

THE BOSTON HOME MORTGAGE MARKET

by

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July 31, 1952

Professor Leicester F. Hamilton
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Dear Professor Hamilton:

In accordance with the requirements for graduation,
I herewith submit a thesis entitled "The Boston Home Mortgage
Market."

Sincerely yours,

James W. Hanson

THE BOSTON HOME MORTGAGE MARKET

Submitted in partial fulfillment of the requirements for the degree of Doctor of Philosophy, July 31, 1952.

This study represents an attempt at analyzing the economic forces underlying home mortgage lending in the Boston market. In contrast to a great many related studies conducted on a nationwide basis, the present analysis is largely confined to a restricted geographic area. Relevant data have been gathered from a wide variety of sources, but an inherent lack of comparability limits the validity of any conclusions drawn from these data alone. To supplement these sources, valuable insights into market behavior have been acquired through a series of fifty interviews with the managements of local mortgage lending institutions and other informed parties.

The earlier chapters of the study consider some of the primary factors underlying the demand for and the supply of home mortgage credit. In each case, specific reference to the Boston situation are preceded by a brief theoretical analysis. The role of the various thrift institutions in the local savings market is summarized, followed by an analysis of dividend returns on different types of savings accounts.

Home financing has frequently been the focus of extensive interventionary efforts on the part of state and federal governments. Part IV considers the salient features of some of these programs as well as the underlying institutional background. Primary emphasis is placed upon the activities of the Home Loan Bank System and the Federal Housing Administration.

Home mortgage lending in the Boston area is analyzed in some detail in Part V, concentrated primarily on the postwar situation but with brief reference to the interwar period as well. Among the most striking features of local market behavior are the rapid rise of federal savings and loan associations during the prewar recovery years and a resurgence of mutual savings banks into dominance after 1946. The methods employed in realizing these significant gains are analyzed, considering both price and non-price competitive tactics. Some insights have been gained in regard to the lending areas of various mortgage types, as well as the reasons accounting for the continuing co-existence of adjacent institutions with vastly differing interest rate schedules. The growth patterns and mortgage lending policies of the five largest savings banks and cooperative banks are compared with those of all such thrift institutions in the Boston area.

In Part VI attention is directed to the utilization of the home loan programs of the Federal Housing Administration and Veterans Administration. Whereas both programs have enjoyed wide acceptance throughout the nation, only the latter has played a prominent role in the local postwar mortgage expansion. Several reasons are advanced to account for this striking difference, chief among which concerns

the inherent capital surplus characteristics of the Boston market.

Part VII considers the development of an effective secondary mortgage market and the strategic role assumed by the federal government up to this point. Local life insurance companies, savings banks, and commercial banks have invested vast amounts of long-term capital in insured and guaranteed mortgages throughout the nation.

The concluding Part VIII deals first with the adequacy of the existing mortgage interest rate structure to properly compensate for the various implicit cost components. In most cases, local lending institutions have been able to accumulate generous surplus reserves and appear to be well fortified against a possible downturn in economic activity and an attendant rise in mortgage foreclosure. The final section analyzes the favorable influence of federal interventionary efforts upon the competitive structure of the Boston mortgage market, particularly with reference to the activities of the Federal Housing Administration and Home Loan Bank System.

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PART I. CHAPTER 1. INTRODUCTION

The home mortgage market performs a vital function in any economy where individual home ownership predominates. By providing long-term financing, mortgage lenders have facilitated home purchase among families lacking the financial resources to pay cash in full. Inasmuch as the various contract provisions offered by mortgage lenders affect overall opportunities for home ownership, the mortgage network is intimately connected with the socio-economic welfare of the community and nation. Largely because of this close inter-relationship, home financing has frequently been the focus of extensive intervention on the part of state and federal governments.

Not only has the mortgage network made home ownership possible for millions of families otherwise destined to be tenants, but it has also provided institutional investors a highly desirable investment outlet. For many thrift institutions savings capital has always been directed primarily into mortgage channels, regardless of minor developments in other financial markets. By making such investments, local savings institutions not only discharge an essential community obligation but realize net yields which on the average compare quite favorably with those on alternative investments. Unlike mortgage operations in Europe, however, a specialized type of mortgage lending institution has not emerged as such in this country, with the result that a wide variety of lending agencies supply home financing needs.

The home mortgage market, as the largest sector in urban real estate financing, represents a major factor in the aggregate long-term capital

market.¹ Despite its continuing significance, however, home mortgage lending has displayed a wide variation through the years, following to some extent the violent fluctuations in new home construction as well as general real estate activity. Largely because of the essentially long-term nature of home financing as well as the low level of repayment during depression periods, the outstanding debt has been somewhat more stable. Nevertheless, from a peak of \$19.6 billion in 1930, the nationwide mortgage debt on 1- to 4-family dwellings fell to \$16.7 billion by 1933, thereafter rose but slightly through the subsequent war years. During the postwar expansionary period, the home mortgage network has been called upon to finance a housing boom of unprecedented proportions, with the outstanding debt rising abruptly from \$19.2 billion in 1945 to \$43.3 billion by 1951.²

The structural composition of the urban mortgage debt is heavily influenced by the type of dwelling unit dominating new construction. Since the mid-1920s, there has been a pronounced shift away from large rental units in favor of small 1- to 4-family homes. As a result, the home mortgage segment of the aggregate urban mortgage debt has steadily mounted in importance, rising from a low of 50.3 per cent in 1932 to 63.9 per cent by 1948.³ This pronounced shift is not wholly the result of free market activity, however, for especially since the

¹In 1949, the \$111.3 billion private long-term debt was distributed into these broad categories: corporate debt, \$54.4 billion; farm mortgages, \$5.4 billion; nonfarm mortgages, \$51.5 billion. Economic Almanac, 1951-2, National Industrial Conference Board, p. 216.

²Survey of Current Business, Department of Commerce. For years up to 1949, see issue for October 1950.

³Ibid.

depression years the rise in owner-occupancy has been heavily influenced by federal interventionary measures.¹

Undoubtedly the most widely known instrument used in urban real estate finance is the mortgage contract. The popular conception of the mortgage as a debt is misleading and technically incorrect, as it is simply a pledge of collateral to secure the accompanying note. Since both are essential in any mortgage transaction, however, the term mortgage will frequently be used throughout the study as a convenient abbreviation for the technically correct "mortgage loan."

The legal and institutional framework surrounding mortgage financing has undergone substantial modifications through the years, generally benefiting the rights and privileges of the debtor. This development has been far from uniform across the country, however, with the result that foreclosure and title laws vary widely among the states. Furthermore, land contracts and trust deeds are common in some regions, while in others conventional mortgage lending constitutes the primary method of financing real estate transfers.² In the latter case, the mortgage contracts written may be classified according to the priority attached to their claims. Where the borrower is able to secure the necessary funds from a single source, only a first mortgage loan is involved. Frequently, however, the proceeds of a single loan are inadequate to supplement the limited savings of the mortgagor, with the result that second and even third mortgage loans are sought for

¹ See M. L. Colean, The Impact of Government On Real Estate Finance in the United States, National Bureau of Economic Research, New York, 1950.

² See E. M. Fisher, Urban Real Estate Markets and Their Financing Needs, National Bureau of Economic Research, New York, 1951, Chapter II.

additional funds.¹

Most home mortgage contracts written in recent years have been of two basic varieties in regard to principal repayment. A straight-term mortgage provides for full repayment only after a fixed term has elapsed, while interest is payable on a monthly or quarterly basis. Although such contracts are seldom written for terms exceeding 3 to 5 years, the essentially long-term character of home financing has necessitated successive loan renewals if foreclosure is to be averted. The obvious dangers involved in making straight-term mortgages have prompted a universal preference among borrower and lender alike for fully amortized loans. As a popular variant of this second loan type, direct-reduction mortgages specify level monthly payments for a stated number of years, by which time the debt is fully retired. By making small monthly payments, the home buyer accumulates an increasing equity in the property without being liable for large lump-sum payments. At the same time, the lender is able to base his lending operations upon a more predictable rate of repayment inflows, and is effectively spared from extensive holdings of frozen assets on which large due payments cannot be collected. When level monthly mortgage payments are made over the entire loan term, the interest component generally absorbs most of the earlier payments but the principal component becomes increasingly significant as repayment proceeds. For example, on a 4 per cent, 20-year mortgage, a level monthly payment of \$6.06 per \$1,000

¹Junior financing was especially widespread before the recent depression, when lenders restricted loan-value ratios to 50 or 60 per cent.

of original loan amount is required. The interest component on the first such payment is \$3.33, but declines continuously with succeeding payments.

An examination of the various contract provisions included in direct-reduction loans demonstrates the degree of complexity as well as flexibility in the mortgage price structure. Although contract interest rates are generally regarded as the basic cost element in mortgage lending, other elements are equally determining at least so far as demand functions are concerned. With debt repayment arranged on a convenient monthly basis, home buyers are frequently more concerned with the amount of this monthly payment than with the specific interest rate or loan term. In many cases the maximum loan amount granted on a given property is the all-determining factor in a prospective home purchase, especially where secondary financing is unavailable or unwanted. In view of their widespread acceptance in recent years, direct-reduction mortgages have been tabbed as the innovation which has made home building the "biggest new industry since World War II."¹

The rapid growth in mortgage operations during the postwar period, as well as increasing evidence of major structural changes in the mortgage network itself, renders an analysis of home financing particularly relevant at this time. The outstanding mortgage debt is at an unprecedented peak level, and portfolios of institutional lenders are filled with unseasoned, high-percentage loans based on highly inflated market valuations. At the same time, however, mortgage investors are increas-

¹Address of P. I. Prentice, editor and publisher of Magazine of Building, at 1951 Convention of Mortgage Bankers Association of America, reprinted in Boston Sunday Herald, September 23, 1951.

ingly interested in the development of an effective secondary market, whereby long-term home credit may flow freely from areas of surplus to those of want.

Inasmuch as the home mortgage market constitutes a principal sector in the economy, considerable attention has been focused upon these developments throughout the nation. So that all parties concerned may acquire a more thorough understanding of mortgage lending, its methods, achievements, and shortcomings, various private and public groups have conducted extensive research studies during recent years. In addition to regular staff analyses by affiliated housing agencies, the central Housing and Home Finance Agency has sponsored a series of local and national studies to be conducted by numerous colleges and universities.¹ Various private foundations have also undertaken serious analyses of home mortgage lending, frequently with an eye toward a better understanding of the fundamental causes of the disastrous loss experience of the 1930s. Through a realization of past errors in mortgage policy, lending institutions as well as governmental planners may become better fortified against a repetition of this experience.

As might be expected, many such studies have been nationwide in scope, analyzing the overall impact of various private and public institutional forces upon the structure and behavior of the mortgage market. At the present time the National Bureau of Economic Research is conducting a series of individual studies under a special Urban

¹Two such mortgage studies have been reviewed in Housing Research, HHFA, Fall, 1951, dealing with both a small (Hagerstown, Md.) and a metropolitan mortgage market (San Francisco.)

Real Estate Finance Project. Some of these studies consider the overall nature of the mortgage market, while others consist of statistical surveys of lending operations of certain institutions since 1920. At least three of these investigations have already been published, while several others are still in preparation.¹ In the prewar period, two studies of a more regional nature were published, one dealing with cooperative banking in Massachusetts and the other, savings banking in New York State.² During the early postwar years, Professor Lintner conducted a thorough study of the savings and mortgage activities of mutual savings banks, concentrating on the Massachusetts situation but having direct application to the nationwide market.³

While aggregative analyses are admittedly essential in acquiring an understanding of overall mortgage lending activity, the merits of a restricted market study should not be overlooked. In the former,

¹Those completed include Colean, The Impact of Government on Real Estate Finance in the United States; Saulnier, Urban Mortgage Lending by Life Insurance Companies; Fisher, Urban Real Estate Markets and Their Financing Needs. Studies yet to be published include analyses of Economic Fluctuations and Urban Real Estate Finance, Commercial Bank Activities in this field, HOLC operations, and Comparative Markets and Risk Experience of Mortgage Lenders.

²D. H. Davenport, The Cooperative Banks of Massachusetts, Business Research Studies No. 20, Graduate School of Business Administration, Harvard University, Boston, 1938; W. Welfling, Savings Banking in New York State, Duke University Press, Durham, North Carolina, 1939.

³John Lintner, Mutual Savings Banks in the Savings and Mortgage Markets, Graduate School of Business Administration, Harvard University, Boston, 1948. This study was financed by the Savings Banks Association of Massachusetts.

many significant differentials among the areas included are concealed or largely offset by counterbalancing forces elsewhere. When a small area is concerned, prevailing relationships are heavily influenced by institutional and legal factors peculiar to that area, and hence are not readily applicable to all markets alike. Nevertheless, due allowance can often be made for such factors, and some significant behavior patterns may be revealed from a local analysis of this nature.

The present study represents an attempt at shedding some light on mortgage lending activity within the Boston area. In contrast to the statistical nature of the various National Bureau surveys, this study has depended upon personal interviews as a primary source of material. Relevant data have been gathered from a wide variety of sources, but their lack of comparability severely limits the validity of any conclusions drawn therefrom. Such difficulties undoubtedly arise in most empirical studies of this nature, but, by a careful and discriminating examination of the available data, reasonably valid insights into market behavior can often be gained. Where relevant data are completely lacking, however, heavy reliance must be placed upon the informed judgment of interviewed parties.

Since the sources cited in the text have compiled their data for widely different purposes, the bases for inclusion and classification are far from uniform. Some deal only with institutional holdings of the outstanding mortgage debt as a whole, while others are concerned solely with mortgages on small 1- to 4-family properties. The Bureau of the Census generally provides separate treatment for single-family

homes, but in 1940 its home mortgage surveys were restricted to owner-occupied dwellings.

Perhaps an even more limiting factor concerns the non-uniformity in geographic coverage among the various sources. Although most data refer to mortgage lending activity in the Boston area alone, some are available only for Massachusetts or even for all of New England. Within the more restricted area, the Federal Reserve Board breaks down their findings only on a county-wide basis, whereas the Bureau of the Census and the Bureau of Labor Statistics use the standard Boston Metropolitan Area as the covered territory. The Metropolitan Area as defined by the Census is almost wholly included within four counties surrounding Boston proper, and constitutes slightly over four-fifths of the combined population of these counties. Even when dealing in Census data alone, however, full comparability is lacking because the "Metropolitan Area" as defined in 1950 was slightly less extensive than the "Metropolitan District" of 1940, largely because of the elevation of the Brockton vicinity to the status of metropolitan area in the most recent survey.¹

¹During the decade of the 1940s, population increased roughly 9 per cent (presumably for the same coverage), with the 1950 figure for the Boston Standard Metropolitan Area being 2.37 million. At the present time there are 65 cities and towns included in this Area, distributed in 5 counties thus (1950 figures in thousands):

County	<u>Population within Met. Boston</u>	<u>% of County Pop. within Met. Boston</u>
Suffolk	896.6	100.0
Middlesex	852.3	80.0
Norfolk	339.0	86.5
Essex	268.2	51.4
Plymouth	14.0	7.4

Since such a small proportion of the Metropolitan Area is within Plymouth County, only the first 4 counties are included in this study. The total population of the 4 counties was 2.88 million in 1950, with 2.34 million being within the Metropolitan Area. 1950 Census of Housing, Preliminary Reports.

In view of the limited resources available for this project, more concentrated analysis has been confined to mortgage operations in those communities located wholly or in part thereof within a 10-mile radius of Boston City Hall. This restricted area includes 32 cities and towns, and contains over 85 per cent of the total population of the Metropolitan Boston Area. (See Chart I.) Most of the lenders interviewed are located within this 10-mile region, and all data compiled from annual reports of state- and federally-chartered thrift institutions are similarly chosen. Unless the Standard Metropolitan Area or the four-county region are mentioned by name, data presented in the text refer to mortgage lending activity within the 10-mile area exclusively. This latter geographic area is alternately termed "Boston area," "immediate Boston vicinity," "metropolitan Boston," etc.

For the most part, location of the lending institution rather than pledged property is used as the basis for classification in this study. In other words, unless stated otherwise, data on mortgage lending activity within the "immediate Boston vicinity" refer to mortgage operations of lenders with headquarters in this restricted area. While it will be shown that most thrift institutions concentrate lending operations on properties within their immediate community, property location is not coincident with lender location in all cases. On the contrary, several locally organized institutions, notably life insurance companies, are relatively active in the nationwide mortgage market but are of minor importance in the local area. Because of the capital surplus characteristics of the Boston market, most inter-regional flows

of mortgage credit represent exported funds, with the reverse movement being of negligible significance. In some cases, however, data are classified according to property location in which event valuable insights can be gained into policies regarding geographic lending areas among local thrift institutions.

This study is concerned primarily with home mortgage lending operations in the Boston area during the postwar period. The material in the study is presented in 8 parts and 15 chapters, the first of which is this introductory discussion. In Parts II and III the major demand and supply forces underlying home mortgage lending are analyzed, first on a quasi-theoretical plane, and then with specific reference to the Boston market. Part IV summarizes some characteristic weaknesses in the pre-depression mortgage market, followed by a description of the principal methods by which the government has attempted to eliminate or largely overcome these weaknesses. Part V presents specific data on mortgage operations of local lending institutions, as well as an analysis of relative contract terms and lending practices. The utilization of the FHA and VA home loan programs is analyzed in Part VI, including the primary reasons accounting for the low scale of insured lending on the local level. The development of an effective secondary mortgage market is considered in Part VII, with special emphasis given to the contribution of insured and guaranteed loans in this development. The concluding Part VIII analyzes the soundness of the existing mortgage structure as well as the influence of federal interventionary efforts upon the competitive structure of the local market.

PART II. DEMAND FORCES: THE MORTGAGOR

CHAPTER 2. SOME THEORETICAL CONSIDERATIONS

The demand for home mortgage credit is closely related to the demand for real housing assets. Unless the refinance of an existing obligation is involved, mortgage credit is sought primarily in connection with the purchase of a new or standing house. The demand for mortgage credit is commonly referred to as being "derived" from the outside housing market. In view of the indispensability of appropriate financing in most home purchases, however, a "joint" demand relationship may be a bit more realistic.¹ Because of the interdependence between the mortgage and real estate markets, this chapter will consider some of the principal forces underlying the demand for housing assets before analyzing mortgage demand directly.

THE HOUSING MARKET

Fundamentally, the demand for mortgage credit as well as for housing assets largely depends upon the demand for and supply of real housing services. These housing services constitute an essential item in every family budget, although the precise services sought by a particular household must be determined in the Walrasian general equilibrium system, given incomes, tastes, technology, etc. The composite demand for these

¹For the implications of this observation, see "Mortgage Demands of Owner-Occupants" below.

services is translated into dollar rentals, and interacts with the existing supply in determining the market rental structure. For our immediate purposes, the distribution of the ownership of housing assets is unimportant, as all family units are treated as if they were tenants. If an individual were an owner-occupant, his behavior as a consumer of housing services is analytically distinct from that as an investor in this particular form of asset.

The "supply of housing services" of course refers to the utilization of housing inventory, whether it be newly-constructed or older property. In theory, the present value of this stock is found by applying the relevant discount factor to anticipated future net revenues.¹ As a result of competition among buyers and sellers of housing assets, market price tends to gravitate toward this value. These capitalized values thence tend to rise and fall with fluctuations in dollar rentals. The latter, in turn, depend on shifts in the demand and/or supply schedules for housing services. Hence, real estate valuations, in theory at least, are a function of the forces determining the basic demand for and supply of housing services.

This observation is not at all surprising, for the same elementary principles apply equally well to pricing in all commodity markets. Nevertheless, the extreme durability of housing inventories gives rise

¹The determination of the "appropriate" discount factor is a subject for analytical study, whether it relates to lending rates, borrowing rates, short or long rates, or some other economic variable. See the discussion of FHA capitalization methods in Chapter 8.

to certain distinguishing market characteristics. Real estate markets are largely dominated by the behavior of a vast standing stock, and annual additions or diminutions to this inventory appear relatively insignificant. This observation is easily verified by considering the ratio of annual nonfarm housing starts to existing stocks. Even in 1950, when an all-time high of 1.4 million units were started in the nation, new construction represented but 3.5 per cent of the standing inventory of 39.4 million dwelling units.¹

Not only is the total stock of housing relatively inflexible in number but it is also fixed as to location. Automobiles, furniture and other consumer durables are relatively mobile as families move about, while a house can be moved only at great expense, if at all. Prefabricated housing has facilitated a more responsive adjustment of production to changes in location of demand concentration,² but under existing

¹Compare data on housing starts presented in Chart I with the total stock of 29.7 million units in 1940 and 39.4 million in 1950. The durability of housing assets is demonstrated by the following age distribution of over 28 million urban dwelling units, as of 1950:

<u>Year Built</u>	<u>Per cent of Dwelling Units Reporting</u>
All years	100.0%
1945 or later	11.8
1940 to 1944	7.7
1930 to 1939	11.8
1920 to 1929	22.2
1919 or earlier	46.4

Source: Bureau of the Census, presented in Economic Almanac 1951-1952, National Industrial Conference Board, p. 410.

²Some folding houses are designed to permit repeated moving even after the unit has once been assembled, e.g., Acorn Houses.

technology, factory-built homes have enjoyed only limited public acceptance.

As a result of this extreme stock-flow relationship, supply schedules of housing services change but slowly over a period of time. As a consequence, dollar rentals in a free market are largely demand determined, and may display erratic behavior at times. In the very short run, the physical stock of housing is absolutely fixed and the only adjustment in market offering to various prices involves doubling-up or vacancies among the standing units.

The Rate of Utilization of Housing Facilities

In a theoretical equilibrium situation, the existing stock of housing facilities would be used to best advantage, with rents and home prices tending to remain unchanged. Under such circumstances, the "rate of utilization"¹ of the standing stock would be at an optimal level, and instances of involuntary doubling-up or property vacancy would be only transitory and of minor significance in the aggregate. On the other hand, it is entirely probable that a certain amount of doubling-up would persist even under equilibrium conditions, for some members of the economy may be unable or ill-advised to seek their own housing accommodations for long periods of time.²

¹The concept "rate of utilization," which might be defined as the degree to which the existing stock of housing is being occupied or used up, was used by Professor Ernest Fisher in an address before the 1951 Convention of Massachusetts Savings Bankers. Reprinted in U.S. Investor, September 29, 1951, pp. 1861-4.

²If general equilibrium were obtained throughout the economy, relative prices would be established so as to stimulate sufficient new construction to offset the real depreciation of the hitherto standing stock. In a growth economy, because of pressures of population growth, rising incomes, etc., new construction would exceed this depreciation; and conversely in a declining economy.

If the supply of housing services were to become excessive relative to the equilibrium level (or alternatively if the demand were to become deficient), the "rate of utilization" of existing facilities would fall below the theoretical optimal level. In this event, vacancies would mount and dollar rentals as well as current market valuations on housing assets would display a downward tendency.¹ Such an "unemployment" situation may persist for long periods of time, as the housing stock has a long average life and is seldom diminished by an appreciable extent during any one year. Natural catastrophes, such as fires, floods, and storms, destroy some units, while others are intentionally demolished in connection with changes in land use or urban redevelopment. During the decade of the twenties, however, the total number of dwelling units withdrawn from use for all reasons probably represented less than 10 per cent of the number of new units put in place.²

In the past, the economy seldom had to wait upon full physical depreciation of standing stock before the rate of utilization would rise again. Ordinarily rising incomes and population pressures would induce a secular increase in overall demand for housing services. This outward shift in demand would intersect the relatively stationary

¹By 1940, the net vacancy ratio in the U. S. had declined to 4.8 per cent, and by 1950, only 1.77 per cent of all nonfarm dwelling units were involuntarily vacant. The corresponding ratios for Massachusetts and Metropolitan Boston in 1950 were 2.4 and 2.0 per cent, respectively. 1950 Census of Housing, Preliminary Reports, Series, HC-1, No. 28.

²L. J. Chawner, "Economic Factors Related to Residential Building," The Annals of the American Academy of Political and Social Science, March 1937, pp. 27-28.

supply schedule at a higher price and at a point of more complete utilization of the standing stock. Hence, dollar rentals would once again rise to the equilibrium level, and asset valuations would begin to turn up.

If, on the other hand, the demand for housing services were to become excessive relative to the equilibrium level (or if supply were to become deficient), the rate of utilization would rise above the theoretical optimum level. Under such circumstances, rentals would mount significantly, a "housing shortage" would develop, and doubling-up would become widespread in the areas concerned. Once again, a disequilibrium situation may prevail for several years, despite the fact that new production would take place as soon as rental prospects¹ rise sufficiently to push capitalized values of housing assets above current costs of construction. As has been true of the postwar housing boom, builders continue to put up new dwelling units as long as anticipated market conditions permit their sale at a profit. This situation obtains notwithstanding the restraints of Regulation X and other governmental credit regulations.² Construction activity is not confined to new dwelling units alone, for during such boom periods existing properties undergo extensive repair, modernization and conversion.

Although new construction is undertaken and maintained only so long as anticipated market valuations exceed total production costs, the latter hardly functions as an upper limit to the former. As data

¹It is to be remembered that rentals in this connection refer to compensation for housing services, whether the occupants are tenants or owners.

²If direct controls over prices, wages, materials allocations, etc., were assumed, this statement would require modification.

on new construction indicate, construction activity even in peak years adds but a small amount to the aggregate housing inventory. Hence, it may take several years before the rate of utilization and dollar rentals fall sufficiently so that selling prices drop to a level approximating current costs of production. The fact that market valuations may exceed production costs for long periods of time reflects not only the length of the planning and construction period, but also imperfect knowledge, financing difficulties, heavy risk, etc. Furthermore, the return to equilibrium may be indefinitely extended if active building operations are accompanied by outward demand shifts, which in turn tend to increase the rate of utilization. This type of inflationary race has characterized much of the postwar housing boom. As late as 1950, nearly 2 million families across the nation were still doubled up, despite an unprecedented volume of new home building.¹ Indeed, only after market valuations drop below the level of current costs of construction would new production be curtailed or eliminated.

It is precisely this derivative nature of new construction, as well as its undisciplined, localized operations, that subjects the industry to such a feast and famine existence. The severity of the

¹Sample surveys of doubling-up have revealed these statistics for selected years:

<u>Date</u>	<u>Estimated Number of Families</u> <u>Doubled Up (OOO)</u>
April 1, 1940	1,846
April 15, 1947	2,712
April 15, 1949	2,040
March 15, 1950 (preliminary)	1,880

Source: Savings Bank Trust Company, Mortgage Statistics Bulletin, 1951, p. 14.

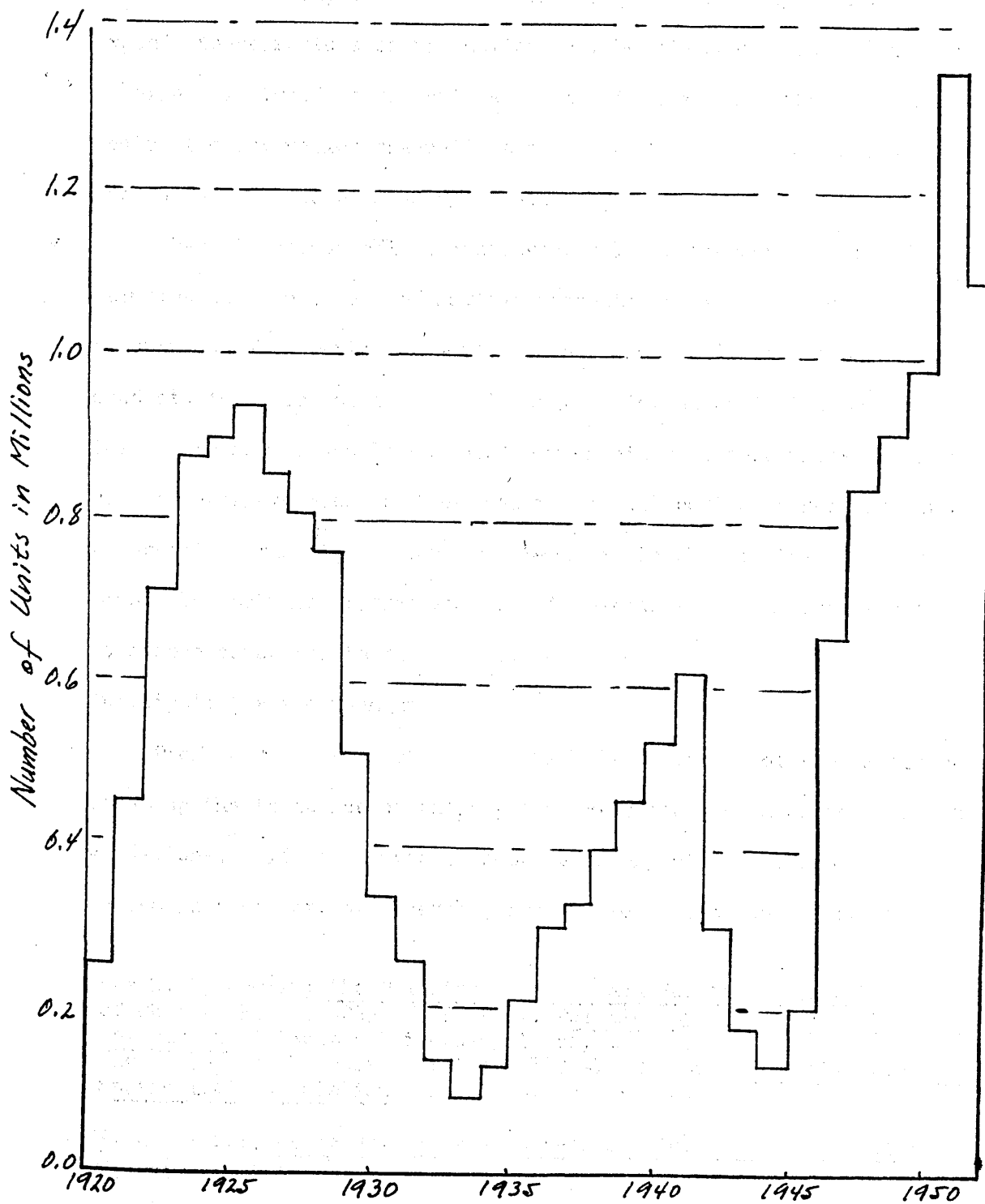
swings in private home construction is vividly illustrated by Chart I on private home building in the country. Costs of production perform the same function in housing just as in all other commodity markets. In the case of most consumer items, however, market price fluctuates quite closely about reproduction costs. Inventories undergo fairly rapid turnover as consumers purchase these non-durables frequently, and consumption accordingly follows production and distribution very closely.

