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CHAPTER 6

Mortgage Lending Policies of Financial Intermediaries

Beginnings of Mortgage Lending

THE mortgage is the oldest form of debt instrument still in wide use and, hence, among the oldest forms of investment available to financial institutions. It was already well developed in the Roman era, with the rights of borrower and lender clearly defined, and evolved through English common law and German courts into the mortgage instrument of today. The Roman *hypotheca* is considered to be the direct forebear of the modern mortgage in which the borrower retains title, possession, and use of his land and property contingent upon fulfillment of his mortgage obligation. This is not to suggest that the modern mortgage is a uniform, simple document. Quite the contrary. Differences in mortgage law and practice persist throughout the United States, mortgage instruments continue to be cumbersome and costly, and foreclosure proceedings lengthy and expensive. The wide diversity of practice among states is confusing, and includes important variations regarding borrowers' rights of redemption, deficiency judgments, foreclosure costs and procedures, and lenders' rights in event of default. The several attempts that have been made over the years, since the early part of the twentieth century, to unify and simplify the variety of state mortgage laws and procedures have all met with failure.[1] The free flow of mortgage funds across state lines is, therefore, still impeded by the complexities and variations of state mortgage laws.[2] In the earliest days of American real estate finance individuals were the main source of mortgage funds, joined somewhat later by private banking houses and specialized private land banks. Despite the early and widespread failures of land banks, similar institutions were organized in the early nineteenth century to lend on farm mortgages. These also were generally unsuccessful, and throughout the eighteenth and early nineteenth centuries "individual

[1] See Richard U. Ratcliff, *Urban Land Economics*, New York, 1949, pp. 218ff; Miles L. Colean, *The Impact of Government on Real Estate Finance in the United States*, New York, National Bureau of Economic Research, 1950, Chap. 3; and Henry Hoagland, *Real Estate Finance*, Homewood, Ill., 1954, pp. 17ff., for discussion of attempts to develop uniform mortgage laws.

[2] See, for example, two papers in *The Mortgage Banker*: Earl B. Schwulst, "Needed Now: Uniform Laws for Out-of-State Mortgage Investing," June 1956, p. 22; and John J. Redfield, "Problems Facing Savings Banks in Out-of-State Mortgage Purchases," January 1956, pp. 36–41.

lenders remained the principal source of credit, and, in spite of Hamilton's admonitions on the incompatibility of mortgage paper with the requirements of commercial banking, state-chartered commercial banks, from the beginning of the Republic, were heavily involved in loans on both farm and town property."[3]

Beginning in the early part of the nineteenth century, other types of financial intermediaries—mutual savings banks, life insurance companies, savings and loan associations (then called building societies)—developed to broaden the sources of funds available for mortgage financing. An additional source was provided after 1863 by the formation of national banks, though they were limited in that function by severe legal restrictions. Participation by these diverse types of financial institutions in mortgage markets expanded over the decades, facilitated by previously discussed factors—increased flows of savings, gradual easing of legal restrictions, and federal programs. In the postwar decade, financial institutions have assumed an increasingly dominant role as suppliers of mortgage funds, and their operations have varied in the process. It is the purpose of this chapter to appraise the mortgage lending policies underlying operations of the main types of financial intermediaries.

Financial Intermediaries and Mortgage Markets

Among the four principal types of mortgage credit suppliers, only the savings and loan association was organized originally for the express purpose of providing long-term credit to finance real estate. The others were organized to meet community needs for commercial credit, savings, and insurance protection. They provided mortgage funds as a part of their investment activities. Among the four institutions there are differences in sources of funds and investment opportunities available to them and in operating techniques in mortgage markets. Operational differences include: orientation towards local markets or towards national markets; acquiring mortgages indirectly through correspondents or branch offices or making direct loans; emphasizing permanent loans on completed properties or short-term construction lending and interim financing; lending chiefly on individual existing properties or on large-scale new projects; making long-term advance commitments to acquire mortgages or acquiring completed mortgages in the "open market"; some concentration on federally insured or guaranteed mortgage lending or specializing in conventional mortgage lending. These operational differences reflect, among other

[3] Colean, *op. cit.*, p. 59.

things, differences in the basic nature and purpose of financial institutions, in the legal framework within which each type operates, in the degree of functional specialization, and in the historical and traditional background against which each type developed. In addition to broad differences in mortgage market operations, which are largely interinstitutional, important differences exist also among institutions of the same class.

To achieve an adequate understanding of factors that influence institutions in their investment policies and guide them in their mortgage lending operations, field interviews were conducted. Information was supplied by thirty-five officers in charge of mortgage departments or over-all investment policies of twenty-seven major lending institutions (most of them located in the East). Besides the four major types of financial institutions, they included mortgage companies, mortgage brokers, and real estate firms. The purpose of that approach was to develop an adequate basis for reporting on aspects of mortgage lending policies not previously treated in the literature, yet fundamental to residential mortgage market developments in the first postwar decade. Material from interviews was distributed for review and appraisal among students of financial markets in government, universities, and research organizations, and later discussed and evaluated in the light of known market developments and available data. The material thus developed and analyzed is the basis of the following discussion of broad aspects of investment policy and of similarities and differences among lender groups. As in earlier chapters, some pertinent historical background is sketched in.[4]

Life Insurance Companies

When life insurance companies were in their infancy and their assets very small "... the dominant investment by all odds was mortgage loans, comprising 80 to 90 per cent of invested assets. The only other investments ... were state and city bonds, and a few bank stocks. There were no corporate securities whatever, and there was a relatively high percentage

[4] The reader may wish to supplement the discussion in this chapter by reference to the following works: Leo Grebler, David M. Blank, and Louis Winnick, *Capital Formation in Residential Real Estate: Trends and Prospects*, Princeton University Press for National Bureau of Economic Research, 1956; Carl F. Behrens, *Commercial Bank Activities in Urban Mortgage Financing*, 1952; R. J. Saulnier, *Urban Mortgage Lending by Life Insurance Companies*, 1950; and Ernest M. Fisher, *Urban Real Estate Markets: Characteristics and Financing*, 1951 (all published by the National Bureau of Economic Research); W. H. Steiner, "Institutional Investments," *Law and Contemporary Problems*, Durham, N.C., 1952; John Lintner, *Mutual Savings Banks in the Savings and Mortgage Markets*, Cambridge, Mass., 1948; Erwin W. Boemler, Roland I. Robinson, Frank H. Gane, and Loring C. Farwell, *Financial Institutions*, Homewood, Ill., 1956.

of cash."[5] Investment portfolios of life insurance companies have shifted markedly during the past century in response to a changing economic environment, modification of insurance investment laws, and availability of new capital market instruments. Mortgages have never again dominated the asset structure of those companies as they did in the early history of the industry, when mortgages were preferred because they were more familiar, and because other investments, now regular components of insurance company portfolios, were prohibited by strict investment laws.[6] Since the turn of the century, the share of mortgages in total assets has varied from a high of over two-fifths in the mid-twenties to a low of about one-seventh at the end of World War II. The rapid rise in life insurance company mortgage investments during the postwar decade brought the ratio to over one-third by the end of 1956. If farm mortgages are excluded, the 1956 ratio—about 31 per cent—is the highest for nonfarm mortgages in this century.[7]

FACTORS IN MORTGAGE INVESTMENT DECISIONS

As mortgage credit suppliers, life insurance companies differ from other institutional investors in several important ways: (1) they have more alternative long-term investment opportunities; (2) they operate generally within a more liberal legal framework; (3) they acquire a larger portion of their mortgages from other mortgage originators; (4) they emphasize different types of mortgage investments; and (5) their mortgage holdings are more concentrated among a small number of companies. Important differences in investment policy and practice exist among individual life insurance companies, as well as between them and other types of investors.

With a wide choice among alternative long-term investments, how do life insurance companies determine the amount of funds they will allocate for investment in mortgages during any one period? The impact on mortgage markets of changes in life insurance company investment programs makes the answer significant. The answer is not simple nor the same for

[5] George T. Conklin, Jr., "A Century of Life Insurance Portfolio Management," Chapter XIV in David McCahan, ed., *Investment of Life Insurance Funds*, Philadelphia, 1953, p. 263.

[6] *Ibid.*, p. 207.

[7] Farm mortgages were an important part of life insurance company portfolios in earlier years, particularly in the early 1920's following the upsurge in farm production during World War I with the rising demand for farm mortgage credit. The trend away from farm mortgages began with the collapse of farm prices in the 1920's and accelerated during the widespread farm failures of the 1930's. Since then farm mortgages have comprised a very minor part of insurance company assets.

For a summary history of insurance company mortgage investments, see Conklin, pp. 266–270, and Saulnier, *op. cit.*, pp. 1–15; for a more detailed discussion, see Grebler, Blank, and Winnick, *op. cit.*, pp. 199–201.

all types of companies. One leading life insurance executive answered the question in this way: "The investment officers of life insurance companies, conditioned by the internal requirements and characteristics of their industry as well as by legal requirements, seek primarily fixed debt obligations of longer term which are protected by an adequate demonstrated earning capacity and by a sufficient equity risk cushion. They face the demands of our economy for this type of capital and *invest in those fields which, risk considered, return the highest net yield.*"[8] Without question, the best yield obtainable consistent with risk is a paramount factor in the investment decisions for all companies. For some companies it appears to be the only factor, as Conklin suggests. For others, however, maximization of yield is not always decisive. Its importance in determining the flow of mortgage funds from life insurance companies usually varies with the size of company, the nature of its mortgage portfolio, and its method of acquiring mortgage loans.

The most important single consideration besides yield influencing mortgage flow is the stability and efficiency of the organizations established for the acquisition and servicing of new mortgage business. It is fundamental, particularly to the very large companies administering substantial mortgage portfolios on a nationwide basis through extensive correspondent or branch office systems.[9] Those mortgage lending organizations or correspondents had been largely disrupted, as noted previously, by the decline in real estate and mortgage activity during the 1930's and by World War II restrictions. After the war, companies hastened to establish new field organizations, in themselves considered valuable assets. To maintain loyal, efficient, and stable field organizations, companies allocate an amount of funds for mortgages considered irreducible before committing for other investments. Regardless of yield, therefore, those companies are committed to at least minimum mortgage programs, until a radical change is made in their way of doing business.

Companies that chose to establish nationwide systems of branch offices rather than correspondents for the acquisition and servicing of mortgages (of which there are only two large ones) are perhaps even more firmly committed to basic mortgage programs by their large overhead costs of operation. One large company, for example, which shifted to a branch office system when many of its independent correspondents failed during the 1930's, had decided to maintain an active mortgage program before

[8] Conklin, *op. cit.*, p. 261.

[9] For a discussion of correspondent and branch office systems and of mortgage lending organizations of life insurance companies see Saulnier, *op. cit.*, pp. 28–36.

committing itself to the high fixed costs of branch mortgage offices. It now has well over two-fifths of its assets in mortgages (the industry average, about one-third) and intends to increase that ratio.

