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Volume Author/Editor: J. E. Morton

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Chapter Author: J. E. Morton

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URBAN MORTGAGE LENDING: COMPARATIVE MARKETS AND EXPERIENCE

INTRODUCTION

BY R. J. SAULNIER

It is doubtful whether any financial development in the United States during the last half century is as significant in its economic effect as the change that has occurred in the structure of outstanding debt. The leading feature of this change has been an increase in the ratio of public to private debt, especially in the ratio of the federal debt to total private debt, but changes having far-reaching effects have taken place also within the private debt sector. The most important of these has been the sharp increase of nonfarm mortgage debt—the subject of the present volume. As Dr. Morton points out in the opening pages of his book, the nonfarm mortgage debt of all borrowers—corporate and noncorporate—rose from 28.1 percent of private long-term debt in 1920 to 54.7 percent in 1953; and the proportion of mortgage debt secured by one- to four-family (mainly one-family) structures rose from around 50 percent in 1925 to 70 percent in 1953.

Notable changes have also taken place on the supply side of the urban mortgage market, the most important of which has been an increase in the proportion of nonfarm mortgage credit supplied by institutional lenders—insurance companies, commercial banks, mutual savings banks, and savings and loan associations. As Dr. Morton points out in his text, the urban mortgage debt held by these lenders increased from 50 percent of the total outstanding in 1920 to nearly 80 percent in 1953. Institutional investors are not committing a larger proportion of their assets to mortgage investments than they were in the twenties, but the proportion of savings which flows through these intermediaries has increased so rapidly in recent years that they now hold an increased part of the outstanding debt. This increase in the importance of institutional investors has naturally exerted great influence on the organization and operation of the mortgage market and has appreciably raised the interest of these institutions in the mortgage as an investment medium. There can be no doubt, therefore, as to the importance and timeliness of this study.

Changes occurring at the financial level of the economy are often reflections of changes in the sphere of production, and to a considerable degree the shifts that have taken place in the composition of long-term debt are of this type. The increase in the ratio of public to private debt, for example, reflects the spectacular rise in this century of governmental activity, growing in good part out of the Great Depression and the nation's involvement in two world-wide wars; the upward surges of mortgage debt in the twenties and again in the late forties and early fifties reflect the vast homebuilding and general construction expansions which followed the termination of World Wars I and II. The growth within total urban mortgage debt of home mortgage debt also reflects basic changes in the housing and home financing markets. Between 1920 and 1940 both the proportion of owner-occupied homes mortgaged and the amount of mortgage debt on these homes relative to their value increased appreciably; the frequency of home ownership, on the other hand, was roughly unchanged over the two decades. Just the opposite changes occurred between 1940 and 1950; the frequency of mortgage debt and the ratio of debt to value either were unchanged or fell, whereas the frequency of home ownership rose sharply. Finally, the increase in the proportion of the mortgage debt held by institutional lenders can be traced to the fact that federal mortgage loan insurance and guarantee programs have given residential mortgages a higher investment quality than they previously possessed. But it is not the author's object to explore the reasons why these changes have occurred, interesting though this effort would be; the important fact is that events have conspired to give the urban mortgage, and in particular the home mortgage, more prominence as an investment medium than it has ever had before.

It was principally a recognition of these facts that led the National Bureau in 1945 to initiate its Urban Real Estate Finance Project. Dr. Morton's book summarizes those studies made under the Project that deal with the lending policies and experience of particular institutions. He has done more, however, than merely summarize the findings of separate studies: he makes cross-institutional comparisons and gives a picture of the urban mortgage investment market as a whole, carrying his account through 1953. The studies on which he draws especially are:

Urban Mortgage Lending by Life Insurance Companies
by R. J. Saulnier,
Commercial Bank Activities in Urban Mortgage Financing
by Carl F. Behrens,
History and Policies of the Home Owners' Loan Corporation
by C. Lowell Harriss,

Urban Real Estate Markets: Characteristics and Financing
by Ernest M. Fisher,

and the unpublished work of E. E. Edwards on savings and loan associations. Other monographic studies in this field have been utilized, such as John Lintner's volume on the mortgage lending activities of Massachusetts mutual savings banks, prepared in the Division of Research at the Harvard University Graduate School of Business Administration under a grant from the Mutual Savings Banks Association of Massachusetts.

