2. NATURE AND CHARACTERISTICS

Essentially, then, the business of the modern mortgage company (unlike that of mortgage lenders who originate or acquire mortgage loans with the intention of holding them in their own portfolios) is to originate and service mortgage loans for the accounts of institutional investors. Most mortgage companies, so defined, engage in one or more related activities, including real estate brokerage and management, insurance, construction, and land development. Conversely, many real estate firms also originate and service mortgage loans for principal investors. Some financial intermediaries, moreover, notably commercial banks, carry on this type of business, originating mortgages expressly for sale to other institutions. The distinguishing characteristic of the mortgage company, as classified for purposes of this study, and following criteria of the *Standard Industrial Classification* manual of the federal government, is that its *principal* activity is the origination and servicing of mortgages. There are always borderline cases under such a criterion and particularly so with mortgage companies which, with few exceptions, are engaged in several related activities. By and large, however, we may justifiably eliminate builders, real estate companies, real estate and mortgage brokers, land developers, and so on, when they conduct a mortgage company type of operation only as a supplement to their main affairs. Such elimination, with minor exceptions, has been accomplished in the data presented in the following sections of this paper.

In relation to their volume of mortgage lending and servicing, present-day mortgage companies in the main are characterized by small capital investments, just as were those in earlier decades. According to one early writer quoted previously, "The first feature of mortgage banking in America which strikes the observer is that the mortgage companies are many in number, the capital of each, with a few exceptions, being small."[9] Whether mortgage companies in operation in 1955 would be considered "many in number" is a relative matter. The number is, unfortunately, not precisely known but may be estimated closely enough for comparison with the numbers of other types of financial institutions. The membership

[9] D. M. Frederiksen, "Mortgage Banking in America," *Journal of Political Economy*, March 1894, p. 210.

of the Mortgage Bankers Association of America includes a little over 1,000 institutions classified as mortgage companies, but their number undoubtedly includes some organizations whose principal activity is not mortgage banking. Mortgage companies that were FHA-approved mortgagees[10] in 1955 numbered some 865. The true number probably lies somewhere between the two. Thus the number of mortgage companies is much smaller than that of commercial banks or savings and loan associations, considerably more than that of mutual savings banks, and almost equal to that of life insurance companies.

Regulation of Activities

Unlike other institutions in the mortgage market, mortgage companies are subject to little direct regulation or supervision. Most of them, as private corporations, are regulated only by the general corporation laws of the states in which they are incorporated. They are not subject to the rigorous supervision and control of state or federal financial authorities, as are banks, savings and loan associations, and insurance companies. FHA-approved mortgagees, however—the bulk of all mortgage companies—are liable to periodic examination and audit by the Federal Housing Administration. Following initial approval, such examination consists principally of an audit of financial statements filed annually with FHA, and irregular sight inspection of company records by FHA auditors. Within broad limitations of financial soundness, FHA-approved mortgage companies are not restricted to certain investments or assets. The Veterans Administration makes no special requirements of companies originating VA-guaranteed mortgage loans, which include practically all FHA-approved mortgage companies. The comparatively limited supervision of mortgage companies may perhaps be explained on the grounds that they do not hold deposits or other large reservoirs of funds of the general public as do financial intermediaries.

Mortgage companies are, also, far less restricted in geographic area of activity and branch office operation than most other types of financial institutions are. Here, again, restrictions are limited to FHA-approved mortgagees and are at present based on policy decisions of the Federal Housing Administration rather than on administrative or statutory requirements. Current FHA policy allows approved mortgage companies to originate and service loans anywhere in their states of residence; and to originate loans in other states where they have servicing arrangements

[10]These are institutions approved by the Federal Housing Administration to deal in FHA-insured mortgages. See the first page of the Appendix for a discussion of requirements to qualify as an FHA-approved mortgagee.

with local FHA-approved mortgagees. In order both to originate and service out-of-state loans FHA-approved mortgage companies must establish branch offices in the chosen localities. All independent mortgagees[11] are permitted to establish such branch offices, subject to FHA approval, within their own and contiguous states. Only the larger approved independent mortgagees may establish offices in noncontiguous states, since the minimum net worth requirement is $250,000, compared with $100,000 to qualify as an FHA-approved independent mortgagee.