Beyond the minimum amounts of mortgage flows maintained by the large companies, the volume of additional funds allocated by them depends essentially upon mortgage yields relative to other investment yields. Further, within the mortgage sector, shifts in favor of mortgages yielding the highest current return are common. Market conditions, however, may not permit the full adjustment desired by the largest companies. Insofar as possible, for example, in the residential mortgage sector shifts are made from federally underwritten mortgages bearing inflexible rates to conventional mortgages when free rates rise in a tightening capital market.

The larger insurance companies are faced also with the practical problem of investing large sums of money year in, year out. It is not easy for them to maximize yields or to move into and out of mortgage markets rapidly in response to changing conditions. The cost, moreover, associated with the operation of separate mortgage, bond, and other investment departments leads to a policy of portfolio diversification not always consistent with yield.

The smaller companies, with fewer funds to be placed in capital markets, with correspondents not heavily dependent upon them for business, and with one integrated investment department, operate typically with a higher degree of investment flexibility than the large companies. They can allocate funds to different sectors of the capital market on the basis of relative yield alone. While their mortgage correspondents are usually permitted to reinvest proceeds from mortgage repayments, additional advance allocations are usually not made. Instead, funds are committed for mortgages as correspondents submit applications for approval, leaving room for flexibility as capital market yields change. The chief investment officer of a moderate-sized company probably spoke for many in stating, "The only real factor influencing my investment policy is relative yield."

Two other elements that play a role in life insurance company investment policy are the percentage ratio of mortgages to total assets, and the human factor. Several companies, for example, operate within a longer-range policy which tends to set a maximum for mortgage expansion (or minimum for reduction). Having reached their goals those companies invest only that amount of new funds which will maintain their mortgage portfolios at the desired relationship to total assets, until the goals may be changed. The human factor obviously often plays an indeterminate but important part in the allocation of investment funds. A strong-minded person with long years of experience at the head of a mortgage department may get more funds for his department than a younger, less experienced executive. One executive, forty-five years in the business and twenty years as head of the mortgage loan department, characterized himself as a "fighter" who battled for his "share of company funds even though yields turn temporarily against me." Such a man has an influence on mortgage loan policy quite apart from economic considerations.

MORTGAGE LENDING POLICIES AND PRACTICES

Among companies there is wide variation in types of mortgage activities, though nearly all devote a significant share of assets to mortgage investments. Some, usually the smaller ones, concentrate on home mortgage loans, and others on large loans secured by income-producing properties, both residential and commercial. Most companies operate between the extremes, investing broadly in both owner-occupied home mortgages—conventional and federally underwritten—and income property loans. The same holds true for operations of life insurance companies more than a decade earlier.[10] The VA-guaranteed loan has been an added feature in most life insurance company mortgage portfolios since early 1946, tending to give them greater volatility.

Most mortgage operations of companies that lend in volume on residential mortgages are in permanent financing of new large-scale housing projects. Financing individual transactions for new or existing properties is better suited to local institutions familiar with local markets and with direct handling of individual transactions than to life insurance companies operating on a nationwide basis through correspondents. Large companies often handle permanent financing of commercial and industrial properties involving large sums of money directly through their home offices. Such loans are frequently secured by both existing and new structures.

During the first postwar decade portfolios of life insurance companies as a group showed a steady trend away from mortgages on rental and commercial properties and in favor of home mortgages (Chart 23). That trend is in keeping with the proportionately greater postwar demand for funds to finance single-family home construction. Nevertheless, life insurance companies continued throughout that time to be the chief single supplier of mortgage funds on commercial properties and a major supplier of funds for multifamily properties (Chapter 2).

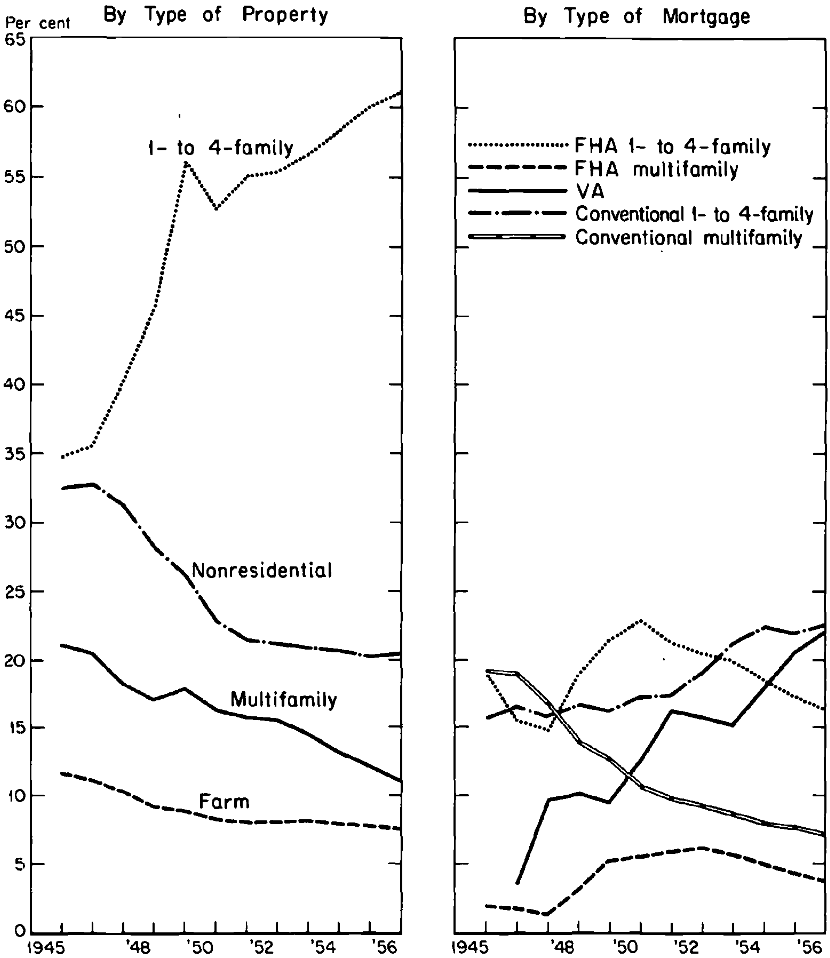
In view of the nature of life insurance business and investment needs, most companies extend so-called permanent long-term mortgage financing,

[10] Saulnier, *op. cit.*, p. 30.

rather than short-term funds to finance construction. They are closely associated with financing construction, however, lending mainly on new properties and usually arranging for acquisition of permanent mortgages

CHART 23

Mortgage Portfolio Composition of Life Insurance Companies, 1945–1956



SOURCE: Klaman, *Volume of Mortgage Debt*, Table 17.

before construction begins. Company policies vary, chiefly between the long-range mortgage acquisition techniques of the larger companies, with some sacrifice of investment flexibility, and the more flexible techniques of most smaller companies that prefer to enter and withdraw from the mortgage market according to market conditions. Among the larger companies, too, there are variations within the process of long-range planning of investment programs.

Planning its mortgage program at least a year ahead, a large company interested in residential mortgages usually makes allocations of funds to mortgage companies, of which it may have nationwide connections with more than a hundred. The mortgage companies initiate loans and submit them to the life insurance company for prior approval before completion. Upon its approval, the company issues firm commitments to acquire such loans at a stated price when completed and ready for devliery.[11] A variation of this technique developed in recent years is the "forward commitment," by which the company agrees to purchase completed mortgages, not when ready for delivery, but at any time within some stated period, often eighteen months or two years after the commitment date. Some companies arrange to delay the taking up of commitments for three months or so after loans are ready for delivery. The forward commitment requires mortgage correspondents to arrange for interim financing from commercial banks beyond the time normally required to close loans and deliver them to the investing company.[12]

The process of planning mortgage investment activity for a year or two ahead and allocating and committing funds for future acquisition of mortgages necessarily reduces the companies' ability to adjust to short-term changes in market conditions. In particular, movements toward expansion are considerably more feasible than toward contraction of mortgage activity in the short run. Commitments are usually binding on the investor, and while allocations of funds may be withdrawn or reduced, most large companies are reluctant to take such action. Some flexibility in programming is maintained during the year by allocating funds on a six-month rather than on a full-year basis. Also, some unallocated funds are usually retained for investment opportunities likely to arise during the year. Reduced flexibility is partly compensated for by the advantages of operational programming inherent in the longer-range mortgage acquisition technique. Larger companies consider continuity of operations more essential than maximized yields at all times. Development of the forward commitment technique represents a further step in their efforts to smooth the flow of funds into mortgages.

[11] See Chapter 8 for a discussion of the relationship between life insurance companies and mortgage companies.

[12] See Chapter 7 for a more detailed discussion of the forward commitment and interim financing techniques.

Besides reduction in investment flexibility, the large institutional investor using the technique just described is faced with important operating problems: (1) long and uncertain time lags between decisions and commitments to invest and the actual disbursement of funds; (2) an uncertain rate of attrition in commitments; and (3) danger of overcommitment when changes in market conditions may supervene.

Time lags between the policy decision to invest a certain amount of funds in mortgages, the commitment of those funds, and the acquisition of the mortgages vary widely between companies and by type of property financed. On new residential construction the typical lag between commitment and mortgage acquisition may be between 6 and 12 months, on new commercial construction as long as 18 to 24 months, but on existing properties as short as between 3 and 6 months. The lapse of time between the initial allocation of funds (before firm commitment) and disbursement is, of course, somewhat longer. The timing of acquisitions and hence of the actual need for ready funds in the mortgage market is far less certain than in the market for corporate securities. (Arrangements for direct placements of corporate bonds between borrower and investor, for example, are quite definite as to dates so that the time of acquisition can be carefully planned.)

The significant but varying rate of attrition in mortgage commitments, and other phenomena without close parallel in long-term corporate financing, complicate planning of mortgage investments. Mortgage commitments may not be taken up because of unforeseen developments: (1) scheduled construction may be deferred; (2) mortgage loans may be smaller than commited for or entirely unnecessary; (3) funds for completed mortgages may be obtained elsewhere on more favorable terms under changing market conditions.

Experience of one of the largest American companies, for example, has been that nearly one-fifth of its mortgage commitments are not taken up. The proportion has varied widely between two-fifths and less than one-tenth, the rate being related to the relative attractiveness of terms on outstanding commitments compared with those available on new commitments. During the year beginning in the autumn of 1953, for example, when capital markets eased and interest rates declined, builders and mortgage companies were able to obtain new commitments or market their completed loans at far better prices than those already set under firm commitments. Lapse of commitments entailed the loss of only the commitment fee which was less than the spread between mortgage prices currently available and the prices arranged for under previous commitments.

