Volume Title: Commercial Bank Activities in Urban Mortgage Financing

Volume Author/Editor: Carl F. Behrens

Volume Publisher: NBER

Volume ISBN: 0-870-14143-0

Volume URL: http://www.nber.org/books/behr52-1

Publication Date: 1952

Chapter Title: Legal Framework of Urban Mortgage Lending by Commercial Banks

Chapter Author: Carl F. Behrens

Chapter URL: http://www.nber.org/chapters/c1736

Chapter pages in book: (p. 14 - 25)

CHAPTER 1

# Legal Framework of Urban Mortgage Lending by Commercial Banks

SINCE World War I, commercial banks in the United States have participated to an increasing extent in the financing of urban real estate. This development parallels in some measure the widened activities of commercial banks in the field of term lending and in other types of secured lending, which they entered mainly because of changes in the credit requirements of potential users of bank credit. These new activities were stimulated also by changes in federal and state laws. Of these, the National Housing Act, which induced changes in state laws allowing banks to make and hold loans insured under the Federal Housing Administration, was extremely important.

In this study, the main purposes of which are to examine the development of urban mortgage lending by commercial banks and to survey their experience with urban real estate mortgage loans since 1920, mortgage lending is defined as a process in which the lender takes collateral "in the form of an instrument which gives him certain rights against the title to real property." [1] By urban mortgage loans are meant all mortgage loans on nonfarm properties, including those on residential, commercial, and industrial real estate. The study covers the activities of all operating national banks, all incorporated state banks, trust companies, and stock savings banks.[2] The mortgage lending activities of mutual savings banks are excluded because these have been the subject of a recent investigation.[3]

[1] *Home Mortgage Lending,* American Institute of Banking (New York, 1938) p. 11.

[2] *Annual Report of the Federal Deposit Insurance Corporation,* 1943, p. 59. In the case of trust companies only mortgages held in the bank's own account are included.

[3] John Lintner, *Mutual Savings Banks in the Savings and Mortgage Markets* (Harvard University, 1948).

## Development of Laws and Regulations Affecting Commercial Bank Mortgage Lending

There have been three fairly distinct periods in the development of urban mortgage lending by commercial banks since the National Bank Act was passed in 1863. The first—1863 to 1913—was one in which state banks largely dominated bank activity in the mortgage field; the second—1914 to 1931—showed few changes in state and national banking laws, and these were mainly in the direction of liberalizing the restrictive legislation; in the third period—covering the years since 1931—there were many changes in banking laws and practices relating to mortgage investment.

### DOMINATION OF BANK MORTGAGE LENDING BY STATE-CHARTERED INSTITUTIONS, 1863–1913

The National Bank Act of 1863 conferred authority on national banks to lend money "on real and personal security," but the words "real and" were struck out in the Act of 1864 and it was not until the passage of the Federal Reserve Act, at the end of 1913, that national banks situated elsewhere than in central reserve cities were permitted by statutory law to make loans secured by farm real estate.[4]

However, banks chartered under the National Bank Act of 1864 were permitted to take real estate mortgages to prevent losses on debts previously contracted in good faith (the so-called DPC loans) and, if necessary, to acquire title to the property, although property acquired in this manner had to be disposed of within five years.[5] The law was strictly interpreted in the early years of the National Bank Act, but later was given a more liberal interpretation. Thomas P. Kane, Deputy Comptroller of the Currency from 1899 to 1923, writes of this: "Competition with trust companies and other banking institutions operating under State authority, more liberal in the scope of corporate powers conferred, forced many competing national associations doing business in the same locality into undertakings not contemplated by the national banking laws and foreign to the legitimate functions of a commercial bank. The powers conferred upon

[4] Act of February 25, 1863, c. 58, 12 Stat. 668; Act of June 3, 1864, c. 106, 13 Stat. 101; and Federal Reserve Act, December 23, 1913, c. 6, 38 Stat. 273, sec. 24.

