the same, FHA mortgage flows responded more tardily and less sharply than VA flows to changes in yield differentials.[4]

Even when contract interest rates on FHA and VA loans were established at the same level, market prices for FHA loans were consistently higher and yields lower—in part because of the relative differences in quality attributed to each by investors. Interest rates on conventional home loans were generally higher than yields on federally underwritten mortgages throughout the postwar decade (Chapter 4). The spread tended to narrow somewhat when capital markets were tightening in late 1953 and again in late 1955. The amount of spread was due not only to the existence of government guarantees but also to differences in contract terms. The evidence suggests that the market place does not regard VA and FHA loans as riskless assets, but rather applies traditional standards of quality with regard to mortgage terms and underlying properties in judging the values of those investments.

Regional Yield Variations

A fundamental difference between markets where mortgages are issued and traded and markets where other securities are involved is that the former are primarily local and the latter are national. While the interregional flow of mortgage funds has increased sharply since the advent of federal mortgage insurance and guarantee, regional yield variations have persisted. Limited data suggest, for example, that in 1956 yields on VA mortgages available in Philadelphia were about 50 basis points higher than in Los Angeles. That variation was not much smaller than that reported for conventional mortgage yields in 1940. The arbitrage process clearly limits the spread in regional mortgage yields. But it is doubtful that regional yield differentials will soon be eliminated because mortgages are tied to local real estate values; they are inextricably linked to local market developments, to local foreclosure and other real estate laws, and to other peculiarly local economic, social, and political factors. Other more specific reasons for the persistence of mortgage yield differentials by geographic region are suggested in Chapter 4.

INSTITUTIONAL FRAMEWORK OF MORTGAGE MARKETS

Postwar changes in mortgage debt and markets and the influences underlying those changes can be appreciated more easily in the context of the

[4] Inclusion of data for 1957 and 1958 in this analysis of yield spreads and mortgage flows is a pre-publication revision, not practicable for the whole study, which covers the years 1945–1956.

institutional framework in which those changes took place. Among important interrelated aspects of the institutional framework of postwar mortgage markets are: fundamental differences in mortgage lending policies and practices of major financial institutions; development of new techniques and characteristics in mortgage market operation; relationships between primary and secondary markets and their changing significance; and characteristics of the market for junior mortgage financing. These subjects are dealt with in Chapters 6 to 8, which are summarized briefly in the remainder of this chapter.

Mortgage Lending Policies and Practices

The major postwar suppliers of mortgage funds differ strikingly in their lending policies and practices. Not only are there basic variations among the types of institutions, but also among individual institutions of the same type. Life insurance companies, for example, are guided in their mortgage operations by a set of factors different from those guiding savings banks or savings and loan associations, but there are also basic operational differences among life insurance companies.

Life insurance companies have a wide degree of investment flexibility and are guided in their choice of investments mainly by yield differentials. Other basic factors influence the volume of their mortgage flows, such as personal biases of investment officers, mortgage correspondent relationships, and the ratio of mortgage loans to assets. Stable and efficient correspondent organizations, which acquire and service mortgages outside the home office states, are regarded as valuable assets. Many life insurance companies—chiefly the larger ones—that have such assets are committed to basic minimum mortgage programs, regardless of changes in mortgage yields. Companies that have established a branch office system to acquire and service mortgages are similarly committed to a minimum mortgage investment program. The degree of expansion beyond what are regarded as irreducible mortgage flows, however, is determined by relative yields in various investment sectors. Upper and lower limits of mortgage expansion and contraction for some companies are adjusted in line with intermediate and longer-range goals of suitable ratios of mortgage loans to total assets. The goals are reviewed periodically and changed as new market circumstances are discerned. The notion of limiting one type of investment to a "desirable" ratio reflects a basic policy of diversification. Other companies, chiefly smaller ones, often disregard the idea of ratios and diversification and vary mortgage flows solely according to changes in relative yield. Smaller companies are also less concerned than larger companies are about

correspondent or branch office organizations and hence operate with a greater degree of flexibility in mortgage markets.

Wide variations characterize the residential mortgage lending operations of life insurance companies, but as a group they are better adapted to permanent, long-term financing of large housing projects rather than of single properties. Lending on large-scale income properties is also widespread among life insurance companies. Though closely associated with the construction process, life insurance companies generally do not extend short-term credits directly. This type of lending would be inconsistent with the nature of their business and investment needs.