During 1955–1956, on the other hand, when capital markets were tightening and new commitments were hard to come by, the attrition rate on outstanding commitments dropped sharply.

The typical rate of disbursement of mortgage funds after the date of commitment, based on the records of one large company, is shown in two panels of Chart 24. The data in panel A show that the rate of disbursement increases rapidly through the second month following commitment. Thereafter, the rate declines gradually through the twelfth month. Only a little more than 5 per cent of mortgage funds are disbursed in succeeding months. The cumulative disbursement curve in panel B indicates that typically about 85 per cent of committed mortgage funds are actually disbursed, and that over three-fifths of the committed amount is disbursed by the end of the eighth month.

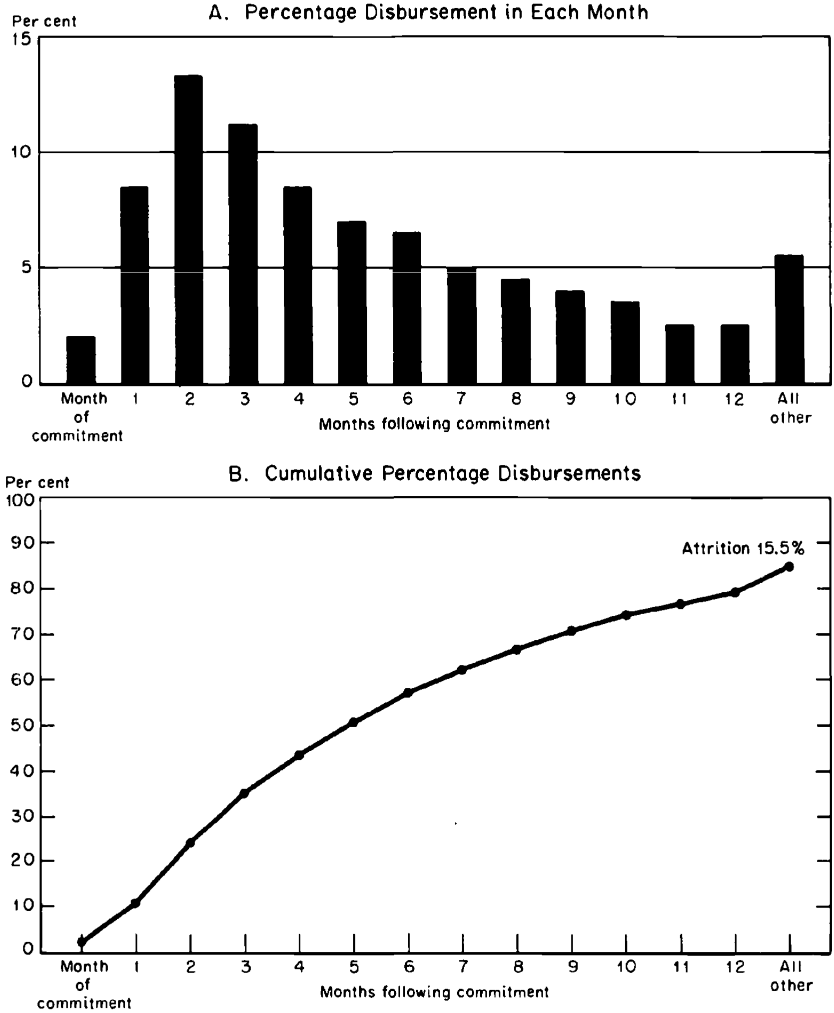
During periods when funds are plentiful, financial markets easy, and competition among investors for mortgages keen, life insurance companies (as well as other types of lenders) may overcommit themselves in the mortgage market. The uncertainties of time lags and attrition associated with commitments, coupled with the need to keep large sums of money invested, have sometimes led investors to have a volume of commitments outstanding too large to be met comfortably from expected receipts. This problem of large institutional investors operating extensive nationwide mortgage programs through mortgage correspondents or branch offices was highlighted by the experience of one of the largest life insurance companies at the end of 1954. It had commitments outstanding about equal to the amount of funds anticipated for total mortgage investments during 1955, which meant that no new allocations or commitments could be made to acquire mortgages during the year. Thereupon, the company obtained short-term funds from commercial banks in a much publicized "warehousing" transaction, in which the company sold a large block of its mortgages to be repurchased within one year.[13]

Companies less in favor of the allocation and commitment process—usually the smaller ones—avoid the uncertain timing of mortgage flows associated with the regular commitment process and the short-term inflexibilities imposed by the long-range forward commitment process. They are not completely committed to a mortgage program and so take advantage of it or not according to changing capital market conditions. One moderate-sized company attempts to forecast mortgage interest rates at least six months to a year ahead, to be in a position to acquire higher-yield

[13] See Chapter 7 for further discussion of this type of warehousing in relation to other types.

CHART 24

Percentage Distribution: Typical Life Insurance Company Disbursement of Mortgage Funds Following Month of Commitment



SOURCE: The records of a large eastern life insurance company; the distribution is based on experience with loans of less than $50,000 on new and existing properties. See Table A-11 below.

mortgages and avoid having a large volume of outstanding commitments on lower-yield ones. An even greater degree of flexibility is secured by some smaller companies that acquire a substantial portion of their mortgages directly rather than through correspondents. In general, however, most smaller and moderate-sized companies acquire the bulk of their mortgages on the basis of prior commitments through mortgage correspondents and hence are subject to many of the uncertainties in timing mortgage flows that beset large companies.

Regardless of asset size or type of mortgage operation all life insurance companies alike were faced with the need for basic changes in investment policy after March 1951. Before the Federal Reserve-Treasury "accord" there was no need to allocate funds for mortgage investment. The general policy was to invest as much money in mortgages as the market would take. Maximum flexibility was permitted by unlimited access to the government securities market, supported by Federal Reserve. The change in monetary and fiscal policy required companies to allocate their funds carefully among alternative investments in accordance with their anticipated income. The large companies, therefore, adopted the allocation technique for acquiring mortgages. The day of pouring funds into markets for mortgages and corporate securities closed with the "accord." Almost without exception life insurance companies, and other institutional investors too, consider March 1951 to be the turning point of investment policy and operating techniques in postwar mortgage markets.

Mutual Savings Banks

Mutual savings banks are the oldest of American thrift institutions, dating from 1816. Organized primarily in industrial areas to encourage thrift among working class groups, these institutions spread rapidly through the eastern part of the country. They have remained geographically concentrated in the New England and Middle Atlantic States, and are relatively few in number. The little over 500 mutual savings banks in seventeen states compare with over 13,000 commercial banks, 6,000 savings and loan associations, and 1,000 life insurance companies spread over the country.

The mutual savings banks, though growing tremendously in size over the years, have continued to serve their original function of providing an outlet for the funds of small savers. Their quasi-philanthropic origins have determined and maintained their investment policies as designed principally to safeguard depositors' funds. As a result, they have achieved a record of safety over nearly a century and a half unparalleled by other types of financial institutions. It is important to understand the nature and origins of mutual savings banks in order to understand the investment policies followed by these institutions.[14]

[14] Among the best references on mutual savings banks are John Lintner, *Mutual Savings Banks in the Savings and Mortgage Markets*, Cambridge, Mass., 1948; and W. H. Steiner, "Mutual Savings Banks," *Law and Contemporary Problems*, Durham, N.C., 1952.

FACTORS IN MORTGAGE INVESTMENT DECISIONS

Mutual savings banks are more limited in their investment outlets than either life insurance companies or commercial banks, but less so than savings and loan associations. Since there are no federally chartered savings banks, each of them is limited in its investments according to the legal restrictions imposed by the state in which it operates. For the protection of depositors most savings bank states restrict investments to a "legal list" intended to insure a high degree of safety and liquidity. These lists have been modified and generally expanded in all states over the years.

Within those legal limits, savings bankers tend to choose investment policies to secure for their banks maximum net returns after due allowances for costs and risks on different types of investments.[15] While investments in corporate securities have been fairly narrowly circumscribed, mortgages have always been considered suitable investments for savings banks, subject, of course, to geographic limitations, and other bounds set, particularly on terms of lending and proportion of assets. Thus, in each year as far back as records are available until the outbreak of World War II, mortgage loans constituted the savings banks' largest single category of assets, never falling below one-third of total resources.[16]

During World War II, savings banks invested more heavily than other types of financial institutions did in U.S. government securities relative to their total assets. Their mortgage holdings declined to one-fourth of assets by the end of 1945, the lowest percentage on record. Partly because of the restricted geographic mortgage market available to savings banks, their mortgage holdings continued to decline relative to other assets in the immediate postwar years. After the 1949 and 1950 changes in investment laws governing out-of-state mortgage acquisitions (discussed below), savings banks as a group rapidly increased their mortgage holdings to nearly three-fifths of assets by the end of 1956, a larger proportion than the previous record in the 1920's.

The postwar investment policy of savings banks has, of course, varied among individual banks, particularly between larger banks that have sought out-of-state mortgage investments to employ their deposits, and small banks that have been able to keep their funds invested locally. Nearly all, however, showed a strong preference for mortgages in the first postwar decade. The generally higher yields on mortgages relative to

[15] Lintner, *op. cit.*, p. 215. His Chapter VIII provides a full discussion of investment policies and shifts in portfolio composition of savings banks.

[16] Raymond W. Goldsmith, *A Study of Saving in the United States*, Princeton University Press, 1955, Vol. I, Table L-29, page 415; Lintner, *op. cit.*, p. 299.

other investments available to them in the East attracted a steadily increasing share of savings bank funds. The consequently higher rate of interest paid on deposits has enabled savings banks to meet the increased competition for savings from other types of financial intermediaries.

In addition to the yield advantage of mortgages during most postwar years, federal mortgage underwriting and regular amortization have endowed mortgage investments with a high degree of safety and liquidity, investment criteria essential to savings banks. For many savings banks, therefore, postwar investment policy has been relatively uncomplicated—to acquire the maximum amount of mortgages consistent with deposit inflows, statutory requirements, and liquidity needs. Of the seventeen savings bank states at the end of 1956 eleven had from over two-fifths to over two-thirds of their assets in mortgages, and the banks in five of the remaining six states had over one-third in mortgages. In several states, FHA and VA loans are exempt from statutory limits on mortgage holdings, which leaves ample room for further expansion in that investment area. Self-imposed limitations and relative yield changes in later postwar years, however, could well slow down—at least temporarily—the rate of mortgage acquisitions by mutual savings banks.

MORTGAGE LENDING POLICIES AND PRACTICES

Savings bank mortgage lending policies and practices in some ways lie between those of savings and loan associations and life insurance companies. In other ways they are unique. Traditionally and by design, mutual savings banks, like savings and loan associations, have supplied funds chiefly to satisfy the needs of their own local mortgage markets. The changes in state statutes of recent postwar years, however, have opened to them the field of national mortgage lending, hitherto the domain of life insurance companies. Their formulation of mortgage programs, methods of mortgage acquisition, and types of mortgage investments, however, are in large measure peculiar to them.

