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Introduction

No price, or set of prices, in our economic system has been the focus of such widespread and continuing attention as the price of borrowed money — the interest rate. It figures prominently in a wide range of discussions extending from those concerned with the direct and immediate interests of borrowers and lenders to those relating to broad economic policy and to the influence of interest rates on prices and production. Despite the vital importance of these problems, and the fact that a knowledge of what it costs a lending agency to provide funds for investment purposes is essential for analysis of any one of them, economic literature is notably deficient in the light it throws on lending costs.

The subject of the present study is lending costs in a single, highly specialized sector of the credit system — farm mortgage lending by life insurance companies. Its purposes are to explore some of the problems involved in measuring the costs incurred in the origination and servicing of loans — that is, the element in interest rates commonly referred to in economic literature as the “costs of loan administration” — to present one such method in some detail, along with certain data on lending costs for the years 1945-47, and to consider the relationship between the level of lending costs and the amount of a company’s farm mortgage investment. While the data used in the analysis are drawn from a restricted segment of the market for borrowed funds, it is hoped that the conclusions to which the analysis leads will suggest relationships between lending costs and the scale of financing activities in other credit areas.

Improved knowledge of loan administration costs is increasingly important to public and private lending agencies. From the viewpoint of private investment, cost information is essential when the managements of life insurance companies must decide on the relative profitability of the several broad lines of investment open to them. Even in farm mortgage investment, information on lending

costs is necessary to determine the attractiveness of particular mortgage offerings. From the standpoint of public policy, factual studies of the costs of extending long-term agricultural credit are useful in revealing certain implications inherent in government policies that determine, or influence, the interest rates chargeable to farmers. Only with reliable knowledge of the costs of loan administration can the adequacy or inadequacy of interest rate levels, in terms of the lending agency's net return at given levels, be judged intelligently.

Obviously, there would be a broader range of uses for studies of lending costs if reasonably accurate measures could be made of differences in the level of loan administration costs among various types and sizes of farm mortgage loans. How, for example, do costs vary among loans of different sizes on comparable types of farms, and among loans on farms alike except for soil quality or type of farming? If it were feasible, which it is not at present, to measure costs to this degree of refinement, lending agencies could formulate their policies to maximize more nearly their net returns, and it would be possible to foretell with greater accuracy the effects likely to flow from a public policy that applies a standard interest rate to all mortgage loans, regardless of size of loan or character of security. While the present study cannot answer all these questions, it does provide a basis for making estimates on many of them, and for pushing forward with additional studies aimed at clarifying others. It is hoped that the study will contribute, in this way, to a better understanding of the implications of certain policy decisions in both the public and private spheres of finance.

In planning this analysis of lending costs it was possible to draw on a few earlier empirical cost studies but, in general, economic literature contains little that bears directly on the subject.¹ This

¹ *Cost Behavior and Price Policy* (National Bureau of Economic Research, 1943), Chapter 2, provides a useful review of empirical cost studies for manufacturing and trade industries; Joel Dean's *The Relation of Cost to Output for a Leather Belt Shop* (National Bureau of Economic Research, Technical Paper No. 2, December 1941) is indispensable to any worker in the field of cost relationships, and his unpublished study, *A Statistical Examination of the Behavior of Average and Marginal Costs* (University of Chicago Ph.D. thesis, 1936), was drawn on freely in the present paper. Another interesting lending cost study, also unpublished, is W. A. Peterson's *Factors Influencing the Cost of the Small Loan Business* (University of Chicago M.A. thesis, 1934), an investigation of cost functions in the personal finance industry.

lack of relevant studies in the field of mortgage lending is not difficult to explain. During the 1920's and earlier the level of interest rates was so high that lending officers could be satisfied with rough estimates of cost. While the expenses of lending rose sharply during the early 1930's, owing to widespread loan delinquencies and foreclosures, this supplied little motivation to study lending costs since the higher expenses were not of the type that could be controlled.

A real stimulus to the study of lending costs did not come until the late thirties. By that time loan delinquencies had been largely cleared up and much of the real estate acquired through foreclosure in earlier years had been sold. Net income margins, however, were being further reduced by increased competition and by the shift from the borrower to the lender of certain costs, such as the finder's fee paid to the correspondent. Naturally, the attempts that were made to measure costs were restricted mainly to the experiences of individual companies; as a result, they were far from comparable, one with another. The principal object of the present study has been to design a basis for recording costs that will be comparable among companies and to use certain data assembled on this basis to indicate the general range of cost variation in the industry as a whole.

The general plan of this paper is first to discuss certain problems of measuring lending costs and then to present the main statistical findings. Detailed definitions of terms are provided in Appendix A, along with facsimiles of the schedules used in reporting data, and the instructions supplied to cooperating companies. Statistical tables giving data for individual companies (unidentified) are found in Appendix B.