[5] June 3, 1864, c. 106, 13 Stat. 108, sec. 28, "Such association shall not purchase or hold real estate in any other case or for any other purpose than as specified in this section."

trust companies and savings banks to make loans upon real estate security induced many national associations to make loans upon like security by resorting to indirect methods to evade the restrictions of the statute. This was particularly true of localities where mortgage loans were the principal securities dealt in by savings banks and trust companies." [6]

Apparently, in later years such evasion was sometimes sanctioned by federal bank supervisory officials. Kane comments on this as follows: "While the national banking laws should be construed as broadly and as liberally as is possible consistent with the intent and spirit of the statutes, it is the sworn duty of an administrative officer to enforce an observance of the law as it exists and not endeavor to twist it out of shape either to meet his own views or the wishes of the bankers as to what it should be.

"Unfortunately there has been too much of a disposition in later years in the administration of the Currency Bureau to change existing law by administrative regulations or rulings, unwarranted by any reasonable construction of the statutes, to meet the demands incident to competition between national and State institutions. In no respect was this fact more patent than in its application to real estate loans. Official rulings in this connection practically nullified the prohibitive provisions of the statutes and conferred upon the banks privileges which had been denied them, up to that time, by Congress since 1864." [7]

In a 1910 digest of banking laws covering the forty-six states, the District of Columbia, and the territories of Arizona and New Mexico only eleven states were reported to have restrictions on real estate lending by commercial banks.[8] These were California, Michigan, Minnesota, New York, North Dakota, Ohio, Oklahoma, Pennsylvania, South Carolina, Texas, and Wisconsin. Loans could be made in California, New York, North Dakota, Oklahoma, and Pennsylvania but only on first liens. In Michigan, South Carolina, and Wisconsin the total amount of real estate mortgage loans was limited to 50 percent of a bank's capital and deposits. In Minnesota it was necessary that the land be worth twice the amount of the loan.

6 Thomas P. Kane, *The Romance and Tragedy of Banking,* 3rd ed. (New York, 1930) p. 90.

7 *Ibid.,* pp. 90, 91.

8 *Digest of State Banking Statutes,* compiled by Samuel A. Welldon, National Monetary Commission, Senate Document No. 353, 61st Congress, 2nd Session (1910).

Despite "official rulings," national banks appeared reluctant to make real estate loans in any volume. Thus, on June 4, 1913 the holdings of real estate loans by these institutions amounted to only $77 million, or 0.7 percent of their total resources. In the state banks, stock savings banks, and loan and trust companies, many of which were under no restrictions as regards real estate lending, real estate loans amounted to $1,620 million, or 15.6 percent of total assets.[9]

### LIBERALIZATION OF THE LEGISLATIVE BASIS OF MORTGAGE LENDING BY NATIONAL BANKS, 1914–31

The following provision in the Federal Reserve Act of 1913 opened the way for national banks to enter the field of farm mortgage lending:

"Any national banking association not situated in a central reserve city may make loans secured by improved and unencumbered farm land, situated within its Federal reserve district, but no such loan shall be made for a longer time than five years, nor for an amount exceeding fifty per centum of the actual value of the property offered as security. Any such bank may make such loans in an aggregate sum equal to twenty-five per centum of its capital and surplus or to one-third of its time deposits and such banks may continue hereafter as heretofore to receive time deposits and to pay interest on the same.

"The Federal Reserve Board shall have power from time to time to add to the list of cities in which national banks shall not be permitted to make loans secured upon real estate in the manner described in this section." [10]

This provision which permitted loans only on farm land was amended in 1916 to provide for one-year loans on urban real estate as follows:

"Any national banking association not situated in a central reserve city may make loans secured by improved and unencumbered farm land situated within its Federal reserve district or within a radius of one hundred miles of the place in which such bank is located, irrespective of district lines, and may also make loans secured by improved and unencumbered real estate located within one hundred miles of the place in which such bank is located, irrespective of district lines; but no loan

[9] *Annual Report of the Comptroller of the Currency*, 1913, pp. 38, 51, 60.