But the typical mortgage company, small in size and volume of business, operates in a single office and confines the bulk of its activity to the metropolitan area in which it is located. In recent years, however, several of the larger companies, have developed intercity branch office systems covering an entire state, and a few of the largest have expanded their operations beyond state lines. Within the broad limitations established by the Federal Housing Administration for out-of-state and branch office operations of its approved mortgagees, it is conceivable that a few mortgage companies may eventually establish nation-wide mortgage operations.

Sources of Income

The chief regular sources of gross income for mortgage companies are fees derived from their principal activities, mortgage origination and servicing. In recent years, fees for servicing mortgages secured by small residential properties have become fairly standardized at ½ per cent of the outstanding balance of the loan. For loans on large scale rental housing and commercial properties, however, servicing fees are far less standardized and considerably smaller, ranging usually from ⅛ to ⅜ per cent. The fee rate varies inversely with the amount of the loan because costs of servicing individual loans are similar, regardless of the amounts involved. Mortgage companies sometimes make concessions in fees in order to place large loans on their servicing accounts.

Maximum rates for origination fees on FHA and VA loans are fixed by the respective administrative agencies at between 1 and 2½ per cent.[12] There are, of course, no established maximum fees for conventional loans. For conventional construction loans, origination fees have varied with

[11]Loan correspondents are not permitted to establish branch offices. (See the appendix, note 31, for the distinction between independent mortgagees and loan correspondents.)

[12]Statutory and administrative regulations have varied, but in nearly all recent years origination fees for FHA home loans have been established at $20.00 or 1 per cent of the amount of the loan, whichever is greater; and for loans to lot owners to build homes, at $50.00 or 2.5 per cent, whichever is greater. On FHA multifamily loans, the maximum origination fee is 1.5 per cent; on VA loans the maximum origination fee is 1 per cent.

market conditions but have seldom gone below 1 per cent or exceeded 2 per cent. For other conventional loans of good quality, origination fees have seldom been charged borrowers, but instead have been collected in the form of a premium price of around ½ per cent above par from principal investors anxious to acquire them.

Another important source of gross income for mortgage companies is interest earned on mortgages held in inventory. Such interest income is, however, largely offset by interest payments to commercial banks on short-term loans necessary to finance mortgage inventory. On balance, therefore, net income attributable to interest on mortgage holdings is relatively small. Companies occasionally earn income from the sale of mortgages at prices above their origination or purchase price, but few engage in such speculative activity. Typically they originate mortgages under prior arrangements with investors at agreed prices, so that for the industry as a whole such gains on a net basis are relatively small. The participation of mortgage companies in related supplementary activities is reflected in earnings from insurance commissions, real estate brokerage and management, land acquisition and development, and occasionally from building operations.

There are no industry-wide data on the relative contributions to gross revenues of the various sources of income discussed above. Income statements for each of the three years – 1951, 1953, and 1955 – obtained by the author from a few mortgage companies of varying size in the Washington, D.C. area, however, are suggestive of the income composition. These statements indicate that income from servicing and origination fees accounted for between two-fifths and two-thirds of gross income in each of the three years. Servicing fees alone typically contributed between one-third and two-fifths of gross income. Relative income from origination fees varied, expectably, more widely between companies and between years, from a low of one-eighth to a high of one-third. Reflecting the varying participation of companies in related activities, income from other sources fluctuated widely, from 5 to 10 per cent in insurance commissions, 3 to 26 per cent in real estate sales and management fees, and 12 to 25 per cent in interest received on mortgage holdings.

The bulk of mortgage company expenses consists of employee and officer wages and salaries, and interest paid to banks, which, according to the few statements at hand, accounted for between one-half and over two-thirds of gross expenses in the years 1951, 1953, and 1955. Other important expense items include taxes, rent, and advertising.