Whether operating in local or out-of-state mortgage markets, or investing in new or existing, residential or commercial, properties, savings banks generally do not plan their mortgage programs as far ahead as the large life insurance companies do. The regularity of life insurance premium income permits long-range planning of investment, unique among financial intermediaries. The net movements of savings deposits to which mortgage investments must be geared, however, are rather irregular and unpredictable. For internal guidance the larger savings banks often project mortgage investment programs for a year or eighteen months ahead on the basis of the expected inflow of deposits. Allocations of funds for mortgage acquisition are made on the basis of the minimum expected inflow of deposits and of mortgage repayments and are reviewed each month in the light of actual deposits and mortgage availability. Additional funds from increased deposits or prepayments are committed to the mortgage market as they become available.

While most savings banks do not maintain as close an organizational relationship with correspondents as life insurance companies do, they frequently use the secondary market to acquire mortgages for immediate delivery (i.e., within ninety days) rather than under long-range prior commitments. Occasionally they buy from other institutional investors that wish to sell seasoned mortgages to obtain funds for new loans. The flexibility thus maintained is valuable in permitting adjustments both to changing deposit inflows and to changing capital market yields.

Without question the most significant single development influencing savings banks' postwar mortgage operations was the frequently mentioned amending of most state statutes in 1949 and 1950 on out-of-state lending. Through this legislation, limited essentially to FHA and VA mortgages, mutual savings banks, many of which had more funds to invest in mortgages than could be absorbed by local markets at prevailing interest rates, entered the national market. And the harvest was ripe. Savings banks—located chiefly in the capital surplus areas of the East—had been providing a steadily decreasing share of mortgage funds compared with other institutional investors because building and real estate activity was increasing less in New England and the Middle Atlantic states than in other sectors of the country, and their access to the widening VA loan market had been severely restricted. In their local markets competition with savings and loan associations was keen. From 1950 on savings banks accounted for a steadily growing share of total mortgage investments (Chapters 2 and 5). In the "non-savings bank" states and capital shortage areas now open to them expanding real estate and construction markets created large demands for funds and higher mortgage yields than those in the Northeast. The growth of out-of-state mortgage business was spectacular for mutual savings banks in Massachusetts and New York. At the end of 1956, banks in these two states accounted for four-fifths of the total amount of mortgage loans held by all mutual savings banks.

Of the total new mortgage loans acquired by New York State savings banks in 1955, almost one-half were on out-of-state properties, compared with a little over one-fourth in 1950, and only 3 per cent in 1946 (Table 14). The sharp increase was accounted for entirely by out-of-state purchases of VA loans, which rose from one-half of one per cent of total mortgage acquisitions of New York State savings banks in 1950 to almost two-fifths in 1955, and represented two-thirds of all VA loans acquired by those banks during the year. Out-of-state purchases of FHA loans in those years were declining.[17] Similar data on gross mortgage acquisitions are

TABLE 14

Mortgage Loans Acquired by New York State Mutual Savings Banks Within the State and Out-of-State, 1946–1955

	AMOUNTS (MILLIONS OF DOLLARS)					PERCENTAGE RATIOS				
YEAR	Total Loans (1)	N.Y. State Loans (2)	*Out-of-State Loans* Total (3)	FHA (4)	VA (5)	*(3) as % of (1)* (6)	*(4) as % of (1)* (7)	*(5) as % of (1)* (8)	*(4) as % of Total FHA Loans* (9)	*(5) as % of Total VA Loans* (10)
1946	424	410	14	14	—	3.3	3.3	—	77.8	—
1947	566	538	28	28	—	4.9	4.9	—	52.8	—
1948	745	621	124	124	—	16.6	16.6	—	52.5	—
1949	1,001	798	203	203	—	20.3	20.3	—	49.5	—
1950	1,734	1,241	493	484	9	28.4	27.9	0.5	58.0	4.1
1951	1,630	1,040	590	529	61	36.2	32.5	3.7	66.0	18.7
1952	1,483	955	528	365	163	35.6	24.6	11.0	64.0	40.8
1953	1,603	961	642	258	384	40.0	16.0	24.0	67.0	54.5
1954	2,022	1,138	884	217	667	43.7	10.7	33.0	61.0	62.5
1955	2,442	1,294	1,148	211	937	47.0	8.6	38.4	52.2	67.2

SOURCE: From unpublished records of New York State Banking Department.

not readily available for Massachusetts or for other states where mutual savings banks are located. Data obtained on mortgage holdings of a large Massachusetts savings bank, however, reveal a similar trend, with out-of-state mortgages accounting for well over one-third of its total mortgage holdings in 1955 compared with less than one-sixth five years earlier.

Distribution of outstanding mortgages between intrastate and out-of-state loans for all mutual savings banks is shown in Table 15. Out-of-state mortgage holdings increased from 25 to 28 per cent of total mortgage holdings from September 30, 1954 to December 31, 1955. VA loans accounted for the bulk of the increase, with such out-of-state loans

[17] Before changes in some state laws permitting out-of-state lending on VA and FHA mortgages, New York State had authorized savings banks to lend on conventional and FHA mortgages in adjoining states. Table 14, showing FHA out-of-state loans, includes, therefore, earlier loans in adjoining states which cannot be separated. Before 1949, all FHA out-of-state loans represent loans in adjoining states. The amount of conventional loans in adjoining states is very small and has been included in Table 14 with total loans in New York State.

TABLE 15

Mortgage Loans Held by Mutual Savings Banks Within Their States and Out-of-State, Selected Dates, 1954 and 1955

	SEPTEMBER 30, 1954					DECEMBER 31, 1955				
			Out-of-State					Out-of-State		
	All Holdings	*Within Own State*	Total	In States Without Savings Banks	In States with Savings Banks	*All Holdings*	*Within Own State*	Total	In States Without Savings Banks	In States with Savings Banks
	AMOUNTS (MILLIONS OF DOLLARS)									
Total	14,288	10,712	3,576	1,942	1,633	17,396	12,492	4,904	2,974	1,930
FHA	3,704	1,501	2,203	1,106	1,097	4,142	1,793	2,349	1,258	1,091
VA	3,894	2,627	1,267	827	440	5,753	3,341	2,411	1,689	722
Conventional	6,690	6,584	106	9	97	7,501	7,359	142	26	116
	PERCENTAGE DISTRIBUTION									
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
FHA	25.9	14.0	61.6	57.0	67.2	23.8	14.4	47.9	42.3	56.5
VA	27.3	24.5	35.4	42.6	26.9	33.1	26.7	49.2	56.8	37.4
Conventional	46.8	61.5	3.0	0.5	5.9	43.1	58.9	2.9	0.9	6.0
Total	100.0	75.0	25.0	13.6	11.4	100.0	71.8	28.2	17.1	11.1
FHA	100.0	40.5	59.5	29.9	29.6	100.0	43.3	56.7	30.4	26.3
VA	100.0	67.5	32.5	21.2	11.3	100.0	58.1	41.9	29.4	12.5
Conventional	100.0	98.4	1.6	0.2	1.4	100.0	98.1	1.9	0.3	1.5

SOURCE: Special Tabulation made by National Association of Mutual Savings Banks representing 517 banks in 1954 and 523 banks in 1955. Mortgages made "within own state" in 1955 represent savings banks servicing their own mortgages within state in which savings bank is domiciled. (From unpublished report of NAMSB, "Distribution of Mortgage Investments of Mutual Savings Banks, as of December 31, 1955.")

nearly doubling. Over two-fifths of all VA loans owned by mutual savings banks at the end of 1955 were out-of-state purchases. In contrast, out-of-state FHA loans increased only slightly but at the end of 1955 represented close to three-fifths of all FHA loans owned by savings banks.

Entry into out-of-state mortgage markets, while of obvious advantage to mutual savings banks, especially the larger ones, raised a number of legal and operational problems not unlike those faced by life insurance companies in the early development of their national mortgage lending programs. The legal obstacles are, however, greater for savings banks because of the penalties and local taxes on out-of-state business to which they might be subject. It is usually necessary for savings banks to arrange to acquire out-of-state mortgage investments in a way that will not be deemed as "doing business" in a foreign state.[18] The purchase of mortgages from an out-of-state originator under an advance commitment must be done so as not to place the originator in the position of agent for the savings bank. Thus, "the commitment should be framed upon the assumption that the originator has already agreed to make the mortgage loan, and not conditionally upon the bank's commitment."[19] Such originators are generally referred to as "servicing contractors" with the banks, rather than as correspondents when associated with the life insurance industry.

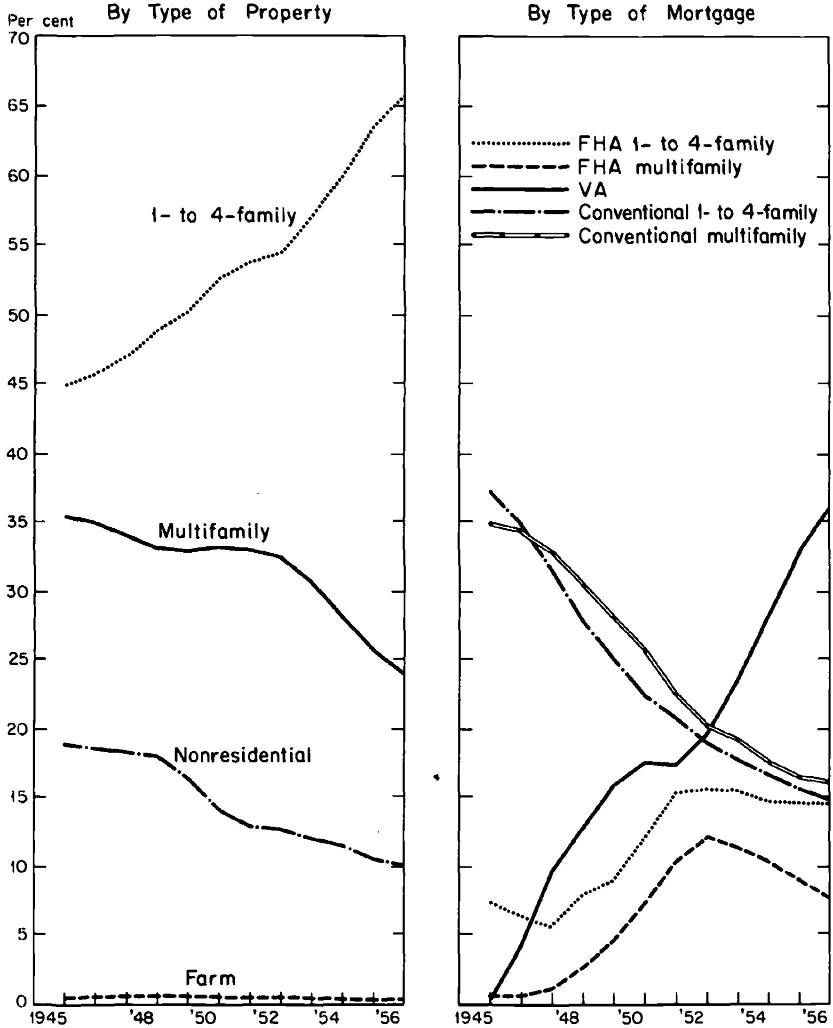
Many savings banks have found it convenient to acquire mortgages from originators, not on an advance commitment basis, but after they are completed and ready for delivery—referred to as mortgages "on the shelf." Several large New York State savings banks acquire their out-of-state mortgages solely through mortgage brokers, buying seasoned or completed mortgages when ready for delivery, in accordance with inflow of deposits and mortgage repayments. In Massachusetts, on the other hand, where a large out-of-state mortgage investment program has developed, savings banks seldom acquire mortgages in this manner. A central purchasing group has been formed to act as agent for a large number of banks in the state. Operations in the Massachusetts purchasing group have been patterned closely after the life insurance company–correspondent relationship. "Servicing contractors" have been selected in various regions of the country, and association is maintained on a continuing basis.