In the construction industry, however, a relative surplus of standing inventories distributed throughout the economy¹ may render new production unprofitable for long periods of time. Construction costs tend to remain fairly stable in the short run, while capitalized values fluctuate widely, as a result of shifts in prospective net rentals or in the rate of discount applied to these revenues. In depressed periods, costs seldom decline as rapidly as do real estate values, and similarly cost advances rarely keep pace with boom price movements. Indeed, current wage rates and material costs are determined by forces operating without as well as within the home building industry, and hence tend to follow overall economic developments rather than home construction activity alone.² As new construction is revived

¹Or within certain regions.

²The rigidity of wage rates is also heavily influenced by labor union efforts, imperfect knowledge, etc.

Chart I. NUMBER OF PRIVATE NEW PERMANENT NONFARM DWELLING UNITS
STARTED ANNUALLY IN THE UNITED STATES, 1920-1951



Source: National Industrial Conference Board, Road Map of Industry, No. 834 and Housing Statistics, HHFA, January 1952, p. 2.

following a period of inactivity, factor resources are initially absorbed from unemployed pools at existing prices. But as operations expand, these factors of production must be bid away from alternate uses by offering higher factor prices. Hence in the later stages of a boom, costs of construction gradually approach and in practice may surpass capitalized values of housing assets.

There is undoubtedly a considerable lag between the point of stimulus and the time when newly-constructed units are available for occupancy. This period of gestation has frequently been analyzed by students to determine its role in aggravating economic fluctuations. Inadequate market knowledge coupled with other imperfections may give rise to overinvestment and an ensuing painful period of readjustment. A careful examination of cyclical behavior in the housing industry cannot be included in this study, but several empirical investigations have been conducted in this field.¹

Anticipating Price Changes

Professor Ernest Fisher has formulated a series of tables demonstrating the influence of anticipated price changes on current market valuations.² If an individual home buyer expected real estate prices to remain constant for several years, he would feel justified in

¹See W. H. Newman, The Building Industry and Building Cycles, University of Chicago Press, 1939; C. D. Long, Building Cycles and the Theory of Investment, Princeton University Press, 1940; J. R. Riggleman, "Building Cycles in the United States," 1875-1932, Journal of the American Statistical Association, June 1933; and others.

²E. M. Fisher, Urban Real Estate Markets and Their Financing Needs, Op. cit., Chapter I.

paying no more than the prevailing price. If he believed a subsequent resale of the property would bring in a sizeable capital gain he may be willing to pay a little more. If he believed market price would advance at a rate of 5 per cent per year for 5 successive years and then remain steady, a house costing \$10,000 could be sold for \$12,760 at the end of the 5-year period. If this inflationary expectation were shared by buyer and seller alike, the prospective capital gain would be reflected in the current price. Assuming a 4 per cent discount rate, the price would approach \$12,271, the exact amount depending upon the relative bargaining strength of the two parties as well as the firmness of their convictions. Largely because of an acute lack of knowledge in the real estate market, this process tends to accelerate rates of price change, whether in expanding or declining periods. Once such a price rise is underway, buyers and sellers may alter their convictions in the direction of a more rapid or of a more enduring inflationary spiral.¹

Although he may not always calculate the precise discounted value of these prospective increments, the actual home buyer certainly considers resale value as a vital factor in arriving at a maximum offering

¹One of two tables presented in Fisher's study will be reproduced in part here, from which the above example has been drawn:

Period	Index of Price in Period N (Assuming 5% Rise per Period)	Index of Present Price (where discount rate=4%)
0	100.0	100.00
1	105.00	104.81
2	110.25	109.48
3	115.76	114.01
4	121.55	118.42
5	127.63	122.71

Source: *Ibid.* The index is found directly by this formula:

$$I = 100 \left\{ 1 + \left[1 - (1+r)^n \right] \left[1+i \right]^{-n} \right\}$$

r = expected rate of change in price,

i = rate of discount.

where
and

price. Furthermore, the market interaction of buyers and sellers in making due allowance for price changes would result in a schedule similar to that described above. On the other hand, under a theoretical perfect capital market situation, one might say that the problem of "anticipating" price changes does not exist as such, but rather reflects more fundamental developments in the market. Investors in housing assets base their offering price upon the present discounted value of all expected future net revenues, consisting mainly of rental incomes. Hence, from a purely economic point of view, the only items that might change present values of such assets are changes in expected net rentals or in the rate of discount, and, at any moment of time, competition among buyers and sellers would insure that market valuations approach these present values. If, for instance, net rentals were expected to increase, a buyer would feel justified in paying more for a property than if he expected them to remain constant or decrease. In other words, if he firmly believes his housing asset could be resold at a higher price five years after its purchase, he implicitly assumes rising rentals or declining interest rates for discounting purposes. To summarize, elementary economic theory describes the market value of any good as the present worth of a series of flows. Nevertheless, in the real housing market, prospective buyers and sellers follow a behavior pattern quite similar to that as described by Professor Fisher in allowing for anticipated price movements.

Rental- vs. Owner-Occupancy

The previous discussion has not been concerned whatever with the distribution of home ownership throughout society. Under the

restrictive assumptions postulated, it is really trivial to consider who selects this type of earning asset as an investment outlet. By and large, however, private demanders for assets in housing fall into these four categories: (1) owner-occupiers, who purchase a home for direct amenity-income purposes; (2) true investors, who purchase such assets solely for their money-income earning capacity; (3) combinations of the above, especially where the owner occupies one unit of a 2- to 4-family property; (4) speculative builders, who may lease newly-constructed units for a short period, perhaps speculating on a price advance before selling. In the case of an owner-occupier, it would be theoretically correct to follow the suggestion of the nineteenth-century French economist, Walras: ". . . (A) man who buys a home to live in may be disassociated into two individuals, one of whom makes an investment and the other consumes directly the service of his capital."¹ Under these circumstances, a competitive rent would be imputed to the home owner by himself as if he were a tenant, and payment for the undepreciated portion of the

¹ Leon Walras, Elements, p. 242, quoted in G. J. Stigler, Production and Distribution Theories, Macmillan, New York, 1941, p. 246.

property would be met out of savings.¹ Certainly either type of home purchaser must bear the many risks of physical depreciation, obsolescence, adverse price movements, etc., associated with any capital investment. Hence, in theory at least, a home purchase is considered in the light of the relative attractiveness of alternative investment outlets, such as government bonds, private securities, savings and loan shares, and other real investments.

Realistically, the first two categories of property owners deserve individual examination, since vastly different forces may underlie their investment decisions. Even if the capitalization process were faithfully employed by both types of purchasers, owner-occupiers may evaluate certain "services" by a weighting system far different from that applied by professional investors. Individualistic features may hold great esteem for the former, but business investors must analyze the general acceptability and marketability of a property in considering its purchase. The latter may be relatively mobile and objective in placing their funds to secure an optimum yield. The typical home purchaser, on the other hand, is confined to a restricted geographic area, is inexperienced and poorly informed concerning market developments, and may be

¹For national income purposes, the Department of Commerce includes in the item "rental income of persons" the imputed net rental return to owner-occupants of non-farm residences. The number, type and size of such houses are obtained from census data. Estimates of the gross rental value of these houses are made on the basis of current rents paid for comparable tenant-occupied units. Net imputed rent is then determined by deducting depreciation, maintenance and other expenses from gross estimates. R. Ruggles, An Introduction to National Income and Income Analysis, McGraw-Hill, New York, 1949, p. 121.

unduly influenced by the many intangibles associated with home ownership.¹

In addition to the above inherent distinguishing characteristics, governmental intervention has further withdrawn this decision-making from a relatively free market. Rent control has undoubtedly had a bearing on new rental construction and, in turn, on the relative availability of rental units.² Ceilings on rentals coupled with outright federal encouragement of individual home ownership have introduced a strong bias in favor of the latter. The personal income tax structure through allowing interest payments as a deductible item, in addition to the FHA and GI home loan programs, grants special concessions to the owner-occupant. Undoubtedly many families in the postwar period have been virtually compelled to purchase their own homes simply because rental units were not obtainable at a reasonable price.³

¹See Abrams, The Future of Housing, Harper and Brothers, New York, 1946.

²Compare Lloyd Rodwin, "Rent Control and Housing," Social Research, September, 1950, pp. 302-319, and G. J. Stigler and M. Friedman, Roofs vs. Ceilings, Foundation for Economic Education, New York, 1947.

³The shift that has taken place is clearly indicated by the following percentage breakdown on the types of structures constructed in selected years in the United States.

Year	Percentage of total units in -		
	1-family structures	Rental-type 2-family structures	Multifamily structures
1927	56.1	12.2	31.7
1936	76.5	4.4	19.1
1940	80.6	6.2	13.2
1946	88.0	3.6	8.4
1948	82.3	5.0	12.7
1950 preliminary	83.0	3.0	14.0

Source: Housing Statistics, HHFA, January 1951, p. 4.

In the present study of the Boston home mortgage market, only the owner-occupant type of home purchaser will be examined in detail. Wherever possible, data will be broken down so as to refer directly to this important branch of the overall mortgage market.

MORTGAGE DEMANDS OF OWNER-OCCUPANTS

The purchase of a new or existing home requires an outlay much larger than the typical family's accumulated savings.¹ To channel the flow of credit from those individuals or institutions with an abundance of liquid holdings to those with a deficiency, the home mortgage system has been established. The classical economist's "effectual" demand postulated both willingness and ability to pay—when applied to home purchase, "ability" usually entails the use of mortgage financing.²

Since financing plays such a prominent role in the housing market, it might be argued that mortgage costs should be an element in the cost of the asset itself. Pure theory would dictate, however, that methods

¹The Federal Reserve estimates that 31 per cent of all spending units in the nation held no liquid assets in 1950; 27 per cent held between \$1 and \$499; and 9 per cent held \$5,000 or more in this form. Economic Almanac, 1951-1952, p. 149. These data may be compared with \$8,558, the estimated construction cost for the average single-family dwellings in the same year. Housing Statistics, January 1951, p. 6.

²Land contracts, widely used in the Middle West, are rare in the local area as an alternative method of financing. In the Metropolitan Boston Area, 94 per cent of all new single family homes purchased during late 1949 and early 1950 involved mortgage financing. (From an unpublished sample survey conducted by the Bureau of Labor Statistics.) When mortgage financing is not used, perhaps the buyer frequently pays for the new property with the proceeds of a previous home sale.

of finance have nothing to do with basic economic values, and that mortgage loans merely involve a reapportionment of the economy's liquid holdings. On the other hand, the universality of mortgage lending has undoubtedly influenced the operations of the housing market itself.¹ The fact that families with modest liquid resources are afforded extensive purchasing power through low equity down payments has undoubtedly affected current home prices. Especially in a seller's market, a liberalizing of credit terms may merely result in a higher price level without any appreciable improvement in the quality of homes purchased. The price charged for a house is adjusted in accordance with the new liberal terms so that the monthly debt service remains unchanged.²

As a compromise solution to the problem of value and indebtedness, one writer has suggested a classification of home sales according to debt status. The great variety of possible mortgage arrangements makes systematic classification extremely cumbersome, if not impossible, if all variables are to be considered. However, that writer would regard sales where over 50 per cent of the price is borrowed as not being true sales at all but merely a peculiar type of tenancy. The remaining sales

¹The interdependence of home purchase and credit availability is aptly demonstrated by the advertising efforts of builders in stressing convenient debt service without even mentioning actual home prices. See Chapter 12.

²See Fisher, Op. cit., Chapter IV.

would be classified into 3 value groups: where debt-price ratios are zero, 1 - 25 per cent, and 26 - 50 per cent, respectively.¹

On a theoretical plane, mortgage interest payments should perhaps not be regarded as a part of current costs of house maintenance. The relevant income flow for yield comparison purposes on various properties is net rentals before deducting mortgage interest payments, and should not be influenced by individual loan arrangements.² In practice, however, the mortgage interest rate is of vital importance to the prospective housing investor, who has the option of purchasing government or private securities, or making any of a great many other investments.

The owner-occupant seeks home mortgage credit for at least two different purposes. The most significant motive involves the purchase of a newly-constructed or an older property, whereby the buyer must resort to borrowing in order to supplement his limited equity savings. In other cases the existing home owner may look to the mortgage market for the refinance of an outstanding obligation. He may need additional funds either to repair, modernize or enlarge his mortgaged property, or even to finance some other consumption expenditure, such as a vacation

¹L. M. Kingsbury, The Economics of Housing, King's Crown Press, New York, 1946, pp. 139-141.

²Similarly, mortgage fees should not be included in the costs of reconstruction, at least when the investment is considered from the social point of view. At the same time, interest payments on construction loans must be counted as a true cost, as they represent a necessary expense in house construction. Ibid., pp. 141-2.

trip, automobile purchase or stock market speculation.¹ The refinance may merely entail an extension of the repayment term or a reduction in interest charges without altering the principal amount of the loan itself.

PRICE OF MORTGAGE CREDIT

Demand functions in any industrial market are extremely difficult to analyze. The list or quoted price may be merely a fictitious figure from which discounts and rebates are to be deducted before a net price is determined. In the mortgage market, however, "price" is an even more elusive concept. Mortgage price has a great many significant dimensions, any or all of which may vary widely. The contract rate of interest is perhaps the commonly accepted variable but its influence in the demand for mortgage funds is not always the major element.

A reduction in mortgage interest rates, ceteris paribus, would tend to stimulate an increased volume of home mortgage applications, both in number and dollar amount. Families hitherto lacking sufficient income prospects to carry the necessary debt burden would enter the housing market as eligible home purchasers. This observation is especially relevant when debt service is put on a monthly payment basis. Other families with more adequate income prospects may be induced to purchase more expensive homes, as the lower interest rate may permit a

¹It is only fair to add these latter transactions are being increasingly scrutinized by lenders and government examiners. Federal credit regulations generally restrict such credit terms.

larger purchase without an increased monthly debt service. Still another possible consequence of a differential reduction in mortgage rates as against the general interest rate structure might involve the purchaser's preference to increase initial debt-value ratios. The released equity payments would then be directed into the relatively more profitable investment channels.¹

Monthly Debt Service

When the mortgage contract calls for level monthly payment over the loan term, debt carrying charges depend upon three major elements: (1) the original loan amount; (2) the term of the loan; and (3) the rate of interest. Although the latter represents the price paid for the use of borrowed funds, liberalizing the remaining two components has played a major role in promoting home purchase among families of modest means.

The loan-value ratio is frequently the most crucial variable in the prospective mortgage loan. If the hopeful home purchaser has \$2,000 in liquid holdings and seeks a house selling for \$10,000, his primary concern is securing an \$8,000 loan. Perhaps he is quite insensitive to a slight upward revision in interest rates so long as the loan is large enough and monthly debt service manageable. Consequently, lenders can effectively influence the level of home mortgage demands by varying permissible loan-value ratios. As higher debt-value ratios are sanctioned by mortgage lenders, the purchasing power of a constant down

¹ This consequence requires that the rate reductions apply to the larger loan as well as to the initial amount. Frequently lenders follow a definite policy of raising interest rates as loan-value ratios increase. See Chapter 12.

payment increases rapidly. This expanding buying capacity may attract new buyers into the market, or it may induce other buyers to purchase better, more expensive homes. On the other hand, it may simply invite an automatic price advance on existing homes.¹ At any rate, varying maximum debt-value ratios has a direct bearing on the number of active buyers in the housing market. The potency of this lever has been recognized by the federal government in the provisions of Regulation X, where maximum loan-value ratios are established for various price classes. The effectiveness of any such regulation, however, depends to a great extent upon the appraisal criteria used by the lender in establishing "value."

Varying allowable loan-value maximums directly affects the minimum down payment required and the implicit rate of interest associated with this payment. Especially where this initial outlay depletes his liquid holdings, the home buyer runs the risk of meeting any subsequent emergencies only with the aid of costly personal loans. When the mortgagor is thus inadequately fortified against adverse contingencies, overall borrower risk is heightened, and so also is lender risk.² It is true, however, that resort to personal loans might be necessary only during the early years of the term, for as repayment proceeds the mortgagor may be able to secure supplemental funds by refinancing the existing

¹See Chapter 8, where FHA encouragement of 90 per cent loans is discussed.

²This may theoretically tend to produce higher interest rates on mortgages with higher loan-value ratios, which in practice is generally quite true. See Chapters 11 and 12.

mortgage at relatively low interest costs.

The remaining dimension of the mortgage contract, the loan term, has entered into popular discussion largely since direct-reduction type loans became widespread. More liberal loan-value provisions signify low cash down payment, but do entail larger debt carrying charges. Lengthening the loan term, however, reduces these periodic payments. Hence, a combination of a high loan-value ratio and a long-term mortgage facilitates home purchase with both a minimum initial equity and modest monthly debt service.

Another price component which should not be overlooked in comparing alternative financing plans concerns the imposition of various fees and bonuses in the granting and servicing of mortgage loans. Although these items appear insignificant when compared to the price of the house, their total cost may easily add up to a full 1 per cent to the effective rate of interest paid. At various times and on various types of loans, mortgage borrowers have been obliged to pay special fees for loan application, property inspection, credit examination, loan servicing, loan renewal and for many other purposes.

The net effect of a combination of such charges on financing costs may be demonstrated with reference to the following table:

TABLE I. COST COMPARISONS ON 20-YEAR AMORTIZED LOANS OF \$1000 AT VARIOUS RATES OF INTEREST

<u>Contract Rate of Interest</u>	<u>Monthly Payment (Principal and Interest)</u>	<u>Excess over Payment where 4.5% Rate</u>	<u>Present Value Of Excess*</u>
4.5%	\$6.33	-	-
5.0	6.60	\$0.27	\$37.65
5.5	6.88	0.55	76.65
6.0	7.17	0.84	117.25

Source: Adapted from R. S. Smith, "A Method of Comparing Home Mortgage Financing," Journal of Marketing, April 1945, pp. 386-8.

*Discounted at a 6 per cent nominal rate, converted monthly.

From these calculations, it is apparent that a 4.5 per cent contract rate of interest would be preferable to a 5 per cent rate only if the additional fees charged the borrower in the former case alone were less than \$37.65 per \$1,000 of loan. If the 4.5 per cent loan required differential extras totaling over \$117.25 per \$1,000 of original loan, the mortgagor would seek a 6 per cent loan without such fees. These comparisons are based upon a nominal discount rate of 6 per cent, which is perhaps unrealistically high under current conditions. A lower rate of discount would serve to increase the effective savings from the lower contract interest rates. For example, if a 4.5 per cent discount rate were applied, the present value of the interest savings from a 4.5 per cent as compared with a 5.0 per cent mortgage rate would be \$42.67.

Before leaving this theoretical discussion of mortgage demand, it may be useful to present in concrete form the influence of varying loan amounts, terms and interest rates on debt service. The amortized monthly repayment scheme is now so universally accepted that a full understanding of current mortgage operations requires some knowledge of these inter-relationships.¹

Of the three determinants of debt service, only loan amount bears a one-to-one relationship with carrying charges. Regardless of term or interest rate, so long as these two items remain unchanged, a doubling of the loan principal will entail a 100 per cent increase in monthly debt service. The influence of varying term and rate of interest on

¹Professor Fisher has prepared a series of tables showing various mortgage loan plans. Op. cit., Chapter IV.

monthly debt payment is a bit more complicated. As mortgage repayment is spread over a larger number of level monthly payments, aggregate interest charges also increase, with the result that the reduction in monthly payment is less than proportionate to the extension in term. Such extensions have their greatest influence in moderating carrying charges while the proportion of amortization payments to total debt service remains quite large.¹

Reductions in rates of interest do reduce debt service, but not in direct proportion to the rate change. Unless the term is also extended, full principal amortization must be crowded into the same number of monthly payments, regardless of any change in interest rate. The ratio of total interest to total principal payments, however, does decline more than proportionately with the interest rate reduction, since larger dollar amounts are applied to principal retirement in the smaller monthly payment.²

¹Or, in other words, when slight increases in aggregate interest payments have relatively little influence on total monthly payment amounts. Since successive extensions do increase total interest payments, reductions in monthly carrying charges are progressively less significant at longer terms. See Table II.

²For example, consider the allocation of the first month's payment as between interest and principal, on a \$10,000 loan, for a 20-year term, at various rates of interest.

<u>Contract Rate of Interest</u>	<u>Total Monthly Payment</u>	<u>Interest Component Amount</u>	<u>Component Per cent</u>	<u>Principal Component Amount</u>	<u>Component Per cent</u>
4%	\$60.60	\$33.33	55.0%	\$27.27	45.0%
5	66.00	41.67	63.2	24.33	36.8
6	71.65	50.00	69.8	21.65	30.2

Computed from Extended Payment Table for Monthly Mortgage Loans, Financial Publishing Company.

On a 20-year loan, a 50 per cent increase in interest rates from 4 to 6 per cent has the effect of increasing the ratio of total interest to total principal payments by 59 per cent. On a \$10,000 loan at 4 per cent, aggregate interest payments (over 20 years) are \$4,544; at a 6 per cent rate, the corresponding total is \$7,196.

TABLE II. MONTHLY PAYMENT REQUIRED TO AMORTIZE A \$1000 MORTGAGE AT VARIOUS RATES OF INTEREST AND FOR VARIOUS TERMS

Rate of Interest	Term in Years					
	<u>5</u>	<u>10</u>	<u>15</u>	<u>20</u>	<u>25</u>	<u>40</u>
3.5	\$ 18.20	\$ 9.89	\$ 7.15	\$ 5.80	\$ 5.01	\$ 3.88
4.0	18.42	10.13	7.40	6.06	5.28	4.18
4.5	18.65	10.36	7.65	6.33	5.56	4.50
5.0	18.88	10.61	7.91	6.60	5.85	4.83
5.5	19.11	10.85	8.17	6.88	6.14	5.16
6.0	19.34	11.10	8.44	7.16	6.44	5.51

Source: Computed from Extended Payment Table for Monthly Mortgage Loans, Financial Publishing Company, Boston, 1940.

The effect on monthly debt service of changes in term and interest rate, both individually and in combination, is indicated in the Table II. From this table the relationships discussed above are clearly demonstrated. For example, a 5-year, 6 per cent loan calls for a monthly payment fully 5 times as large as a similar loan at 3.5 per cent over a 40 year term. Extension of loan term is much more effective in reducing debt service at lower rates; at 3.5 per cent, lengthening the term from 5 to 40 years reduces each monthly payment by nearly 80 per cent, whereas at 6 per cent, the reduction is slightly over 70 per cent. On the other hand, interest rate changes are most influential in connection with long-term loans; for a 5-year term, increasing rates from 3.5 to 6 per cent raises monthly payment only 6 per cent, while a similar rate increase on a 40-year loan entails a 42 per cent advance.

These relationships may also be indicated by referring to a conventional indifference curve representation of alternative level monthly payment patterns. (See Chart II.)

Especially when the level monthly payment plan is used, lenders give careful consideration to the relation between debt service and anticipated borrower income. In the past when unamortized loans were

written for nominal 3-year terms, the only mortgage obligations to be met regularly out of current income were interest payments. Now, however, the entire principal as well as interest is paid out of income in the form of monthly installments. Hence, it is particularly relevant to consider how varying interest rates and loan terms affect the principal amount that can be amortized by a constant monthly payment. For instance, assume the borrower's income can reasonably warrant an outlay of \$50 per month toward debt service. The following table indicates the maximum loan amounts this fixed payment will service, to the nearest \$5.

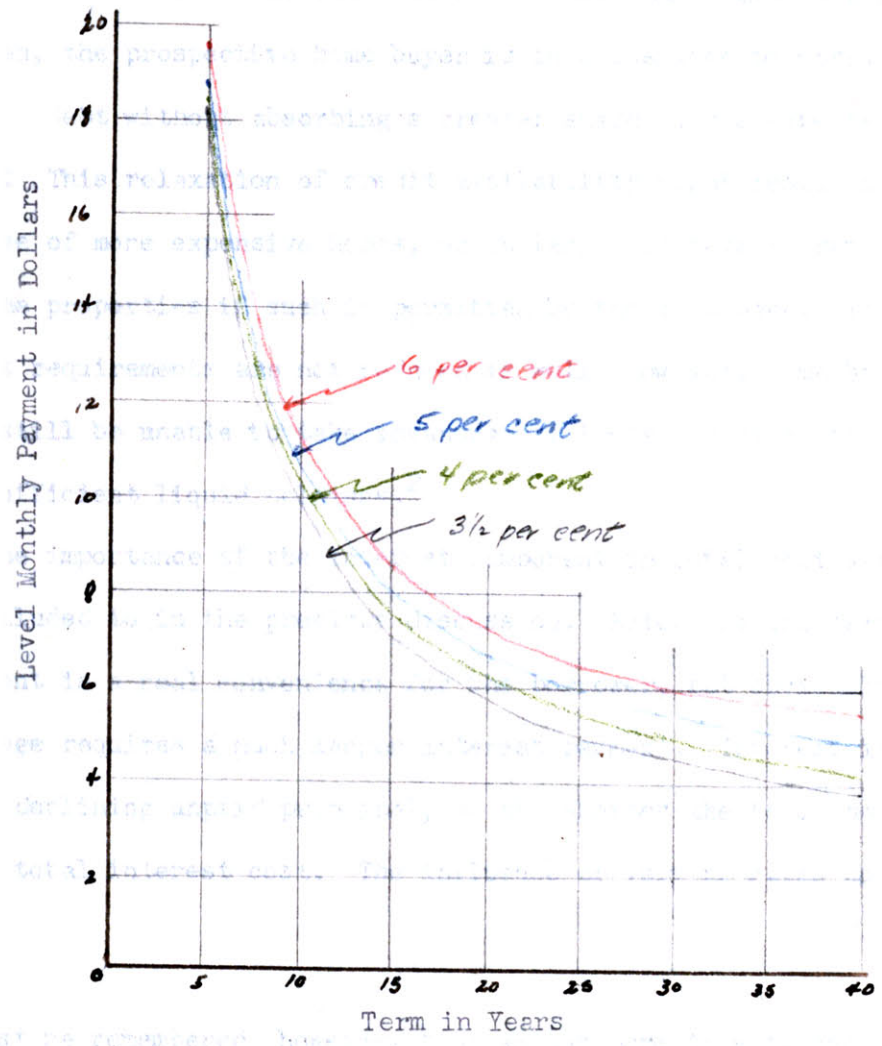
TABLE III. LOAN AMOUNT AMORTIZED BY CONSTANT MONTHLY PAYMENTS OF \$50, AT VARIOUS RATES OF INTEREST AND FOR VARIOUS TERMS

<u>Rate of Interest</u>	<u>Term in Years</u>					
	<u>5</u>	<u>10</u>	<u>15</u>	<u>20</u>	<u>25</u>	<u>40</u>
3.5%	\$2750	\$5055	\$6995	\$8620	\$9990	\$12,905
4.0	2715	4940	6760	8250	9475	11,965
4.5	2680	4825	6535	7905	8995	11,120
5.0	2650	4715	6325	7575	8555	10,370
5.5	2615	4605	6120	7270	8140	9,696
6.0	2585	4505	5925	6979	7760	9,085

Source: Same as Table II.

Analogous observations may be drawn from this table as from the previous one. At the extremes, the level monthly payment will amortize 5 times as large a loan on a 3.5 per cent, 40-year basis as on a 6 per cent, 5-year basis. Lengthening the term of the loan permits the amortization of a larger amount, but not in direct proportion to the extension. At a 3.5 per cent rate, the amortized amount increases 4.7 times as the term is lengthened from 5 to 40 years; at a 6 per cent rate, the multiplier is only 3.5. Where the term is as short as 5 years, total debt

CHART II. LEVEL MONTHLY PAYMENT REQUIRED TO AMORTIZE A \$1,000 MORTGAGE AT VARIOUS INTEREST RATES AND LOAN TERMS



Source: Same as Table II.

service consists mainly of principal payments and, consequently, is less affected by interest rate changes than when payment extends over a longer period. The amount amortized over 5 years is but 6 per cent greater for a 3.5 per cent than for a 6 per cent loan; the corresponding difference on a 40-year loan is 42 per cent.