The first three chapters of Dr. Morton's study focus on the supply side of the mortgage market. They elaborate on the broad shifts mentioned above and compare the amounts of mortgages held by various institutional investors. It is perhaps unnecessary to comment on this portion of the book, but it may be useful to summarize the findings, presented there and in later chapters, in which the author traces the changes that have occurred since 1920 in the characteristics of mortgage loans and shows what there is to learn from loan experience studies as to the factors that are most significant in gauging the quality of mortgage investments.

Turning to the first of these matters—the characteristics of outstanding loans—Dr. Morton summarizes data obtained through special sample surveys of the portfolios of institutional lenders as of 1946-47, and draws on the 1950 census survey of residential financing. The foremost fact to be noted here is the extent to which mortgage loans are now made under federal insurance or guarantee. In developments starting with the Federal Housing Administration program in 1934 and continuing with the Veterans' Administration program which began in 1944, the home mortgage debt and the debt secured by multifamily projects have increasingly been made in an insured or guaranteed form, until, as the author puts it, the problem of investment analysis has become less one of judging the risk quality of individual mortgages than of understanding and correctly anticipating the loan insurance and guarantee policies of the federal government. At the present time something over two-fifths of the mortgage debt on one- to four-family homes and almost as high a proportion of the debt on multifamily properties are protected by federal insurance or guarantee. It should be observed, however, that although the proportion in the one- to four-family dwelling field rose rapidly to its present level, it has tended to level out recently, suggesting that a rough balance may have been struck between the federally protected and the conventional field of home lending.

Bearing directly on the question of how far one might expect the mortgage insurance and guarantee feature to spread, and possibly indicating some limitation on its use, are the data brought out by the author on the tendency for insured and guaranteed lending to be concentrated in certain segments of the mortgage market. In general, insured and guaranteed loans are made with greatest frequency on homes, and to borrowers, in an intermediate economic position. Whether one takes the borrower's income, the value of the house, or the occupational status of the owner as a basis for comparing conventional loans with insured or guaranteed loans, the evidence shows that insured and guaranteed loans are most prevalent in the intermediate range and that conventional loans are most important at the upper and lower ends of the scale. This fact has many interesting implications, not the least of which relates to loan experience. The studies which the author discusses in his final chapter show clearly that the best experience during the trying years of the thirties was on the very types of loans that are now most frequently protected by federal loan insurance or guarantees—those secured by small, medium-priced dwellings—and that the least favorable experience was on those that are still made predominantly without such protection. This suggests that one may overestimate the risk-reducing effects of federal insurance and guarantee programs on the mortgage market as a whole and appreciably underestimate the risk elements which that market still contains.

The facts which the author uses to describe the mortgage loan portfolios of institutional lenders, and which inferentially suggest the markets which these lenders serve, were employed in the separate monographic studies to depict lending by particular agencies, but in his use of them he seeks mainly to bring out the points of difference and similarity among lenders in the kinds of loans made, and thus to reveal whatever functional specialization there is on the supply side of the urban mortgage market. As might be expected, institutional specialization is most marked in connection with the type of property underlying the transaction. Judged by the number of loans held, loans secured by one- to four-family structures, and notably by single family homes, predominate in the portfolios of institutional lenders. Nine-tenths of the number of loans held by insurance companies and commercial banks and nearly all of those held by savings and loan associations were in this category. A some-what different picture emerges when the dollar volume of loans held is taken as the basis of comparison. By this measure, 44 percent, 64 percent, and 94 percent, respectively, of the mortgage debt held by insurance companies, commercial banks, and savings and loan associations were secured, as of 1946-47, by one- to four-family residential properties. Nearly 50 percent of the mortgage loans of mutual savings banks were secured as of the end of 1947 by one- to four-family structures. Life insurance companies, and to a lesser degree mutual savings banks and commercial banks, extend substantial amounts of their mortgage credit outside of the small home field; savings and loan associations, on the other hand, devote their resources almost exclusively to the financing of single family dwellings. In so far as there is functional specialization, therefore, it is in the nearly total limitation of the savings and loan associations to home mortgage financing, and, looked at from the borrower's viewpoint, in the fact that facilities for the financing of large residential and commercial properties are available primarily among the life insurance companies, and to a lesser extent among the mutual savings banks and commercial banks.