The changing composition of postwar mortgage portfolios of mutual savings banks, shown in Chart 25, reflects the change in investment policies just described. The most striking development indicated by the chart

[18] For a discussion of the legal problems, see Redfield, "Problems Facing Savings Banks in Out-of-State Mortgage Purchases," pp. 36–41.

[19] *Ibid.*, p. 38.

CHART 25
Mortgage Portfolio Composition of Mutual Savings Banks, End of Year, 1945–1956



SOURCE: Klaman, *Volume of Mortgage Debt*, Table 19.

is the sharp increase in the proportion of VA loans held, from about one-sixth in 1950–1951 to well over one-third by the end of 1956, while the proportions of FHA and conventional residential loans and those on commercial properties were declining or showing little change. That rapid and marked shift was without parallel among other types of financial institutions. Also, unlike the experience of other financial institutions, acquisition of VA mortgages by mutual savings banks increased almost without interruption through periods of both credit restraint and credit ease from 1951 through 1956. As a result mutual savings banks have become the largest suppliers of funds for VA-guaranteed mortgages.[20]

While their stature as national mortgage lenders has increased in the postwar period, mutual savings banks have maintained their traditional service to local mortgage markets. Many smaller banks, and even some of the larger ones, concentrate all their mortgage lending activity in their own local territories. The others meet local mortgage demands in full before turning to out-of-state investments. All savings banks, whether placing funds locally or out-of-state, invest predominantly in permanent long-term mortgages. They originate only construction loans that will become desirable additions to their portfolios, as permanent mortgages on new properties. They lend also on mortgages secured by existing properties. As Chart 25 indicates, savings banks have a large proportion of their portfolios in mortgages secured by multifamily and commercial properties as well as by one- to four-family homes. Loans in out-of-state areas are chiefly on new residential projects. Multifamily mortgages, though declining in recent years, compose a proportion of savings banks' mortgage portfolios larger than the proportion for any other lender throughout the postwar period. That mutual savings banks are the largest single source of funds for multifamily mortgages (Chapter 2) derives largely from their concentration in the Northeast, where most multifamily real estate and construction are located.

In summary: In their mortgage lending policies and practices mutual savings banks are similar to life insurance companies in that they are important national mortgage lenders, they acquire a large part of their mortgages indirectly through originators, and in out-of-state markets invest chiefly in mortgages on new residential properties. They are similar to savings and loan associations in their concentration on mortgages as compared with other investments, in their primary attention to local mortgage markets, and in their emphasis on loans secured by individual new or existing properties in such markets. Mutual savings banks are unlike either type of institution with respect to composition of mortgage portfolios and shifts in that composition during the postwar period; in location, being chiefly in the Northeast; and in techniques developed for

[20] This development has been discussed in some detail and supported statistically in Chapter 5.

mortgage acquisition, including purchases in the secondary market for immediate delivery.

Savings and Loan Associations

Among institutional investors in the mortgage market, savings and loan associations are exceptional in their essentially specialized function as home mortgage lenders. The only other capital market instrument in which they invest to any extent—U.S. Government obligations—has in recent years of the postwar decade accounted for about 6 to 7 per cent of total assets. State chartered institutions in several states are permitted to invest in municipal obligations, but only a few have made such investments, and in extremely small amounts. The specialized role of savings and loan associations, moreover, is carried through even in home mortgage markets, where they deal directly with borrowers in rather limited local market areas and lend predominantly on amortized conventional home mortgages. That role has changed little since the first association was formed over a century ago by a small group cooperating for the express purpose of pooling funds regularly to enable the contributors to acquire homes.[21]

BACKGROUND AND DEVELOPMENT

During the decades of growth and adaptation to changing patterns of saving and lending, the savings and loan association has been transformed from a simple form of cooperative organization, in which nearly every shareholder was a borrower, to an institution in which saving is not necessarily associated with borrowing.[22] The change has been reflected in the change of name from building societies, or homestead societies, to savings and loan associations. Some of the earlier names, however, including building and loan associations and cooperative banks, still persist.

In the postwar years most savings and loan associations have competed effectively against mutual savings banks and commercial banks for the savings of individuals. They have been able to attract an increasingly large share of those savings mainly because of their relatively high dividend rate on share holdings, which in turn is based on high yields earned on conventional home mortgage loans. Their assets have increased at a considerably faster rate than the assets of each of the other main types of financial intermediaries.

[21] H. Morton Bodfish, *Savings and Loan Principles,* and *History of Building Societies in the United States,* New York, 1940.

[22] Colean, *op. cit.,* p. 61.

The extraordinary growth of savings and loan associations into one of the leading institutional depositories and investors of savings could hardly have been visualized by the founders. The early associations, in fact, were not intended to be permanent institutions, but rather to be disbanded after all members of the cooperatives had achieved the purpose of acquiring homes. Associations continued to be temporary until the latter part of the nineteenth century, when the permanent plan of organization took hold. The plan evolved naturally from the serial type of structure, which gave an association continuity of existence by accepting new members at frequent intervals through the issue of shares maturing serially. By the early 1890's the savings and loan movement had spread from the Atlantic seaboard to the Mississippi and Ohio valleys, the Southwest, and the Far West. The permanent plan of organization, with its separation of savers from borrowers, permitted associations to increase in number and size along with the growth of the nation.

At the same time, there was an ill-fated movement to establish "nationals," which actively solicited savings and made loans throughout the country, partly through branch offices and often by mail.[23] Many were purely promotional, fraudulent ventures. Most of the legitimate ones were poorly managed and unable to provide adequate supervision over loans made in various areas of the country. The result was widespread failures, hastened by the depression of 1893. By the end of the century, national savings and loan associations were virtually out of existence, with a loss of some $250 million to unfortunate investors.[24] The spectacular failure of the "nationals" resulted in a serious setback for the entire savings and loan movement and led ultimately to closer governmental supervision and tighter geographic limitation of activity.[25]

The recovery of the industry proceeded slowly during the beginning of the twentieth century, and received its first impetus from the housing boom of the 1920's. While the numbers of both commercial and mutual savings banks declined between World War I and the end of the 1920's, the number of savings and loan associations almost doubled from 1918 to 1929, having reached a peak of more than 12,000 in 1925. Many of the newly formed associations—small, lacking in managerial skill, and too numerous in many areas—were unable to survive the depression of the 1930's. By 1939 there were approximately one-third fewer associations than in 1929. The number was further reduced during World War II.

[23] For a discussion of the development, operation, and demise of national savings and loan associations see Bodfish, *History of Building Societies*, pp. 68–82.

[24] *Ibid.*, p. 84.

[25] Colean, *op. cit.*, p. 61.

Since the end of the war the number of associations has been relatively stable at around 6,000, with average asset size at the end of 1956 well over \$5 million, compared with less than \$½ million thirty years earlier. This is still much smaller than the average asset size of the other main types of financial intermediaries.

Out of the accumulated experience of a century of success and failure, of growth and decline, savings and loan associations have evolved into the present-day modern type of financial institution. Its function remains the same—providing funds for home building and purchase. It continues to depend for its chief source of funds on the small individual saver. In every postwar year the steady growth of share capital and mortgage repayments have provided the bulk of funds invested in mortgages by savings and loan associations. Occasional additional funds have come in from sales of U.S. government obligations, chiefly in the early postwar period, and from borrowings from the Federal Home Loan Bank System, chiefly in two years of unusual mortgage lending activity, 1950 and 1955.

MORTGAGE LENDING POLICIES AND PRACTICES

Limited as they are in their investment outlets, savings and loan associations have less flexibility than other financial institutions have in adjusting their mortgage flows to changing capital market conditions. Within the mortgage market, moreover, their adjustments are limited because they are confined through law and tradition mainly to the home mortgage market. These limitations on investment policy have not handicapped the associations during most of the post-World War II decade, however, when strong demands for home mortgage loans have absorbed their large inflow of savings, and in some years have exceeded it. Through their specialization in conventional mortgage loans with flexible interest rates savings and loan associations gained a further advantage, capturing a larger share of the home mortgage market during periods of rising interest rates and yields. At such times other lenders have reduced their funds available for federally underwritten loans bearing fixed rates.[26]

Like life insurance companies and mutual savings banks, savings and loan associations invest primarily in permanent long-term mortgage loans. Like commercial banks, however, they also provide a large volume of short-term construction funds, but such loans are usually a means of obtaining long-term mortgages. Unlike life insurance companies, the

[26] See Saul B. Klaman, "Effects of Credit and Monetary Policy on Real Estate Markets, 1952–1954," *Journal of Land Economics*, August 1956, pp. 239–249; Chapter 5 of this book; and "Savings and Loan Associations in the Mortgage Market," *Monthly Review of Credit and Business Conditions*, Federal Reserve Bank of New York, 1956, pp. 96–99.

associations generally have direct contact with most of their borrowers and do not operate through correspondent or branch office organizations. The small asset size of the associations makes less necessary out-of-state outlets, which many savings banks need to keep their funds invested. In their degree of concentration on conventional home mortgage loans, savings and loan associations are unique among institutional investors.

Thus, current mortgage lending policies of the associations reflect their early history and tradition as well as the more recent changes in mortgage markets and the construction industry. Through the years, they have continued to supply the largest share of mortgage funds directly to individuals acquiring new or existing houses. More recently, they have also become important suppliers of construction funds to large-scale builders of houses for sale.