From this table, the potency of more liberal credit terms can be readily demonstrated. As interest rates fall and repayment periods lengthen, the prospective home buyer is in a position to carry a larger mortgage debt without absorbing a greater share of his expected monthly income.¹ This relaxation of credit availability might result in the purchase of more expensive homes, or in larger debt-value ratios for the same properties if such is permitted by the mortgagee. If down payment requirements are not reduced as well, however, some households would still be unable to take advantage of these opportunities because of insufficient liquid holdings.²

The importance of the interest component in total debt service has been alluded to in the previous discussion. Extending the period of loan repayment is a real convenience for the borrower, but obviously this privilege requires a much larger interest payment. Interest is computed on the declining unpaid principal, so the shorter the term the smaller is the total interest cost. The influence of varying rates and loan

¹It must be remembered, however, that as the term is extended aggregate debt service absorbs an increasing proportion of aggregate "life" income.

²Hence the effectiveness of Regulation X.

terms on the interest component is indicated by the following table. For example, if the mortgagor were granted a \$10,000 loan at 4 per cent running for 40 years, total interest payments would exactly match this \$10,000 sum.

TABLE IV. INTEREST COMPONENT AS A PER CENT OF TOTAL DEBT PAYMENT FOR CONSTANT MONTHLY PAYMENT MORTGAGES, AT VARIOUS RATES OF INTEREST AND FOR VARIOUS TERMS

<u>Rate of Interest</u>	<u>Term in Years</u>					
	<u>5</u>	<u>10</u>	<u>15</u>	<u>20</u>	<u>25</u>	<u>40</u>
3.5%	8	16	22	28	33	46
4.0	10	18	25	31	37	50
4.5	11	20	27	34	40	54
5.0	12	22	30	37	43	57
5.5	13	23	32	39	46	60
6.0	14	25	34	42	48	62

Source: Same as Table II.

INTERNAL RATE OF DISCOUNT

The variety of loan combinations possible under the level monthly payment type mortgage makes comparison of alternative plans difficult. If the home purchaser is offered a choice of several mortgage contracts, with varying rates of interest, loan terms, or loan amounts, what criteria would he employ in making his decision? This problem will be briefly analyzed here.

The influence of varying maximum loan-value ratios in affecting the dollar volume of home purchases has been considered above.¹ The mortgagor, however, rarely has a real choice in specifying the loan amount, for he ordinarily requires all that the lender will grant to supplement his limited equity accumulation in purchasing a particular

¹See pp. 32-33.

house, If the lender refuses to approve his request, the borrower may either try another lender, consider a less expensive house, seek a second mortgage, or continue renting. Frequently he could perhaps secure the desired larger loan only at a higher rate of interest, which may or may not render the monthly debt service too burdensome.

Even if a larger loan could be gotten only at a higher interest rate, the home buyer may be wise to retain a small emergency cash reserve and seek the maximum possible loan. The inherent dangers involved in completely draining his liquid resources to meet a larger down payment are hardly worth the possible saving in interest payments.¹ In the event he finds this emergency reserve to be unnecessarily large or if his income rises materially, the mortgagor may subsequently reduce his mortgage obligation through prepayment.

The home purchaser who has a substantial liquid accumulation may rationally select the optimum loan amount. The magnitude of his down payment would depend upon the relation between mortgage interest rates and the expected net returns on outside investments. If the former were much lower, the mortgagor would request a larger loan than if the relative yields were more nearly equal.²

When the alternative mortgage plans specify varying interest rates and loan terms, the problem becomes more complicated. Under these circumstances, the mortgagor's selection may depend upon an implicit "intra-personal" rate of discount. This concept will be clearly identified in the following analysis.

¹See p. 33.

²In the continuous case, he would increase the requested loan amount until, at the margin, the two rates are equalized. Cf. below.

First of all, consider the case where interest rates remain constant over a wide range of alternative loan terms. For example, assume mortgage lenders charge a 4 per cent rate of interest on all acceptable loans, whether the term be 10 or 20 years. Therefore, provided his credit rating is satisfactory, the mortgage applicant may select one of two level payment plans. One calls for monthly debt service of \$10.13 per \$1,000 of loan amount over a 10-year term; and the other, a \$6.06 monthly payment for 20 years. In theory, the plan selected by the mortgagor would depend upon the implicit discount rate applied to these future outlays.

If this intra-personal discount rate were equal to the market rate of interest, the borrower would be indifferent as to his choice of loan plans. Obviously, by definition, the present worth of either stream of future disbursements would equal \$1,000 when a 4 per cent discount factor is assumed.¹ In this hypothetical case, however, the home buyer would actually be indifferent as to whether or not he borrows at all, for he would seek a loan only if the market rate were less than his own discount rate.² The fact that the home buyer applies for mortgage credit implies the existence of a surplus analogous to a "consumer's surplus" in Marshallian terminology.

¹For the balance of the present analysis, all calculations will refer to a \$1,000 loan amount.

²In theory, he might become a lender if the market yield ever exceeded this discount rate. In the continuous case, the individual would borrow or lend until the two rates are equal at the margin.

So long as the internal discount rate exceeds the market rate of 4 per cent, the 20-year loan term would be preferred to the shorter term loan. This fact may be demonstrated by referring to the standard present value formula,

$$A = Ra \frac{1}{d} = R \left[\frac{1 - (1+d)^{-n}}{d} \right], \quad \text{where}$$

A = present value of a series of n monthly payments of R dollars, discounted at a yearly nominal rate of d per cent, converted monthly.¹

As stated above, when the internal rate d is 4 per cent, the present value of both payment schedules is equal to the original loan amount, \$1,000. As d increases, A continually falls below this amount, but, the relative decline is not identical for the two loan options. If d = 5 per cent, the present value of \$10.13 per month for 10 years is \$955; while for monthly payments of \$6.06 over a 20-year term, A = \$918. Corresponding present values for a 6 per cent discount rate are \$912 and \$845, respectively. Hence, it appears that the preference for the longer-term mortgage becomes more pronounced as a higher discount rate is postulated.

This conclusion is hardly surprising, for mortgagors might be expected to prefer extending the repayment period so long as interest rates are not increased. It might be more realistic, however, to assume that lenders ascribe a high degree of risk to granting long-term

¹For a discussion of simple annuities refer to any standard text on the business mathematics, e.g., Hummel and Seebeck, Mathematics of Finance, Ch. IV.

mortgages, and, as a result, do adjust rates of interest according to length of term. To simplify the analysis, consider the case where the mortgage market menu consists of only two loan plans: one involving a 4 per cent, 10-year loan; and the other, a 5 per cent, 20-year loan. The corresponding monthly payments per \$1,000 of original loan for these two options are \$10.13 and \$6.60, respectively. Once again, the "intra-personal" discount rate will implicitly influence the home purchaser's selection of loan plan, although this time the decision is a bit more complicated.

As an aid in analyzing this problem, the following table has been prepared using the present value formula:

TABLE V. PRESENT VALUE OF A SERIES OF n MONTHLY PAYMENTS OF R DOLLARS, DISCOUNTED AT A YEARLY NOMINAL RATE OF d PER CENT, CONVERTED MONTHLY

<u>Discount Rate</u> (d)	<u>Present Value (A)</u>	
	<u>$R = \\$10.13, n = 120$</u>	<u>$R = \\$6.60, n = 240$</u>
4.0%	\$1000	\$1089
5.0	955	1000
6.0	912	921
6.5	892	884
7.0	872	851

If $d = 4$ per cent, neither plan would be attractive to the home buyer. Certainly he would not borrow \$1,000 if the present value of the monthly outlays were \$1,089. Furthermore, he would be indifferent as between a 10-year loan or no loan at all, for reasons described above.

At a 5 per cent discount rate, the borrower would definitely prefer the shorter-term mortgage, as the present value computations indicate. Similar observations are applicable to the situation where $d = 6$ per cent,

although the margin of preference has narrowed considerably. If $d = 6.5$ per cent, the 20-year mortgage is actually chosen in favor of the shorter-term loan. By interpolation, the point of indifference is estimated to be in the region of $d = 6.25$ per cent. At this critical discount rate, present values are identical and the two loan plans appear equally favorable to the mortgagor. At lower rates, the 4 per cent, 10-year plan is preferred; and, conversely, at values of d above 6.25 per cent, the 5 per cent, 20-year plan is chosen.

This point of indifference was estimated by a process of trial and error. Unfortunately, an exact solution to the relevant equation cannot be found by elementary mathematical methods. This equation may be expressed in the following way:

$$R_1 \left[\frac{1 - (1 + d_1)^{-n_1}}{d_1} \right] = R_2 \left[\frac{1 - (1 + d_2)^{-n_2}}{d_2} \right], \text{ where } d_1 = d_2.$$

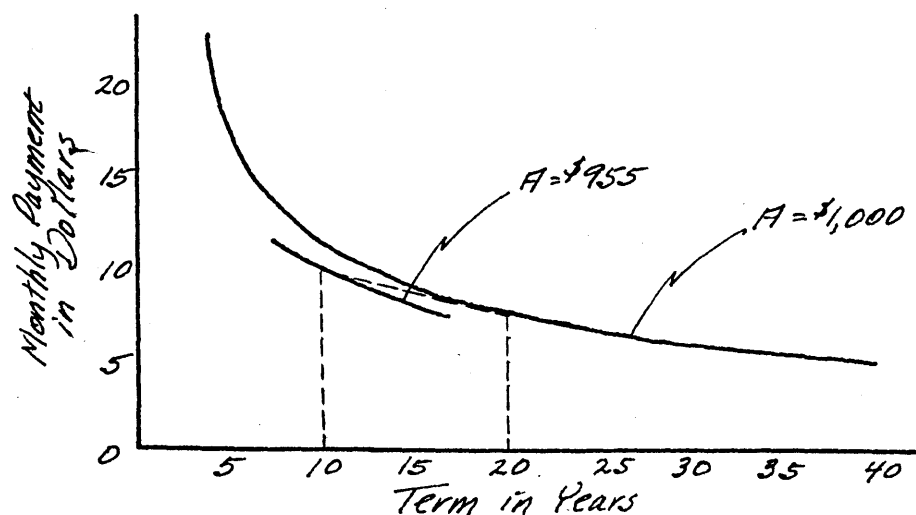
As stated at the outset of the present discussion, the concept of "intra-personal discount rate" is of limited practical value in analyzing mortgage market behavior. It may merely provide a partial ex post rationalization of an existing interest rate structure. This concept combines into a single rate a great many seemingly incommensurate variables, such as future income prospects, psychological time preference, expectations as to future interest rate changes, psychological desirability for a debt-free home, etc. Even in the absence of positive time preference, in the terminology of Irving Fisher, the home buyer may choose a relatively long repayment period despite the slightly higher interest rate imposed. Theoretically, an individual would consider it economic to pay cash for a home only if he possessed an unusually large sum of liquid funds not investible in ordinary higher income-yielding assets. In a

realistic sense, however, this statement demands serious qualification, for decided benefits, material as well as subjective, accrue to the owner of a debt-free home.

Certainly the home buyer does not consider his own particular discount rate in choosing one loan plan in favor of another.¹ Perhaps the most common, as well as the most important, criterion in making the selection consists of relating debt service to expected incomes. A 4 per cent, 10-year mortgage might entail a monthly payment schedule that is too burdensome for the mortgagor to carry safely, while the same loan may be easily handled if recast on a 5 per cent, 20-year basis.²

¹ Indeed, a single discount rate may be applicable to the individual's loan preference function only at a particular moment of time and over severely restricted range of loan amounts and terms. The rate may be different for each year up to a certain point and then may approach infinity, etc.

² Carrying this theoretical analysis one step further, it is possible to solve these loan selection problems by means of a conventional indifference curve representation. Consider the example used in the text where the home buyer had the option of choosing either a 4 per cent, 10-year loan, or a 5 per cent, 20-year loan. To demonstrate this diagrammatic technique, assume a discount rate of 5 per cent. The continuous contours connect points representing monthly payment schedules to which the mortgagor is indifferent (i.e., where A is constant.)



2 (Continued) First locate the two monthly payment plans on the coordinate axis, which are \$10.13 - 10 years, and \$6.60 - 20 years in this example. Then sketch the relevant indifference curve through one of these two points. Now if the second point lies within the arms of this contour, the former indicates the preferred loan plan. Conversely, if it lies outside the contour, the second is preferable. Alternatively, indifference curves could be drawn through each point, and the curve bearing the lower present value (A) indicates the preferred plan. Accordingly, the 10-year repayment period is selected when $d = 5$ per cent.

CHAPTER 3. HOME MORTGAGE DEMAND IN METROPOLITAN BOSTON

Before concluding Part II, some additional characteristics of the Boston housing market will be reviewed. The implications of certain demand relationships will be developed in later chapters insofar as they influence mortgage lending operations.

ECONOMIC CHARACTERISTICS OF THE BOSTON AREA

Boston, while one of the oldest and largest cities in colonial America, has gradually waned in national prominence since that time. Although it is still the largest population center in New England, the Metropolitan Boston Area has declined in national ranking from fourth to sixth since 1920. Of the 32 largest metropolitan areas in the country, only Pittsburgh has shown a slower rate of growth during this period, the Boston Area having increased 28.5 per cent. Typical of most urban growth patterns, the City of Boston has grown much less rapidly than have the outlying suburban communities. The population of the City of Boston has advanced little over 10 per cent since 1920, with only Providence showing a smaller percentage gain among the 32 areas.¹

Growth patterns for the 6 largest metropolitan areas are indicated by the following table prepared by the National Industrial Conference Board:

¹Road Maps of Industry, No. 826, National Industrial Conference Board, October 26, 1951.

TABLE VI.

POPULATION TRENDS
CITY VS. SUBURBS, 1920 - 1950

Number of Persons (000)

<u>Central City</u>	<u>1950</u>		<u>1920</u>	
	<u>Inside</u> <u>Central City</u>	<u>Outside</u> <u>Central City</u>	<u>Inside</u> <u>Central City</u>	<u>Outside</u> <u>Central City</u>
New York- North- ern New Jersey	8,625.7	4,277.8	6,332.7	2,158.0
Chicago	3,621.1	1,873.5	2,701.7	820.1
Los Angeles	1,970.3	2,397.6	576.7	421.2
Philadelphia	2,064.8	1,595.9	1,823.8	890.5
Detroit	1,849.9	1,166.3	993.7	312.1
Boston	800.6	1,569.9	748.1	1,096.2

Source: Road Maps of Industry, No. 826, National Industrial Conference Board, October 26, 1951.

The gradual increase in total population in the Boston area is further suggested by observing comparative data on birth and death rates. In 1947, the birth rate per 1,000 inhabitants stood at 23.3 in Massachusetts against a national average of 25.8. Corresponding statistics on death rates were 11.2 and 10.1 per 1,000 inhabitants, respectively.¹ These significant differences suggest the existence of an older age distribution in the local area, perhaps characteristic of a relatively mature economy.

The composition of the Boston labor force and of business activity in general also reflects a mature, established economy. In accordance with its slower population growth, the local increase in number of workers has not matched that of the nation. During the decade of the 1940s, the total labor force in the Metropolitan Boston Area advanced only 8 per cent to 993.2 thousands, compared with a 13 per cent increase in the

¹Economic Almanac, 1950, p. 4.

United States.¹ Another major source of labor for the industrial expansion during the past decade has come from vast unemployed pools, which had declined from 168 thousand in 1940 to 56 thousand by 1950.²

The proportion of the population in the labor force is slightly higher in the Boston area than throughout the nation, largely because of women workers. Especially during the early 1940s a large number of women were attracted into full-time employment, so that by 1950 nearly a third of all women in the Boston area were actively in the labor force. In addition to the stimulus of wartime labor needs, the proportionately more significant role played by women in the local area is due in part to the urban concentration of population and the location of many firms offering extensive employment to women, such as insurance, finance, soft goods production and jewelry.³

Manufacturing continues to be the largest single source of employment both locally as well as nationally. These activities in the Metropolitan Area are widely diffused among the various major industrial categories, with nearly 275 thousand persons in 1947 employed in over

¹Business Record, National Industrial Conference Board, February 1952.

²The 1940 data refer to the Metropolitan "District." 1940 Census of Population, Vol. II, Part 3, Table A-50. Data from 1950 Census are presented in Business Record, February 1952, p. 70, and refer to the Metropolitan "Area." See Chapter 1.

³"The New England Labor Force," Monthly Review, Federal Reserve Bank of Boston, March 1952.

5,400 manufacturing establishments.¹ At that time, 11 per cent of this working force was employed in the electrical machinery industry, followed closely by the following, in order: food and kindred products, leather and leather products, other machinery, apparel, and printing and publishing industries. While the textile industry continues to represent a primary activity throughout New England, fewer than 11 thousand workers in Metropolitan Boston were employed in "textile mill products" in 1947. Heavy industries are relatively insignificant in the local area, as 3.9 thousand were employed in primary metals at that time.

Just as the Boston economy has approached a rather mature stage in its development, so also is a large proportion of its labor force in the older age brackets.² This consequence follows directly from the age distribution of a relatively stable population, but it is also influenced by the industrial structure. For example, a larger proportion of the gainfully employed persons are included in professional and technical groups in the Boston area than throughout the United States. The corresponding ratios for these groups in 1950 were 12 and 8.8 per cent, locally and nationally, respectively. The continuing shortage of such trained personnel has perhaps caused many individuals to remain on the job beyond the usual retirement age. Furthermore, the more mature New England industries may not offer the same ample opportunities for unskilled young workers as do the more rapidly growing industries concentrated in newer sections.³

¹1947 Census of Manufactures, Bureau of the Census, Volume III, Table 1.

²See Monthly Review, Federal Reserve Bank of Boston, September 1951. See also p. 50 above for data on birth and death rates.

³"The New England Labor Force," op. cit., p. 2.

With a high proportion of its labor force employed in the skilled, technical and professional occupations, it is not surprising that Massachusetts ranks above the average in per capita income payments. In 1950 per capita incomes in the Commonwealth were \$1,600, compared with a United States average of \$1,436. In accordance with its relative decline in population and economic prominence, the margin of local over national per capita income payments has steadily narrowed in recent years. In 1929, the corresponding average incomes were \$897 and \$680, and in 1940, \$764 and \$575, respectively.¹

THE BOSTON HOUSING MARKET

Inasmuch as most of the above demand factors reflect a mature economy, one might expect the local demand for new housing to be relatively stable and predictable.² Over the past three decades, however, the volume of new home construction has fluctuated widely in the Boston area, and the postwar era has witnessed a building boom of unprecedented proportions. Although population increased only 9 per cent between 1940 and 1950, the total number of households and occupied dwelling units in the Metropolitan Boston Area advanced 19 per cent. Over the same decade, the average number of persons per occupied dwelling unit fell significantly from 3.90 to 3.56. This disproportionate increase in occupied units reflects not only rising incomes but also an unusually

¹R. E. Graham, "State Income Payments in 1950," Survey of Current Business, August 1951, pp. 11-21. In 1949 the median family income in the Metropolitan Boston District was \$3,514. Business Record, February 1952, p. 70.

²Data on the age of housing are not available for various communities, but a casual observation of local standing homes indicates an abundance of century-old properties.

high rate of net family formation.¹

Fluctuations in local home building activity are indicated in Table VII, but unfortunately these data are not directly comparable with the national statistics presented earlier.² Local data refer to building permit applications in representative Massachusetts cities and towns, but the number of communities chosen for the tabulation has gradually been extended from 39 to 146. Since adjusted data for prior years are not always included when the coverage is expanded, it is impossible to measure the amplitude of cycles in local home building over the past 30 years. A further limitation on comparability arises from the fact that the permit data refer to the number of buildings constructed but give no indication as to the number of individual dwelling units included. Nevertheless, the severity of cyclical fluctuations in local home building may be deduced from data in Table VII. For example, nearly 12,000 new building permits were filed in 39 cities during the peak year 1925, while 9 years later the number of applications was but 1,314 for 55 cities and towns.³

¹In 1950, the marriage rate per 1,000 inhabitants in Massachusetts was 12.0, compared with a United States average of 11.2. Economic Almanac, 1951-2, p. 16.

²Chart I.

³Massachusetts Department of Labor and Industries. The fluctuations in number of dwelling units involved in these applications were even more pronounced. This belief is based on the fact that only 57.9 per cent of the applications referred to single family dwellings in 1925, while the share rose sharply to 98.0 per cent by 1934.

TABLE VII. BUILDING PERMIT APPLICATIONS FOR RESIDENTIAL PURPOSES IN
SELECTED MUNICIPALITIES IN MASSACHUSETTS, SELECTED YEARS,
1925-1950

<u>Year</u>	<u>Number of Municipalities</u>	<u>Number of Buildings</u>	<u>Estimated Cost (000)</u>
1925	39	11,795	\$ 117,366
1927	55	11,418	101,959
1934	55	1,314	9,513
1936	55	2,935	18,020
1940	55	4,896	32,720
1946	68	6,947	52,368
1947	68	9,049	73,346
1948	68	10,560	103,795
1949	68	11,718	137,609
1950	68	15,910	163,612

Source: Annual Summary Reports by the Massachusetts Department of Labor and Industries.

Periods of extensive home building activity are generally accompanied by a heavy trading in existing properties, as an increased demand for housing services manifests itself in the purchase of both types of dwelling units. Sellers of existing homes may prefer more expensive accommodations, may be moving out of the community, or may merely be willing to part with their asset at the prevailing high price level. Since approximately 90 per cent of all home purchases involve mortgage financing, a rough measure of transfer activity among both new and existing properties is supplied by data on mortgage recordings. In Table VIII, total mortgage recordings on 1- to 3-family properties are compared with postwar home construction activity in 5 communities in the Boston area. As would be expected, total mortgage recordings far exceed the volume of new home construction, although in relative terms this margin varies considerably. The mortgage index rose smoothly during the 5-year period under consideration, while the index of home construction followed a highly irregular path. Moreover, the latter index increased

TABLE VIII. RELATION BETWEEN NEW HOME CONSTRUCTION AND TOTAL MORTGAGE RECORDINGS ON 1- TO 3-FAMILY PROPERTIES IN FIVE* METROPOLITAN BOSTON COMMUNITIES, 1946-1950

<u>Year</u>	<u>No. of Homes Built</u>	<u>Index 1946 = 100</u>	<u>No. of 1 - 3 Family Properties Mortgaged</u>	<u>Index 1946 = 100</u>
1946	693	100	5551	100
1947	764	110	5859	106
1948	1574	227	6133	110
1949	1179	170	6389	115
1950	1814	262	7441	134

Source: Home construction data from Massachusetts Department of Labor and Industries; Mortgage data computed from tabulations of the Metropolitan Mortgage Bureau of Boston.

* Includes: Arlington, Belmont, Lexington, Newton, Quincy.

162 per cent between 1945 and 1950, while the former advanced but 34 per cent. This significant difference in relative movements suggests that the purchase of existing homes is not only quantitatively more important but also far more stable than the purchase of newly-constructed units, at least in prosperity periods.¹ Another factor which perhaps stabilized data on mortgage recordings refers to the unknown but substantial volume of refinance activity included in these data. It is likely that mortgage borrowing for purposes of home improvement or modernization is relatively unaffected by minor changes in economic conditions.²

Characteristics of Housing Stock in Metropolitan Boston

Boston is typical of most metropolitan areas in that single-family dwellings comprise a relatively small proportion of all residential

¹In depression periods, the index on new home building would drop to a fraction of the corresponding prosperity level, while the path charted by the index on property transfers would be less predictable. Although transfer of ownership of existing properties is undoubtedly less common in depression than in prosperity periods, many home owners are compelled to dispose of their holdings because of mortgage delinquency and foreclosure, inadequate income to maintain the property, etc.

²Such refinance activity bears an important influence on these data on mortgage recordings as number rather than dollar volume is the basis for the tabulation.

properties. In the local housing market, 2- to 4-family dwellings have traditionally been a favorite investment, accounting for slightly over one-half of all residential properties in 1950. At the same time, single-family units represented about one-third and large rental units about one-tenth of this total stock. (See Table IX.)

TABLE IX. DWELLING UNITS IN METROPOLITAN BOSTON BY TYPE OF STRUCTURE, 1940, 1950.
(Number in Thousands)

<u>Type of Structure</u>	<u>1940</u>		<u>1950</u>	
	<u>Number</u>	<u>Per cent</u>	<u>Number</u>	<u>Per cent</u>
All dwelling units	596.9	100	680.7	100
1-4 family	507.4	85	559.5	82
1 family detached	196.9	33	204.1	30
1 family attached	n.a.	n.a.	7.0	1
other 1-4 family	n.a.	n.a.	348.4	51
5-9 family	43.9	7	62.6	9
10 or more	45.6	8	58.6	9

Source: 1950 Census of Housing, Preliminary Reports, Series HC-3, no. 7.
n.a. - not available.

Although these data indicate a predominance of multi-family properties in the Boston housing inventory, the pattern of new construction has varied widely over the past 30 years. A complete breakdown on type of structure is not available, but the share of total residential construction represented by single-family homes is known for the Massachusetts communities referred to in Table VII. The building boom of the 1920s was concentrated in large part on multi-family units, and in 1925 such properties constituted 42.1 per cent of the number and 66.9 per cent of the estimated cost of total residential construction.¹ With the onset of the depression, investment in new rental housing appeared most unattractive, and by 1934 single-family units represented 98.0 per cent of the number and 97.8 per cent of the value of the severely curtailed

¹In this connection, multi-family properties refer to all but single-family units, i.e., they include all 2- or more-family properties.

production.

In the postwar period, there has been a renewed interest in multi-family construction, although the extent of this activity is far below previous peaks. In 1949 these efforts reached their highest postwar level when multi-family properties accounted for 15.3 per cent of the number and 47.9 per cent of the value of all newly-constructed residential properties in the Commonwealth. By 1950, however, the corresponding percentage shares had fallen to 8.4 and 24.1 per cent, respectively.¹

In a relatively free housing market these wide shifts in the composition of new construction would result from fundamental changes in the relative investment attractiveness of single- and multi-family properties. Since the early 1930s, however, a significant but uncalculable portion of these movements merely reflects modifications in federal housing policies. In postwar years, for example, the VA home loan program has stimulated an active demand for small owner-occupied homes, while changing FHA rental housing regulations² and extensive public housing activity have produced a fluctuating volume of multi-family construction. Public housing has never contributed as much as 5 per cent of new single-family construction, while in multi-family construction it has been far more significant, though highly variable. The ratio of public to private starts in 2- or more-family structures ranged from 0 in 1946 to a high of 6.20 in 1950. The peak year for public housing, however, was 1949 when 4,740 dwelling units were financed with public funds, all but 870 of which involved structures with 5 or

¹Massachusetts Department of Labor and Industries. These data correspond closely with BLS data on construction in the Metropolitan Boston area, the latter finding single-families to account for 58 and 77 per cent of all new dwelling units in 1949 and 1950, respectively. Construction, U. S. Department of Labor, May 1951, pp. 12-14.

²Especially regarding emergency provisions of Title VI of the FHA program. (Section 608.)

more units. In the same year private capital accounted for 8,170 new dwelling units, with 5- or more-family structures accounting for only 620 units.¹

By affecting the type of residential construction, federal efforts have directly influenced overall tenure status in the local housing market. Obviously owner-occupancy is far more prevalent in areas where single-family properties predominate than in large metropolitan areas where multi-family properties are most common. For example, in 1950 owner-occupied homes accounted for 31 and 44 per cent of all occupied dwelling units in the Metropolitan Areas of New York and Boston, respectively, while the corresponding ratio in the smaller Youngstown Area was 70 per cent.² Largely because of the postwar interest in single-family construction, however, the number of owner-occupied units in the Metropolitan Boston Area increased 50 per cent during the 1940s, while the number of rental units remained relatively unchanged. (See Table X.) In addition to positive federal encouragement of owner-occupancy, perhaps this behavior is due in part to negative effects of rent controls in curbing the construction of new rental structures.

TABLE X. TENURE STATUS OF DWELLING UNITS IN THE BOSTON STANDARD METROPOLITAN AREA 1940, 1950

Tenure	1940		1950		Change 1940-1950 Per cent
	Number (000)	Per cent	Number (000)	Per cent	
All occupied dwelling units	558.2	100	665.6	100	19
Owner-occupied	195.0	35	291.1	44	49
Renter-occupied	363.2	65	374.5	56	3

Source: 1950 Census of Housing, Preliminary Reports, Series HC - 3, No. 7.

¹Construction, U. S. Department of Labor, May 1951, pp. 12-14.

²Business Record, February 1952, p. 71. These ratios are perhaps even higher in smaller non-metropolitan areas.

Mortgage Indebtedness

The significance of mortgage indebtedness in any given housing market depends upon several factors. Since most new mortgages arise in connection with home purchase, the volume of recent purchases whether the properties be new or old is a primary determinant of overall mortgage status. Sample surveys conducted by the Bureau of Labor Statistics reveal that mortgage financing is involved in over 90 per cent of all new home purchases.¹ Undoubtedly mortgage financing is equally common in the trading of older properties, but in this case the buyer may, in effect, assume full liability for the partially amortized mortgage of the seller as part payment therefor, with the proportion of mortgaged among all properties remaining unchanged.² Where resort to mortgage borrowing is not required, the home buyer often applies the proceeds of a previous property sale to the present purchase. The degree to which the recentness of a home purchase influences overall mortgage status obviously depends upon the average life of the mortgage contract.

There appears to be a positive correlation between the significance of mortgage indebtedness and the population size of the housing market concerned. (See Table XI.) In early 1951 mortgaged properties as a proportion of total occupied units throughout the nation ranged from 33 per cent in "open country" to 57 per cent in metropolitan areas. Recent data are not available for the Boston area alone, but findings of the 1940 Census of Housing may reveal a reason for the apparent connection

¹Unpublished studies by the New England Office of the Bureau of Labor Statistics, U. S. Department of Labor.