Operating Techniques and Problems

Mortgage companies act as intermediaries between borrowers (both builders and home purchasers) and institutional investors, usually located in different parts of the country. In generating and holding business, therefore, mortgage companies must maintain close and continuing contacts with both potential sources of demand for and supply of mortgage funds.[13] Because of their dependence on external short-term financing to operate their business, they must maintain a close relationship also with commercial banks. This dependence on commercial bank credits is one of the main distinguishing features between modern mortgage companies and earlier mortgage banks and guarantee companies, which financed their operations through the issuance of debentures or mortgage participation certificates.

In the postwar years, mortgage companies have tended to concentrate their activities in FHA and VA home mortgage loans, often in connection with new large-scale housing projects in metropolitan areas. They negotiate and close the bulk of these and of conventional mortgage loans on the basis of prior allocations of funds and of advance commitments to buy mortgages from principal investors. Few loans in recent years have been originated by mortgage companies on their own responsibility for unknown investors, as the data and discussion in section 4 suggest.

On the basis of firm commitments from institutional investors to purchase completed mortgages (subject to the satisfaction of stated conditions) the mortgage company is able to arrange construction financing from commercial banks for its builder customers, and, at a later point, interim financing for itself. As previously noted, the latter type of financing is necessary to enable mortgage companies to close mortgages and carry them in inventory pending the processing of papers and delivery to ultimate investors. The length of processing time has varied typically between 60 and 180 days, but in recent years with the development of new commitment techniques, principally "forward" and "standby" commitments, mortgage companies have had to adapt their operations accordingly, to carry mortgage inventory for longer periods than usual, and to arrange for modified types of commercial bank interim credits.

The new commitment techniques used extensively from late 1954 through 1956, and earlier during 1952-1953, reflected essentially a shortage of mortgage funds relative to demands. In these periods regular take-out commitments from institutional investors were difficult to obtain. The forward commitment technique was adopted by some investors, notably life insurance companies, able to plan long range income flows and investment needs. Forward commitments differ from regular commitments principally in the time period of commitment; investors obligate

[13]For administrative details of mortgage company operations, see Robert H. Pease and Homer V. Cherrington, *Mortgage Banking* (McGraw-Hill, 1953), especially Chapters 14-18.

themselves to acquire mortgages from originators within a stated period, generally up to two years from the commitment date, rather than upon completion of the mortgage loan. The standby commitment, on the other hand, has become the chief resource when permanent commitments of either the regular or forward variety have been hard to come by. Given usually by commercial banks, and on occasion by long-term institutional investors, it involves a pledge by them to purchase mortgages at a price so far below the prevailing market price that there is little likelihood of having to fulfill it. Such a commitment is given by financial institutions principally for the nonrefundable fee associated with it. To builders and mortgage companies, the advantage of a standby commitment is as a temporary expedient to obtain construction financing and originate new business when regular commitments are unavailable.

The principal operating burden on mortgage companies of the reduced availability of regular institutional commitments and the substitution of new commitment techniques is to make more uncertain, and generally to lengthen, the period of time during which they are required to hold completed mortgages. As dependence on commercial bank credit increased, new arrangements under the general term of "warehousing" were developed. These arrangements essentially involve an extension of maturities, increased amounts of credit on a revolving fund basis, and the substitution of standby for regular commitments to back up commercial bank loans. Without the support of extended interim financing or warehousing from commercial banks, mortgage companies could not have operated effectively in recent years. Moreover, some of the larger mortgage companies, recognizing the need for longer and varied terms of credit to finance operations under changing money and capital market conditions, have been able to arrange for fairly long – up to five years – and flexible revolving lines of credit with financing institutions other than banks.