Information on the amount of loans made by savings and loan associations, classified according to loans "for construction of homes" and loans for "purchase of homes," has been available for years from the Federal Home Loan Bank Board. Unfortunately, the precise meaning of that classification has never been clear. A common interpretation has been that loans for construction of homes represent permanent mortgage loans on new houses, while loans for purchase of homes consist of mortgage loans on existing houses.[27] However, conferences with Federal Home Loan Bank Board research officials and officers of reporting associations revealed this interpretation to be incorrect. Loans classified as for construction of homes include temporary loans to builders as well as permanent loans to individuals. Loans classified as for purchase of homes include loans for the purchase of both new and existing houses. Moreover, the figures given are confused by a significant degree of duplication; loans reported once under the construction category are reported again under the purchase category.

In an effort to determine more accurately the real nature of savings and loan mortgage activity, a questionnaire was mailed to about 500 of the larger associations likely to be able to give definite information.[28] The responses received from 55 associations in 22 states—or 11 per cent of the sample—cannot be taken to represent precisely the characteristics of the entire industry. The results seem worth reporting here because they throw some light on a previously dark area, the nature of savings and loan construction lending. The amounts of loans made by reporting associations for construction of homes were 39 per cent of their total volume of mortgage

[27] See Grebler, Blank, and Winnick, *op. cit.*, p. 180, note to Table 50.
[28] The questionnaire is given as Exhibit at the end of the book.

lending in 1955; this compares with a ratio of 35 per cent for all associations in the United States. The closeness of these two figures may be taken as some indication of the representativeness of the associations reporting in the survey.

Most of the reporting associations made between one-fourth and one-half of their loans to finance home construction. There is apparently little direct relationship between size of an association's mortgage portfolio and the proportion of its new mortgage loans made for home construction, as Table 16 shows. Associations with mortgage holdings between $10 and

TABLE 16

Savings and Loan Associations Loans for Construction of Homes, by Size of Mortgage Portfolio, Fifty-five Reporting Associations, 1955

Size of Mortgage Portfolio ($ millions)	*Number of Associations Reporting*	*Proportion of Loans Made for Construction of Homes* 0–20	21–30	31–40 (per cent)	41–50	Over 50
Under 10	9	2	3	2	—	2
10–20	11	1	3	3	2	2
20–30	14	3	2	5	2	2
30–50	13	4	4	—	2	3
Over 50	8	—	—	3	3	2
Total	55	10	12	13	9	11

SOURCE: Questionnaire survey conducted in this study (Exhibit).

$50 million make a widely varying proportion of their loans for home construction. The largest associations, however, with mortgage portfolios over $50 million, reported the consistently largest proportion of loans for home construction.

The survey indicated that in their loans for home construction, most associations included loans to builders to finance construction operations as well as loans to individuals to finance new home acquisition. Among them, loans to builders generally constitute either a small or a very large proportion of total home construction loans. Associations appear to be either heavily or hardly at all engaged in providing builder financing. The frequency distribution curve describing these data, therefore, is bimodal. The relationship between size of mortgage portfolio and loans made to builders, shown in Table 17, appears to be only a little more direct than the relationship between size and total construction loans, shown in Table 16. There is some evidence, however, from Table 17 that the largest

TABLE 17

Proportion of Savings and Loan Association Home Construction Loans Made to Builders, by Size of Mortgage Portfolio, Fifty-five Reporting Associations, 1955

Size of Mortgage Portfolio ($ millions)	*Number of Associations Reporting*	*Proportion of Home Construction Loans Made to Builders* 0–20	21–40	41–60	61–80	Over 80	Not Reported
		(per cent)					
Under 10	9	5	1	—	—	2	1
10–20	11	3	1	1	3	3	—
20–30	14	5	—	1	3	5	—
30–50	13	1	—	5	2	3	2
Over 50	8	—	—	2	2	3	1
Total	55	14	2	9	10	16	4

SOURCE: Same as Table 16.

associations tend to make a greater proportion of their construction loans to builders than the smallest associations do.

When the proportion of construction loans to builders is related to the proportion of total home construction loans (Table 18), a closer relationship may be observed. Most of the associations originating over 40 per cent of their loans for home construction extend well over 60 per cent of such loans to builders. Conversely, those making less than 20 per cent of their loans for home construction provide less than 20 per cent to builders.

The survey results throw light also upon a time-honored assumption that savings and loan associations engage in financing builders' operations

TABLE 18

Relationship between Proportion of Savings and Loan Association Loans Made to Builders and Proportion of Their Loans Made for Home Construction, Fifty-five Reporting Associations, 1955

Proportion of Loans Made for Home Construction	*Number of Associations Reporting*	*Proportion of Home Construction Loans Made to Builders* 0–20	21–40	41–60	61–80	Over 80	Not Reported
		(per cent)					
0–20	10	6	—	1	1	—	2
21–30	12	4	2	3	1	1	1
31–40	13	4	—	3	1	5	—
41–50	9	1	—	1	4	3	—
Over 50	11	—	—	1	3	6	1
Total	55	15	2	9	10	15	4

SOURCE: Same as Table 16.

only as a means of acquiring permanent mortgage loans, short-term financing of such operations being not in keeping with their fundamental purposes. Answers from the 55 associations indicate that this assumption is true only with qualifications. A significant proportion of loans made by savings and loan associations to builders do not lead to permanent mortgage loans for their portfolios.

Table 19 shows clearly that only about 45 per cent of the associations reported that nearly all of their loans to builders—90 to 100 per cent—resulted in permanent mortgage loans after the new buildings had been completed and sold. An additional one-fourth of the associations reported the same result for from 75 to 89 per cent of their loans to builders. Thus,

TABLE 19

Percentage of Savings and Loan Association Loans to Builders Resulting in Permanent Mortgage Loans, Fifty-five Reporting Associations, 1955

Percentage of Loans to Builders	Percentage of Reporting Savings and Loan Associations
0–24	4
25–49	6
50–74	21
75–89	24
90–100	45

SOURCE: Same as Table 16.

about 7 out of 10 reporting institutions indicated that at least three-fourths of their builder loans became permanent loans for their mortgage portfolios. From another view of the data, not shown in the table, more than two-fifths of the reporting associations indicated that over 25 per cent of their loans to builders were refinanced upon completion of construction by other institutions, or otherwise did not lead to permanent loans for their portfolios.

The reasons for the outcome just described in the minority of construction loans to builders were not determined. While an association may have expected to obtain the permanent loan, the ultimate purchaser may have arranged for more favorable financing terms elsewhere, or may have purchased without a mortgage. In other cases, the builder may have obtained a take-out commitment from another institution before arranging with the savings and loan association for construction financing. In any event, the survey results as a whole suggest that, whether by intention, or circumstance, a significant number of savings and loan associations have been a source of short-term construction financing for builders as well as of long-term financing for house buyers.

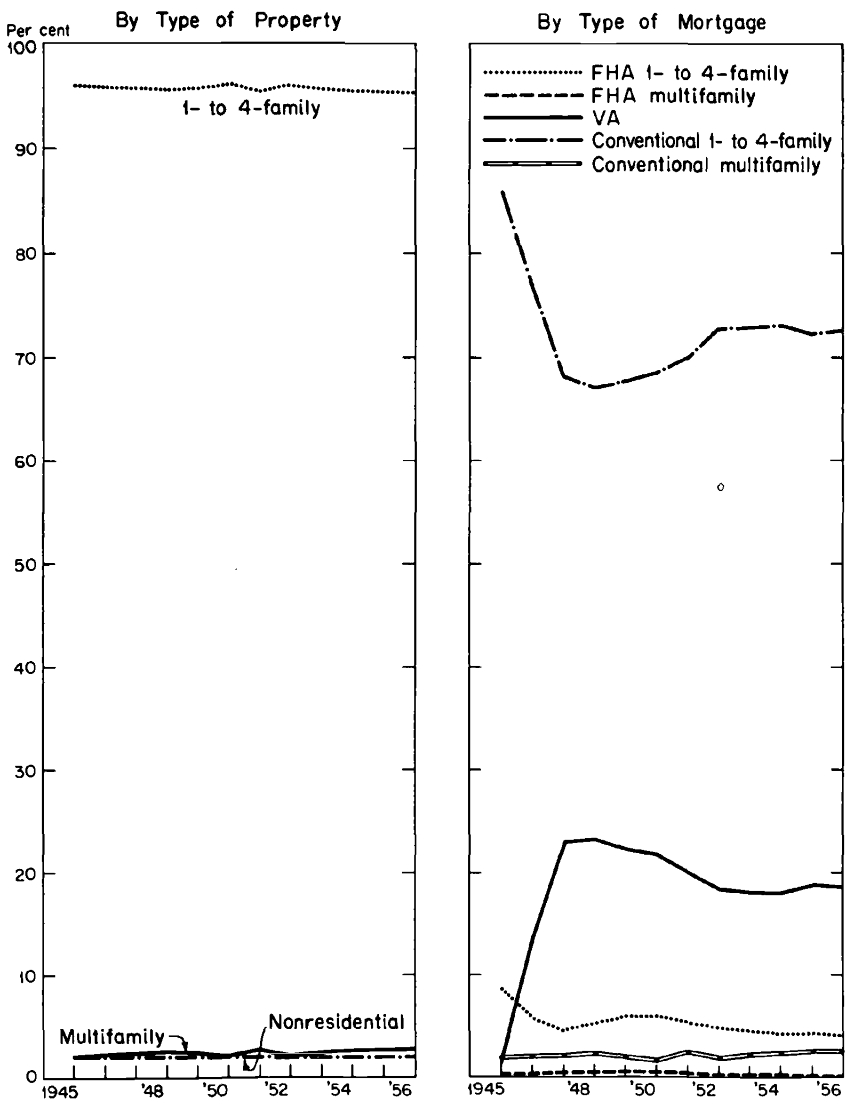
It is important to know how associations make the transition from builder loans to permanent home purchase loans for understanding savings and loan lending practice and proper interpretation of national statistics. Do they make a new loan to a new owner-borrower upon completion of construction, receiving payment in full from the builder? Or do they simply arrange for the purchaser to assume the original loan made to the builder? While the questions deal almost entirely with technique, they have direct bearing upon interpretation of gross mortgage lending figures for savings and loan associations. If the first technique is used, two loans would be reported for financing one property—construction and purchase. If the second, only one loan would appear in the statistics.

From the point of view of lender practice the survey findings indicate wide differences among associations. About one-third reported that less than 20 per cent (for the majority, less than 10 per cent) of their loans to builders that led to permanent loans were replaced by new loans. More than one-half reported that over 80 per cent (for the majority, over 90 per cent) of such builder loans were paid off and replaced by new permanent loans. Thus, associations refinance either the bulk of their builder loans or a very small proportion of them with new permanent loans. Few fall into middle ground. The two extremes also characterize the distribution of the proportion of builder loans made by savings and loan associations (Table 17). In any case the reporting of two separate loans for financing one property inevitably leads to overstatement of the volume of mortgage lending reported for the nation's savings and loan associations.