²Under current mortgage lending practice, the seller is generally relieved of all existing mortgage obligations after the sale is consummated and after the lender has drawn up a completely new contract for the buyer. In the past, however, the existing note was often simply endorsed by the latter, but the original mortgagor was still technically liable in the event of delinquency or default.

TABLE XI. MORTGAGE STATUS OF OWNER-OCCUPIED NONFARM DWELLING UNITS, BY LOCATION OF PROPERTY, EARLY 1951

<u>Location of Property</u>	<u>All Cases</u> <u>Number</u>	<u>Per cent</u>	<u>Mortgaged</u> <u>Per cent</u>	<u>Not Mortgaged</u> <u>Per cent</u>
Metropolitan Area	495	100	57	43
City, 50,000 or more	238	100	58	42
City, 2,500-49,999	357	100	43	57
Towns, up to 2,500	269	100	40	60
Open Country	141	100	33	67

Source: "1951 Survey of Consumer Finances," Part V, Federal Reserve Bulletin, December 1951, pp. 1516-26, Table 3.

between mortgage status and population size. While 66.1 per cent of all local 1- to 4-family properties were mortgaged in 1940, the corresponding ratios for single-family and for 2- to 4-family units taken separately were 63.1 and 72.7 per cent, respectively.¹ From these data, it appears as if purchasers of 2- to 4-family properties must resort to mortgage financing more frequently or for longer periods of time than do single-family buyers. Since the former properties tend to predominate in large urban centers, it may be expected that mortgaged properties are most widespread in such centers.

Prices of Homes in Metropolitan Boston

Except for partial coverage during the postwar period, data on average home prices are almost totally lacking for the local area. Permit data presented in Table VII are of limited assistance, as they refer only to the total number of buildings constructed and their estimated cost, but give no indication of cost per family dwelling unit. More detailed information for the years 1946-50 has been obtained in regard to permit applications among 18 communities in the Boston area. In these cities and towns, average construction cost per unit shows a consistent upward trend, rising from \$4.49 thousand in 1946 to \$8.92 and \$9.57

¹1940 Census of Housing, Volume IV, Part 2, Table E-1.

thousand in 1949 and 1950, respectively.¹ Sample surveys conducted by the Bureau of Labor Statistics reveal similar average construction costs for late 1949 and mid-1950 of \$8.3 and \$9.6 thousand, respectively. These latter data refer to actual costs on single-family homes started², while the former are cost estimates filed with permit applications.

These data relate only to costs of construction, and, as analyzed in the theoretical section, may not follow trends in actual market valuations very closely. Although production costs had fallen somewhat between the mid-1920s and the early 1930s, informed judgment of interviewed parties points to a much sharper decline in current real estate prices during that period. By 1940, the "average value" of single-family properties as used in census tabulations had reached \$5,642 in the Metropolitan Boston District.³ During the postwar period the local housing market has enjoyed boom conditions, and, except for 1949, new construction and home prices rose steadily through 1950. The brief economic reversal in 1949 was accompanied by a 25 per cent drop in new home construction in the 5 communities of brisk housing activity.⁴ In addition, the upward drift in home prices was temporarily checked, as the average purchase price in 10 local communities fell nearly 4 per cent from the

¹Massachusetts Department of Labor and Industries.

²Construction costs as defined by the BLS include all labor, materials, subcontracted work, and contractor's profit chargeable directly to the project. Land development costs and sales profits are excluded from this coverage.

³1940 Census of Housing, Vol. IV, Table E-3. The reliability of "average value" usually depends upon the accuracy of the home owner's estimate of what his property is "worth" -- hardly a scientific appraisal in most cases.

⁴See Table VIII.

1948 level. (Table XII.)¹

TABLE XII. AVERAGE SALES PRICE OF ALL HOMES PURCHASED IN TEN MUNICIPALITIES* IN METROPOLITAN BOSTON, 1948-1951.

<u>Period</u>	<u>Average Purchase Price</u>	<u>Period</u>	<u>Average Purchase Price</u>
1948- First Quarter	\$12,366	1950	\$11,975
1949	11,889	1951	13,304

Source: Computed from tabulations of the Metropolitan Mortgage Bureau, Boston

*Including Belmont, Arlington, Dorchester, Quincy, Lexington, Medford, Newton, Somerville, Winchester and Roxbury.

Another, perhaps more exact, method of measuring movements in real estate valuations involves a comparison of resale and original prices for the same properties. Of course, this technique is of real utility only when the resale follows the initial purchase rather closely, lest the price comparison might take account of property depreciation or obsolescence as well as overall market trends. To minimize this possibility, the following data refer to resale activity only if the property had been initially purchased within the preceding year.

TABLE XIII. RESALE ACTIVITY IN MIDDLESEX AND NORFOLK COUNTIES, MASSACHUSETTS, 1946-1951

(Resale of same parcel within a one-year period)

<u>Year of Sale</u>	<u>Middlesex County</u>			<u>Norfolk County</u>		
	<u>Number of Sales</u>	<u>% of \$ Increase in Total Sales Revenues</u>	<u>% of Sales at same or lower price</u>	<u>Number of Sales</u>	<u>% of \$ Increase in Total Sales Revenues</u>	<u>% of Sales at same or lower price</u>
1947	799	17	16	n.a.	n.a.	n.a.
1948	366	11	15	129	13	16
1949	389	6	33	142	3	39
1950	351	10	17	133	8	25
1951	354	14	9	132	14	10

Source: Metropolitan Mortgage Bureau
n.a. - not available.

¹While prices fell slightly, average construction costs as indicated by permit data continued to increase nearly 12 per cent between 1948 and 1949. Massachusetts Department of Labor and Industries.

The temporary setback in 1949 is most pronounced in these data. Total sales revenues showed very little change, and one-third of all property resale activity was made without any advance in price. The subsequent recovery was prompt and certain, however, and by 1951 an upward drift in prices was once again well in evidence.

PART III. SUPPLY FORCES: THE MORTGAGEE

CHAPTER 4. SOME INSTITUTIONAL AND THEORETICAL CONSIDERATIONS

The mortgage market is closely tied to external developments in the industrial and financial sectors of the economy. The inherent connection between the demand for home mortgage credit and the overall housing market has been analyzed in the preceding chapters. On the supply side, the availability of loanable funds for home financing is closely related to the outside capital market. It will be shown that certain types of institutional lenders are obliged by law or custom to invest in home mortgages regardless of minor developments in other loanable funds markets. By and large, however, mortgage loans compete with alternate investment opportunities in attracting the funds of credit suppliers. Specifically, they must compare favorably with securities or other investment outlets in regard to these generally accepted criteria: safety, liquidity, shiftability, and yield. Whether or not mortgage loans have succeeded in providing these desired investment characteristics will be considered in some detail throughout this study.

At the present time, the availability of home mortgage credit is largely influenced by the efforts of three major lender types operating in the market. The conglomerate of private individual investors constitutes the oldest and still a substantial source of mortgage funds. The second, and perhaps most significant, type of mortgagee includes the various private institutions seeking mortgage loans as an investment outlet. Mortgage lending serves a variety of functions for these institutions. Conventional thrift associations act as middlemen in channeling the flow of community savings into the capital funds market, and as such originate and hold mortgage loans to maturity. Other specialized institutions, frequently called mortgage companies, operate in the market

primarily to initiate mortgage loans for the purpose of reselling them to others at a profit. These brokers, ordinarily with limited capital resources, may or may not maintain a standing inventory of mortgage investments from which sales are made to other financial institutions. The latter select mortgages for investment purposes just as they might purchase any public or private security, and may include the identical thrift institutions referred to above. Quantitatively more significant within this category, however, are life insurance companies, which purchase huge amounts of sound mortgage loans on distant properties. In either case, the original mortgagee or broker is ordinarily engaged to service the mortgage after it has been assigned to a permanent holder.

The third dominant power in the home mortgage market, the federal government, has so far played a minor role as a direct source of mortgage credit. Only in emergency periods has this function been authorized, such as during the depression when the HOIC program was in full swing. In the postwar period this activity has been reinstated in another form, that of granting direct loans to veterans where comparable liberal credit accommodations are unavailable through private channels.¹ Nevertheless, the bulk of federal intervention in the home mortgage to date has been less direct but fully as positive in its impact. The institutional nature of this intervention will be considered in Part IV, with specific reference to the Boston area being taken up in the succeeding Parts V and VI. The balance of the present section will be concerned with the development of the first two types of mortgage lenders.

¹Actually this "direct" lending program differs only slightly in degree from the inflationary advance commitment procedure followed by FNMA, especially in the years 1948-50. See Chapter 14.

DECLINE OF INDIVIDUALS AS MORTGAGEES

Inasmuch as individual home ownership has long been promoted in this country, one might anticipate an early development of a well-coordinated system for financing home purchase. Actually, however, for many years home credit needs were supplied in large part by individual lenders, whose operations have been generally undisciplined and unrestricted down to the present day. Even with the emergence of more specialized institutional lenders, positive steps toward coordination and uniformity are of relatively recent origin, with the result that mortgage lending practices have traditionally varied widely from city to city, and within communities as well.

So long as the United States was predominantly an agricultural economy, most families were housed on farms and did not seek home mortgage credit as such. At that time, financing land settlement and improvement was generally supplied by individuals and by various state and private banks. During the early nineteenth century, however, the movement to urban centers gathered momentum and families acquired property solely for home occupancy as distinct from any agricultural or commercial venture. Various types of lending institutions emerged to meet these new home financing needs, especially in the more industrialized eastern regions of the nation, and the shortcomings of individuals as lenders became increasingly evident. The geographic area served by an individual was severely restricted, as he could invest his limited savings only in mortgage loans where the pledged property was nearby and familiar to him. Moreover, the scope of his lending operations were ordinarily too small to permit a well-diversified portfolio and an efficient servicing procedure. Lastly, he rarely was an expert at rating mortgage risk functions,

and ordinarily relied upon the time-honored debt-value technique exclusively. Hence, institutional investors appeared far better adapted for efficient home mortgage operations, and the decline of the individual as a mortgagee was inevitable.

Despite these shortcomings, the individual continues to perform a vital function in localities where specialized institutions are either absent, unable, or unwilling to supply mortgage credit needs. The first condition applies more generally to newer sections of the country where thrift institutions have never achieved the prominence typical of the Northeast. The "unable" circumstance frequently arises when limited cash savings compel a home buyer to seek an aggregate loan exceeding that obtainable from a savings institution. Under these circumstances, the buyer may request a supplemental second mortgage loan from an individual lender. The "unwilling" situation may be a corollary of the preceding one, where institutions refuse to approve certain loan requests because of inferior mortgagor credit, poor property construction, or undesirable location. The individual may originate the mortgage himself, or he may purchase it through a broker or mortgage company that perhaps has been unable to sell the paper to a conventional thrift institution. Where the individual lender is concerned, purchase-money mortgages are quite common under which he, as seller of the property, accepts a mortgage in part payment therefor. Purchase-money mortgages are generally sought to supplement other borrowed funds, although they may also represent a first lien.¹

¹The individual also played an important role in the large-scale bond financing during the 1920s. To finance the purchase of hotels and expensive apartments, individuals invested heavily in this salable paper issued in small, convenient denominations. Wickens, "Developments in Home Financing," Annals of the American Academy of Political and Social Science, March 1937, p. 75.

The individual has largely retreated from direct mortgage lending in many sections of the Boston market. Except under conditions outlined above, the private person has preferred to invest his modest savings in government and corporate securities, or else increase his savings account in a local thrift institution. By entrusting his funds with the latter, he indirectly invests in home mortgages but at the same time is spared the problems of servicing and maintaining a sound investment portfolio. In return for this convenience, the individual seeks safety above all, but does expect a modest interest yield consistent with this safety. He generally accumulates a savings account to meet some future expenditure, to provide for old age, or merely to establish an emergency reserve. Since he does not expect to use either principal or interest payments for current expenditures, the savings depositor is willing to give the institution a 30-day withdrawal notice, if necessary.

CIRCULAR FLOW ANALYSIS

As indicated in the preceding demand analysis, individuals ordinarily seek home mortgage credit either to finance the purchase of a new or existing property or to refinance an existing obligation.¹ Although there is no analytical distinction on the demand side as to whether a new or an older property is purchased, supply implications may be quite different. Indeed, when a newly-constructed home is purchased, the buyer, ordinarily with the aid of borrowed funds, injects purchasing power directly into the industrial sector through his payment to the builder. Such a purchase constitutes a real transaction in the national income sense, and is accordingly included in the accounts of real economic

¹In addition, an existing owner of unmortgaged property may need additional funds for any of a variety of reasons and may pledge his property as collateral. Such credit, however, is frequently sought in connection with property improvement and modernization, and hence is drawn up on a short-term basis.

activity.¹ The inflationary aspects of such purchases during expansionary periods have been recognized by the federal government, and efforts to curb these dangers are manifest in the credit regulations of Regulation X.

The purchase of an existing property, on the other hand, does not constitute a real transaction in the national income sense, and expansionary potentialities are perhaps less direct and clear-cut. Indeed, when the ownership of an existing stock of housing is redistributed throughout society, there is no necessary inflationary or deflationary bias involved. The seller of the property shifts the form of his asset holdings from a relatively illiquid house to cash or perhaps to a highly liquid thrift account. The buyer, on the other hand, acquires the ownership of a durable good in exchange for parting with some liquidity holdings as well as assuming a substantial mortgage obligation.²

If a mortgage is still attached to the property at the time of its resale, the lending institution ordinarily draws up a new mortgage contract, with the previous owner receiving the loan proceeds. Thus the latter is enabled to withdraw his equity from the mortgaged property as a result of the willingness of the lending institution to inject new funds into the mortgage market. During the immediate postwar period before extensive home building was underway, many existing home owners realized substantial capital gains through disposing of their property, whether mortgaged or not, in a brisk real estate market. Such gains

¹If, for example, the thrift institution financing the transaction were loaned up at the time and required added savings inflows, the loan proceeds would be supplied indirectly by new savings of depositors. On the other hand, depositors may merely be transferring some of their cash holdings into savings accounts which are but slightly less liquid.

²It is theoretically possible, though highly unlikely, that if the thrift institution were virtually loaned up when the buyer sought the mortgage credit, the seller could in effect supply the loan proceeds himself through making an immediate deposit of the full loan amount.

were made possible in large part by virtue of liberal mortgage credit availability, and such trading of existing properties undoubtedly had a definite inflationary influence.

As indicated earlier, a home seller is often obliged to take back a substantial purchase-money mortgage in order to complete the sale. In this event, however, there is no necessary flow of funds in the mortgage market, and the seller realizes liquidity from the transaction only as the attendant mortgage loan is repaid. Purchase-money mortgages, perhaps more than any other type of mortgage, are sorely lacking in marketability, and can be converted into cash only at substantial discounts if at all. The history of speculative builders in particular in accepting and discounting such second mortgages in selling excessively over-priced properties has been most unfortunate.¹

The refinance of an existing mortgage without change in ownership may require additional long-term credit only if the new contract increases the outstanding loan balance. Frequently the rewritten contract merely consolidates previous first, second, and even third mortgages into a single instrument. On the other hand, it may offer the mortgagor a more favorable repayment schedule, such as a term extension, interest rate reduction, more convenient periodic payments, etc. Especially in periods of vigorous competition among mortgage lenders, the home owner may find it advantageous to refinance his mortgage at the institution offering the most substantial "price" concessions. Provided he possessed reasonably complete knowledge of alternate loan plans, the mortgagor may employ a technique similar to that described in Chapter 2 in selecting the optimum combination of contract provisions.

¹See Chapter 6.

Straight-term and Fully Amortized Loans

The principal difference between straight-term and fully amortized loans upon the new lending operations of thrift institutions can be conveniently described by using a simple application of the Austrian "Period of Production" analysis.¹ The straight-term loan contract is analogous to the "point input-point output" case, whereby full repayment follows the granting of the loan by a specific time interval. Fully amortized loans, on the other hand, may be represented as a variant of the "point input-continuous output" case, whereby principal repayment is gradual rather than in a lump-sum amount.

Consider the case where a lending institution writes all mortgages on a fixed 3-year basis, and where all such loans are held until maturity at which time they are fully retired. When the contract specifies no amortization payments, the outstanding loan balance remains at the original level, say \$300, until repaid in full at the end of the term. If the annual volume of all straight-term mortgages made by a lending institution were valued at \$300, its outstanding portfolio could be represented as in Table I. Assuming no mortgage holdings at the outset, the thrift institution increases its total mortgage investment only until the earliest mortgages are retired, during which interval loans may be made either out of newly-deposited funds or out of idle investible resources. After 3 years, repayment revenues are sufficient to meet all new mortgage demands under the restrictive assumptions made, and the outstanding balance remains at \$900 indefinitely in the continuous case.² In this simple case, the "period of production" is 3 years, and the lender has a virtual turnover of capital within this period.

¹See, for example, E. Böhm-Bawerk, A Positive Theory of Capital, 1889, (Smart's Translation).

²In this simple model, interest payments are disregarded; perhaps it could be assumed that interest revenues exactly cover all administrative costs, dividend payments, and necessary reserve allocation.

As the term of the loan is extended, the thrift institution must continue injecting new funds into the active mortgage market for a longer period of time. For example, if the term were extended to 6 years, new savings or idle capital would be required for the initial 6 years, and the period of production would be doubled. Varying the loan term thus affects the period over which the lending institution (and indirectly the community of savers) must wait to realize full liquidity on a particular mortgage investment. The specific term is of utmost significance to the individual mortgagor, however, for the shorter repayment period entails a much more concentrated saving schedule on his own part. This consequence is reflected in a leading argument for 20-year mortgage loans: if the average home buyer is unable to accumulate sufficient equity to

TABLE I. COMPARATIVE PORTFOLIO COMPOSITION UNDER STRAIGHT-TERM AND FULLY AMORTIZED MORTGAGE LENDING

<u>Year</u>	<u>New Loans</u>	<u>Straight-term</u>		<u>Amortized*</u>	
		<u>End of Year</u> <u>Balance</u>	<u>Composition</u>	<u>End of Year</u> <u>Balance</u>	<u>Composition</u>
1	A-\$300	\$300	A-\$300	\$250	A-\$250
2	B- 300	600	B- 300	400	B- 250
3	C- 300	900	A- 300	450	A- 150
			B- 300		B- 150
4	D- 300	900	A- 300	450	A- 50
			D- 300		D- 250
			C- 300		C- 150
			B- 300		B- 50

*Assuming "straight-line" amortization, with continuous new lending at an annual rate of \$300.

repay his mortgage in less than 20 years, it is unrealistic to write this long-term obligation with a short-term instrument.

The most popular variant of the fully amortized loan type calls for level monthly payments over the entire loan term, thereby producing an accelerated amortization schedule as maturity is approached. Early payments consist of interest charges for the most part, while as the

term progresses this share declines steadily. To simplify the analogy of such contracts to the "point input-continuous output" case, assume that the unpaid principal balance diminishes continuously through "straight-line" amortization. In other words, for each 3-year loan made, the lending institution realizes a continuous inflow of amortization sums equivalent to one-third of the original loan amount within every 12-month period.

The right-hand side of Table I has been drawn up under the same basic assumptions as the left-hand side, except that loan contracts specify full amortization rather than lump-sum payment at the end of the 3-year term. In either case, a type of equilibrium is reached at the end of 3 years, after which time repayment sums are sufficient to maintain the hypothetical circular flow. When fully amortized loans are considered, however, the "period of production" is halved, and even though complete retirement requires 3 years, a lending institution with a balanced portfolio has a turnover of loan capital every $1\frac{1}{2}$ years.¹ In the latter case, amortization revenues supply an increasing share of new loan requirements during the initial 3 years, with the amount rising from \$50 in the first year to \$250 in the third.

Certainly the assumption of continuous lending precludes a literal application of this analysis to the real world. Nevertheless, the behavior of a large mortgage lending institution with a well-balanced loan portfolio may approximate this theoretical situation. For example, if 20-year amortized loans had been made regularly and held to maturity, the mortgagee would have to place new loans each year valued at 10 per

¹i.e., the outstanding balance of \$450 divided by the new loan amount of \$300.

cent of its outstanding portfolio in order to maintain this balance.¹ Hence, as will be shown later, a \$100 million thrift institution faces continuing re-investment problems as substantial amortization payments are received every business day.

MORTGAGES AS AN INVESTMENT FOR THRIFT INSTITUTIONS

A mortgage lending institution is analogous to a water reservoir, in that it receives an inflow of savings from the community at large and directs these funds into worthy long-term investment channels. In so doing, it continually faces the conflict of seeking optimum profitability on these investments while preserving the safety of the funds entrusted to it. Individual depositors regard the safekeeping of their funds as the most essential function of the depository, but the universal adoption of public and private insurance programs has lessened the competitive advantage of an established safety record.² This consequence certainly does not imply that the safekeeping function has been relegated to a subordinate role, but rather that the discriminating depositor can now afford to expect additional benefits from the thrift institution. He has become more sensitive to convenience, both as regards location and ease of doing business, and may shop around among competing depositories in quest of maximum interest returns, consistent with safety. The relative achievements of competing institutions in the Boston area in meeting these changing demands of community savers will be discussed later in the

¹This is necessarily true when "straight-line" amortization is required, as shown in the above hypothetical illustration. Under the popular direct-reduction type of contract, there is a curvature in the amortization schedule, but the 10 per cent re-investment requirement would still be approximated in a large well-balanced portfolio.

²See Part IV.

section.¹

Although thrift institutions solicit only savings funds of a relatively long-term character, they must be prepared to meet most withdrawal requests on demand. Local savings and cooperative banks may require a 30-day notice from depositors and shareholders before withdrawals are paid, but, in practice, rarely exercise this privilege except in times of extreme financial stress.

If an institution wished to maintain absolute liquidity to prepare for the possibility of complete withdrawal, it would have to retain all deposited funds in cash. Any other possible use of the funds would impair their immediate convertibility. Certain investments, such as U. S. Treasury Bills and Certificates, permit a prompt recovery of cash with a minimum risk of loss. Such highly liquid assets, however, necessarily involve a sacrifice in the form of reduced interest income. At the opposite end of the spectrum are opportunities which offer the investor a less certain repayment of cash only after a long period of time. The chance of loss on such an investment is particularly high if the holder attempts to secure a cash recovery by selling the paper before maturity. As compensation for tying up funds in this manner, the investor ordinarily receives a generous interest return. Hence, the conflict between safety and profitability resolves itself in part into the conflict between liquidity and interest yields.

Established thrift institutions can utilize their past experience with depositors' funds in shaping an investment policy about a fairly predictable rate of withdrawal. To meet immediate liquidity requirements, a

¹Although total savings inflow may be relatively inelastic to interest rate changes, there is evidence of a considerable degree of "consumer" sensitivity to alternate dividend rates among competing institutions. See "Dividend Returns on Savings Accounts" in Chapter 5.

certain portion of these funds are retained as cash, deposited in correspondent banks, and invested in short-term government paper. The balance may be prudently placed in various longer-term investment outlets, notably mortgage loans. By an appropriate combination of maturities and amortization schedules, the mortgage portfolio may produce a flow of repayments that will assist in meeting anticipated withdrawal demands.

Mortgage loans have characteristically lacked any significant degree of liquidity or shiftability. Straight mortgages are highly illiquid, for the lender must await maturity before he has any contractual right to receive any principal repayment. Furthermore, the short-term nature of such loans has made it difficult for the mortgagor to retire his obligation even at maturity. As a result, the latter would frequently seek repeated loan renewals, aggravating the inferior liquidity of this investment. Amortized mortgages, on the other hand, are liquid to the extent that principal repayment is spread out over the entire loan term. For example, a level monthly payment type mortgage is amortized according to the following schedule:

TABLE II. AMORTIZATION OF PRINCIPAL ON A LOAN OF \$10,000 FOR 25-YEAR TERM AT 5 PER CENT INTEREST RATE

<u>End of Year</u>	<u>Amount Amortized</u>	<u>End of Year</u>	<u>Amount Amortized</u>
1	\$ 210	15	\$ 4500
3	650	17	5400
5	1140	20	6920
7	1690	22	8070
10	2610	25	10,000
12	3310		

Source: Insured Mortgage Portfolio, Federal Housing Administration, October 1938, pp. 14-15.

The equity component of the constant monthly payment rises rapidly as maturity is reached, especially during the latter half of the term.

Approximately a third of the debt is amortized during the first half of the term, while the last third is retired during the final 6 years of the repayment period. The preceding analysis on circular flows has indicated the effect of amortization in producing a continuous stream of repayments.

Shiftability generally refers to that quality of an investment which permits its conversion into cash via sale or rediscount. Liquidity and shiftability serve complementary functions in an individual investment portfolio, for the institution may need to carry only minimum cash reserves so long as its long-term paper can be readily turned into cash without heavy loss. Of course, for the whole system of institutional investors, the effectiveness of shiftability depends upon the existence of active buyers as well as sellers in the market, lest substantial capital losses be incurred. In the past, mortgage loans have not been shiftable to any significant degree. The potential resale market was severely localized at best, and even then few investors or institutions sought this unstandardized paper. Recent legislation, coupled with the growing popularity of amortized loans, has greatly strengthened and widened the secondary mortgage market.¹

The preceding discussion indicates how mortgages represent an increasingly desirable investment outlet for thrift institutions, at least so far as liquidity and shiftability are concerned. Before an overall evaluation of mortgage lending can be made, however, its safety and profitability characteristics must be analyzed.

A comparison of net yields on mortgage loans as against alternate investment yields can be made only after the various rates of return are reduced to a common base. The gross return on any investment includes

¹This legislation is summarized in Part IV and its influence is analyzed in Part VII.

compensation for three distinct elements. In the first place, all administrative costs of originating and servicing the investment must be covered. Expense rates in mortgage lending vary widely among institutions, according to type and size, as well as according to the type of loans made. For example, monthly amortized loans covering small homes are much more expensive to service, relatively speaking, than are straight-term loans or single loans on large income properties.¹

The second major component in gross investment yield consists of pure interest. This interest rate is the theoretical return which accrues to a riskless investment involving no service costs whatever. For practical purposes, the yield on government securities is taken as an approximate measure of this rate. Under equilibrium conditions in a perfect capital market, the pure interest component would be equal in all alternative investments.

The third major component implicit in gross interest rates consists of compensation for the risk assumed in making the investment. This element is not an absolute phenomenon, for every investment involves a risk of loss to a certain degree. The degree, however, varies widely among different classes of investments and within each class as well. Mortgage lending, for instance, may involve substantial risk, though highly variable, and the lender is accordingly justified in charging an additional return as due compensation for its assumption.

When a thrift institution finances a home purchase through making a mortgage loan, it converts into cash the present value of a series of payments promised by the mortgagor. The seller of the property may be either unable or unwilling to extend credit to the home buyer. Hence, the institution monetizes the mortgagor's obligation, and makes a cash

¹See pp. 87-88.

payment to the seller for his illiquid asset. The latter shifts the risk of full repayment on to the lending institution, which must then assess the home buyer the necessary premium for bearing this risk.

The fundamental risk in home mortgage lending concerns the possibility that the borrower may be unable or unwilling to fulfill the stipulated mortgage obligations, thereby necessitating foreclosure or some other loss adjustment.¹ This failure may stem from a wide variety of causes. The mortgagor may find the monthly debt service too burdensome for his impaired income stream at some point during the repayment period, because of illness, accident, unemployment, severe deflation, etc. Other factors which might increase mortgage delinquency and default result from the breaking up of the family, on account of premature death, divorce, etc. Even if the repayment schedule is not oppressive, the mortgagor may simply lack the proper motivation to maintain payments over the loan term. He may have lost his enthusiasm for home ownership in general. On the other hand, the value of the mortgaged property, because of obsolescence, neighborhood blighting, or severe physical depreciation may have fallen more rapidly than the outstanding debt balance. Accordingly, the mortgagor may have little incentive to continue accumulating a worthless equity in the property.

In the event of such a default, the mortgagee may call upon his second line of defense, that of foreclosure. This contingent claim on the pledged property affords the lender an opportunity to recover some or all of the unpaid principal balance when the mortgagor does default. Until the recent depression, mortgage lenders had placed an

¹Especially when mortgage delinquency is due to external economic conditions, the lender may prefer not to foreclose but rather to permit the existing owner to retain the property with the former recognizing his loss through reducing interest charges, reducing the outstanding loan balance, etc.

almost limitless confidence in the dependability of this hedge against loss. The disastrous loss experience of the 1930s, however, demonstrated beyond a doubt that proper risk analysis must consist of more than merely prescribing a reasonable debt-value ratio. History has shown that periods of economic crisis tend to be accompanied by waves of mortgage delinquency and foreclosure. The acquisition of mortgaged property has not guaranteed solvency in the loan portfolio, for the volume of foreclosures tends to vary inversely with general real estate activity and market valuations.¹ Hence, in a period of severe deflation, the sale of a property mortgaged during a period of prosperity would probably provide insufficient revenues to cover the unpaid debt balance and the expense incident to foreclosure.²

The effectiveness of the foreclosure option in minimizing mortgage risk is further diminished by the costly, time-consuming, and often unnecessary procedures required in many states. Statutory rules and regulations surrounding foreclosure proceedings and title acquisition vary widely across the nation. During the recent depression, redemption periods ran as high as 24 months in Alabama, whereas most states on the

¹This tendency is indicated by the following table, showing indexes of real estate activity in Boston and non-farm real estate foreclosures in Massachusetts, for selected years:

<u>Year</u>	<u>Real Estate Activity in Boston</u>	<u>Foreclosures in Massachusetts</u>
1931	109.7	n.a.
1934	73.6	124.6
1935	74.3	143.1
1936	80.9	106.2
1937	85.5	98.5
1938	78.8	75.6
1939	89.2	76.8
1940	100.3	66.2
1943	103.0	15.0
1945	134.4	6.8

Source: Reprinted from Lintner, Mutual Savings Banks, op. cit., Appendix Table X-2, p. 503.