In their mortgage lending operations, the larger life insurance companies typically operate through the allocation and commitment process. Many plan their operations a year or more ahead, allocating funds to correspondents and committing themselves to accept completed mortgages upon delivery or within a stated time. This type of operation clearly limits flexibility in the short run but eases the problems of keeping large aggregations of funds fully invested over the business cycle. Many large companies are willing to forego the short-run maximization of yields in favor of a long-range program of continuity of operations. The technique, however, gives rise to other basic problems: the uncertain time lags between allocations, commitments, and disbursements of funds; the uncertain rate of attrition in commitments; and the danger of being overcommitted relative to premium and other inflows if market conditions change. Smaller companies that are not so heavily committed to mortgage programs and to the system of fund allocations to correspondents and branch offices probably enjoy flexibility in greater degree than larger companies.

Investment outlets of mutual savings banks are more limited than those of life insurance companies or commercial banks, but less limited than those of savings and loan associations. Savings banks have tended to choose, within the legal list of investments available to them, those bearing the highest yields commensurate with risk. In most of the first postwar decade, that policy resulted in acquisition of available mortgages in the maximum amounts consistent with deposit inflows and statutory requirements. In their mortgage lending programs, savings banks have operated traditionally in local markets as long-term residential mortgage lenders. Since 1950, when most savings bank states amended their statutes to permit investment in out-of-state federally underwritten mortgages, these mutual institutions have become important national mortgage lenders as well. The granting of authority to purchase out-of-state mortgages

was probably the most significant single factor influencing the postwar mortgage lending policies of mutual savings banks. But the expanded opportunities brought increased legal and organizational problems. In acquiring out-of-state mortgages, some savings banks patterned their operations after those of life insurance companies (though legal restrictions concerning "foreign corporations" prohibited a true investor-correspondent relationship). As a result, these savings banks have been faced with problems similar to those of life insurance companies with correspondent relationships—problems associated with the long-range commitments process. Partly for this reason other savings banks have preferred in the main to acquire out-of-state mortgages, which have been and are ready for immediate delivery.

Aside from problems of mortgage acquisition techniques, savings banks with an uncertain volume of deposit inflows can hardly plan their mortgage programs so far ahead as life insurance companies with their more predictable premium income. For purposes of internal planning, the banks allocate funds for mortgages on the basis of minimum expected net deposits and mortgage repayments. Programs are under constant review and revision as changes develop in deposit and other cash inflows and in market conditions. A wider degree of short-run program flexibility than most life insurance companies have is afforded by absence of permanent organizational arrangements with mortgage originators and, for many banks, by acquisition of mortgages in the secondary market for immediate delivery.

Compared with other major financial institutions in the mortgage market, savings and loan associations are singularly limited by law and tradition to the specialized role of home mortgage lenders. In home mortgage markets they specialize, also, in providing conventional loans directly to individual borrowers in local markets and thus are less flexible than other financial institutions in adjusting investment programs to changes in capital market conditions. Changes in their mortgage flows, therefore, signify changes in their savings inflows, in their ability to borrow from Federal Home Loan Banks, and in their competitive position among other lenders rather than shifts to and from other investment markets.

While engaged primarily in providing long-term permanent mortgage funds directly to home buyers, the associations have also become important suppliers of short-term construction funds to builders—usually with the intent of acquiring the permanent mortgage loans on completed properties. A significant number of their construction loans, however, has been

refinanced as permanent mortgage loans by other lenders, according to information obtained in a survey made for this study (see Chapter 6). Whether or not the original purpose of such construction loans was to obtain the permanent mortgage financing, the ultimate effect has been that of short-term construction financing.

In their permanent mortgage financing activities, savings and loan associations, in addition to dominating the conventional home mortgage market, have supplied a large volume of VA mortgage funds. That volume was about as large over the full postwar decade as the volume supplied by each of the other major financial intermediaries, and in the early years of the decade the associations were the largest source of such mortgage funds. The frequently noted indifference of savings and loan associations to federally underwritten mortgages, therefore, applies only to FHA-insured loans. While there are many individual exceptions, the savings and loan industry as a whole has provided little support to the FHA mortgage insurance program since its inception in 1934—a situation that may change in the years ahead, particularly if the VA guarantee program is allowed to expire.

Among the four major types of financial intermediaries, commercial banks play the most varied role in mortgage markets. Some banks limit their participation to short-term construction loans, others to indirect interim financing credits ("warehousing"), and still others to long-term permanent mortgages. Some commercial banks, of course, provide more than one of these types of financing, while others do not participate at all in real estate financing. In general, the smaller country banks are more actively engaged in permanent mortgage financing and the large city banks in construction and interim financing.

Even among larger banks construction financing is concentrated among the relatively few that have acquired experience in that highly specialized, complex, and lucrative operation. Before extending construction credit, the commercial bank typically requires a firm "take-out" commitment from another financial institution by which it agrees to provide the permanent mortgage financing. In the later part of the postwar decade, the "standby" commitment was often used to back up construction loans when regular take-out commitments were not readily available (see Chapter 7 for discussion of standby commitments).