The specialization by savings and loan associations in conventional mortgage lending on one- to four-family houses and the stability of their mortgage portfolio composition through most of the post-World War II decade can be seen in Chart 26. The picture contrasts with those of the portfolios of most other institutional investors, which showed important shifts during the period (see Charts 23, 25, and 27). VA-guaranteed loans played a role in the postwar portfolios of savings and loan associations about as significant as in those of other types of institutions, except for savings banks. This finding reveals as only half true the common generalization that savings and loan associations prefer conventional to federally underwritten loans. More accurately, they prefer conventional and VA loans to FHA loans. The latter accounted for little more than 5 per cent of total mortgage holdings in each of the postwar years.

What are the reasons for the unusually small volume of FHA-insured

CHART 26
Mortgage Portfolio Composition of Savings and Loan Associations, End of Year, 1945–1956



Source: Klaman, *Volume of Mortgage Debt*, Table 16.

loans in savings and loan portfolios? One explanation may be that, while the incentive to serve returning veterans has overcome the drawbacks in handling VA-guaranteed loans, those drawbacks remain for FHA loans. The small size of the associations and their lack of trained investment personnel create difficulties in dealing with the technical complexities of loan origination and administration. The processing delays, too, are particularly inconvenient for savings and loan associations in their direct, face-to-face dealings with borrowers. Perhaps more basic is the fact that the savings and loan industry has been opposed to the FHA mortgage insurance program from its beginning in 1934. Its opposition was founded originally on the belief that a program of mortgage insurance embodied a philosophy fundamentally at odds with that of the reserve home loan banking institutions, established two years earlier, in the form of the Federal Home Loan Bank System. Further, it felt that federal mortgage insurance would attract more financial institutions to the mortgage lending field (as it did) and thus increase competition for the industry.

Both the savings and loan industry and the FHA mortgage insurance program have thrived over the past two decades or so, but the two have never really joined hands. Most savings and loan managers continue to avoid FHA mortgages. Some of the larger associations—the exceptions—have broken through tradition to invest a large share of their funds in FHA mortgages. So long as associations can continue to invest the bulk of their funds in higher-yielding conventional mortgages, they may be expected to invest a minimum in FHA loans.

Commercial Banks

SIGNIFICANCE OF REAL ESTATE LOANS

Commercial banks, as noted earlier, have been lending on real estate as security almost from the beginning of their development more than two centuries ago. Since the turn of the twentieth century, however, real estate loans have constituted only a small proportion of total commercial bank assets, partly because of legal restrictions on mortgage lending and partly because of the basic orientation of commercial banks towards short-term credits. That proportion has increased for national banks since the steady liberalization of national banking laws following the passage of the Federal Reserve Act in 1913. Before that, participation of national banks in real estate lending was much more restricted than that of state banks. Since 1934, development of the federally underwritten mortgage, exempt from most lending restrictions and readily marketable, has resulted in increased activity of all commercial banks in the nonfarm mortgage market.[29]

Since the end of World War II, national banks have accounted for more than one-half of the real estate loans held by all commercial banks, compared with less than one-twentieth in 1913, and about one-third in 1935. In percentage of assets, total commercial bank real estate loans have increased from about 7 per cent in 1939 and 3 per cent in 1945 to over 10 per cent in 1956. The postwar increase, while substantial, has left the mortgage-to-assets ratio for commercial banks still well below that for savings-type institutions. In addition to making long-term real estate loans, commercial banks play a unique and important role in real estate markets by providing short-term credits either for construction or for interim financing. Much of this activity is not directly measurable, and a large portion is not included statistically among commercial bank real estate loans at all.[30]

MORTGAGE LENDING POLICIES AND PRACTICES

Among the four principal types of mortgage investors, commercial banks play the most varied role in the mortgage market. Furthermore, there is a wider variation of mortgage lending policies and practices among commercial banks than among members of the other three main groups of lending institutions. Commercial banks provide three types of credit to the real estate mortgage market: long-term permanent mortgage loans; short-term construction credits; and interim financing to other real estate mortgage lenders. In addition, some commercial banks carry on a mortgage company type of operation, originating loans for sale to other investors and servicing the mortgages originated and sold.

Among the country's 13,600 commercial banks, many refrain from any type of real estate finance, many specialize in one type only, and still others operate a broad financing program including all types of long- and short-term real estate credit. In general, long-term financing of real estate is a more extensive activity of the smaller country banks than of the large city banks. Naturally, there are important exceptions. One of the main reasons for the dominant position of commercial banks in the West Coast

[29] For description of the liberalization of legal restrictions on commercial bank mortgage lending and other factors influencing their expansion in the field, see Grebler, Blank, and Winnick, *op. cit.*, pp. 201–203; Behrens, *op. cit.*, Chapter 1; and "Commercial Banks in the Mortgage Market," *Monthly Review of Credit and Business Conditions*, Federal Reserve Bank of New York, April 1956, pp. 47–48.

[30] "Unsecured construction loans and loans to real estate lenders which are either unsecured or secured by the pledge of mortgages owned by the borrower are not classified as real estate loans in bank condition statements." (Behrens, *op. cit.*, footnote 1, p. 47.)

mortgage market, for example, is the fact that the largest bank in the country, located there, is heavily engaged in mortgage lending activity through its many branches.[31] Another of the leading banks, located in the East, carries a large real estate mortgage portfolio in addition to supplying a heavy volume of short-term real estate credits. With few exceptions, the large New York money market banks limit their real estate credit operations almost entirely to short-term financing of construction operations and of real estate mortgage lenders, or both. Large banks in the East most extensively engaged in those two types of real estate financing were chosen as subjects for field interviews in investigating mortgage lending policies and practices of commercial banks. The choice was appropriate because of the dominant and uniquely important role of commercial banks as short-term real estate mortgage lenders, because of the increasing use of such credits in the postwar years, and because of the limited literature on the nature of such activities.

Short-term financing of construction operations is a highly specialized banking activity and, unlike long-term real estate financing, is concentrated among relatively few large banks. In the early post-World War II years many commercial banks, anxious to build up their real estate loan portfolios, made construction loans in order to obtain permanent mortgages on the completed properties.[32] This practice became much less common as long-term mortgage debt held by banks increased to desired levels. The more widespread practice of commercial banks is to supply short-term credits for construction, while permanent financing is furnished by another institution. The concentration of construction financing among a few banks is indicated in part by reference to 1950 data. They reveal that, of the $840 million in construction loans outstanding as of June 30, more than two-fifths was held by banks in the New York Federal Reserve District. Those banks accounted for only about one-sixth of all commercial bank real estate loans.[33] Evidence from interviews suggests that the situation has changed little since then.

In the booming postwar construction market, construction lending has been a lucrative field of investment for commercial banks. Even so,

[31] See, for example, Paul F. Wendt and Daniel B. Rathbun, *The San Francisco Bay Area Residential Mortgage Market*, Housing and Home Finance Agency, Housing Research Paper No. 20, May 1952, Chapter III, especially p. 31, footnote 54.

[32] *Ibid.*, p. 28.

[33] Data on construction loans of commercial banks were obtained from a special supplement to the June 30, 1950 commercial bank call report. Summary results of that report were published in the FDIC Report No. 33, *Operating Insured Commercial and Mutual Savings Banks, June 30, 1950*, pp. 5–7. No later data on the subject were available at the time of writing.

because it is considered a highly complex, specialized, and risky kind of operation, many of the large eastern banks have never made a construction loan or have made only a few to accommodate correspondent banks. Others have only recently established construction and mortgage loan departments.[34] Banks that have been successful construction lenders for many years have acquired the skilled management and developed the operating techniques to meet the special needs and complexities of the construction loan market and to minimize risks associated with short-term construction financing. The major risks are those of unavailability of permanent mortgage financing, unsold completed properties, and uncompleted construction.

With few exceptions, commercial banks make construction loans only after builders applying have obtained commitments elsewhere for permanent financing of proposed construction. These firm "take-out" commitments assure the bank of availability of permanent mortgage financing and of repayment of its construction loan upon satisfactory sale of the completed property. In some instances, depending on the state of the capital market, the construction lender may insist on "dual take-out commitments," under which the permanent lender agrees to purchase the builder's loans on completed but unsold properties, as well as to provide financing for those sold to acceptable purchasers.[35] This type of commitment, which is not very common, relieves the bank of any risk associated with failure to sell. Frequently, a local correspondent bank through which loans are made (see below) will commit itself to take over loans on unsold properties.

Where "dual take-outs" or local bank commitments are not available, banks may reduce the risk of unsold properties in the case of residential construction projects by requiring the builder to show executed sales contracts for a large percentage of his proposed houses. He may then proceed to build only at a specified rate in advance of sales. On commercial construction, contracts for leases are often required before funds are advanced.

In contending with the risk of uncompleted construction, banks may require performance or completion bonds. The chief reliance is judicious selection of builders, close supervision of progress at the site, and payment

[34] One of the largest New York banks which established a real estate and mortgage loan department in 1955 gave three reasons for its action: (1) to share in what was apparently a lucrative type of loan business, judging from operations of competitive banks; (2) to fulfill requests of correspondent banks to participate in construction financing; and (3) to meet the needs of local bank customers for mortgage loans.

[35] James F. Schneider, "Construction Loans For Your Short-Term Portfolio," unpublished doctoral thesis, Graduate School of Banking, Rutgers University, June 1952.

of construction funds at predetermined selected stages of work. Naturally, the risk of noncompletion is least on large-scale commercial projects involving established, financially responsible real estate and construction firms. In the case of construction loans on multifamily properties approved by the Federal Housing Administration, FHA insures the construction loan as well as the permanent loan and so relieves the commercial banks of most of the risk.

Most of the large eastern banks make short-term construction loans on residential projects in participation with correspondent banks situated throughout the country. (Loans on large-scale nonresidential projects, in which some banks specialize, are often handled directly.) By most arrangements the large money market bank takes 80 to 90 per cent of a given loan and the local bank the remaining percentage. The smaller banks, limited by law in the size of loan to one borrower and by their own assets, are precluded from assuming a larger per cent of construction loans. Only the participation arrangements with larger banks make it possible for them to engage in many construction financing projects.

From the standpoint of earnings those arrangements are particularly attractive to correspondent banks. The interest rate on construction loans has rarely been less than 5 per cent in the postwar period, and in periods when money markets have been tight it has risen to 5½ and 6 per cent. Usually the local correspondent bank earns a considerably higher gross rate of return. It is generally increased by an over-ride of ½ of 1 per cent on the large bank's share, to 9½ per cent (on a 90 to 10 participation basis), or to 7 per cent (on an 80 to 20 basis). Another addition is the origination fee (1 to 1½ per cent) paid by the builder, usually retained by the local bank in consideration of its work—placing the loan on the books, servicing it, and seeing it through to completion. The resulting increases in gross rate of return are from 10 to 11 per cent (on a 90 to 10 basis) and from 8 to 8½ per cent (80 to 20). Even after costs of loan handling and administration, the net return for local correspondent banks exceeds that on other types of bank loans, with the possible exception of consumer loans. Consequently, banks that have developed the know-how for construction lending generally maintain the maximum amount permitted by statute.