If forward and standby commitments remain as basic market techniques, mortgage companies may continue to operate with larger inventories than has been customary in the past, holding committed mortgages for principals or seeking permanent investors for mortgages created under "standbys." In any event, whether operating with a smaller or larger inventory, mortgage companies will undoubtedly continue to rely heavily on commercial bank credit in the future as they have in the past. But the dependence is a two-way relationship. Commercial banks active as interim real estate mortgage lenders will depend on mortgage companies as their chief outlet for such lending. In recent years, according to Federal Reserve surveys, mortgage companies have accounted for 75 to 90 per cent of commercial bank loans outstanding to real estate mortgage lenders. The importance of commercial bank interim real estate credits in postwar mortgage markets has increased directly with the rapid growth in mortgage company activities. The data developed in this study on mortgage company notes payable to banks, summarized in Table 19, therefore, are a good measure of the volume of commercial bank interim real estate financing in the postwar decade, supplementing data recently made available by the Federal Reserve.[14]

Relationship to Investors

As already noted, modern mortgage companies, unlike their predecessors, look chiefly to financial institutions rather than to individuals as outlets for mortgage loans and, among the institutions, depend most heavily upon life insurance companies. The policy of most insurance companies to acquire non-local loans through mortgage correspondents has been basic to the development and growth of the mortgage banking industry. In recent years, mutual savings banks have become an increasingly important outlet for mortgage company loans. Commercial banks and savings and loan associations, however, rarely acquire mortgages from mortgage companies. Some mortgage companies, reflecting their early background and history, continue to sell an important proportion of their loans to individuals. Sales of mortgages to individuals, however, amounted to much less than 5 per cent of all mortgage company sales in 1955.[15]

There are wide variations and gradations of arrangements, contractual and otherwise, existing between mortgage companies and institutional investors for the acquisition of mortgage loans. One common arrangement is the contractual correspondent-investor relationship in which a mortgage company acts as the sole representative of a financial institution in the origination and servicing of mortgage loans in a designated area. The investor generally allocates funds or otherwise commits itself to purchase mortgages on a continuing basis from the correspondent, the amount varying with conditions in capital markets, portfolio needs, and volume of repayments on loans serviced for the investor. Mortgage companies generally maintain this kind of relationship with large life insurance companies and with some large savings banks.

Typically, under this arrangement, correspondents may receive allocations of funds from principals twice a year for six month periods. The kinds of loans desired by investors under these allocations are generally indicated or known to the mortgage company through continuously close contact. Armed with a specified fund allocation and knowledge of inves-

[14]A comparison between this item and commercial bank loans to mortgage companies revealed by Federal Reserve surveys is shown in the appendix, Table A-12.
[15]See the fourth part of section 4 and Table 15 for information on principal purchasers of mortgage loans originated by mortgage companies.

tors' loan preferences, the correspondent proceeds to arrange for mortgage loans through builders, land developers, realtors, architects, other regular customers or prospective new borrowers. The mortgage company generally will not firmly commit itself to make these loans, however, until it has submitted them to the principal investor for prior approval and received firm commitments to purchase them at stated prices and under other stated particulars. The investors' commitments may be either for immediate purchase of loans when completed and ready for delivery, or within some stated period in the future at its own convenience rather than at completion of the loans. Under the latter or forward type of commitment, described earlier, it is, of course, necessary for the mortgage correspondent to arrange for appropriate commercial bank warehousing credits. Some mortgage companies originate loans entirely for one investor, usually so large that the exclusive arrangement provides an advantageous volume of business for the correspondent. Other companies, dealing with investors of various types, perhaps have the advantage of somewhat greater flexibility in being able to negotiate a wider diversity of loans, each acceptable to at least one of their principal investors.

Another type of mortgage company–investor relationship is characterized, in effect, by the absence of a continuing contractual arrangement. Such a relationship is often preferred by smaller investors coming into the mortgage market from time to time as they desire mortgage investments. Such investors seldom make allocations of funds to correspondents; they may acquire loans from one or more mortgage companies in the same general area and enter into servicing contracts on the basis of individual transactions. In dealing with these investors, mortgage originators with limited capital more commonly submit prospective loans for prior approval and commitment than originate them on their own financial responsibility.