[10] December 23, 1913, c. 6, 38 Stat. 273, sec. 24.

made upon the security of such farm land shall be made for a longer time than five years, and no loan made upon the security of such real estate as distinguished from farm land shall be made for a longer time than one year nor shall the amount of any such loan, whether upon such farm land or upon such real estate, exceed fifty per centum of the actual value of the property offered as security. Any such bank may make such loans, whether secured by such farm land or such real estate, in an aggregate sum equal to twenty-five per centum of its capital and surplus or to one-third of its time deposits and such banks may continue hereafter as heretofore to receive time deposits and to pay interest on the same.

"The Federal Reserve Board shall have power from time to time to add to the list of cities in which national banks shall not be permitted to make loans secured upon real estate in the manner described in this section." [11]

The unfavorable competitive position of national banks during the latter part of the nineteenth century and the first decade of the twentieth was, no doubt, an important factor in liberalizing the basis on which these banks were allowed to make real estate loans. During the next decade the position of national banks improved both absolutely and relative to that of state-chartered institutions. During the ten-year period June 1913 to June 1923, state bank holdings of real estate loans advanced from $1,620 million to $1,818 million, or only 12 percent, while national bank holdings of comparable assets increased 500 percent, from $77 million to $463 million. Relative to deposits, however, the real estate loans of national banks were still considerably less than those of state banks, stock savings banks, and loan and trust companies.[12]

A further modification of the national bank laws was proposed in 1924 by Representative Louis T. McFadden, who recommended that Section 24 of the Federal Reserve Act be amended to provide that the time limit on loans made by national banks on improved business and residential property be increased from one to five years and that national banks be permitted to make such loans to an aggregate amount not in excess of 50 percent of their time deposits.

These proposals were favorably commented upon by the Comptroller of the Currency as follows: "Of all the numerous suggestions made to the office of the comptroller for revision of the national

[11] September 7, 1916, c. 461, 39 Stat. 754, "An Act to amend certain sections of the Act entitled 'Federal Reserve Act.'"

[12] *Annual Report of the Comptroller of the Currency*, 1923, pp. 29, 34, 99, 101, 103.

banking laws, on none has there been greater unanimity than on the suggestion for liberalizing the lending powers of national banks upon the security of real estate. From every section of the country, especially from banks located outside of the large cities, there is an insistent demand for the removal of the handicaps which the existing laws impose in this connection.

"Section 24 prohibits a national bank from lending money upon first mortgage security upon city property for a longer period than one year and further limits the aggregate amount of such loans to a sum not in excess of one-third of the time deposits. The State banks and trust companies in active competition have no such limitations imposed upon them. A first mortgage upon improved city property is considered a very fine form of security. But real estate loans are ordinarily made for a longer period than one year. If a national bank is prohibited from meeting the needs of its customers in this connection, the customer naturally will go to the State bank to borrow the money upon his real estate, and the State banks as a result will get his account and in many cases his entire commercial business. This is one of the severest forms of competition which the national banks outside of the large banking centers face to-day and it accounts in a large measure for the rapid growth of the trust companies in those localities and for the relative reduction of the resources of national banks.

"The argument which is most generally advanced against having long-term real estate securities in national banks is that they are not readily convertible. This has been adduced against the removal of the one-year period for city real estate and the five-year period for country real estate. As a matter of fact, the probabilities are that if real estate is to be handled by the banks the liquidity would be greater if indefinite latitude as to time were granted. The banks would then handle most of their mortgage real estate loans in somewhat the same way they handle bonds which they sell. There is a well-established and definite market for real estate mortgages. This market does not cover mortgages of as short a term as one year, and, as a rule, the shortest term is five years. If the banks were able to carry these maturities of five years or over, they would then have the notes and mortgages in such condition that they could be disposed of to a wide clientele. A five-year mortgage is salable and convertible, whereas a one-year mortgage is not. On this account alone it is very possible that, instead of increasing the volume of frozen assets of

banks, this longer period would produce greater liquidity and at the same time enable the banks to add very much to their services to their customers." [13]