There is apparently little relationship between a commercial bank's willingness to engage in short-term construction financing and its willingness to provide short-term credits to real estate mortgage lenders. Some active construction lenders engage in little or no financing of other mortgage originators, while others carry on extensive operations in both types of short-term financing as well as in long-term permanent mortgage financing.

Apart from site and location, the extent of a bank's operations in these areas of financing depends heavily on the predilections and experience of its officers. There is variation among them also in administration, some banks coordinating all real estate finance activities in one department, others maintaining separate units.

For many years, commercial banks have been in the business of extending short-term credits to mortgage loan originators, chiefly mortgage companies, to enable them to carry mortgages in inventory for the interval between origination and lodgment with institutions providing permanent financing. Several variations of this type of financing, under the general term of "warehousing," have been introduced in the postwar period. A detailed discussion of postwar variations—which have often made for complexity and confusion—is reserved for the following chapter. Interim financing of mortgage lenders by commercial banks increased sharply towards the end of the post-World War II decade in response to changes in market conditions and operating techniques. Near the end of 1956, commercial bank loans outstanding to real estate mortgage lenders amounted to $1.5 billion, compared with $0.6 billion in the summer of 1954 and $0.4 billion in mid-1950.[36] The bulk of these loans was extended by large banks in New York, Boston, Chicago, and other metropolitan centers.

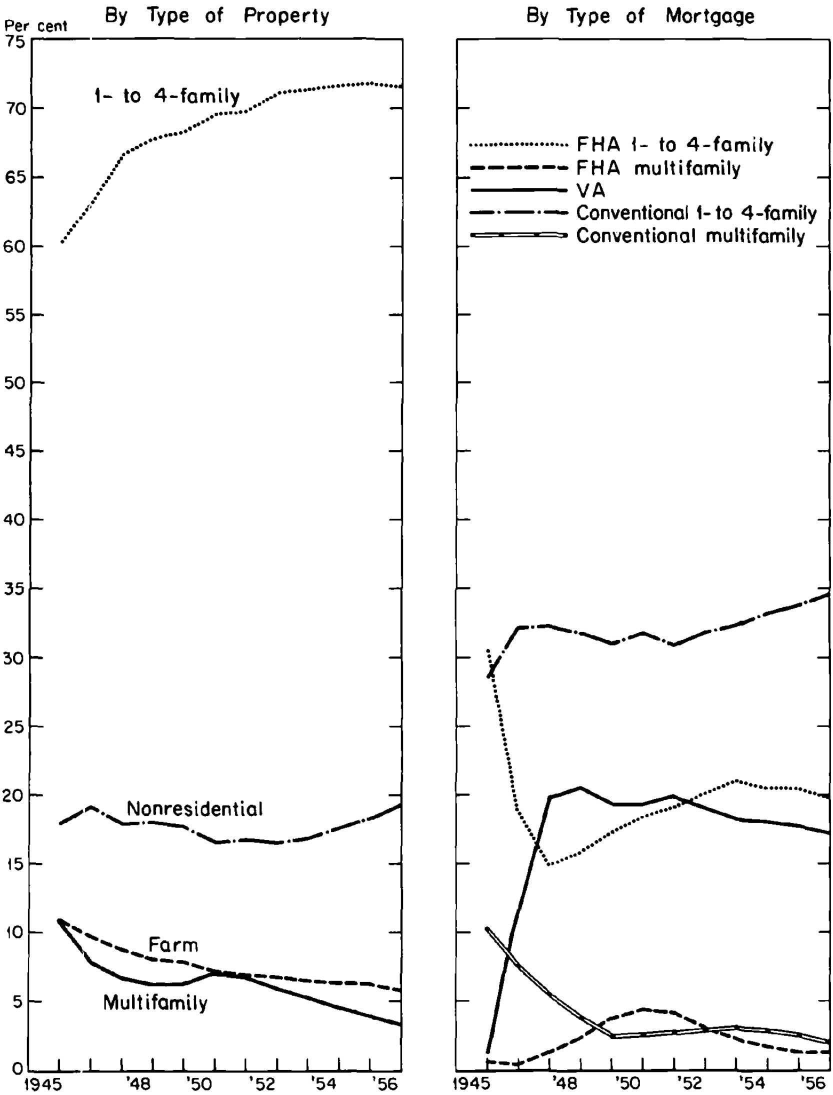
Compared with the increase in interim financing loans, the expansion in commercial bank mortgage loans held in bank portfolios has been far less, but their volume has remained much larger. Unfortunately, data on the volume of short-term construction financing by commercial banks are available only for June 1950, when it was twice as large as interim loans to mortgage lenders, but equal only to about 7 per cent of permanent mortgage loans held in portfolio. In any event, "the strategic role of construction loans (and of interim loans to mortgage lenders) is far greater than is indicated merely by their outstanding amounts at any one date." Important reasons are, "construction loans and those extended to intermediate financing institutions have a relatively rapid turnover; consequently, even their quantitative importance relative to the volume of credit extended on a long-term mortgage basis is not propertly reflected by an outstandings figure . . . . Furthermore, construction loans are of crucial importance in the real estate financing process in the sense that they are commonly essential to the undertaking of building projects, especially those of large scope."[37]

[36] See Table 20 in Chapter 7.

[37] R. J. Saulnier, Introduction to Behrens, *op. cit.*, p. 2.

CHART 27

Mortgage Portfolio Composition of Commercial Banks, End of Year, 1945–1956



SOURCE: Klaman, *Volume of Mortgage Debt,* Table 18.

The composition of commercial bank mortgage portfolios, which consists largely of permanent long-term mortgages, has changed little during the post-World War II decade (Chart 27). Shifts among types of mortgages have been smaller than in accounts of other financial institutions, except savings and loan associations. In contrast to portfolios of mutual savings banks and life insurance companies, conventional home mortgage loans have continued to form a substantially larger part of commercial bank portfolios than either VA or FHA loans have throughout the period of sharp postwar expansion in residential mortgage lending. This difference reflects partly the lending policies of smaller country banks throughout the nation that maintain close personal contact with customers, and whose mortgage operations are similar in this respect to those of savings and loan associations. Whether lending on federally underwritten or conventional mortgages, however, commercial banks—large or small—make loans directly to borrowers in local areas (sometimes through branch offices) rather than on a nationwide basis through correspondents. The latter method is often used in their short-term construction lending operations.

Throughout the postwar decade, the mortgage portfolios of commercial banks have contained a considerably smaller amount and proportion of loans on multifamily properties than those of mutual savings banks (the leading lender) and life insurance companies. They have also included a rather steady and consistently smaller volume of loans on nonresidential properties compared with the volume held by life insurance companies. In markets for both of these income type properties, however, commercial banks have assumed an important role as construction lenders.

Other Financial Institutions in the Mortgage Market

Among other types of private financial institutions, only the mortgage company has played a significant role in the postwar mortgage market. Its role is, in fact, so unique and has assumed such increasing importance since the end of World War II that efforts were made to bring together existing data and to obtain primary information not previously available to describe and appraise its place in the nation's mortgage activities. The results of this effort were published in a separate report which is summarized in Chapter 8 of this book, to both of which the reader may turn for discussion of the postwar mortgage company.[38]

As for other types of private institutions, those that can be separately identified as mortgage investors—nonlife insurance companies, credit unions, investment companies, fraternal orders, personal trust funds, and pension funds—held a combined volume of mortgage loans amounting to little more than $3 billion at the end of 1956, or only about 2 per cent of the total mortgage debt outstanding. Because of the insignificance of

[38] Klaman, *The Postwar Rise of Mortgage Companies*, Occasional Paper 60, New York, NBER, 1959.

these miscellaneous institutions in the mortgage market, and the limitations on time and resources, no effort was made to appraise their mortgage lending policies. For many of them, barriers to increased mortgage investment exist in the form of legal restrictions and complexities, cumbersomeness of the mortgage instrument compared with other capital market instruments, inadequate organization for mortgage acquisition, and general prejudices and lack of knowledge about mortgage markets. At the end of 1956 little more than 2 per cent of the $120 billion in assets owned by noninsured pension funds, personal trust funds, fraternal orders, credit unions, and nonlife insurance companies was invested in mortgages.[39]

Perhaps the liveliest expectations for expanded mortgage market participation among these institutions have been expressed for pension funds. Those funds, in some views, will, in exploring outlets for ever-increasing treasuries, become attracted to the investment advantages of federally underwritten mortgages both from the standpoint of risk and of yield. The Mortgage Bankers Association of America not long ago established a committee to study pension fund characteristics. Several mortgage companies have acted to sponsor an organization established specifically to meet mortgage origination and servicing problems for pension funds and similar potential investors. Evidence of increased interest in mortgages on the part of pension funds can be found. Between the end of 1954 and 1956 those funds doubled their mortgage investments from $140 to $285 million—a much more rapid absolute and relative increase than other types of miscellaneous institutions undertook.

Even so, most pension fund administrators and students of pension fund operations foresee no great growth in mortgage investment. They argue that the relatively risk-free status of FHA and VA loans is not a controlling consideration. High-grade corporate bonds are just as likely to be paid at maturity. Moreover, the increased liquidity of federally underwritten mortgages through regular amortization is of no interest to the pension fund manager. He has no need for liquidity; rather, with the rapid growth of pension funds, the return flow of investment funds often creates new problems of selecting investment outlets.

The question of yield is of course basic, but yield is subject to many modifications. Administrative and servicing costs associated with a mortgage portfolio, higher in comparison with those for a corporate securities portfolio, narrow any market yield differential in favor of mortgages. The demonstrated present and potential future capital gains of a common

[39] Estimates of the Board of Governors of the Federal Reserve System, Flow-of-Funds Unit; and National Bureau of Economic Research, Postwar Capital Market Study.

stock portfolio have attracted an increasingly large share of pension fund investments into equities. Because of long-term orientation, interim price fluctuations are of small concern to administrators. Finally, just as life insurance companies and other large financial institutions are, pension funds are reluctant to be involved in real estate foreclosure action, even though capital losses in the case of FHA and VA loans are limited.[40]

[40] The discussion of why pension funds are not likely to become an important source of mortgage investment leans heavily upon the views of Roger F. Murray. See, for example, his "Pension Funds as a Market for Mortgages," *Savings and Mortgage Supply*, Proceedings of the Eighth Annual Conference of the Mortgage Bankers Association of America, 1953.

The National Bureau of Economic Research began in 1958, under Murray's direction, a research program on the impact of public and private pension systems on saving and investment. Plans for the study are outlined in the National Bureau's *Thirty-ninth Annual Report*, May 1959, pp. 63–68.