²Especially if the mortgage were of the straight-term variety, or, if fully amortized, if it were relatively unseasoned.

Atlantic seaboard, including Massachusetts, had no such restriction. In connection with its operations, the HOLC found average costs of foreclosure to range from \$5.18 in Texas to \$354.30 in Illinois, with the corresponding figure for Massachusetts being \$29.08.¹

It should be repeated that the mortgagor's note constitutes the primary credit instrument, and the mortgage itself is merely a security device to protect the lender. If, however, the mortgagor defaults and also if subsequent disposition of the foreclosed property fails to cover the unpaid debt balance, the mortgagee may resort to the third line of defense. In this event, the creditor may issue a deficiency judgment against the other assets of the borrower, measured by the difference between the sale price and the amount of the debt. Its issuance is justifiable only if the judicial sale is conducted in a reasonably normal market. Otherwise, as has characterized depression foreclosure experience, the original mortgagee is the only active bidder at the auction sale, and hence may purchase property "worth" thousands of dollars for a mere \$100. This eventuality operates both as a windfall gain to the mortgagee and as a double loss to the mortgagor when deficiency judgments are readily enforceable.² To protect the mortgagor from such oppressive conditions a series of legislative measures and court decisions have progressively limited the overall effectiveness of deficiency judgments. Rather than abolish the right of issuance altogether, however, most states have sought an equitable compromise through setting up the "fair value" device as a guide in foreclosure sales.³

¹D. A. Bridewell, "The Effects of Defective Mortgage Laws on Home Financing," Law and Contemporary Problems, Autumn 1938, pp. 545-563.

²J. D. Popeat, "State Legislative Relief for the Mortgage Debtor During the Depression," Law and Contemporary Problems, Autumn 1938, pp. 529-936.

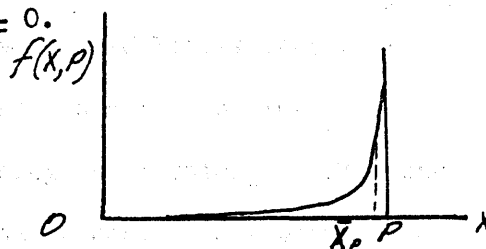
³Ibid., pp. 531-536.

MORTGAGE RISK AND PROBABILITY THEORY

It may be helpful to digress a moment and apply some elementary probability theory to the mortgage risk problem. Each mortgage loan gives rise to a risk function which could be represented by a probability distribution showing the relative likelihood of its being repaid fully or in any part thereof. To restrict our analysis to a simple example, consider the case of 10-year mortgage loans, where no principal or interest payment is made until the end of the term.¹ The probability distribution furnishes the lender with an "expected value," perhaps best identified as the mean of the distribution, which should be at least equal to the repayment sum on similar risk-free investments plus any differential administrative expense. In order to realize a given rate of return, the mortgagee would specify a repayment sum (P) larger than the corresponding expected value (\bar{X}_p).

This repayment function undoubtedly resembles a highly skewed distribution, with the specified repayment as a maximum but with no determinate lower limit short of zero. The expected repayment is a function of the parameter P, where the probability of any given repayment X is found from the implicit function $f(X, P) = 0$.

$$E[f(X, P)] = \bar{X}_p = \int_{X=0}^{X=P} X f(X, P) dx = g(P).$$



It is quite realistic to regard the modal repayment as coinciding with the required sum, while the expected value is necessarily less than or

¹This is, in effect, a straight discount type contract, which is still widely used by private home construction lenders, where the term rarely exceeds 6 months.

equal to this sum.¹

This hypothetical risk function would require some modification when the second and third lines of defense are taken into consideration. Effective losses on defaulted mortgage loans are substantially lessened when due allowance is made for subsequent revenues arising out of foreclosure sale and a possible deficiency judgment. The extent of the resulting adjustment in net returns may be indicated by the relation of net losses charged off at the time of sale to the total book value of the foreclosed properties sold by all Massachusetts savings banks.

TABLE III. NET LOSSES CHARGED OFF ON FORECLOSED REAL ESTATE AT TIME OF SALE, IN DOLLAR VOLUME, AND AS A PERCENTAGE OF THE TOTAL BOOK VALUE OF ESTATES SOLD BY ALL MASSACHUSETTS SAVINGS BANKS, SELECTED YEARS, 1926-1945.

<u>Year</u>	<u>Total Net Losses Charged</u> <u>Off at Time of Sale</u> <u>(000)</u>	<u>Net Losses as Percentage of</u> <u>Total Book Value of</u> <u>Estates Sold</u>
1926	\$ 13	1.13%
1929	212	3.30
1933	1,525	3.68
1936	2,584	7.61
1940	10,831	20.00
1943	13,471	31.60
1945	6,049	26.29

Source: Lintner, op. cit., Table 35, p. 279.

The fact that the dollar volume of these recognized losses increased steadily each year from 1926 through 1943 reflects the particular foreclosure policies followed by these lending institutions.² Professor Saulnier has conducted a sample survey of the foreclosure experience of 24 life insurance companies during the period 1920-46. During these

¹In discussions of uncertainty, economists have used the mode as well as the mean in referring to expected value, although the preference for the latter seems clear-cut here. See F. Lutz, The Theory of Investment in the Firm, Princeton University Press, 1951, pp. 179-180.

²See Lintner, op. cit., Chapter X.

years the loss on the disposal of foreclosed 1- to 4-family dwellings averaged 8.8 per cent of the lender's investment at foreclosure.¹

On individual transactions, dispersion (e.g., standard deviation) of the repayment probability distribution may be so high that loan terms are materially affected. Where a single loan is considered, there is a significant likelihood that the mortgagor's repayment may fall far short of (or, alternately, may well exceed) the mean value (\bar{X}). In this event, the assignment of P or, in effect, the contract rate of interest, depends largely upon the speculative characteristics of mortgage lenders. An individual lender may be regarded as balancing the "expected" return against some measure of the dispersion. Most lenders perhaps have a strong aversion to this latter risk, and would assume a wider dispersion only if the mean value were correspondingly increased.² For example, second mortgage loans have been made only at high rates of interest, partly because of a low X/p ratio, but also because of the lender's fear of a total loss of principal.³ The behavior of first mortgage lenders may be analyzed in a similar manner. Except in boom periods when orthodox risk rating is often forgotten in the inflationary spiral, conservative lenders may refuse loan applications even at premium rates, because certain mortgagor credit or property elements entail extraordinary risk. Instead of adjusting repayment sums (or interest rates) to reflect varying X/p ratios and σ , many lenders have adopted a policy of strict

¹Saulnier, *op. cit.*, Chapter VI, Table 28.

²Professor Lutz suggests that this "risk preference function" for an individual entrepreneur may be represented by conventional indifference curves, with the mean and standard deviation as the two parameters. Lutz, *op. cit.*, pp. 189-190.

³Their fears were not unfounded, as demonstrated by the widespread failure of second mortgage lenders during the early 1930s.

credit rationing, and thereby offer essentially identical terms to all qualified applicants.

When any lender is able to pool together many individual mortgage loans, he may benefit from the operation of the "law of large numbers." Actual repayment sums may show a wide variation from the true expected value, but, as the number of trials is increased, this variation decreases monotonically. The probable variation from the mean increases only with the increase in the square root of the number of cases observed (e.g., $\sigma_{\bar{x}} = \frac{\sigma}{\sqrt{N}}$). Hence, the actual approaches the expected experience as the lender expands his operations, and the element of uncertainty is correspondingly lessened.

To take a concrete example, consider a population of mortgage loans where the lender will either receive full payment (100 per cent) or nothing whatever (0 per cent). Provided each type were equally represented in the population, both as to number and loan amount, the expected value is 50 per cent of the specified repayment amount. If his "risk preference function" were ignored for the moment, the mortgagee would assign P so that $\bar{X} = \frac{1}{2} P$ would at least correspond to returns on alternative investments. Actually, however, dispersion is unusually high, and on a single loan, the lender would receive either 0 or 100 per cent of what he specified. If two loans were made, the probability of receiving exactly 50 per cent of the total P is $\frac{1}{2}$, and of receiving all or nothing, $\frac{1}{4}$ each. As the number of loans is increased, the range of probable repayment will concentrate more closely about the theoretical expected value of 50 per cent. This simplified illustration is admittedly unrealistic, for in the real world the lender may receive virtually any amount between nothing and full repayment from an individual mortgage loan.

As in any sampling process, it is important that the mortgagee strive

to eliminate any undesirable bias in selecting his loan portfolio. For example, if a sample of loans with similar risk characteristics were isolated, the actual repayment may vary widely from the expected value as determined by the past experience of the entire group containing a wide diversity of risk elements. Hence, unless the lender is purposely assigning his interest rates according to a special segment of the population, he should seek a random distribution of risk characteristics in his portfolio.¹

ADVANTAGES OF INSTITUTIONS AS MORTGAGE LENDERS

Institutional lenders, by including in their respective portfolios mortgages with differing types of risk elements, are generally the only type of mortgagee that are large enough to effectively utilize the law of large numbers. Although the success of many types of mortgage loans may depend upon similar variables, the relative influence of each variable may differ considerably. For example, a severe slump in a major industry may increase the likelihood of mortgage default throughout the economy, but it would spell almost certain loss in the localities immediately concerned.² To limit the total amount loaned on any single-risk element, the mortgagee often strives to distribute his loans over a reasonably wide geographic area, and avoids a heavy concentration in communities dependent upon the prosperity of a single company or industry. He may also seek to place mortgage loans on various types of property according to price range, neighborhood, architectural design, number of family accommodations, etc. To achieve a proper balance between mortgages and

¹Assuming, of course, that the lender has reasonably complete knowledge of the expected net yield for the entire population of loans, but not the various discriminant functions for particular segments, etc.

²The feast and famine plight of New England textiles and the many single industry communities serve as an apt illustration in this regard.

investments in the external capital market, a thrift institution may supplement mortgage lending with purchases of government and private corporate securities.

As a business enterprise, the thrift institution may enjoy decreasing average costs over a wide range of output. Average administrative costs of initiating and servicing mortgage loans, consisting largely of salary payments, appear to decline continuously as more loans are handled. Rental expense per \$1,000 of assets also appears to decline slightly as the size of institutions is increased. Among the major cost items, only advertising budgets increase more than proportionately with the increase in asset size. (See Table IV.) The role of advertising in securing and maintaining mortgage portfolios will be considered in some detail later in the study.¹

TABLE IV. AVERAGE EXPENSE RATES PER \$1,000 OF ASSETS FOR ALL MASSACHUSETTS SAVINGS BANKS AND COOPERATIVE BANKS IN MASSACHUSETTS, BY SIZE GROUPS, 1950

SAVINGS BANKS						
Year ending October 1950						
Size Group	No. of	Total	Expenses per \$1,000 of Assets			
Assets per Bank (millions of \$)	Banks in Group		Salaries	Rent	Advertising	Other
Under 2	6	\$7.56	\$4.97	\$.53	\$.10	\$1.96
2 - 5	26	5.76	3.52	.36	.18	1.70
5 - 10	47	5.88	3.45	.43	.23	1.77
10- 20	56	4.93	2.93	.37	.19	1.44
20- 35	26	5.15	2.86	.40	.26	1.63
Over 35	28	4.69	2.60	.37	.23	1.49
All Banks	189	4.92	2.76	.39	.22	1.55

COOPERATIVE BANKS						
Year ending April 1950						
Size Group	No. of	Total	Expenses per \$1,000 of Assets			
Assets per Bank (millions of \$)	Banks in Group		Salaries	Rent	Advertising	Other
Under 1	19	9.86	5.45	1.20	.35	2.88
1 - 2	54	8.97	5.29	.93	.31	2.44
2 - 3	28	9.09	5.16	1.00	.44	2.49
3 - 4	22	8.97	4.92	1.44	.39	2.22
4 - 5	18	8.51	4.80	.86	.45	2.40
5 - 7	17	8.51	4.41	.85	.66	2.59
Over 7	17	8.24	4.38	.85	.62	2.39
All Banks	175	8.68	4.73	.97	.52	2.46

Source: Annual Report, Massachusetts Commissioner of Banks, 1950.

¹See Chapter 12.

These data indicate that overall average costs of operation as a percentage of total assets tend to vary inversely with the asset size of the thrift institution. Among cooperative banks, average costs per \$1,000 of assets in 1950 were 16 per cent less in the highest than in the lowest size bracket. The corresponding range in average costs among savings banks was a significantly wider 38 per cent and was heavily influenced by the relatively high cost operations of the smallest institutions. This observation, however, does not necessarily apply to costs of mortgage lending or to profitability ratios. Moreover, no deductions can be drawn from these data alone as to the relative efficiency of the two types of local thrift institutions. As succeeding discussions will indicate, cooperative banks have traditionally invested much more heavily in mortgage loans than have savings banks. Inasmuch as mortgage loans, while high yielding, are among the most expensive to service in an investment portfolio, the higher expense ratios among cooperative banks are not surprising.

Within each institutional type, the appearance of "decreasing costs" probably indicates some real economies in handling larger mortgage portfolios. The inference follows directly, however, only if overall mortgage investment policy is relatively independent of the asset size of the institution. For instance, if the larger savings banks invest most of their deposits in government bonds while the smaller banks concentrate on mortgage loans, the hypothesis of decreasing costs in mortgage lending would be seriously questioned. Actually, size appears to have a minor influence on the ratio of mortgage loans to total assets; in 1950 this ratio was 35.8 per cent for the 5 largest and 34.9 per cent for all 56 savings banks in Metropolitan Boston.¹

¹Computed from Annual Report, 1950. See "Additional Comments on the Largest Institutions" in Chapter 12.

Furthermore, even if the mortgage-to-assets ratio appears to be independent of asset size, it does not necessarily follow from the above data that thrift institutions enjoy real economies in mortgage originating and servicing. These apparent economies may result largely from the type and size of loan made rather than from any inherent advantage accruing to the operation of a large portfolio. Even these "apparent" economies are an indirect consequence of size, however, for only the larger institutions are able and justified to make large individual loans on which administrative costs are admittedly minimized.

Specialized lending institutions become experts in the mortgage field, and real economies may result from spreading this "fixed factor" over many individual transactions. As specialists, they may directly minimize mortgage risk by scientifically analyzing the economic soundness of the proposed home purchase. After a careful investigation of the mortgagor and his capacity to assume the attendant financial obligations, as well as of the long-run value of the property, these experts may prescribe the appropriate mortgage plan, if any. Perhaps certain thrift institutions, obligated by law or custom to regard mortgages as their primary investment outlet, may readily compensate for this lack of diversification by thoroughly exploiting their role as mortgage specialists. This suggests a practical limitation to extreme diversification. As explained earlier, the law of large numbers is utilized to the best advantage when the various loans are spread over as many different risks as possible. Nevertheless, the small institutional lender may be wise to run the theoretical risks of geographic concentration of mortgage loans in order to operate in a locality where he is thoroughly acquainted with the borrower as well as the mortgaged property. Until mortgage lending practices become more scientific and standardized and until the

operation of the secondary home mortgage market approaches that of the organized stock exchange, small thrift institutions at least will continue to operate only in local markets where they possess an unusual insight or familiarity.

An objective analysis of a proposed home purchase certainly provides a real service for the mortgagor as well as for the mortgagee. The buyer is guarded against an unwise investment, with reference to the housing asset itself as well as to his capacity to carry the debt burden over the loan term. Undoubtedly such expert counsel may be highly desirable when any consumers (or producers) good is acquired. On the other hand, a transaction involving the purchase of an asset as expensive and as durable as a house perhaps merits special consideration, especially where the buyer is inexperienced and poorly informed, a universal characteristic of owner-occupancy.

CHAPTER 5. MAJOR SOURCES OF MORTGAGE CREDIT IN METROPOLITAN BOSTON

The prominent role played by individual investors in mortgage lending history has already been described. Such mortgagees are as yet subject to limited public regulation and supervision and little comprehensive data have been compiled on their operations. Individual investors may enter the mortgage market for a great many reasons, and may write loan contracts far different from those of specialized institutions. Their interest in the market may involve merely a small loan to a needy friend or relative; on the other hand, they may invest substantial sums in mortgages which often had been initiated by mortgage companies. They may seek speculative investment through buying heavily discounted second mortgages, or they may be virtually compelled to accept a second purchase-money mortgage in order to consummate a property sale. Specific reference to mortgage lending by individuals in certain local communities will be given in Part V.

The balance of this study will be concerned largely with the mortgage operations of various institutional lenders in the Boston area. Before making specific reference to these operations, however, some general economic characteristics of the dominant lender types will be summarized. The various local thrift institutions, including savings and loan associations, savings banks, and commercial banks, are described first, followed by brief reference to life insurance companies, credit unions, and miscellaneous institutions.

THRIFT INSTITUTIONS

The first type of mortgagee to be considered includes the various types of thrift institutions, which regard the promotion of savings as a common objective. These institutions compete with each other in attract-

ing the savings of the general public, and, in so doing, seek to pay generous dividends on the funds entrusted to them. As pointed out earlier, however, safety rather than profitability is paramount in the investment of their funds, largely because of the nature of their depositary functions. Furthermore, all local savings and loan associations and savings banks are mutual-type organizations and as such have no stockholders' equity to cushion the investment of the savings deposits entrusted to them. Although these institutions may serve similar ends, their methods of achieving a safe return on deposited capital varies widely, as evidenced by their investment portfolios.

Thrift institutions operate as intermediaries between the community of savers and the host of parties seeking these investment funds. Demanders of long-term credit may include home buyers, purchasers of other durable goods, private corporations, other financial institutions, governments, and many others. To provide additional funds for any one or all of these investment outlets, an operating thrift institution may require an inflow of savings capital from existing and potential depositors, attracted perhaps by offering higher dividend returns. Depending upon the sensitivity of savings depositors to interest rate changes, a differential increase in dividend rates may provoke a net inflow from the community at large or it may merely result in a redistribution of the existing stock of savings. Certainly interest elasticity is much greater for the individual institution, ceteris paribus, than for the aggregate of all depositaries. Nevertheless, a significant advance in dividend rates paid by one institution frequently stimulates prompt retaliatory action on the part of nearby competing institutions.¹

¹For some concrete evidence of interest elasticity, see "Dividend Returns" below.

If a thrift institution regards dividend adjustment or even advertising programs as ineffective or unsatisfactory in expanding savings accounts in the short-run, sound mortgage requests may be met through alternative methods. Some lending institutions may acquire investible funds through borrowing,¹ while most others must rely upon loan repayments and prepayments, as well as the sale of governmental and private securities, foreclosed real estate, and other assets. The degree to which an institution can rely upon these latter methods of course depends upon the composition of its investment portfolio as well as market conditions prevailing when liquidity is sought. For example, opportunities of securing additional loanable funds through converting government bonds into cash are extremely limited in the case of savings and loan associations which frequently place over 90 per cent of share capital in mortgage investment.² The first major source of home mortgage credit to be considered in detail is this latter type of thrift institution, for which mortgages represent the primary investment outlet, regardless of minor developments in the outside financial sector.

COOPERATIVE BANKS

Across the nation savings and loan associations provide the largest source of mortgage credit for home ownership.³ Some 4,500 associations are organized and operated under state charters, while an additional 1500 federal savings and loan associations operate under federal charters

¹At the present time, this option is available primarily to federal savings and loan associations; state-chartered thrift institutions, even if members of the Home Loan Bank, may not make new loans with borrowed funds.

²The existence of a heavy concentration of government bonds may guarantee liquidity to the institution, but perhaps only at a substantial sacrifice in the form of a capital loss. The effect of the bond market drop in early 1951 on mortgage lending operations of insurance companies is mentioned in Part VII.

³In 1950, these institutions held 29.3 per cent of the total mortgage debt on 1-4 family nonfarm homes. Housing Statistics, January 1952, p. 30.

pursuant to legislation passed in 1933.¹ State-chartered savings and loan associations, first introduced into this country in 1831, continue to operate under various names, including building and loan associations, homestead associations, savings societies, cooperative banks and others. Cooperative banks, the designation of such associations in Massachusetts and Rhode Island, have been active in financing home purchases in the Boston area since 1877. At the present time, there are 175 cooperative banks in the Commonwealth of Massachusetts, with 76 in the local Boston area covered in the present study. Regardless of the type of charter or name of institution, all savings and loan associations serve the two-fold purpose implied by this title: Providing a local depository for the "savings" of the community; and extending "loans" to finance home ownership.

Although considerable revisions have been made, the modern association continues to reflect the intent and policies of its earliest predecessors. The early society was essentially a closed group of prospective home owners who agreed to pool their savings toward this end. As soon as sufficient funds were accumulated, an auction was held to extend a home loan to the shareholder offering the highest premium over and above interest charges. When the last member had been accommodated, the mutual association was dissolved.

These small private arrangements have gradually evolved into a system of permanent institutions accepting savings from the general public and extending loans to any satisfactory borrower who agrees to purchase at least one share. The auction idea, however, was not forgotten in Massachusetts until the recent depression, for, unless by-laws

¹The total number of associations dwindled steadily from a peak of 12,804 in 1927, to 9,663 by 1936 and thence down to 5,980 by 1950. The earlier decline resulted largely from liquidations and the latter from merger activity. Over the 23-year period, however, total assets of all associations more than doubled to a 1950 figure of \$16.9 billion. Economic Almanac, 1951-1952, p. 145.

permitted otherwise, the prescribed procedure in granting loans to members involved

. . . the disbursal of accumulated funds at each monthly meeting . . . according to the premium bid by them for priority of right to a real estate or share loan, which shall consist of a percentage charged on the amount loaned in addition to interest, at a rate not less than 5 per cent per annum, payable in monthly installments.¹

Sources of Capital

Over their 75-year history, the range of savings plans offered by cooperative banks has been greatly enlarged, with the result that the depositary functions of the various thrift institution types are becoming more nearly the same. As a fundamental distinguishing feature of these institutions, however, cooperative banks have always promoted the habit of regular monthly saving among their patrons through a special incentive arrangement. Purchasers of serial shares agree to make payments at the rate of \$1 per share each month until the dues paid in plus any accumulated profits total \$200. When this value is reached, usually stretching over a period of approximately 12 years, the shares become "matured" after which the holder may withdraw the full amount if he so desires. Failure to meet regular monthly payments subjects the serial shareholder to a possible fine of 1 cent per month for each dollar in arrears, until the interval of delinquency reaches 6 months.² These fines, as well as penalties for withdrawal of funds prior to maturity, provide a real incentive for the shareholder to fulfill his initial intentions of systematic thrift.

¹General Laws of Massachusetts, Chapter 170, Section 21, as of 1932.

²Although many cooperative banks continue to enforce this fine arrangement, shareholders generally have the option to convert their account into a conventional savings account where regular savings are not required and dividend rates are little if any lower. From Interviews.

In order to more effectively serve community thrift needs as well as to permit larger scale operations, cooperative banks have progressively been authorized to augment their savings capital by other means. Frequently holders of serial shares at maturity were still earning satisfactory incomes and faced no immediate cash needs. Inasmuch as alternative investment outlets were severely limited unless the funds were placed in low-yielding saving bank deposits, shareholders welcomed the opportunity in 1914 to leave their matured shares with the cooperative bank at generous dividend rates. Six years later cooperative banks were also authorized to issue paid-up share certificates in denominations of \$200, thereby attracting large amounts of new capital from individuals who had not previously held shares.¹ Since May 1947, sources of share capital have been further expanded to include savings shares, whereby holders may deposit and withdraw funds at any time without fine.² Except for the provision that the balance be divided up into savings shares of \$200 each, this thrift plan is virtually identical to that available at all savings banks. Some cooperative banks offer additional savings plans, including club accounts, military share accounts, dividend savings accounts and others.

The same individual may purchase shares in the various categories, but his total participation in each is limited. These restrictions reflect a basic policy among such institutions of catering to the small saver lacking suitable alternative investment outlets. No less important perhaps is the desire to minimize the dangers of heavy sudden withdrawals by limiting individual holdings. An individual may hold up

¹ Davenport, op. cit., p. 11.

² Except in emergencies, when a 30-day withdrawal notice may be required.

to 40 serial shares with a maturity value of \$8,000, and in addition may accumulate paid-up shares and regular shares with a combined value of \$6,000. These deposit limits may be extended through the issuance of joint accounts, up to a total of \$24,000 and \$18,000 in the above categories, respectively.¹ Dividend returns on the various share accounts tend to vary inversely with the liquidity retained by the shareholder. For instance, serial shares involve an essentially long-term investment program, whereby the holder may actually prefer to borrow if necessary to avoid delinquency. Such a decision may be economically justified in view of the added dividend return on serial shares, but it largely reflects the desire to avoid the personal embarrassment of paying even a token fine. Savings shares, at the opposite extreme, afford the holder an opportunity to convert his balance into cash at any time without loss.² As of April 1951, the average dividend rates paid by all Massachusetts cooperative banks ranged from 3.17 per cent on serial shares to 2.15 per cent for savings accounts.³

The relative contribution of the various savings programs in the capital structure of cooperative banks has changed widely over the past 30 years. Although the serial share account continues to represent the largest single type of account, its importance has declined steadily in favor of alternate plans. Moreover, as fewer new serial shares are purchased, it would naturally follow that matured shares would also gradually decline in significance. Accordingly, between 1940 and 1950, the proportion of total liabilities represented by serial and matured shares com-

¹As might be expected, the average holdings are far below these legal maximums. For example, in April 1950, 329,450 members held 3,067,958 serial shares, for an average subscription of 9.3 shares per person. Annual Report, Massachusetts Commissioner of Banks.

²If he withdraws his funds prior to a dividend payment date, he may sacrifice interest returns for the current period, just as in the case of savings accounts in savings and commercial banks.

³See "Dividend Returns" below.

bined fell from 81.1 per cent to 61.6 per cent. (See Table V.) At the same time, paid-up shares have become increasingly popular, and field interviews reveal that many local banks have found a ready acceptance for the newly-authorized savings shares.¹

The significant decline in the purchase of unmatured shares is viewed with alarm by some ardent proponents of true cooperative banking, who regard a quasi-compulsory scheme as the best means of stimulating systematic thrift. Furthermore, they insist that the significant "product differentiation" found in serial shares would still command wide public acceptance if the plan were effectively promoted.²

TABLE V. PRINCIPAL SOURCES OF CAPITAL FUNDS IN MASSACHUSETTS COOPERATIVE BANKS, AS A PER CENT OF TOTAL LIABILITIES, SELECTED YEARS, 1920-1951

Year	Total Liabilities (millions)	Serial Shares*	Matured Shares	Paid-up Shares	Savings Shares	Guaranty Fund and Surplus	Other Liabilities
1920	\$ 174.0	88.9%	6.6%	0.3%	-	2.8%	1.4%
1925	369.3	69.9	18.1	6.2	-	2.8	3.0
1930	562.7	64.2	24.3	6.8	-	3.3	1.4
1936	456.2	48.4	35.1	8.8	-	5.7	2.0
1940	395.6	43.9	37.2	10.6	-	6.3	2.0
1946	482.8	40.2	32.3	15.9	.0%	8.3	3.3
1948	555.1	37.4	28.6	20.4	.8	8.7	4.8
1950	605.9	35.0	26.6	22.7	2.8	9.0	3.9
1951	646.9	32.8	**	48.6	4.9	9.1	4.6

Source: Annual Reports, Massachusetts Commissioner of Banks.

*Includes dues and profits capital on both pledged and unpledged shares.

**Matured shares consolidated with paid-up share certificates as of July 23, 1950.

Perhaps the growing popularity of savings and paid-up shares indicates that cooperative banks must compete with competing thrift institutions on a day-to-day basis, and can no longer rely upon long-term contractual arrangements to maintain a steady, predictable inflow of saving capital. This development may also result in an increased interest elasticity among alternate depositaries, as the previous predominance of serial shares provided an element of immobility to the flow of savings.

¹ Although the latter had accounted for only 4.9 per cent of total liabilities by April 1951; since July 23, 1950, matured and paid-up shares have been consolidated for reporting purposes. See Table V.

² See, for example, "Going Down" Cooperative Banker, Massachusetts Cooperative Bank League, August 1951, p. 7.

To provide a cushion against a possible impairment of the safety of share capital, cooperative banks are required to accumulate loss reserves out of net earnings. At each distribution of profits the board of directors must credit to the guaranty fund and surplus a certain percentage of their net earnings. These two reserve accounts are to be accumulated up to $10\frac{1}{4}$ per cent of a bank's total liabilities, after which an extra dividend must be declared. As the preceding table indicates, the reserve position of Massachusetts cooperative banks has improved steadily over the past 30 years, and the legal limit was approached by 1951. In addition to this assurance, cooperative banks are also protected by the State Share Insurance Fund, created in 1934.¹ This compulsory fund is supported by proportional annual assessments upon member banks, currently set at $1/12$ of 1 per cent of share and creditor liabilities,² in return for which all share accounts are insured in full.