These proposals to liberalize the laws under which national banks could compete for mortgages, being tied up with other proposals relating to branch banking, were debated for three years and it was not until 1927 that they became law in the McFadden Act.[14] Between mid-1927 and mid-1929 the nonfarm real estate loans of national banks increased by about 45 percent while their total resources were growing by around 3 percent. During the same period there was a decline in the reported nonfarm real estate loans of state commercial banks, and virtually no change in their total assets.[15]

## LEGISLATIVE DEVELOPMENTS IN THE PERIOD SINCE 1931

The decline in security prices after October 1929 was soon followed by a rapidly rising tide of urban real estate mortgage foreclosures. These exceeded 252,000 in 1933, or nearly twice the number foreclosed in 1929 and nearly four times the number foreclosed in 1926.[16] Since the majority of urban mortgage loans were secured by small, single family, residential properties, a large proportion of the loans foreclosed were home mortgages. The Federal Home Loan Bank Act was the first legislative action taken to meet this emergency, but it soon became apparent that an additional and more powerful instrument was required to alleviate the existing distress.[17] For this purpose, the Home Owners' Loan Corporation, which began lending operations in June of 1933, was created.[18] During the three years of its refinancing operations more than a million mortgages on individual homes were taken over by the HOLC.[19]

[13] *Annual Report of the Comptroller of the Currency,* 1924, p. 11.

[14] February 25, 1927, c. 191, 44 Stat. 1232, sec. 16, amending sec. 24 of the Federal Reserve Act.

[15] *Annual Report of the Comptroller of the Currency,* 1927, pp. 735, 739, 771 and 775; *ibid.,* 1929, pp. 665, 669, 701 and 705.

[16] *Statistical Summary, 1949,* Home Loan Bank Board, Table 16, p. 18.

[17] July 22, 1932, c. 522, 47 Stat. 725.

[18] Home Owners' Loan Act of 1933, June 13, 1933, c. 64, 48 Stat. 128.

[19] *Sixth Annual Report of the Federal Home Loan Bank Board,* 1938, p. 69. An account of the operations of the HOLC, and of its experience in handling distressed mortgage loans will be found in C. Lowell Harriss, *History and Policies of the Home Owners' Loan Corporation* (National Bureau of Economic Research, Financial Research Program, 1951).

Once the machinery for preventing wholesale foreclosures had been established, attention could be directed to corrective measures and to recovery. The first major legislation designed specifically to improve mortgage lending conditions was the National Housing Act which created a Federal Housing Administration in 1934.[20] Essentially, this Act provided for the insurance of mortgage loans and, secondarily, for the insurance of unsecured loans for the repair and modernization of real property. The mortgage insurance plan did not become fully operative, however, until the end of the first quarter of 1935, because of the lack of appropriate state enabling legislation. In the meantime, the plan for insurance of modernization credits developed rapidly and by the end of March 1935 more than 100,000 repair and modernization loans for an amount in excess of $50 million had been made.[21] Support for this legislation came from a wide variety of sources, including some financial institutions, labor groups, builders, manufacturers of building supplies, and real estate associations. Much of this support was based on the belief that the proposed legislation would improve mortgage lending practices and promote recovery in the construction industry. The second major legislative development was the amendment of the Federal Reserve Act on August 23, 1935 to permit national banking associations under specified conditions to make ten-year, 60 percent amortized loans where they had previously been restricted to five-year, 50 percent loans.[22]

## The Present Legal Basis of Commercial Bank Mortgage Lending

The laws that currently cover the mortgage lending operations of national banks are Section 24 of the Federal Reserve Act, and Section 5200 of the National Bank Act. The amended section of the Federal Reserve Act reads as follows:

"1. Real-estate loans by national banks

Sec. 24. Any national banking association may make real-estate loans secured by first liens upon improved real estate, including improved farm

[20] June 27, 1934, c. 847, 48 Stat. 1246.