The most common of the techniques for extending construction loans is that used by most large New York money market banks, which operate through correspondent banks in various parts of the country. The function of a correspondent bank is to place and service the loans, toward

which it provides about 10 per cent of the funds, 90 per cent coming from the money market bank. To the large New York bank, the gross return has ranged between 5 and 5½ per cent, but to the correspondent bank the return has been around 10 per cent. That return includes earnings not only on its contribution to the construction loan but also a share of the return on the balance provided by the parent bank.

Interim credits (so-called warehousing) to mortgage lenders have long been extended by commercial banks. This type of financing, used principally by mortgage companies, bridges the gap between the completion of the mortgage loan and its delivery to principal investors. Interim credits enable the companies to carry mortgage inventories far larger than their own resources would permit. Variations and extensions of interim financing in the postwar decade, discussed in Chapter 7, have at times tended to introduce a note of instability into the mortgage market. The volume of interim financing provided by commercial banks increased sharply during the postwar years in response to changes in market conditions and operating techniques, and to demands of mortgage companies, whose operations are vitally dependent upon interim financing.

The story of the growth and change in mortgage company operations during the postwar decade is one of the most interesting and important developments in the institutional setting of mortgage markets. A brief account, more fully presented in *The Postwar Rise of Mortgage Companies* is given in Chapter 8. Mortgage companies originate and service mortgage loans for the accounts of institutional investors, not for their own portfolios, and usually engage in one or more related real estate activities. Relative to their volume of business, mortgage companies have a very small capital investment. Their phenomenal growth is directly connected with the introduction of the federal mortgage underwriting program and its reduction of geographic barriers to mortgage investment. It also stems from decisions by most life insurance companies to acquire out-of-state mortgages through such locally owned independent companies rather than through their own branch offices or subsidiaries.

Characteristics of the structure and operations of mortgage companies in the first postwar decade may be briefly summarized:

1. The unusual growth of mortgage companies is seen in the doubling of their number and tenfold increase in assets from $160 million to $1.8 billion between 1945 and 1955. Further evidence is expansion of mortgage servicing business to about $20 billion by the end of 1955, three times the mid-1951 volume. Their servicing volume covered two-thirds of home mortgages and four-fifths of federally underwritten loans held by life

insurance companies, savings banks, and FNMA (principal purchasers of loans from mortgage companies).

2. The concentration of mortgage company activity in federally underwritten mortgages is shown by data for 1953–1955; 90 per cent of loans closed and 75 to 80 per cent of loans held by surveyed companies were VA-guaranteed and FHA-insured. Of their conventional loans, the bulk were on one- to four-family properties.

3. The financial structure of mortgage companies is relatively simple, their assets consisting largely of mortgage and construction loans and their liabilities of notes payable to banks. The dependence of mortgage companies on commercial banks is indicated by the fact that in most years close to 90 per cent of mortgage inventory was financed through interim commercial bank loans.

4. According to rough estimates postwar mortgage banking has been very profitable—return on net worth amounting to about 15 per cent in 1955, a rate slightly higher than that of sales finance companies and much higher than that of commercial banks.

5. The mortgage banking industry is young. More than one-half of all FHA-approved mortgage companies were incorporated in the postwar decade, and about one-fourth since 1950.

6. In their relationships with borrowers and investors, most mortgage companies closed at least 90 per cent of their loans only after receiving firm commitments from institutional investors.

Market Characteristics and Techniques

The techniques that characterize mortgage market operations have evolved in response to the special needs of the real estate and construction industries, to the changing character of institutional operations, to the effects of monetary and fiscal policies, and to shifts in capital market conditions. One basic characteristic, inherent in the mortgage lending process and in the construction and real estate activity underlying it, is the time lag between commitments to invest and the actual acquisition of mortgages—usually longer and more uncertain than those in other areas of the capital market. One reflection of this characteristic is the substantial lag in mortgage interest rate changes behind those of other capital market securities (Chapter 4). Another is the lag in changes in mortgage flows behind changes in market conditions several months earlier—an observation essential to interpretation of data on mortgage finance.

Fundamental to mortgage market operations is use of the commitment technique in acquiring loans. This technique has become an increasingly

important part of the mortgage investment process, as institutional investors have become the major suppliers of mortgage funds. In the basic commitment technique—a promise to provide mortgage credit under specified terms and conditions—modifications have been developed in the postwar decade in response to capital market stringency. The main innovations have been the "forward" and "standby" commitments. The forward commitment—used chiefly by life insurance companies—is an arrangement for disbursing funds within a specified future time, rather than upon the completion of mortgages. It provides a more regularized flow of funds over years of intermittent capital market ease and stringency. The standby commitment comes into wide use only when regular take-out or forward commitments cannot be had. It is given at a price so far below the market price that neither lender nor borrower expects to complete the transaction. Each expects that before the scheduled disbursement of funds regular commitments will become available at current market prices. The standby commitment is important to builders and mortgage originators as an assurance of a source of permanent long-term funds. It is desired by investors mainly because of the fees associated with it.