There are differences also among institutional mortgage lenders in the terms on which loans are made, but these are overshadowed in importance by the striking changes that have occurred in the last twenty years in the terms on which all lenders extend mortgage credit, changes that are brought out clearly for the first time in the data which the Urban Real Estate Finance Project obtained on the characteristics of loans made since 1920. Perhaps the most important of these changes has been the spread of the principle of full amortization. Savings and loan associations have always made the bulk of their mortgage loans on that basis, but only a relatively small percentage of the loans made by life insurance companies in the twenties—a quarter or less—were fully amortized. The loans made by commercial banks in the twenties were even less frequently extended on a full repayment basis. Less than 15 percent of the amount of credit secured by one- to four-family structures and less than 10 percent secured by other types of property required full repayment by maturity, and in a large proportion of the cases the loan contracts made no provision at all for amortization. The reason for this, quite obviously, was that commercial banks were compelled to make their loans with contract maturities so short that only very little repayment, if any, was feasible. It was not until the McFadden Act was passed in 1927 that commercial banks were permitted to go beyond one year in the maturities of their nonfarm mortgage loans, and even then the outer limit was set at five years. Within that framework it was obviously impossible to require any substantial repayment. It was because of statutory restrictions that the practice grew of taking what reduction could be obtained in a mortgage loan at its maturity and then remaking it for another short span of years. There were good reasons, of course, why such severe limitations were written into the banking statutes, but the debacle of the thirties proved beyond question that they were inadequate for the task for which they were designed; what was required was a set of terms more closely adapted to the realities of the family budget.

The change that came with the initiation of federal mortgage loan insurance was nowhere more striking than in the adoption of full-amortization repayment plans. Insured and guaranteed loans are necessarily made on a full-amortization basis, but the interesting fact is that conventional loans are now, in the majority of cases, similarly written. Of the conventional loans secured by one- to four-family properties that were outstanding in the portfolios of insurance companies and commercial banks in 1946-47, only about a tenth were nonamortized, only about 25 percent were partially amortized, and the remainder provided for full repayment by maturity. Straight loans providing for no amortization are also infrequent in lending on income properties by insurance companies and commercial banks, but in this case contracts calling for only partial amortization by maturity are fairly common, especially on the larger loans. Even so, about one-half of the number of loans on commercial and multi-family structures called for full repayment by maturity.

The wide adoption of the amortization principle is regarded by many observers as having placed the urban mortgage loan on a greatly improved level of investment quality, as contrasted with the nonamortized loans so characteristic of the twenties. A judgment on the merits of this view must, however, take into account the fact that the trend to full amortization is but one side of the revolution in home mortgage lending practices that has occurred in the last twenty years. As has been pointed out above, it was the legal requirement of short maturities that required nonamortization clauses, and with the release of this restriction the lending institutions were in a position to require full or partial repayment by maturity. In fact, the much lauded feature of full repayment by maturity has been won at the price of extended maturities and has been accompanied also by a substantial rise in ratios of amount of debt contracted under the mortgage to the value of the underlying security.