[21] *Second Annual Report of the Federal Housing Administration,* 1935, pp. v and vi, 1 and 8, and Miles L. Colean, *The Impact of Government on Real Estate Finance in the United States* (National Bureau of Economic Research, Financial Research Program, 1950) Chapter 6, pp. 97–98.

[22] Banking Act of 1935, August 23, 1935, c. 614, 49 Stat. 706, Title II, sec. 208, amending sec. 24 of the Federal Reserve Act.

land and improved business and residential properties. A loan secured by real estate within the meaning of this section shall be in the form of an obligation or obligations secured by a mortgage, trust deed, or other instrument upon real estate, which shall constitute a first lien on real estate in fee simple or, under such rules and regulations as may be prescribed by the Comptroller of the Currency, on a leasehold (1) under a lease for not less than ninety-nine years which is renewable or (2) under a lease having a period of not less than fifty years to run from the date the loan is made or acquired by the national banking association, and any national banking association may purchase any obligation so secured when the entire amount of such obligation is sold to the association. The amount of any such loan hereafter made shall not exceed 50 per centum of the appraised value of the real estate offered as security and no such loan shall be made for a longer term than five years; except that (1) any such loan may be made in an amount not to exceed 60 per centum of the appraised value of the real estate offered as security and for a term not longer than ten years if the loan is secured by an amortized mortgage, deed of trust, or other such instrument under the terms of which the installment payments are sufficient to amortize 40 per centum or more of the principal of the loan within a period of not more than ten years, and (2) the foregoing limitations and restrictions shall not prevent the renewal or extension of loans heretofore made and shall not apply to real-estate loans which are insured under the provisions of title II, title VI, title VIII, or section 8 of title I of the National Housing Act or which are insured by the Secretary of Agriculture pursuant to title I of the Bankhead-Jones Farm Tenant Act. No such association shall make such loans in an aggregate sum in excess of the amount of the capital stock of such association paid in and unimpaired plus the amount of its unimpaired surplus fund, or in excess of 60 per centum of the amount of its time and savings deposits, whichever is the greater." [23]

Section 5200 of the National Bank Act now reads as follows:

"The total obligations to any national banking association of any person, copartnership, association, or corporation shall at no time exceed 10 per centum of the amount of the capital stock of such association actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund." [24]

[23] Federal Reserve Act as amended October 25, 1949, c. 729, 63 Stat. 906; and April 20, 1950 (Public Law No. 475, 81st Congress).

[24] *Federal Laws Affecting National Banks as of July 1, 1940* [U.S.R.S., sec. 5200] p. 203, paragraph 1375.

There is wide variation in the laws under which state commercial banks make mortgage loans. A recent digest of these laws indicates that restrictions are placed on the term of years for which ordinary real estate loans may be written in only twenty states, and restrictions on the maximum loan-to-value ratio of such loans in twenty-three states.[25]

## Commercial Bank Supervision of Mortgage Lending

There are many examples in the early history of banking in the United States of attempts to regulate banking institutions through the chartering process, but regulation through examination and supervision was slow in developing.[26] In 1870 state banks were regularly examined in only two states: Connecticut and New Hampshire. By 1910 examinations were made, at least annually, in forty-one of the then existing forty-six states. However, even at the turn of the century the examination of national banks, which had begun under the National Bank Act, left much to be desired. It has been stated that the examiners, "inadequate in number, compensated on a fee basis, and drawn in many cases from the ranks of those without actual accounting experience, did their work, hurriedly, inefficiently and without special reference to the soundness and liquidity of bank loans."[27]

The fee system was abolished with the passage of the Federal Reserve Act and examiners of both national and state banks were paid on an annual salary and expense basis. And yet as late as 1926 Professor H. Parker Willis, in testimony before the Senate Committee on Banking and Currency, commented on state bank supervision as follows: "In spite of some progress within recent years toward uniformity of practice and procedure under the several State laws on banking, there is even now a very general lack of any accepted or single standard of efficiency and oversight, as well as a general lack of any uniform recognition of the appropriate matter to be contained in a banking law."[28]

[25] *Legal Maximum for Loan-Value Ratio and for Term of Real Estate Loans by State Banks Generally and to G. I.'s,* American Bankers Association (New York, July 5, 1946).