Investment Opportunities

The investment policies of cooperative banks continue to reflect their initial objective of providing credit for home acquisition. Most of their funds are invested in first mortgages on owner-occupied homes, where the mortgagor is either an existing or a new shareholder. Until recent years the share-accumulation plan was almost exclusively used, under which the borrower would subscribe to a number of serial shares with a total maturity value equal to the loan amount. This cooperative form mortgage involves two separate contracts. The first requires monthly payment on a certain number of shares until the current value of the

¹ Acts of 1934, Chapter 73. See Part IV for a discussion of the institutional background underlying this legislation.

² The State Fund may also require five additional payments of $1/5$ of 1 per cent, each, but only one such call may be made within any year.

accumulated payments and accrued dividends equals the face amount of the mortgage loan. The second contract specifies a monthly interest payment on the full amount of the loan until maturity is reached.

The basic weakness of this plan, insofar as the borrower is concerned, is that the term of the loan is a function of the profitability of the cooperative bank making the mortgage. If general business conditions are favorable and the bank enjoys generous income flows, the debt may be extinguished within 12 years. If, on the other hand, the institution is compelled to reduce or suspend dividend payments during this interval, the period of repayment is correspondingly lengthened. In the event of bank failure, a common depression occurrence throughout the country, the borrower is still liable for the full debt and the share accumulation may be of limited value. Frequently this element of uncertainty in total debt service has weakened the borrower's incentives to maintain payments and, especially when terms are lengthened, has undoubtedly aggravated mortgage default.¹

While the mortgagor was subjected to adverse conditions external to his own control, the cooperative form contract has constituted a source of strength for the mortgagee. The bank is enabled to modify the effective rate on all its loans without technically altering any individual contracts on monthly payment amounts. When business turns bad, it merely reduces dividend payments, and existing debt repayment terms are automatically extended.² Only when the dividend rate on serial shares exactly equals the mortgage rate of interest is the effective rate equal to the nominal rate. The mortgagee also has a fairly effective

¹ Bodfish and Theobald, Savings and Loan Principles, Prentice-Hall, New York, 1938, p. 183.

² Davenport, The Co-operative Banks of Massachusetts, op. cit., 1938, p. 5.

hedge against loss of seasoned loans through refinancing elsewhere, for any withdrawal of pledged serial shares before maturity may subject the borrower to substantial reductions in dividend returns. This interesting mortgage type may be more readily analyzed by referring to a concrete example.

Assume that the home buyer seeks a loan of \$1,000 from his cooperative bank, and agrees to the terms of a 6 per cent cooperative form mortgage. Since the principal amount of \$1,000 equals the face value of 5 matured serial shares, he subscribes to a capital payment of \$5 per month until the debt is extinguished. The second element in the constant monthly debt service consists of an interest payment of \$5 per month. As explained above, the total number of level monthly payments required depends upon the dividends paid by the mortgagee. To take a relatively prosperous institution, assume a dividend rate of 5 per cent throughout the whole period. In this case, the loan is terminated after 146 months, found by using this simple annuity formula:

$$S = R s_{\overline{n}|i} = \$5 \overline{s}_{146} | 5/12 \% = \$1,000 \text{ (approx.)},$$

where S = the dated value of a set of 146 monthly payments of R dollars each at the end of the term, and i = interest rate per conversion period. If the less favorable dividend rate of 3 per cent were paid, the repayment period would be extended to 162 months, while a 6 per cent rate would terminate the mortgage after 138 months. In this latter case, the mortgage contract would appear just as any direct-reduction loan at 6 per cent. In order to compare the relative interest burden on these two types of mortgage contracts, consider the rate of interest on a direct reduction type when level monthly payments of \$10 are required for a 146 month term. Once again, using elementary annuity formulas, the effective interest rate is found to be approximately 6.5 per cent. Obviously, the effective rate on cooperative form loans increases as the spread

between dividend and nominal mortgage rates widens.¹

Because of unfortunate depression experience, the cooperative form mortgage has largely been abandoned in favor of the more popular direct-reduction type loan. Permission to extend this new type of mortgage was granted in 1935, undoubtedly hastened by federal intervention into the home financing field during this period. The HOLC, FHA, and federal savings and loan associations all prescribed this type of contract for all home loans coming under their jurisdiction.²

The primary advantage of the direct-reduction loan has already been alluded to above, namely, that the mortgagor can know at the outset the exact repayment period and frequently the effective rate of interest over the term as well. The monthly payment ordinarily includes a twelfth of the estimated real estate taxes on the property, and frequently hazard insurance premiums as well. Initially, the maximum permissible loan amount was \$8,000, whether the contract be of the share-accumulation or direct-reduction type, and the loan-value ratio was limited to 80 per cent. Gradually, however, the former restriction has been relaxed, and currently a cooperative bank may lend up to \$20,000 on single parcels of real estate, although the aggregate of loans over \$16,000 can never exceed 5 per cent of total assets.³ The 80 per cent loan-value limit still remains, however, and the unexpired term of any mortgage loan cannot exceed 20 years, except where the

¹An examination of cooperative bank annual reports and field interviews reveal that this spread was frequently very narrow. Actually, during the 1920s, some institutions were approaching a 6 per cent rate on both loans and shares, made possible largely by various fines and penalties as well as by revenues from invested reserves. These latter often covered all administrative costs for the lending institution. Since a large proportion of all serial shareholders withdrew their funds before maturity, these high dividend rates were not actually paid on all shares.

²See below for a description of federal savings and loan associations.

³Annotated Laws of Massachusetts, Chapter 170, Section 24.

loan is insured or guaranteed by the FHA or VA. To be eligible for a home loan, whether insured or not, the mortgaged property must lie either within Massachusetts or within 25 miles of the main office if in a contiguous state.

Until the recent depression, cooperative banks were virtually alone in writing fully amortized mortgages requiring level monthly payment over the repayment period. Since that time, however, the practice of putting debt retirement on a convenient income basis has enjoyed universal acceptance and is currently found in well over 90 per cent of all new home loans made in the local area.¹

Although cooperative bank lending is generally associated with the monthly payment type mortgage, these institutions also have limited authority to extend straight-term loans. So-called common form mortgage loans may be made for a maximum term of 3 years and up to 70 per cent of value. Amortization is required only during the period when loan-value ratios exceed 60 per cent.² Monthly payment loans may be converted into straight term loans provided repayment has already proceeded 4 years and the unpaid debt does not exceed 60 per cent of current value. As data on Boston cooperative banks indicate, these loans were most important during the depression, constituting about 4 per cent of total assets in 1936. Apparently a majority of these mortgages represented purchase-money mortgages written in connection with the sale of foreclosed real estate.

In addition to providing mortgage credit for home purchase, cooperative banks also extend loans to existing mortgagors for purposes of home modernization. This may involve the repair, alteration or improvement

¹See Chapter 11.

²Chapter 170, Section 23.

of the mortgaged property, or merely the purchase and installation of fixtures and durable appliances.¹ Shareholders may also obtain loans up to 95 per cent of the withdrawal value of their unpledged shares.² Similar to an insurance policy loan, these loans are of great convenience to a member in temporary distress when an outright withdrawal might deprive him of substantial dividend accruals. Although they constitute one of the safest possible bank investments, share loans have never assumed any great importance.³ The dollar volume of these loans increased during the early depression years, but continuing unemployment and loss of income forced many borrowing shareholders to withdraw their shares entirely.

Cooperative banks in Massachusetts concentrate their investment activity on home mortgage lending, and accordingly place about 80 per cent of their assets in this outlet.⁴ With the remaining 20 per cent, these institutions seek a more diversified portfolio while operating within the legal restrictions placed upon them. In order to meet unexpected demands for share withdrawals and share loans, they must establish and maintain adequate liquidity reserves. These reserves generally consist of cash and deposits in one or all of the following: the Cooperative Central Bank, a national bank or trust company, or the Federal Home Loan Bank. With the balance of their investible funds, cooperative banks may select bonds and notes from a restricted list prepared by the state supervisory authority.⁵ This eligible paper

¹Passed in Acts of 1945.

²Chapter 170, Section 25.

³This form of investment has always constituted less than 3 per cent of total assets since the First World War. Annual Report, Massachusetts Commissioner of Banks.

⁴Annual Report, Massachusetts Commissioner of Banks.

⁵Taken from the eligible investment lists for Massachusetts savings banks.

includes various government and private securities for which there exists a ready and reasonably stable market.

A cooperative bank may become a member of the Federal Home Loan Bank in the Boston District, and as such may invest up to 3 per cent of its assets in Bank stock. Up to the present time, 121 out of 175 cooperative banks in Massachusetts have availed themselves of this privilege.¹ As member institutions, they may borrow from the Federal Home Loan Bank up to their credit limit, although approval of the State Bank Commissioner is required for all advances above a minimum amount. Present regulations limit total borrowings of cooperative banks to 3 per cent of share capital or \$100 thousand, whichever is lesser.² Moreover, while the Bank System grants long-term loans for periods of up to 10 years, cooperative bank members may borrow up to a 1 year maximum, with renewals only where circumstances warrant. As of April 1951, "notes payable" accounted for less than 1 per cent of total liabilities among all banks in the Commonwealth.

All cooperative banks in the state are required to become members of the Cooperative Central Bank. This Bank, established in 1932, resembles the Federal System in its stated objectives of promoting elasticity and flexibility in the operations of member institutions. By pooling together a portion of their reserve funds, cooperative banks are afforded the opportunity to borrow from the Central Bank when additional liquidity is required. The Central Bank, along with the Share Insurance Fund, provides member institutions with the necessary machinery to

¹ Statistical Summary, Home Loan Bank Board, 1951.

² Interview, Federal Home Loan Bank of Boston. Under Chapter 195 of the Acts of 1936, cooperative banks were granted temporary authorization to borrow from any source to make real estate loans. At the present time, they are forbidden to make any loans with borrowed funds.

handle various emergency situations. When the Bank Commissioner examines a bank that appears to be in an insecure condition, he certifies this discovery to the Central Bank. The latter, in turn, operates the business until conditions permit its return to the original directors or until liquidation proceedings are completed. Whenever necessary to protect the shareholders of the certified bank, the Central Bank may require additional sums from the Share Insurance Fund.¹

Cooperative Banks in the Boston Area

The system of cooperative banks in the Boston area enjoyed a continuous growth both in number and asset size from a modest beginning in 1877 down to the recent depression. During the decade of the 1920s, total assets tripled and by 1929 the number of institutions reached a peak of 108 in the Boston vicinity and 228 throughout the Commonwealth.² Their growth pattern has followed rather closely the movements in general business activity, with share capital rising and falling with income levels. Often as soon as a small group of individuals believed their expanded saving and home purchase plans were sufficient to warrant a separate community institution, a new cooperative bank would be incorporated. So long as boom conditions prevailed, these small banks thrived on a prompt investment of heavy capital inflows, frequently to finance the purchase of homes at highly inflated prices. This business was generally acquired with a minimum of effort and expense, perhaps with only part-time management operating in cramped quarters. The inherent shortcomings of setting up undersized units in already overbanked communities became all too apparent as economic conditions tightened,

¹Davenport, op. cit., p. 6.

²It will be recalled that the restricted area considered in this study includes all communities within 10 miles of the Boston City Hall.

and many cooperative banks were effectively forced out of the mortgage market. Although no shareholder lost a dollar of his capital as a result of the recent depression experience, several banks were turned over to the Central Bank for liquidation, and many others found it advisable to merge their operations with stronger institutions in the same community.

The number of cooperative banks in the Boston area declined to 100 in 1936, and to 85 by 1940. Most of this loss, however, was due to the conversion of 16 banks into federal savings and loan associations, with the balance resulting from mergers and liquidations. Merger activity was not confined to depression expediency alone, for the total number of active banks steadily fell to 76 by 1951.

TABLE VI. NUMBER, TOTAL ASSETS, AND AVERAGE ASSETS OF COOPERATIVE BANKS IN THE BOSTON AREA, SELECTED YEARS, 1927 - 1951

<u>Year*</u>	<u>Number of Banks</u>	<u>Total Assets</u> <u>(millions)</u>	<u>Average Assets</u> <u>(millions)</u>
1927	103	\$272.1	\$2.64
1936	100	263.3	2.63
1940	85	231.0	2.72
1946	78	274.6	3.52
1947	77	291.9	3.79
1948	77	304.0	3.95
1950	76	325.6	4.28
1951	76	343.9	4.52

Source: Annual Report, Massachusetts Commissioner of Banks.

*As of October 31 through 1948; subsequent years as of April 30.

As these data indicate, the system of cooperative banks, though hard hit by depression losses, has perhaps strengthened its overall position in the local market since the booming twenties. This hypothesis will be more thoroughly examined later in the study, but a few remarks may be in order here. Many of the "sub-marginal" banks, perhaps functioning more as a social organization than as a true business, have been weeded out without material loss to shareholders. During the recovery period, the surviving institutions were able to increase their average asset level above that of 1927, despite the fact that the reduc-

tion in cooperative form mortgages meant an automatic loss of pledged share capital. Not only has the average bank strengthened its dollar asset position, but its guaranty fund and surplus has also mounted steadily, constituting 9.12 per cent of total liabilities by 1951.¹

In spite of these indications of growth, cooperative banks continue to function primarily as small, local sources of home mortgage credit.² The typical cooperative bank has between 3 and 4 shareholders for each mortgagor, has modest business quarters and currently operates with a total salary budget of \$15,000.³ Except for two institutions in the \$30 million class, each of the cooperative banks in the Boston area has assets holdings of less than \$15 million, with the modal size bank at less than \$2 million.

TABLE VII. SIZE DISTRIBUTION OF COOPERATIVE BANKS IN THE BOSTON AREA, APRIL 1951

<u>Asset Size Group</u> (millions of dollars)	<u>Number of Banks</u>	<u>Per cent of Total</u>
All Groups	76	100.0
0 - 1	4	5.3
1 - 2	17	22.4
2 - 3	15	19.7
3 - 4	13	17.1
4 - 5	7	9.2
5 - 7	9	11.8
7 -10	4	5.3
10-15	5	6.6
15 and over	2	2.6

Source: Annual Report, Massachusetts Commissioner of Banks, 1951.

Cooperative banks are strictly mutual-type institutions in that full ownership rests with the shareholders who share in all profits after operating expenses and reserve allocation have been met. Although this technicality still remains, however, the traditional mutual character

¹This percentage applies to all banks in the Commonwealth. See p. 101.

²See the discussion on geographic coverage of mortgage loans, Chapter 12.

³Computed from 1950 Annual Report, and applies to all 175 banks in the state.

of cooperative banking has gradually waned, particularly over the past two decades. Mortgagors are selected according to general credit acceptability, and their dual role as shareholder-borrower is merely a nominal requirement. Each individual member continues to possess voting power, but this privilege is seldom exercised, and policy determination generally rests with salaried management and an elected board of directors. Regular meetings are held every month for the whole membership, while certain members of the board meet each week to pass on mortgage loan applications.

FEDERAL SAVINGS AND LOAN ASSOCIATIONS

Federal savings and loan associations represent the federally-chartered counterpart to cooperative banks, which are subject only to state supervision. Authorization to charter these associations was granted in the Home Owners' Loan Act of 1933, one of the various measures enacted during the depression.¹ Depending on the adequacy of existing home financing facilities, federals could either constitute new institutions or merely involve the rechartering of established savings and loan associations. As pointed out above, many communities in the Boston area were already saturated with thrift institutions and there appeared little justification for new entrants. Accordingly, all local federals received their charters as converted cooperative banks, pursuant to enabling legislation passed in 1935.² Conversion was easily accomplished during the early years of the program, but since the late 1930s the task has become increasingly difficult.³

¹See a brief discussion of the institutional background in Part IV.

²Chapter 215, Acts of 1935.

³See "Federal Savings and Loan Associations in the Boston Area" below.

Federal savings and loan associations are similar to cooperative banks in most respects, except where matters of supervision and regulation are concerned. Regardless of charter, they represent privately owned and operated thrift institutions whose primary investment outlet involves home mortgage lending. While the organization of either type is technically mutual in character, most association members rarely participate in policy matters so long as satisfactory operations obtain. At annual meetings, they may exercise their voting privilege in electing a board of directors which guides the management and policies of the institution.¹

Unlike cooperative banks which operate exclusively under state jurisdiction, federal savings and loan associations are chartered and supervised by the Home Loan Bank Board. Board examiners thoroughly investigate the condition of each federal association at least once every year, and reports on current operations are required each month. As a condition of membership, a federal must also qualify as a member of the Federal Home Loan Bank System and of the Federal Savings and Loan Insurance Corporation. Membership in the latter two agencies is generally open to qualified state-chartered associations as well, and by 1950 nearly a third of all such institutions in the country had joined both systems.² Cooperative banks in Massachusetts, while permitted to become members of the Home Loan Bank, must subscribe to their own State Share Insurance Fund. The two alternate insurance programs are basically similar except that the coverage of the FSLIC is nationwide and conse-

¹In the case of cooperative banks, each shareholder receives one vote regardless of his holdings; in federals, an individual receives one vote if he is a borrower, or, as a saver, he may cast one vote for each \$100 in his savings account, up to a limit of 50 votes. Rules and Regulations, Section 144.1.

²Statistical Summary, Home Loan Bank Board, 1951.

quently more highly diversified so far as risk elements are concerned. Both are supported by proportional assessments upon the member associations, with the current annual premium equal to 1/12 of 1 per cent of share liabilities in either case.¹ Individual savings accounts in associations covered by the FSLIC are insured against loss up to \$10,000, while the State Fund insures their share accounts in full. Some cooperative bank executives regard the latter agency as unnecessary duplication and accordingly seek its abandonment in favor of the more extensive federal program. Many others vigorously maintain that every effort must be made to preserve the existing dual-system of banking.²

Savings Capital

The savings-investment facilities of federal saving and loan associations are basically similar to those currently provided by state-chartered cooperative banks. From the outset, however, federals departed from their previous reliance upon the serial share with its compulsory systematic thrift plan, and accepted savings shares of any amount at any time. They imposed no fines or penalties of any kind, and thus functioned much as any savings bank. This shift in emphasis away from quasi-compulsory systematic saving was then regarded as the essential difference between the two types of charter.³ Perhaps to the chagrin of orthodox cooperative bankers, this distinction has been substantially weakened now that savings shares are widely accepted by cooperative banks as well.⁴

¹The liability for additional assessments is 1/8 of 1 per cent yearly for FSLIC, and 1/5 of 1 per cent in the case of the State Fund.

²The relative merits of the two programs are discussed by Messrs. Chamberlain and Andrews in Cooperative Banker, June 1951.

³See Davenport, op. cit., p. 43.

⁴See above, p. 98.

The predominance of ordinary savings share accounts in the capital structure of federals does not imply an absence of alternate plans. Actually many associations offer a bonus saving plan which embraces the essential features of the conventional serial share account. Any member desiring a "bonus" agrees to make regular monthly payments of a specified amount on a savings account until its withdrawal value equals 200 times the agreed monthly payment--precisely the same matured value stipulated under serial shares. Provided the member fulfills this agreement, without a delay of more than 60 days in any payment and without any prepayment of more than 12 months, he shall receive a bonus of 1 per cent above the regular dividend rate. The bonus saving plan has an added feature for members who are forced to withdraw their accumulation before full maturity. A bonus is paid whenever the withdrawal value exceeds 50 times the monthly payment, with the bonus rate increasing by $\frac{1}{4}$ of 1 per cent for each such multiple of 50 up to a full 1 per cent. In any event, the bonus saver cannot receive less than the regular dividends.¹

Federal savings and loan associations generally offer a variety of other savings plans as well. Investment accounts are available in multiples of \$100, either in certificate or book form, on which semi-annual dividends are payable in cash. For the convenience of members, various special accounts are available, such as Christmas clubs, tax clubs, vacation clubs, etc. Unlike cooperative banks, federal associations are not required by charter to limit the maximum savings account held by one individual.

¹This flexibility in bonus plans offers genuine benefits to the typical saver as opposed to the orthodox serial share account. Davenport reveals that only 2 out of 5 serial shares reached maturity during a period when pledged serial shares were used directly in mortgage repayment. He states that the average life was but 4 years, which would roughly be equivalent to a $\frac{3}{4}$ of 1 per cent bonus in a federal association. Davenport, op. cit., pp. 33-34.

To supplement these sources of savings capital, a federal savings and loan association may borrow from the credit reserve facilities of the Home Loan Bank. Advances from the Bank System may be sought to meet unusual savings withdrawals or merely to make additional home loans.¹ Under its liberal charter, a federal association may borrow in the aggregate an amount equal to one-half of its savings capital from the Home Loan Bank and other sources.² This is in sharp contrast to the borrowing opportunities available to cooperative banks. Their Central Bank is primarily designed for assisting members in distress, and even affiliates of the Home Loan Bank may secure sizeable advances only with the permission of supervisory authorities.³ Actually, many local federals have relied upon extensive borrowing to maintain capacity lending operations and thereby to facilitate their rapid growth.

Investments

Although federal savings and loan associations place most of their capital in home mortgages, their overall mortgage investment opportunities are less rigid than those of cooperative banks. From the outset, they have been authorized to lend up to \$20,000 on an individual home, while cooperative banks were then limited to \$8,000.⁴ Under either type of charter, however, such loans may not exceed 80 per cent of appraised value, and must be repayable monthly within 20 years, except where insured or guaranteed by the FHA or VA.

¹Typical of most thrift institutions, federal associations ordinarily pay off withdrawal requests on demand, although a 30-day notice may be required.

²Rules and Regulations, Section 144.1(9).

³And never for the purpose of making new loans.

⁴Raised to \$10,000 in 1937.

Federals also may make straight mortgage loans under certain conditions. Provided the principal amount does not exceed 50 per cent of value and provided interest payments are made at least semi-annually, unamortized loans may be written with a maximum term of 5 years. Higher percentage loans are sometimes granted for shorter terms, with 80 per cent construction mortgages permissible for a term not exceeding one year.¹

The regular lending area of a federal association consists of the area within a radius of 50 miles from its main office, plus any additional territory which had been permissible while it operated as a state-chartered institution.² At the present time, loans guaranteed by the Veterans Administration are exempt from this provision, and hence may be initiated or purchased without regard to the location of the mortgaged property. Moreover, FHA-insured loans may be made or purchased without limit so long as the property lies within 100 miles of the association's home office, and even this restriction is waived with special permission.³

Under its charter, a federal savings and loan association may invest up to 15 per cent of its assets in mortgages without regard to certain of the above restrictions. Within this limit, an association may make mortgage loans exceeding \$20,000 on certain types of improved real estate other than home properties. The maximum loan-value ratio and loan term permitted on such mortgages depend upon the type of property considered. Within this 15 per cent limit, federals may also invest in mortgages on properties located beyond the regular lending area.⁴

¹ Rules and Regulations, Section 145.6-1

² For local associations, this latter area includes the Commonwealth of Massachusetts.

³ The total amount invested in the latter is included in the 15 per cent of assets group described below. Rules and Regulations for Insurance of Accounts, FSLIC, 1951, Section 163.9.

⁴ Rules and Regulations, Section 145.6-7. Most real estate owned and non-installment loans also come under this 15 per cent limitation.

Just as cooperative banks may make share loans, any federal association may extend loans on the security of its savings accounts, whether or not the borrower is the owner of such account. Under no circumstances, however, can the loan amount exceed the withdrawal value of the pledged account.¹ Unsecured loans may be made to home owners for purposes of property alteration, repair or improvement. Unless the obligation is insured by a governmental agency, such loans cannot exceed \$1,500 and must be repayable in regular monthly installments within a 5-year term.²

Other than mortgage lending, the investment opportunities of federal associations are quite limited. These other investments include the following: securities and fully guaranteed obligations of the United States government; stock of a Federal Home Loan Bank; and other obligations of these Banks. Federals may invest without limit in any or all of these alternative outlets.³

Federal Savings and Loan Associations in the Boston Area

Pursuant to enabling legislation passed in 1935, 16 cooperative banks in the Boston area had converted into federal associations by the end of 1937. Interviews reveal that several additional local institutions would have followed suit, had state banking authorities not stepped in to curb the movement. During 1937 alone, 12 cooperative banks from the Boston area relinquished their state charters by virtue of a required 3/4 affirmative vote of those members present and voting at a special meeting. Inasmuch as most shareholders in these mutual institutions failed to exercise their voting privilege, the supposedly stringent requirement

¹Section 145.7

²The property must be located in the regular lending area as defined above. Section 145.8.

³Section 145.9.

of a 3/4 vote was easily secured by a small group of federal supporters. The Bank Commissioner revealed that conversion had been effected on the average by the votes of approximately $2\frac{1}{2}$ per cent of all stockholders concerned, and at one meeting only 1.1 per cent of the membership were present to vote.¹ This easy desertion from the state ranks was brought to the attention of the legislature, and thereupon was promptly checked. Beginning in 1938, conversion could be accomplished only after a majority of all shareholders voted in favor of the measure, whether they be present at the special meeting or not. Five years later, cooperative banks were absolutely prohibited from relinquishing their state charter as an emergency wartime measure.² This clause was successively renewed into the postwar period as well, so that no new federals were chartered until late 1951, when a \$10 million suburban bank converted. Under current regulations, a two-thirds affirmative vote of all eligible shareholders is required for conversion.³

Certain advantages available to associations operating under federal charters have already been outlined. For example, the blanket insurance of all savings accounts up to a specified limit by a federal instrumentality undoubtedly appealed to many depression-ridden associations. Converting institutions perhaps regarded the word "federal" in itself as engendering a great deal of public confidence and assurance, while others were equally adamant in decrying this dangerous spread of federal influence.⁴ Undoubtedly personal and political views of the interested parties have heavily influenced any decision relative to conversion, whether the prevailing sentiment be affirmative or negative.

¹Annual Report, Massachusetts Commissioner of Banks, 1937, p. iv.

²The number of federal associations actually declined by one in November 1945, as a result of a merger of the Suffolk and First Federals.

³The majority requirement is found in General Laws, Acts of 1938, Chapter 163; the 2/3 requirement was first specified in the Acts of 1943, Chapter 243.

⁴From interviews.

The data presented in Table VIII, summarizing some salient features of the early converting institutions, may suggest additional motives for conversion.¹ The institutions which converted during these years were quite similar to the remaining cooperative banks in the state so far as average assets and age of institution is concerned.² From Table VIII, however, it appears that borrowed funds represented a much larger item in the operations of the converting associations than among those retaining their state charter. While most cooperative banks have never followed a policy of meeting liquidity needs through extensive borrowing, this account represented 2.1 per cent of total assets among the former institutions against less than 0.3 per cent for the latter. This contrast may reflect either unusually heavy withdrawal demands among converting associations or else a policy of seeking bank advances to make additional real estate mortgages. The opportunities for more extensive long-term borrowing from the Home Loan Bank System undoubtedly induced many of these cooperative banks to seek federal charters. All but four associations had already joined the Bank System prior to conversion, but their effective credit line was severely curbed by existing state regulations.

There is additional evidence to suggest that some of the converting associations were on the average less secure than the others. At their respective points of conversion, the average guaranty fund and surplus for the 16 associations represented 4.1 per cent of total assets, while the non-converters held reserves of 5.9 per cent. This rather sizeable difference is not due to the influence of an unusually weak member among

¹A similar analysis is used by Davenport in considering the conversion of cooperative banks throughout the state. *Op. cit.*, pp. 41-43.

²The years of original incorporation ranged from 1880 for Waltham to 1922 for Dudley; the average asset size of the 16 converting banks was \$2.34 million against a state average of \$2.04 million in 1936 for 187 institutions, and \$2.63 for 100 banks in the local area.

TABLE VIII. COOPERATIVE BANKS IN THE BOSTON AREA CONVERTING INTO FEDERAL SAVINGS AND LOAN ASSOCIATIONS 1935-1937

<u>Cooperative Bank</u>	<u>Location</u>	<u>Total Assets</u> (000)	<u>Guaranty Fund and Surplus</u> (000)	<u>Borrowed Funds</u> (000)	<u>Foreclosed Real Estate and Delinquent Loans*</u> (000)
<u>Converted in 1935</u>					
Dudley	Boston	\$ 641	\$ 21	\$ 63	18
Harvard	Boston	1,027	45	0	114
Union	Boston	310	14	0	55
<u>Converted in 1936</u>					
Ausonia	Boston	106	5	0	11
<u>Converted in 1937</u>					
Coolidge Corner	Brookline	763	21	89	174
Edward Everett	Boston	520	28	0	71
Faneuil	Boston	316	25	0	87
Home Owners	Boston	357	4	37	1
Inman	Cambridge	1,131	97	10	348
Suffolk	Boston	4,742	254	0	684
Waltham	Waltham	6,370	246	0	837
West Somerville	Somerville	3,539	181	100	634
Winter Hill	Somerville	6,599	265	476	2,126
Wollaston	Quincy	4,301	174	0	606
Metropolitan Boston	Boston	601	28	20	116
Boston	Boston	6,234	133	0	731
Totals for all 16 converted banks		37,557	1,541	795	6,613
Percentage of Total Assets		100.0	4.1	2.1	17.6
Totals for 187 non-converting banks, as of October 1936		382,499	22,528	1,105	63,563
Percentage of Total Assets		100.0	5.9	.29	16.6

Source: Annual Reports, Massachusetts Commissioner of Banks

*Sum of "Real Estate by Foreclosure" and "Loans on Real Estate Dues Temporarily Suspended."

the larger banks, for the low figure of 1.1 per cent belongs to small \$350 thousand institution. Actually all of the larger banks held reserves approximating this 4.1 per cent average, and only two smaller institutions exceeded this figure, with reserves of 7.9 and 8.5 per cent, respectively.