Dr. Morton's data are fortunately very illuminating of both of these trends. He shows not only that large segments of the conventional loans outstanding around 1946-47 carried long repayment terms, but that they had been made on the basis of quite high loan-to-value ratios. Thus, of the amount of conventional credit on one- to four-family dwellings outstanding when the recent surveys were taken, 68 percent of that held by insurance companies and 47 percent of the savings and loan association total had an original contract maturity of fifteen years or more. Only 8 percent of the amount of commercial bank credit was of comparable length, but 44 percent of the banks' home loan volume had an original contract maturity of from ten to fourteen years. As for loan-to-value ratios, nearly 80 percent of the amount of combined conventional and insured home mortgage credit outstanding in 1946-47 on the books of three institutional lenders—insurance companies, commercial banks, and savings and loan associations—involved borrower equities at the time the loans were made of less than 40 percent.

Although there have been times—notably in the housing boom of the late forties—when the liberalization of home financing terms produced some increase in housing prices, the liberal terms on which mortgage loans are currently made have doubtless broadened the market for sales of homes and made it possible for families with a given income and savings to acquire, and eventually to own outright, a better residence than they could otherwise afford. Yet there is another side to the story: namely, the impact of more liberal terms on the investment quality of mortgage loans. To Dr. Morton's chapter on this matter many students of mortgage finance may turn for guidance, for he summarizes a mass of new facts on the effect of various characteristics of loan contracts, borrowers, and underlying properties on the investor's experience with mortgages.

Considering the whole body of evidence which the author reviews, the factor of predominant importance in mortgage loan experience appears to be the phase of the business cycle in which the loan is made. The facts suggest that the closer a loan is made to a major downturn in consumer income and in real estate values, the greater the chance that it will end in default. It is far from clear, however, why this is the case. It may be said that the record of the twenties merely confirms a credit principle of long standing, namely that a seasoned loan—certainly one on which an appreciable reduction of debt had been made—is of much higher quality than an otherwise similar loan that is unseasoned. Reassuring as this is when one contemplates the fact that most loans are nowadays made on an installment basis, it raises doubts concerning the inherent quality of loan portfolios in times when the turnover of loans is high and only a small proportion of those outstanding have been on the books of lending institutions long enough to have had any appreciable degree of seasoning. The fact is that even fully amortized loans made shortly before the 1929 crash fared poorly in the thirties; indeed, only very little better than those made on a nonamortized basis. Perhaps the chief lesson to be drawn from the studies is that a sustained level of aggregate income, and the limitation of individual loans to amounts that are moderate in relation to borrower income, are the foundations of favorable loan experience, and that full amortization, for all its advantages, is an uncertain protection against default in an economy which experiences sudden and severe deflation.

There is also the possibility—and this is in no sense inconsistent with the seasoning hypothesis—that the high rate of foreclosure on loans made just before the 1929 reversal may have been due to a deterioration in the quality of new loans which occurred at that time—and which may be characteristic of cycles generally. It is known, at any rate, that there was some tendency in the second half of the twenties for loan-to-value ratios to rise, and for maturities to lengthen; other things may have occurred to lower credit quality, such as more liberal appraisals of property and less rigorous standards in screening loan applications, though we have no systematic evidence for these points. There can be no certainty that a deterioration of credit terms is a recurring cyclical phenomenon, since the liberalization of terms which occurred in the twenties was in part a secular movement and in part a fortuitous legal development—the McFadden Act opened the road for more liberal bank lending in 1927. At the same time, *a priori* considerations, and the experience with domestic corporate bonds and foreign bonds in the twenties, suggest this as a strong likelihood.

Supporting the belief that a pre-1929 lowering of loan quality was significantly implicated in the mortgage difficulties of the early thirties is the fact that among the loans made in the years 1920-29 the frequency of default increased with increases in contract maturity and in loan-to-value ratios. It may be argued that a loan on which the original maturity is realistically geared to feasible repayment possibilities is a better loan than one that requires successive extensions, and that a liberal loan-to-value ratio on a first mortgage loan is to be desired—even on grounds of investment quality—over a more conservative first mortgage supplemented by high cost borrowing on a secondary lien. Yet the fact is that the experience on the more liberally designed loans was less favorable than on those of a more conservative cast. Again, experience suggests that the advantages of liberal lending can be safely indulged in only when consumer income is maintained or increased.