[26] See Vance L. Sailor, "Bank Supervision and the Business Cycle," *The Journal of Finance* (October 1948) pp. 65–77.

[27] Chester A. Phillips, *Bank Credit* (New York, 1923) p. 296.

[28] U. S. Congress, Senate, *Hearings* before a Subcommittee of the Committee on Banking and Currency on S. 1782 and H. R. 2; 69th Congress, 1st Session (1926) p. 139.

Funds for state bank supervision were often irregular and inadequate; political considerations entered into the appointment of bank superintendents and examiners; records were unsatisfactory, incomplete and poorly kept in numerous instances; and relations with the national bank system and with the Federal Reserve System were unsatisfactory in many cases. Conditions in the federal supervisory agencies also left much to be desired. However, progress has been made in recent years in the development of objective criteria by which the soundness of different types of bank assets can be judged. In the following section these criteria are discussed as they relate to the mortgage loan portfolio.

### OBJECTIVES AND CRITERIA

Bank examination is concerned with the interests of depositors, borrowers, and shareholders but its main concern is naturally with the depositors. To this end the examination provides for periodic reviews of bank operations, to learn if the laws, rules and regulations under which the bank operates are being complied with, and, having due regard to the character and volatility of the bank's deposits, to learn if the depositors' funds have been converted into satisfactory earning assets.

Specifically, an examiner is interested, when examining the urban mortgage loan portfolio of a commercial bank, in determining whether new loans have been made on a legal basis. That is, he determines whether the loan bears a ratio to the property's appraised value which falls within the prescribed limit, whether the mortgage has been properly recorded, and whether the title to the property is clear. All mortgage loans, regardless of when they were originated, are examined to determine if payments to principal and interest are current, and if insurance and taxes on all properties have been paid as they came due. Also, the examiner will be interested in the character of the loan portfolio. Loans with unusual characteristics as well as concentrations in certain types of mortgage loans, in certain size groups, maturities, locations, and periods of acquisition, may be a basis for criticism. The quality of a bank's servicing of its mortgage loan portfolio will also be of special interest to the supervising agency and at the present time special importance is attached to unusually thin equities and low rates of interest.

Considerable latitude is allowed the examiner in grouping urban

mortgage loans, but they are usually separated into two general classifications: criticized and uncriticized loans. Criticized loans, as will be indicated below, are further subdivided. In making this basic division into criticized and uncriticized loans, the examiner takes into account factors that fall into one or the other of two categories: namely, those which relate to equity and those which relate to loan performance. Loans that have an adequate equity or guaranty and on which regular payments of principal and interest have been made are classified as satisfactory or uncriticized; loans falling short in one or both of these respects are regarded as unsatisfactory or criticized loans.

An early tentative attempt by a federal supervisory agency to systematize loan classification is illustrated by the following listing of characteristics of substandard real estate loans:

1. Real estate loans in process of foreclosure or deeds pending.
2. Real estate loans under rent assignment and/or "mortgagee in possession" in which no material progress or improvement has been shown and combined annual interest and amortization received is less than 5 percent of the unpaid principal.
3. Real estate loans, the arrears of which are equal to 10 percent of the unpaid principal and/or have continued in default for more than one year in interest and/or taxes.
4. Real estate loans, the arrears of which are equal to 5 percent of the unpaid principal and/or have continued in default for more than six months and in which the unpaid principal is 70 percent or more of the bank's appraised value of the property.
5. Real estate loans, current but nonamortizing, in which the unpaid principal is 80 percent or more of the bank's appraised value of the property.
6. Real estate loans, current and amortizing, in which the unpaid principal is 80 percent or more of the bank's appraised value of the property, and combined annual interest and amortization is less than 5 percent of the unpaid principal.
7. Real estate loans, current and amortizing, in which the unpaid principal exceeds 90 percent of the bank's appraised value.
8. Real estate loans, not included above, which contain substantial risk of loss.