There appears to be no significant relation between depression mortgage losses and the propensity to convert. As indicated in the table, foreclosed real estate plus temporarily delinquent loans, taken

as a rough index of mortgage experience, constituted a slightly higher percentage of total assets among converting banks than among the remaining institutions.

These overall data on bank borrowings, reserve accumulations, and mortgage delinquency and foreclosure may indicate that some banks electing to convert had perhaps encountered more severe depression experience than the average, although this is not equally true in all cases. The largest cooperative bank converting during this period appears to have been in a singularly unfavorable position on all counts, save its reserve funds. This bank, whose assets represented one-sixth of the total for all 16 banks, held one-third of all foreclosures and delinquent loans, and had borrowed three-fifths of the total bank borrowings. Actually, only 7 out of the 16 associations held any such "bills payable," representing over 10 per cent of total assets in but two cases. On the whole, it seems reasonable to suggest that, while a few weak banks felt that little could be lost through conversion, others were among the strongest cooperative banks and regarded the new charter as an effective means of achieving a rapid growth.

From this humble beginning local federal savings and loan associations have enjoyed a phenomenal growth over the past 15 years. Most federals took advantage of their expanded borrowing opportunities and, coupled with an aggressive merchandising policy, found a ready market for their various mortgage loan programs. Specific reference to mortgage operations, as well as to the promotional efforts themselves, will be made later in the study. Federal associations, proud of these achievements, have widely publicized their rapid growth by pointing to their comparative asset position in 1936 and 1951. (See Table IX.)

TABLE IX. TOTAL AND AVERAGE ASSETS HELD BY FEDERAL SAVINGS AND LOAN ASSOCIATIONS IN THE BOSTON AREA, SELECTED YEARS, 1936-1951

<u>Year</u>	<u>No. of Associations</u>	<u>Total Assets</u> <u>(millions)</u>	<u>Average Assets</u> <u>(millions)</u>
1936	16	\$ 37.56	\$ 2.34
1940	16	63.04	3.94
1946	15	122.44	8.17
1948	15	148.32	9.90
1950	15	182.81	12.20
1951	16	199.35	12.46

Source: Northeastern Federal Savings League and Federal Home Loan Bank of Boston

* As of October 1936, or at date of conversion, whichever is earlier. Subsequent years, as of December 31.

While the asset position of the entire group shows a fourfold increase during the 15-year span, growth patterns of individual associations have varied widely. The association with the highest asset level at the date of conversion, mentioned above, experienced the slowest rate of growth, 62.3 per cent. The two largest federals today have grown roughly with the average, while the third and fifth largest have displayed phenomenal increases in total assets of over 68 and 24 times, respectively.¹

As stated above, liberal credit availability from the Home Loan Bank has undoubtedly played a prominent role in this growth picture. As of December 31, 1951, all 16 federal associations currently held advances from the System, varying in amount from \$50 to \$2,500 thousand. Total advances represented 10.0 per cent of aggregate share capital for the group, while this ratio approached 15 per cent for two associations. For the entire group, aggregate borrowings were equivalent to 46 per cent of combined cash and government bond holdings, but exceeded 100 per cent in the case of the heaviest borrowers.²

¹Home Owners Federal rose from \$357 thousand to \$24.4 million, and Brookline Federal from \$763 thousand to \$18.8 million.

²All these data are compiled from regular reports filed with the Home Loan Bank of Boston. The latter data refer to operating conditions as of June 30, 1951.

These advances are of several varieties. Throughout the 11 Home Loan Bank districts the outstanding volume of long-term, secured loans is half as large as that of unsecured loans with terms up to 1 year. In the Boston district, however, the directors follow a policy of promoting short-term advances almost entirely, so that these loans constitute nearly 99 per cent of the outstanding balance.¹ The local Bank regards unsecured loans as very desirable inasmuch as these constitute a lien prior to any shareholder claims in the event of default. Such loans are ordinarily granted to any qualified member borrower provided its total unsecured borrowings do not exceed 20 per cent of its share capital. No amortization is required where the term does not exceed 6 months, but quarterly principal repayment is required on 1-year loans unless secured by federal government securities or Home Loan Bank deposits.

While short-term loans are designed primarily to meet immediate liquidity needs, some local federal savings and loan associations have used long-term advances from the Home Loan Bank as a means of expanding mortgage lending activity. Although these secured loans are not widely used in this capital surplus area, the Bank is authorized to grant fully amortized loans with terms of up to 10 years. Currently the rate of interest charged on either type of loan is $2\frac{1}{2}$ per cent per annum, equal to the dividend rate paid by most associations on savings capital.² Since share accounts may involve additional administrative detail and expense, borrowing from the Bank may appear to be an economical method for financing a rapid expansion. Lest this privilege be indiscriminately exercised, local Home Loan Bank directors attempt to pursue a conservative lending policy, approving long-term loans only where genuinely justified.

¹Interview, Federal Home Loan Bank of Boston.

²On long-term advances, only the current "billing" rate is $2\frac{1}{2}$ per cent, but the "contract" rate is 3 per cent.

A comparative analysis of growth patterns among federal savings and loan associations as opposed to local cooperative banks indicates a much more rapid dollar expansion among the former. Average total assets in federal associations rose nearly $4\frac{1}{2}$ times between 1936 and 1951, against a 72 per cent increase among cooperative banks. Although non-converting local cooperative banks in 1936 were slightly larger than those converting, they are now hardly one-third as large, on the average, as federals. While local cooperative banks tend to be heavily concentrated in asset size classes under \$5 million, exactly one-half of the federal associations have total assets exceeding \$10 million. (See Table X.) The largest federal, at an asset level of \$35 million, is slightly larger than the leading state-chartered association, with the former increasing nearly 6 times since 1936 and the latter registering a less spectacular two-thirds increase.¹

TABLE X. SIZE DISTRIBUTION OF FEDERAL SAVINGS AND LOAN ASSOCIATIONS
IN THE BOSTON AREA, DECEMBER 31, 1951

<u>Asset Size Group</u> (Millions of dollars)	<u>Number of Associations</u>	<u>Per Cent of Total</u>
All Groups	16	100.00
\$ 0 - 5	2	12.50
5 - 7	4	25.00
7 -10	2	12.50
10 -15	3	18.75
15 -25	3	18.75
25 and over	2	12.50

Source: Federal Home Loan Bank of Boston

Similar to cooperative bank practice, federals are required to accumulate reserves by successive appropriations out of net earnings until a level equivalent to 10 per cent of share capital has been reached. Among the 16 associations in the Boston area, such reserves and undivided

¹See "Additional Comments on Largest Institutions" at the conclusion of Chapter 12.

profits represented approximately 8.4 per cent of aggregate share capital at the end of December 1951.¹ These ratios varied widely among the constituent members, however, ranging from less than 6 per cent to slightly more than 12 per cent, the latter referring to one of the largest local associations.

Largely because of the significant role assumed by Home Loan Bank advances, the liability structure of local federals differs somewhat from that of cooperative banks. Among the former, share capital and reserves accounted for 83 and 7 per cent, respectively, of total liabilities in 1951 while among the latter, the corresponding ratios were 87 and 9 per cent.²

MUTUAL SAVINGS BANKS

Quantitatively, mutual savings banks constitute the most significant institutional lender in the local long-term capital market. By accumulating and investing the modest savings of thousands of depositors, the 56 local savings banks in 1951 held total assets valued at over \$1.8 billion, well over 3 times the combined asset valuation of all 91 cooperative banks and federal savings and loan associations in this area.³ Although mortgage loans represent but one among many investment outlets, the predominance of savings banks in the mortgage market is no less certain.⁴

¹A simple average computed from individual data compiled by the Northeastern Federal Savings League.

²The latter figures refer to all 175 banks in Massachusetts as of April 1951. At that time "notes payable" represented only 0.44 per cent of total liabilities.

³Annual Report, Massachusetts Commissioner of Banks, and Federal Home Loan Bank.

⁴See Part V. In 1951 the dollar mortgage portfolio of the savings banks was greater than total assets of the above two groups of thrift institutions combined.

Historical Development

Mutual savings banks have a long and interesting history, dating back to their European origin during the late eighteenth century and their subsequent importation into the United States in 1816. In this latter year, mutual savings institutions were organized in Philadelphia and Boston, the latter bank still using its original title, the "Provident Institution for Savings in the Town of Boston." Founded to provide a safekeeping for the limited savings of the growing laboring classes and other lower income groups, this institution in 5 years held deposits of \$600 thousand and a surplus of \$6,200.¹ Commercial banks catered primarily to the financing needs of the merchant and well-to-do classes, and cooperative banks were not to appear for another half century. As a result of this virtual monopoly, Massachusetts savings banks, frequently termed "institutions" because of general antipathy to "banks," developed rapidly during the nineteenth century.² Accepting deposits of as little as five cents and meeting most withdrawal requests on demand, these institutions served the public well by providing convenience, safety, and reasonable profitability for their savings. By 1875, 180 savings banks had been incorporated, holding well over a million individual deposit accounts. At that time, nearly one person in two in the Commonwealth owned a savings account, with an average withdrawal value of \$330. During the following 75 years, the system of savings banks continued its steady growth until its 189 members held 3.2 million deposit accounts averaging \$1,032 in 1950.³

¹W. H. Kniffin, The Savings Bank and Its Practical Work, Banker's Publishing Co., New York, 1912, pp. 15-16.

²Welfling, op. cit., p. 4.

³Annual Report, Massachusetts Commissioner of Banks. In 1950 there was a deposit account for every 1.47 persons in Massachusetts. Obviously some duplication is inevitable as many individuals hold savings accounts in more than one bank.

Mutual savings banks have become firmly rooted in New England and the Middle Atlantic states, but have never flourished elsewhere. Although the more than 500 existing institutions are spread over 17 states, a heavy majority are found in Massachusetts, Connecticut and New York. Several sound reasons have been advanced to account for this geographic concentration.¹ The primary factor has undoubtedly concerned the unequal economic development of the country at the time when most savings institutions were founded. The more industrialized East had already produced a sizeable laboring class dependent upon money wages and sorely in need of a safe depository for reserves of various sorts. In the frontier West, economic activity centered about agriculture, mining and lumbering, largely individualistic pursuits. Any money saving which might arise from these operations was perhaps invested in speculative endeavors, and there appeared little need for philanthropic thrift institutions.

Financing needs of the growing West were generally provided by ordinary commercial banks, who alone had the power to create credit and thereby alleviate the continuing capital shortage. Moreover, savings banks, which regard safekeeping of depositors' funds as paramount, were prohibited by law or tradition from underwriting the extensive industrial and commercial needs of these entrepreneurs. As industrialization developed in the newer areas, there emerged a growing wage earning class seeking the services of a thrift institution. By this time, however, commercial banks were so firmly entrenched that demands for savings depositories were frequently met by the establishment of savings departments within existing institutions. Where commercial banks failed to sufficiently expand their services, stock savings banks and building and loan associations were organized.

¹See Lintner, op. cit., pp. 50-55.

Mutual savings banks and savings and loan associations are equally mutual so far as ownership of assets and distribution of earnings are concerned. In the case of the former banks, however, individual depositors do not possess even nominal control over the management and policies of the institution. Complete authority is vested in a self-perpetuating group of incorporators who select the board of trustees and salaried personnel. These two types of organization are also distinct with respect to priority of the institution's assets in the event of default. Investors in savings and loan shares become legal co-owners of the association, while savings bank depositors are technically creditors and are accordingly afforded the rights of this status.¹ Despite these legal technicalities, shares in savings and loan associations and savings accounts in savings banks are generally regarded as close substitutes to the general public, and hence must be so considered in any realistic approach to the market.

Decline in Prominence

Although savings banks continue to represent the largest savings depository in the states in which they are heavily concentrated, their share of the market has shrunk considerably since the late nineteenth century, that is, since real alternatives have been available to the saving public. That the savings banks' position has diminished nationally may be explained largely by the relative decline of the mature East where these institutions predominate.² Their relative loss in these latter regions as well, however, must be accounted for on different grounds.

¹ Ibid., pp. 103-104.

² In 1880 deposits in mutual savings banks constituted 87.5 per cent of total savings in all depositories in the United States; by 1927, this share had fallen to 29.2 per cent, and by 1950, to 28.5 per cent. Lintner, op. cit., Appendix Table 1-1, and Economic Almanac.

Not until the recent depression was this steady downward movement arrested, when public confidence was badly shaken in competing depositaries. It is indeed a tribute to the soundness of mutual savings banks that total deposits in Massachusetts institutions actually increased 1.6 per cent during the decade of the 1930s, rising in all but 3 years. Over the same period, savings deposits in commercial banks and unpledged shares in savings and loan associations in the Commonwealth fell by 38.1 and 7.3 per cent, respectively.¹

The ability to maintain public confidence during periods of distress is certainly a desirable characteristic, but its competitive attraction is waning. As stated elsewhere in this study, the universal adoption and acceptance of deposit and share insurance have undoubtedly led many savers to select their depositary on grounds other than mere safety alone.² Any severe depression in the future might provoke heavy withdrawal demands among distressed depositors in all institutions, but the probability of a heavy transferal of fear money is materially lessened.

Undoubtedly much of the relative gain enjoyed by the savings banks during the depression years was due to abnormal panic withdrawals from competing depositaries, rather than to substantial increases in new saving inflows. Nevertheless, this favorable experience has checked, perhaps permanently, the downward drift in the position of savings banks in the savings market. Deposits in Massachusetts savings banks as a

¹Lintner, op. cit., Appendix Table II-2.

²All mutual savings banks in Massachusetts are required to belong to the Mutual Savings Central Fund, Inc., and the accompanying Deposit Insurance Fund. Organized much as the corresponding central institutions for cooperative banks, each saving deposit account is insured in full. Although savings banks are also eligible for membership, only one local institution with assets of \$37 million has joined the Home Loan Bank System. State regulations permit member savings banks to borrow from the System only when liquidity needs warrant.

percentage of total accounts in all thrift institutions fell sharply from a high of well over 90 per cent in the early 1900s to 66.7 per cent by 1928. As indicated above, however, these institutions were looked upon as a safe refuge during the depression years, and as a consequence savings bank deposits represented an increasing share of total thrift accounts, reaching 73.9 per cent by 1937. As indicated in Table XI, the position of Massachusetts savings banks has diminished slightly since the immediate prewar period, but it appears to have reached a new plateau above the 1928 level. At any rate, savings banks appear to be firmly entrenched in the local savings market, holding a volume of savings deposits over twice as large as the combined holdings of their principal competitors.

Before discussing the current status of savings banks any further, it may be in order to review some of the factors accounting for their relative decline in the savings market. This matter is not a focal point

TABLE XI. PERCENTAGE DISTRIBUTION OF SAVINGS DEPOSITS IN MASSACHUSETTS AMONG MUTUAL SAVINGS BANKS, SAVINGS DEPARTMENTS OF COMMERCIAL BANKS, AND SAVINGS AND LOAN ASSOCIATIONS, SELECTED YEARS, 1910-1950

Year	Savings Banks	Savings Deposits in Commercial Banks			Unpledged Share in Savings and Loan Associations		
		National	Trust	Total	Federal	State	Total
1910	92.1	1.2	0.8	2.0	-	5.9	5.9
1920	76.8	5.3	9.4	14.7	-	8.6	8.6
1928	66.7	12.1	7.8	19.9	-	13.4	13.4
1937	73.9	8.3	4.9	13.2	2.1	10.7	12.8
1940	73.4	7.5	5.2	12.7	3.2	10.6	13.8
1946	69.4	10.9*	6.8	17.7	4.1	8.9	13.0
1950	68.8	9.9	5.3	15.2	5.4	10.6	16.0

Source: for years 1910-1946, Lintner, *op. cit.*, Appendix Table V-3; for 1950, *Annual Report*, Massachusetts Commissioner of Banks, Federal Deposit Insurance Corporation, and Northeastern Federal Savings League.

*Includes all time deposits in national banks.

of the present study, but a bank's mortgage lending activity is inextricably tied to its complementary role as a savings depository. In

summarizing some of these underlying factors, the capital structure of savings banks will be touched on. These data refer to all thrift institutions in the Commonwealth, but the fundamental movements appear to apply equally well to the immediate Boston vicinity.

As suggested in Table XI, the rising importance of competing institutions is undoubtedly both the cause as well as the consequence of the relative decline of savings banks in the local market. This tautology is of little value unless the differential success of other institutions can be accounted for by other independent variables. These variables may concern the relative attractiveness of the alternative thrift services available and the effectiveness with which they are presented to the saving public. Between 1910 and 1928, savings accounts in national banks, trust companies, and cooperative banks rose rapidly, while federal savings and loan associations have made the largest relative gains since 1937.

Savings banks have concentrated on ordinary savings accounts, whereby individuals may deposit and withdraw their funds at will without fine or penalty.¹ As in the case of cooperative banks, the maximum savings account to be held by an individual is limited by law to \$5,000 plus a dividend accumulation to \$10,000, though this amount can be increased through the issuance of joint accounts. While these restrictions perhaps reduce the probability of huge sudden withdrawals, it has undoubtedly meant the loss of some large, stable deposits. Perhaps the statutory limitation should be related in some fashion to the asset size of the bank, for even a \$50,000 account may not subject a \$100 million institution to undue hazards. Management could still exercise the privilege of refusing any large sum which appeared only transitory. Perhaps

¹Some banks limit the maximum deposit accepted at one time; moreover, they may require a 30-day withdrawal notice if necessary for liquidity considerations.

federal savings and loan associations have realized some of their rapid growth as a result of accepting larger deposits, and even some smaller ones which would have appeared unstable to savings banks.¹

While ordinary savings accounts may be economical to operate and also enjoy wide public appeal, competing institutions have undoubtedly gained by offering a wide range of thrift plans. The quasi-compulsory scheme of savings and loan associations has been well adapted to the needs of savers who regard such a stimulus to be of great importance in carrying out a long-term savings program. Furthermore, even though most serial shareholders (and holders of bonus accounts) prove to be unable to fulfill their initial aspirations, the mere offering of a bonus return may be sufficient to attract the new account initially.

Savings banks have introduced a variety of special thrift plans to accommodate the systematic saver, though none has provided the same type of incentive as the serial share device. The most common programs include: payroll deduction plans, based on savings bank deposits alone or in combination with savings bond purchases; school savings; Christmas clubs; and various other special purpose clubs.² Another important program providing the community of savers with real incentives for systematic thrift concerns savings bank life insurance. First authorized in 1907, over-the-counter life insurance has been adopted by 35 institutions in the Commonwealth, of which 15 are located in the Boston vicinity. This low-cost, flexible program has been very well received, and has played

¹See Lintner, *op. cit.*, p. 149-150. Many savings banks refused to accept an individual deposit above a certain amount at any one time, on the grounds that these constituted temporary, unstable funds and as such did not warrant the same dividend treatment as existing accounts.

²See Lintner, *op. cit.*, Chapter VI for an analysis of these various thrift plans.

an important part in promoting other bank services, especially where insurance is combined with regular savings plans. As of January 1952, there were 445 thousand savings bank life insurance policies outstanding, with an aggregate value of \$420 million.¹

Except in communities where savings bank life insurance has been effectively introduced, savings and loan associations continue to offer the most widely accepted systematic savings programs. Perhaps to be successful as a community depository, a thrift institution must promote not one but a variety of loan plans. The serial share plan undoubtedly contributed to the rapid expansion of cooperative banks up to the depression years, but this compulsory scheme is not sufficient for continued success. As described earlier, these associations sought authorization to issue savings shares in order to attain a well-rounded thrift program, and have found a wide acceptance for them.

Professor Lintner has found convenience to be another major factor explaining the relative decline in savings banks as a depository.² Especially since 1910, the incorporation of many new cooperative banks and credit unions as well as the introduction of savings departments and branch offices in existing commercial banks provided savers with a wider range of conveniently located depositories. Since 1937, newly-chartered federal savings and loan associations have endeavored to set up their facilities in the most favorable locations. Another important aspect of the convenience problem relates to the idea of "department store" banking. If they desired, commercial banks could perhaps expand their savings departments by effectively promoting this service to individuals who also hold

¹C. S. Casady, Self Help for Sale, Savings Bank Life Insurance Council, 1952, See Lintner, op. cit., Chapter VII for a detailed analysis of this program.

²Lintner, op. cit., pp. 143-147.

checking accounts or have other business with the bank. Furthermore, an institution can effectively expand its savings inflows by a more aggressive merchandising of its other services. Federal savings and loan associations have at times promoted home mortgage lending almost exclusively, but in securing a firm foothold in the mortgage market, they have also greatly increased their savings accounts. Their willingness to make home mortgages, coupled with effective merchandising during the immediate prewar years, has undoubtedly accounted in part for their rapid capital growth. This is in sharp contrast to the negative policy pursued by most savings banks. The latter not only withdrew almost completely from the mortgage market, but they also set up arbitrary rules limiting savings inflows.

Perhaps effective merchandising more than any other single factor has accounted for the rapid relative gain among federal savings and loan associations. In addition to setting up attractive business quarters, these associations have hired comparatively expensive management personnel and have engaged quite heavily in various promotional campaigns, notably advertising. Although data on salary schedules are entirely lacking, interviews reveal that executives in federals receive much higher compensation than corresponding officers in either savings or cooperative banks. Furthermore, the management of a federal association has substantial inducements to expand its operations, as salary scales follow asset size quite closely.¹

While specific data are not available, the impression has been gained from interviews that average advertising expenditures among local federals are equivalent to nearly \$1 per \$1,000 of assets. A leading association

¹Interviews. This latter practice was mentioned by officers of local federals as well as other parties.

in the Commonwealth is currently conducting an elaborate campaign costing in the aggregate at least twice this average amount.¹ Such an emphasis on advertising contrasts sharply with the practice of other local thrift institutions, especially savings banks. Advertising has always been of minor significance among the latter, representing \$0.10 per \$1,000 of assets in 1936 and rising only to \$0.22 per \$1,000 by 1951. The postwar expansion in savings bank advertising programs has reflected in large part the general advance in operating expenses, for this item in 1950 accounted for a smaller share of total costs than in 1946.² Among all cooperative banks in the Commonwealth, advertising expense per \$1,000 of assets increased from \$0.31 in 1936 to \$0.52 by 1951.³

Another factor undoubtedly having some effect on the relative growth of competing depositaries concerns the dividend rates paid on savings accounts. Savings banks have traditionally paid lower rates of return on deposit accounts than have cooperative banks on their serial and paid-up shares. In the past three years, however, savings banks have gradually raised their dividend rates, up to a level exceeding those paid on savings share accounts in cooperative banks and approaching those of federal savings and loan associations.⁴ Higher dividend rates coupled with more effective promotional efforts on the part of the more progressive institutions may once again strengthen the overall position of savings banks in the local thrift market.

¹Interviews.

²Annual Report, Massachusetts Commissioner of Banks. These data refer to all banks in the Commonwealth.

³Ibid.

⁴See "Dividend Returns" below.

Investment Opportunities

Mutual savings banks, in order to remain in the competitive race among alternate depositaries, must not only assure safety of deposits but also pay reasonable dividends over and above all operating expenses. Criteria of profitability as well as safety are no less important for savings banks than for competing thrift institutions. So that the safety consideration is given due weight, Massachusetts savings banks are restricted by law in selecting investment portfolios, and in addition, must set aside a substantial part of earnings to surplus as further protection. Guaranty funds and profit and loss accounts are established and maintained through annual contributions from the bank's operations until their combined accumulation reaches 15 per cent of total deposit liabilities.¹ Since the turn of the century, the aggregate surplus account of all savings banks has represented a steadily increasing percentage of total deposits. From a level of 8 per cent in 1928, this percentage has advanced every year down to the present, except during the Second World War, until aggregate reserves represented slightly over 12 per cent of total deposits in 1951.² Although these are intended to function in part at least as loss reserves, savings banks have traditionally been reluctant to draw upon them to cover heavy mortgage losses, as during the recent depression. In order to conceal any weakness in operations, they hesitated to write down published surplus figures, thereby resulting in a distorted mortgage foreclosure-loss policy.³

¹Currently a savings bank is required to set aside $1/8-1/4$ of 1 per cent of its deposits each year until the guaranty fund equals $7\frac{1}{2}$ per cent of deposits; when the combined accumulation of both funds reaches $15\frac{1}{2}$ per cent of deposits, an extra dividend must be declared. Massachusetts Annotated Laws, Chapter 168.

²Savings Banks Association of Massachusetts.

³See Lintner, op. cit., pp. 292-298.

Massachusetts savings banks may place their deposit capital and surplus in first mortgage loans and in other outlets selected from a list of eligible investments in accordance with statutory requirements. These legal restrictions generally limit the total investment in any one outlet, and prescribe securities of a certain type and grade. Furthermore, geographic barriers are frequently imposed as to location of borrower, usually giving preference to local credit demands.

Until 1949, mortgage investment was restricted to lending on urban real estate located within the Commonwealth or within 50 miles of the bank's home office. Within this geographic area, savings banks are authorized to offer the home buyer a variety of mortgage loan plans, provided the aggregate loan balance does not exceed 70 per cent of deposits.¹ The characteristic pre-depression savings bank mortgage prescribed a straight loan made either on demand or for a term of up to 3 years, with the loan amount not exceeding 60 per cent of the property value. If these unamortized loans required renewal at maturity, the bank ordinarily granted the request so long as interest payments were regular and estimated loan-value ratios were not over 60 per cent.

The evils of straight mortgages, discussed elsewhere in this study, have become all too apparent to savings banks and to the general public as well. Consequently, though such loans may still be made, local savings banks now deal almost exclusively in amortized loans of various types. They are authorized to make 80 per cent mortgage loans up to \$12,000, provided repayment is accomplished within 20 years through monthly payments including principal, interest, and real estate taxes.² These

¹These mortgage investment restrictions are all found in the Massachusetts Annotated Laws, Chapter 168, Section 54.

²Cf. the more liberal authorization of cooperative banks in making 80 per cent loans up to \$20,000; furthermore, cooperative banks were granted the authority to make 80 per cent loans much earlier than were savings banks.

payments must be constant over the loan term, except larger amounts may be required during the first 5 years. In the case of construction lending, the bank has the right to require only the interest component of the monthly payment, with principal amortization deferred until the property is occupied.¹

Larger mortgage loans are permissible only where the debt-value ratio is correspondingly lower. A 75 per cent loan may be made up to \$16,000, and a 70 per cent loan up to \$50,000, provided the original principal is amortized no less than 3 per cent per year. The maximum term is 20 years, and regular payment is required at intervals not exceeding 3 months. When the loan does not exceed 60 per cent of appraised value, the maximum loan amount is not specified, but regular amortization is required if the term exceeds 3 years. Savings banks, unlike cooperative banks and federal associations, may lend up to 40 per cent of value on the security of unimproved property, with amortization and maximum loan amount unspecified but with a term limit of 3 years. Regulations regarding property improvement loans are similar to those of cooperative banks, whereby monthly payment loans up to \$1,000 may be made for a maximum 5-year term.²

These above restrictions do not apply to mortgage loans insured by the FHA or guaranteed in part or full by the VA, so far as loan amount, term, or amortization requirements are concerned. Until June 1949, however, such insured or guaranteed loans were subject to the same geographic limitations as conventional mortgages. At this time, after years of diligent efforts on the part of some progressive savings bankers, these

¹Up to a maximum of 9 months. Savings banks may also extend straight 75 per cent blanket construction loans to operative builders for a term up to 2 years. Such non-amortized loans must be secured by a first mortgage upon 2 or more parcels of real estate contained within the same project. Furthermore, the aggregate balance of these loans outstanding at any time cannot exceed one per cent of deposits.

²Clause 10th A, Section 54.

institutions were authorized to make a limited investment in FHA-insured and VA-guaranteed loans without regard to property location. Under present regulations, a savings bank may invest in each type of loan up to 10 per cent of its deposits or 50 per cent of the value of all mortgages on in-state properties, whichever is lesser.¹ The consequences of this significant amendment in creating a more active secondary mortgage market will be discussed in Part VII.

The principal alternative investments available to savings banks include: loans on personal security; securities and fully guaranteed obligations of the United States government, the Commonwealth of Massachusetts, and certain other states; legally issued bonds of the legal subdivisions of various states; certain bonds and notes of railroads, street railways, telephone companies, and other public utilities; and bank stocks. Statutory and administrative regulations limit most of these investments to a certain percentage of total deposits, the most notable exception being federal government securities. Savings banks are nevertheless afforded considerable discretion in selecting particular investments within this legal list, their choice resting largely on the relative availability of alternate investments and their expected rates of return.²

The net yields on alternate investments must be compared after due allowance is made for the state excise tax. All Massachusetts savings banks are subject to an annual state levy at the rate of 0.5 per cent of their average deposit balances less their dollar investment in real

¹Amendment to Section 54A, approved June 2, 1949. (Acts of 1949, Chapter 269.) The regulation limiting total mortgage loans to 70 per cent of deposits still stands.

²Lintner, op. cit., p. 216.

estate taken in foreclosure or used for business purposes, mortgage loans on property situated within the Commonwealth, various government securities, and shares of stock in Massachusetts trust companies. This tax may accordingly render private securities and out-of-state FHA and VA loans less attractive whenever the value of average deposits exceeds these allowable deductions.

The investment portfolio of Massachusetts savings banks has undergone considerable revision over the past 30 years. Whereas cooperative banks and federal savings and loan associations have traditionally invested nearly 80 per cent of their capital in real estate loans, mortgage lending has fluctuated widely as an investment outlet for savings banks. Although the mortgage portfolio will be more fully analyzed in Part V, its relative importance as well as the changing role of alternate investments is indicated in Table XII below.