From the standpoint of market participants and market processes both advantages and disadvantages derive from the standby commitment technique. An advantage to the builder is that he can proceed with construction. An advantage to the originator is that he can maintain or increase his volume of business. An advantage to the investor is that he earns a fee for only a promise to lend. Market processes profit from the technique, in that construction can proceed during periods of temporary credit stringency and that a pool of completed mortgages can be created ready for immediate delivery to investors. Disadvantages of standby commitments to market participants accrue only if anticipated easing of credit conditions fail to develop. Builders may then incur costs for credit substantially higher than planned, and lenders may find their resources taxed by unexpected calls upon them to honor their commitments. From the standpoint of market processes, disadvantages may be instability encouraged by expansion in construction to unsustainable levels and creation of mortgages that cannot be readily absorbed by long-term investors.

Accompanying postwar innovations in commitment techniques was the development of variations in commercial bank interim financing under the broad category of "warehousing." They involved mainly lengthening of loan maturities and adapting old techniques to new types of borrowers.

Like commitment innovations, these variations evolved to overcome temporary shortages of long-term funds and to meet the changing needs of long-term investors. Common to all variations of warehousing is the use of interim bank credit pending the availability of long-term permanent mortgage funds. The collateral for interim loans is usually mortgages, but on occasion interim loans are made in conjunction with construction loans and standby commitments. While throughout the postwar decade mortgage companies have remained the dominant user of warehousing credit, occasional dramatic uses of such credit have been made by life insurance companies that have become temporarily over-committed in mortgages relative to expected cash inflows.

One indication of the significance of interim financing is provided by rough estimates showing that in 1955—the peak year of its use—commercial bank interim credits were associated with the financing of perhaps one-third of all new houses built and purchased that year. If assumed (as evidence allows) to be used only with FHA and VA mortgages, warehousing may have been involved in about one-half the volume of federally underwritten mortgages written on new houses in 1955. Like innovations in commitment techniques, variations and broadened usage of warehousing credits provided by commercial banks may have salutary or harmful effects on market processes, depending on conditions. There is little doubt that the regular short-term interim credit serves a useful purpose in bridging the gap between closing mortgage loans and their sale to investors. The harmful unstabilizing effects arise from excessive use of short-term bank credit in lieu of unavailable long-term funds.

Primary and Secondary Mortgage Markets

The relationship between primary and secondary mortgage markets is unique among capital market sectors. It derives from special institutional arrangements and techniques of mortgage loan origination and investor acquisition. It is upon the clear differentiation of the processes of mortgage origination and ultimate investment that the distinction between primary and secondary mortgage markets is drawn.

Mortgage market participants would regard a secondary market transaction as one in which, for example, a life insurance company acquired a mortgage originated by a mortgage company. Such a definition clearly rests upon the technique of mortgage acquisition and upon the separation of the origination and investment processes between two different types of institutions. Almost all the information available on mortgage originations and purchases is based on this concept. In other financial markets,

secondary transactions are generally regarded as market trading in existing securities as distinct from primary transactions in which new debt or equity instruments are created. If the second concept is applied to home mortgage markets, the estimated dollar volume of secondary transactions would probably be no greater than 10 per cent of primary market activity by the end of the first postwar decade. Under the broader concept commonly accepted in mortgage markets, secondary transactions would be relatively much greater.

Under any concept, a secondary market for mortgages scarcely existed before the Federal Housing Administration was established in 1934. Lack of uniformity or standardization in loan contracts, property appraisals, and borrower evaluation limited mortgage transactions to individual local primary markets. Shifting mortgages among investors was difficult and expensive—and risky. The FHA mortgage insurance program endowed federally underwritten mortgages with a degree of quality and uniformity needed to make them broadly shiftable among investors, and reduced geographic barriers to investment. Standardization of mortgage terms and of property and borrower appraisal techniques reduced the need for close lender supervision and for investigation of individual transactions. A secondary mortgage market in federally underwritten mortgages took shape and expanded.

At the same time, changes in primary market transactions were taking place as large-scale production and sale of houses expanded. In many instances, the traditional individual transaction between mortgagor and lender was replaced by mass mortgage transactions between builders and investors on behalf of numerous unknown house buyers and ultimate mortgagors. The individual negotiation process between mortgage borrower and lender, however, remains an important characteristic of primary market transactions.