There are other characteristics of loan contracts that *a priori* considerations suggest have a significant bearing on the quality of loans, but the importance of most of these could not be evaluated in the Project's experience studies for lack of relevant information. The quality and trend of the neighborhood in which the property is located, and the condition of the property itself, are doubtless critical factors, but there is no systematic information on these points. Nor is a great deal known as to the relation between the personal characteristics of borrowers and loan experience. A special analysis of loans made by the Home Owners' Loan Corporation showed that age exerts an appreciable influence on loan experience —young and old persons proved to have much less favorable records as mortgagors than those of middle age—but such matters as the occupation, employment stability, etc., of the borrower could not be evaluated.

For all of the gaps that inadequate data make inevitable, there is much in the account that Dr. Morton gives here of factors affecting loan experience that will interest the practical man engaged in lending money on the security of real estate; there is a good deal, also, that should interest the economic theoretician, especially in connection with interest theory. The study makes it possible to test, at least tentatively, whether mortgage lenders have been able to make adjustments in the interest rates that they charge mortgagors that properly compensate for the differences in the losses actually realized on various categories of loans. Presumably, most lenders attempt to make such adjustments, at least as between broad classes of loans. It would be a mistake, however, to picture them as unerring calculators of the probabilities involved, or even as being in a position exactly to make the adjustments that would be dictated by perfect knowledge and foresight when they must somehow survive in competition with less knowledgeable and prescient competitors. Yet it is reasonable to expect that there would be some effort to make appropriate adjustments, and it may be asked whether the record reveals any appreciable success.

Our basis for testing the success or failure of mortgage lenders in making such adjustments is far from perfect, but the record does show that differences in contract interest rates as between groups of loans were as often as not the opposite of what would have been necessary to adjust for differences in eventual loss rates. Referring to the author's Table 46, twenty-seven comparisons can be made of differences in interest rates and in loss rates as between pairs of loan categories—fifteen for life insurance companies and twelve for commercial banks. Among the 27, there were 12 cases in which the differences in contract rates were the opposite of what subsequent experience shows would have been necessary to correct for differences in losses. In 15 cases the differences in contract rates were in the right direction, but for the most part they did not go far enough: 13 were less than what experience eventually showed was necessary, 1 was more than necessary, and only 1 sufficed to equate the realized yields on the two groups of loans being compared. In short, the lenders made the wrong adjustments about as frequently as they made the right ones, and where they made the right ones they almost always failed to go as far as they should. Life insurance company experience in this respect was almost exactly the same as that of commercial banks; both groups of lenders seemed to have greater success in making the needed adjustments on loans secured by income properties than on loans secured by one- to four-family residences.

Before formulating any conclusions on the basis of this record, it should be recalled that the loan officer must make interest rate adjustments for differences in lending costs as well as for differences in probable losses. Our lack of information concerning cost differentials seriously impairs our ability, therefore, to make judgments as to the success or failure of the adjustment effort. Cost differentials would certainly have to be taken into account in some of the comparisons that can be made in Table 46—for example, as between loans secured by one- to four-family properties and those otherwise secured—though there is presumably much less need for taking them into account in comparing loans that differ, for example, with respect to loan-to-value ratios.

There is much else in the materials of this study which the economic theorist should find useful. There is the evidence on the extent to which contract rates of interest are modified before loans are actually extinguished, the tendency for lender competition to be increased in recent years, doubtless as a result of loan insurance and guarantee programs, and the tendency for regional differences in interest rates to become less marked. The evidence on the relation of lending costs to portfolio size is interesting, though hardly as elaborate (if that could ever be) as would be necessary to test conventional beliefs concerning the relation of cost to scale of operations. Like many empirical studies, however, the one in hand will serve best to clarify specific problems of practice and policy as these arise.