TABLE XII. PERCENTAGE DISTRIBUTION OF ASSETS IN MASSACHUSETTS SAVINGS BANKS, SELECTED YEARS, 1920-1951

<u>Year</u>	<u>Total Assets</u> (Billions)	<u>Public Securi-</u> <u>ties</u>	<u>Private Securi-</u> <u>ties</u>	<u>Real Estate</u> <u>Loans</u>	<u>Loans on</u> <u>Personal</u> <u>Security</u>	<u>Real Estate</u> <u>by Fore-</u> <u>closure</u>	<u>Cash</u> <u>Items</u>	<u>Misc.</u>
1920	\$1.31	17.0	21.4	43.9	14.7	0.1	2.1	0.8
1927	2.02	14.4	21.7	53.7	7.7	0.1	1.6	0.9
1931	2.38	12.1	25.5	53.0	5.6	1.2	1.6	1.0
1936	2.35	24.1	19.2	44.2	1.5	6.7	1.2	3.1
1940	2.40	33.1	15.3	40.0	0.9	5.5	4.1	1.1
1946	3.41	63.5	9.4	24.0	0.3	0.0	2.3	0.5
1948	3.65	59.8	10.5	26.6	0.5	0.0	2.1	0.5
1950	3.74	53.3	9.8	34.0	0.6	0.0	1.9	0.4
1951	3.84	46.7*	10.8	39.3	0.6	0.0	2.0	0.6

Source: Annual Report, Massachusetts Commissioner of Banks.

* All but 0.08 per cent of this investment represents securities and obligations of the United States Government.

As total assets mounted during the 1920s, savings banks concentrated their investment efforts on mortgages and private securities, and actually

reduced their dollar holdings of government obligations. The par value of holdings of federal securities fell by 45 per cent between 1923 and 1931 while holdings of various private securities and mortgages approached their legal limit.¹ During the next 15 years, however, this pattern was completely reversed, as nearly every private investment diminished steadily and federal securities mounted in importance. The dollar reduction in the mortgage and private security portfolios contributed more to their relative decline than did the actual increase in total assets. The government portfolio was increased even in the few years when total resources declined.² Just as private securities had been available with generous yields during the 1920s, these same investments appeared risky and offered smaller interest returns as the depression wore on. Federal securities, on the other hand, became increasingly available, especially with the onset of World War II, and, while yields were declining along with the overall interest rate structure, these guaranteed investments appeared highly attractive. The added interest return to compensate for the risk element in non-government securities had steadily declined, especially when the 0.5 per cent state tax is deducted from the yield.

In the postwar period, holdings of government bonds have fallen considerably from their peak in 1946. This reversal in investment policy has been accompanied by a renewed interest in private securities but primarily reflects a vigorous program to rebuild sorely depleted mortgage portfolios. With a direct turn-about-face, savings banks, after withdrawing almost completely from the mortgage market in the 1930s, have played a leading role in the postwar housing boom. Mortgage lending policies of mutual

¹Lintner, *op. cit.*, p. 223.

²*Ibid.*, pp. 224-225.

savings banks in the Boston area will be analyzed in some detail in Part V.

Savings Banks in the Boston Area

The previous discussion of the development of savings banks in Massachusetts applies equally well to the Boston vicinity in particular. Whereas many new local cooperative banks sprang up during the first 3 decades of this century, savings banks have been well established for a much longer period. Of the 56 savings banks currently operating in the Boston area, only 6 have been incorporated in the present century, all being organized before the first World War. Of the remainder, at least 10 have been operating for over 100 years.

Not only are the existing institutions well established in years, but also the number of savings banks leaving the market has been very slight. The depression experience of savings banks, as pointed out above, was singularly favorable so far as the safety of depositors' funds is concerned. Three of the smaller banks merged with their stronger neighbors and only one bank, the Somerville Institution for Savings, was forced to liquidate.¹ Since the depression, there have been two additional mergers, one involving a relatively inactive \$100 thousand institution.²

The Savings banks in the Boston area have enjoyed a gradual, but certain growth over the past quarter century, with both total and average assets more than doubling in dollar amount. (See Table XIII.) Compared with competing thrift institutions, savings banks as a group in 1951 held assets valued at nearly 4 times those of cooperative banks and federal associations combined. Moreover, in regard to average assets size, local savings banks are over $2\frac{1}{2}$ times as large as federals, and over 7 times as large as cooperative banks.

¹Closed February 2, 1932, but on July 24, 1933, the institution reopened as the Somerset Savings Bank.

²The latter Columbus merged with the Boston Five Cents in 1941; The Blackstone consolidated with the Charlestown Savings Bank in 1945, with the latter \$75 million institution receiving a convenient branch office in the hub area.

TABLE XIII. NUMBER, TOTAL ASSETS, AND AVERAGE ASSETS OF SAVINGS BANKS
IN THE BOSTON AREA, SELECTED YEARS, 1927-1951

<u>Year*</u>	<u>Number of Banks</u>	<u>Total Assets (Millions)</u>	<u>Average Assets (Millions)</u>
1927	61	\$ 903.0	\$ 14.8
1936	58	1,159.2	20.0
1940	58	1,193.6	20.6
1946	56	1,618.7	28.9
1947	56	1,173.6	29.9
1948	56	1,705.0	30.4
1949	56	1,729.5	30.9
1950	56	1,787.0	31.9
1951	56	1,829.3	32.6

Source: Annual Report, Massachusetts Commissioner of Banks.

* As of October 31.

The 56 savings banks vary widely with respect to asset holdings, ranging from less than \$3 million to well over \$200 million. Just as in the case of cooperative banks, the 2 largest savings banks are more than twice the size of their nearest rival, thereby tending to raise the average size well above the mode. Only 4 banks have assets below \$5 million, the size class including nearly 75 per cent of all cooperative banks in the area. As indicated in Table XIV, savings banks are concentrated quite heavily in the \$10-25 million class.

TABLE XIV. ASSET SIZE DISTRIBUTION OF SAVINGS BANKS IN THE BOSTON AREA,
1951

<u>Asset Group (Millions)</u>	<u>Number of Banks</u>	<u>Per Cent of Total</u>
All Groups	56	100.0
\$0 - 5	4	7.1
5 -10	7	12.5
10 -15	11	19.6
15 -25	11	19.6
25 -35	6	10.7
35 -50	8	14.4
50 -75	4	7.1
75 and over	5	8.9

Source: Annual Reports, Massachusetts Commissioner of Banks.

COMMERCIAL BANKS

Commercial banks have played a subordinate role in the development of the local mortgage market. As discussed earlier, mutual savings banks have been serving the thrift needs of the Boston community since 1816, when the city had but 35,000 inhabitants. Commercial banks, while their origin dates back to the founding of the First National Bank of Boston in 1784, have traditionally concentrated on commercial lending and operating checking services. They have accepted and invested the time and savings deposits of individuals, but the bulk of this latter activity has been handled by the mutual institutions, first the savings banks and, later on, by savings and loan associations as well.

In the newer sections of the country, however, commercial banks are frequently the only financial institutions which accept savings, especially among small rural communities. Consequently these community institutions, in addition to performing the customary banking functions, are called upon to supply the mortgage credit needs of home buyers, a highly specialized activity. Many such commercial banks are too small to maintain an expert mortgage lending department, and accordingly have suffered abnormally heavy foreclosure losses during depression periods. Indeed, the advantages of specialization may be indicated by referring to bank failure statistics. Of the 4,096 bank suspensions during the period 1926-1930, only 15 occurred in New England, the stronghold of specialized mutual thrift institutions. Of course, other reasons, such as general unsound lending practices, depressed agricultural prices, insufficient capital, and other local conditions may have been more influential in explaining this geographic distribution, but specialization in mortgage lending offers decided advantages.¹

¹Welfling, op. cit., pp. 182-3.

Traditional bank investment policy dictates that only a small portion of commercial bank funds should be invested in long-term illiquid assets such as home mortgage loans. This restriction carries no implication that mortgages are inherently unsafe as an investment, but rather that they can rarely be converted into cash on demand. Banks that do accept time or savings deposits in considerable volume, however, may appropriately invest a larger portion of these longer-term funds in real estate mortgages. Since 1908 trust companies in Massachusetts have been required to segregate the assets of their savings department from those of the commercial and trust departments, and must operate the former just as if it were a savings bank.¹ In national banks, no segregation of assets among the various departments is required, but such banks are limited for purposes of liquidity in their aggregate loans on first mortgages. According to current provisions of the National Bank Act, national banks may invest in mortgages up to 60 per cent of their time and savings deposits or up to the full value of their capital and unimpaired surplus fund, whichever is greater.²

The growth pattern of savings deposits in national banks and trust companies in Massachusetts has been indicated in Table XI.³ While savings accounts in savings banks have grown steadily for over a century, savings deposits in commercial banks were of negligible importance until the 1920s. Although trust companies had been authorized to accept these funds since 1890, total deposits began to mount only after the separation of savings departments in 1908. Their peak year was reached by 1920, when these

¹State regulations on mortgage investment by trust companies do not apply in general to commercial and trust departments. Funds in the commercial departments may be placed in 60 per cent mortgages with terms not exceeding 3 years. (General Laws, Chapter 172, Section 33.) Mortgage lending is generally exclusively conducted in the savings department, with the mortgage portfolio representing far less than 1 per cent of total assets in the other two departments.

²The capital limit is generally smaller and, hence, less limiting in practice.

³See p. 129.

deposits represented 9.4 per cent of total holdings among the various thrift institutions. Savings deposits in national banks continued to increase in importance through 1931, but the share of both types fell during the depression years. The Second World War brought a substantial inflow of new savings into these institutions, so that by 1946 commercial banks once again held a larger volume of savings accounts than did all savings and loan associations in the Commonwealth. In the postwar era, however, savings deposits in both national and state banks have actually declined, with cooperative banks and federal associations realizing the greatest relative gain. Trust companies have witnessed a larger postwar loss in savings accounts than have national banks, partly because of numerous mergers of the state-chartered institutions with the latter. The overall decline in commercial bank savings deposits in favor of savings and loan shares is undoubtedly due in large part to a wide difference in dividend rates; a factor of increasing importance to the saving public.¹ Furthermore, many commercial banks accept savings deposits largely as a matter of convenience for their customers, and make little or no effort to promote this phase of their operations.

A primary point of difference between trust companies and savings companies and savings banks concerns their form of organization. Whereas the latter are legally mutual thrift institutions, the former are stock companies and are treated as any other private incorporated business. Shareholders of the bank receive ordinary dividend returns on their capital stock, whereas depositors alone share in the profits of a mutual institution. Furthermore, trust company profits have always been subject in full to the federal corporate income tax. Profits of mutual thrift institutions have traditionally been free from this tax, but since 1951 full tax liability on retained earnings must be assumed after loss

¹See "Dividend Returns" below.

reserves have attained a certain level. Undoubtedly, these two deductions from the gross income of commercial banks have heavily influenced their capacity to pay competitive dividend rates,¹ although the extent of this influence has not been statistically examined.

As stated above, savings departments are operated just as if they were autonomous savings banks, so far as savings and investment are concerned.² A separate board of investment is required for the savings department, and dividends are paid on depositors' funds just as in other thrift institutions. Identical to savings bank regulations, trust companies are required to set up and maintain loss reserves for their savings departments. The aggregate guaranty fund and surplus for the 51 savings departments in the Commonwealth bore a ratio of 7.54 per cent to deposits in 1950.³ Although the assets of the savings department are segregated, the success of this department depends upon the operations of the whole bank. With this interdependence, however, savings depositors do have the added protection of the capital stock as well as the general reserve accounts of the bank.

Commercial banks may occupy an important position in the home mortgage market, even if their mortgage holdings are but a small fraction of the total. Their investment policies are generally quite flexible, so that entrance and withdrawal from the active mortgage market may often be accomplished with relative ease. During the 1920s, rapidly increasing savings deposits in these institutions across the nation were promptly invested in high-yielding mortgage loans. Many of these loans were based on highly inflated property valuations, and subsequent depression losses were severe in many cases. The primary cause of these difficulties was

¹See "Dividend Returns" below.

²General Laws of Massachusetts, Chapter 172.

³Annual Report, Massachusetts Commissioner of Banks.

not investing an unsound share of bank capital in mortgages, but rather the prevalence of indiscriminate lending practices and the absence of appropriate amortization provisions.¹ At any rate, commercial banks retreated from active participation in mortgage lending, and concentrated on other phases of their overall operations. The introduction of FHA-insured loans, as well as more liberal provisions for conventional lending by national banks in 1935², has enticed these institutions back into the mortgage market, although on a limited scale in this area. While this in and out policy of commercial banks and insurance companies may provide a degree of flexibility in meeting overall mortgage credit requirements in boom periods, it tends to impede the development of truly specialized mortgage lending institutions throughout the country.³ Such "fair weather lending" has been severely criticized by traditional savings and loan interests, who, as stated earlier, are virtually compelled to invest heavily in mortgages regardless of developments in other sectors of the private capital market. Although the principal investments of commercial banks and insurance companies are in other fields, ". . . when the yields drop in their normal investment fields, (they) barge into home mortgages. When other investments open up, they desert the mortgage market."⁴

The most frequent charge levied against mortgage lending by commercial banks relates to their investing short-term deposit funds in long-term

¹Ratcliff, op. cit., p. 246.

²Not until 1916 were national banks permitted to make urban real estate loans and then the term was limited to 1 year and the amount to 50 per cent of value. Furthermore, total holdings of farm and urban mortgage loans could not exceed 25 per cent of capital and surplus or 1/3 of time deposits. After years of agitation, the maximum term was increased to 5 years in the McFaddin Act of 1927. On August 23, 1935, the Federal Reserve Act was amended to permit national banks to make 10-year, 60 per cent amortized loans, with the limitations on total mortgage holdings as given above on page 88. FHA and VA loans are exempt from the above restrictions on loan-value ratios and terms.

³See concluding remarks at the end of Chapter 15.

⁴From an address by G. Bliss, Cooperative Banker, August 1951, p. 1

obligations. Even if the bank had a large volume of time or savings deposits, one school of thought maintains that liquidity needs would still warrant loans with a maximum term of 3 - 5 years. By accepting a singularly low dividend return,¹ savers supposedly assume that immediate payment is all the more likely,² and liquidity must be of supreme concern in all investment decisions. Public regulation and examination, as well as improved mortgage lending practices and contracts, have materially weakened the validity of this argument. Since savings departments in Massachusetts trust companies are treated as savings banks insofar as savings and mortgage operations are concerned, state-chartered commercial banks, at least, certainly appear to be fully justified in making long-term mortgages. While no mortgage loan is perfectly liquid, universal principal amortization and the availability of an increasingly effective secondary market have rendered mortgage investment highly desirable, especially where the loan is either FHA-insured or VA-guaranteed. Accordingly, national banks, not legally bound to confine lending operations to in-state properties, invest freely in insured and guaranteed mortgage loans throughout all sections of the country.

Another common charge levied at real estate lending by commercial banks revolves about the money-creating aspects of such credit extension. At first glance, this distinction may appear to arise from the differing liquidity characteristics of bank demand deposits compared with conventional savings or share accounts. In a realistic sense, however, most savings accounts must be treated as very close substitutes for currency and checking accounts, as the 30-day waiting period is seldom invoked and withdrawal

¹See below.

²See Morton Bodfish, "A Sound System of Mortgage Credit and Its Relation to Banking Policy," Journal of Public Utility and Land Economics, August 1935, pp. 215-225.

is ordinarily automatic. Nevertheless, even if demand and savings deposits are indistinguishable so far as liquidity characteristics are concerned, mortgage lending (or any other type of credit extension) might have more expansionary potentialities within the system of commercial banks than within the system of conventional thrift institutions. While an individual thrift institution is not required to maintain as large a share of its deposited funds in cash reserves as does a commercial bank, the so-called "leakage" of loaned funds is far more significant among the system of thrift institutions. For example, suppose each individual commercial bank may invest 80 per cent of its deposited funds in mortgage loans. In this case, there is a very strong likelihood that most of these advanced funds will be redeposited and thereby remain within the system so that additional credit, in turn, may be extended by the banks included. The ultimate increase in purchasing power from an initial loan then depends upon minimum reserve ratios and the extent of such leakages from the system.

The same type of analysis can be applied to lending by conventional thrift institutions. Even if each individual bank would invest over 90 per cent of its savings capital in mortgage loans, the probability that the advanced funds would remain within the system of thrift institutions is much smaller. On the contrary, a large proportion of these funds would eventually fall into the system of commercial banks and only a relatively small proportion would be redeposited into true thrift accounts. In other words, the expansionary potentialities of savings bank lending, for instance, as opposed to commercial bank lending may be theoretically even more extensive by virtue of lower reserve requirements. In practice, however, the far more substantial leakage of advanced funds from the system of savings banks renders this chain reaction of limited consequence.

Indeed, whereas a large majority of loans made by commercial banks arise indirectly from deposit liabilities of other banks, savings banks depend almost entirely upon their own community savings inflows for loanable funds.

In addition to direct participation in home mortgage lending, commercial banks influence the mortgage market in other ways. These banks have played a prominent role in the short-term financing of home building operations, certainly an appropriate outlet for commercial department funds. Especially in areas where there is a continuing relative scarcity of long-term capital, commercial banks finance speculative builders contingent upon an advance commitment from outside sources to take the permanent mortgage. As of June 30, 1950, construction loans totaled \$837 million, constituting nearly 7.4 per cent of all non-farm real estate loans held by insured commercial banks across the country.¹

Another important activity of commercial banks in the area of real estate finance concerns the extension of credit to other types of mortgage lending companies. Although ordinary thrift institutions have perhaps resorted to bank borrowing only to meet acute liquidity needs, mortgage companies and other types of intermediary institutions frequently rely upon borrowed funds for working capital. These short-term bank advances are used to supplement limited equity funds in originating and holding mortgage loans until a suitable permanent mortgagee is found. In mid-1950 about 3.5 per cent of all nonfarm real estate loans held by FDIC-insured commercial banks across the country constituted "loans to nonbank mortgage lenders," less than one-half of which were actually secured by real estate.²

¹Operating Insured Commercial and Mutual Savings Banks, FDIC, Report No. 33, 1950, p. 5.

²Ibid., p. 5.

These modest figures on holdings of short-term loans understate the real importance of commercial banks in financing new construction and the operations of other mortgage lenders. Funds invested in such short-term paper have a rapid turnover whereas permanent mortgage credit ties up investible funds for long periods of time and thus predominates data on outstanding holdings.

Savings Departments in Local Trust Companies

The number of trust companies operating in the immediate Boston area has fallen steadily since the late 1920s. As a result of several depression liquidations and later merger activity among trust companies and national banks, this number fell from 48 in 1927 to 27 by 1950. The number of trust companies maintaining savings departments has similarly decreased from 42 to 22 over the same interval.

TABLE XV. TOTAL AND AVERAGE ASSETS OF SAVINGS DEPARTMENT IN TRUST COMPANIES IN THE BOSTON AREA, SELECTED YEARS, 1927-1950

<u>Year</u>	<u>Number of Savings Departments</u>	<u>Total Assets (Millions)</u>	<u>Average Assets (Millions)</u>
1927	42	\$ 138.6	\$3.30
1936	30	80.8	2.70
1940	30	94.0	3.13
1946	24	192.1	8.00
1948	22	170.3	7.74
1950	22	154.1	7.00

Source: Annual Report, Massachusetts Commissioner of Banks.

The data in Table XV reflect wide fluctuations in total resources as well as in the average size of local savings departments. Although depression losses were unusually severe, aggregate assets recovered to unprecedented heights during the Second World War. Average assets nearly tripled between 1940 and 1946, and have decreased slightly but steadily since that time.

The 22 savings departments vary widely in asset size, ranging from \$1.4 to \$28.6 million in 1950. Within this range, the remaining 20 departments are evenly distributed with 9 having assets below \$5 million

and 6 above \$10 million.¹ Two of the largest Boston trust companies have no savings department whatever, and the largest institution in the area with assets of nearly \$200 million has a \$7 million savings department. The larger savings departments tend to appear in communities where mutual institutions are less predominant than in Boston proper. Trust companies, just as national banks, have set up numerous branch offices in the county of organization, affording a convenient savings depository for a great many suburban savers.²

DIVIDEND RETURNS ON SAVINGS ACCOUNTS

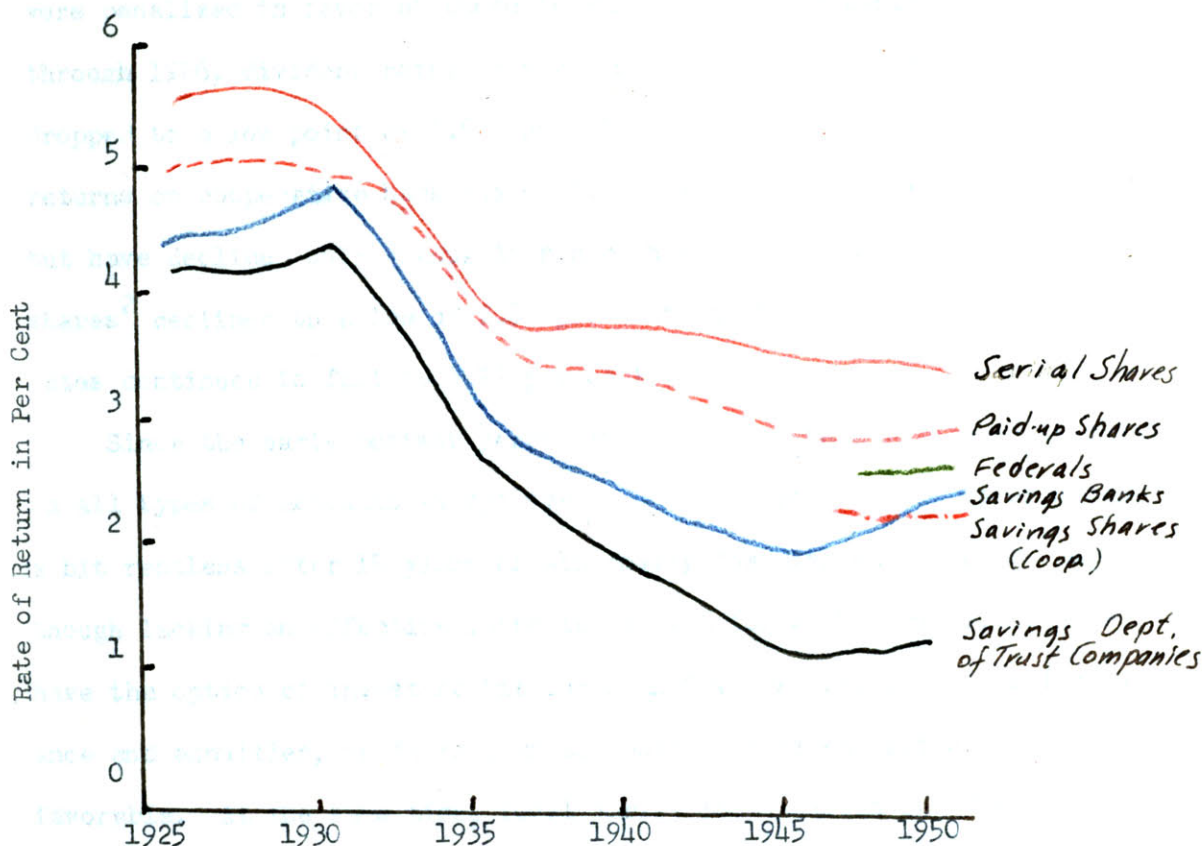
Perhaps one of the outstanding characteristics of the local savings market is the increasing similarity of the thrift services offered by the various institutions, especially since the early depression years and the introduction of extensive federal intervention. Despite this similarity, however, dividends paid by the various types of thrift institutions have consistently covered a wide range. (See Chart II.)

Rates of return on the various types of savings accounts have changed in an approximately parallel fashion over the past 25 years. During the late 1920s, interest and dividend rates had reached a high plateau, ranging from nearly 4.5 per cent on savings deposits in trust companies to 5.5 per cent on serial shares in cooperative banks. The latter institutions paid dividends of approximately 5 per cent on paid-up shares for 7 years through 1932, while rates on savings bank deposits had climbed to near this level by 1930 but then fell abruptly. Following the general trend in interest rate movements, average rates on each type of account fell consistently during the depression years and well into the postwar period as well.

¹ Annual Report, Massachusetts Commissioner of Banks.

² Within the immediate Boston vicinity there were 22 national banks in 1950, some with as many as 29 branch offices.

CHART II. AVERAGE RATES OF RETURN PAID BY COOPERATIVE BANKS, FEDERAL SAVINGS AND LOAN ASSOCIATIONS*, MUTUAL SAVINGS BANKS, AND SAVINGS DEPARTMENTS OF TRUST COMPANIES IN MASSACHUSETTS, 1926-1951



Source: Annual Report, Massachusetts Commissioner of Banks; Federal Home Loan Bank of Boston.

* Average rates for 15 associations in the Boston vicinity through 1950; for 16 in 1951.

Dividend returns on accounts in savings banks and in trust company savings departments realized the greatest decline, both in absolute as well as relative terms. Falling operating incomes forced a downward adjustment from the unjustifiably high rates of the 1920s, but equally significant was the failure on the part of most lending institutions to set up adequate loss reserves on a systematic basis. The unusually heavy mortgage losses developing during the depression years resulted in good part from extensive mortgage lending at a time when both dividend payments and mortgage risk were at a maximum. Following the downturn, mortgage

losses currently developing were so large that dividends necessarily fell more rapidly than earnings, with the result that depositors in the 1930s were penalized in favor of those in the 1920s.¹ Decreasing each year through 1946, dividend rates on savings bank and trust company deposits dropped to a low point of 1.86 and 1.14 per cent, respectively. Dividend returns on cooperative bank shares fell sharply during the early 1930s, but have declined only gradually since that time. Rates on paid-up shares² declined to a low of 2.63 per cent in 1947, while serial share rates continued to fall to 3.17 per cent by 1951.

Since the early postwar years, average rates have tightened slightly on all types of accounts except serial shares. Perhaps the saver became a bit restless after 15 years of abnormally low dividend returns. Although lacking an effective lobby to bargain for higher rates, he does have the option of investing his funds in Savings Bonds, in life insurance and annuities, or in savings accounts if dividend rates appear favorable. At the same time, local thrift institutions had finally recovered from their severe depression experience, and were in a healthy operating position. Although expenses had begun to increase, dollar earnings were advancing more rapidly, and surplus reserves had risen steadily since the depression. Since these mutual institutions appeared to be well fortified for any postwar contingency, it was only natural that depositors should share in their increasing profits. Just as savings bank rates fell much faster than did cooperative bank rates during the 17-year period 1930-1946, they have also showed the greatest relative increase in recent years. By 1950, they had exceeded average rates on the newly-issued savings shares of cooperative banks. Complete data on dividend

¹See Lintner, "Our Tremendous Mortgage Debt," Harvard Business Review, January 1949, p. 97.

²Which were ordinarily somewhat lower than rates on matured shares until then were consolidated in 1950.

rates among local federal savings and loan associations are not available, but recent reports to the Boston Home Loan Bank indicate an average rate of 2.48 per cent. All but one local federal paid 2.5 per cent on savings accounts in 1951, slightly higher than dividend rates on comparable accounts in the other institutions. Moreover, the bonus savings plan entitles the systematic saver to an addition 0.25 to 1.00 per cent return, depending on the term of regular saving. This combination rate of 3.5 per cent is well above the yield on the corresponding, but more rigid, serial share account of cooperative banks.

The rather wide variation in average rates of return on the alternative types of savings accounts might suggest that depositors are relatively insensitive to expected dividend returns when selecting a depository. Indeed, savings deposits in trust companies were receiving a dividend return of 1.27 per cent in 1950, while federal associations were paying on the average twice that rate on essentially the same type of savings investment. These comparisons all relate to average rates of return, a much more stable measure than actual rates paid by the individual institutions. In 1950 dividends paid on savings deposits in savings banks ranged from 1.5 to 4.0 per cent, in savings departments of trust companies from "1.00 or less" (63 per cent of all cases) to 2.25 per cent, and rates on cooperative bank serial shares varied from 2.0 to 4.5 per cent.¹

This wide range in dividend rates, however, does not imply that individual savers are totally ignorant or disinterested in comparative rates of return. In the first place, the maximum rates cited above are paid by very few institutions, and these are generally located in rural

¹Annual Report, Massachusetts Commissioner of Banks.

areas well isolated from the money market centers. Even if the saver examined the annual reports of all institutions in the state in order to place his funds where the return is greatest, he may discover that his application for a new account would be rejected. Such institutions operate in a restricted mortgage market, serving only the limited financing needs of their own community, and accordingly prefer to accept only local savings so long as these inflows suffice to meet all mortgage demands. Especially during the depression years when local thrift institutions shunned away from mortgage lending, new savings accounts were frequently refused as a matter of policy until more fertile investment opportunities appeared. Such a negative policy can certainly inflict considerable damage to the long-run success and public respect of any thrift institution, especially when competing associations continue to accept new savings willingly. In rural areas, the community of savers and home buyers may have limited alternatives, and the institution may continue to exploit its quasi-monopolistic position. When such restrictive policies are pursued by firms in metropolitan areas, such as in the Boston vicinity during the late 1930s, rival institutions, especially newly-chartered federal savings and loan associations in this instance, realize a permanent advantage in the market.

Federal savings and loan associations have not only actively promoted new savings accounts, but they have offered substantial financial inducements in the form of higher dividend rates. Undoubtedly, the fact that these associations have consistently paid well over 2 per cent on savings accounts, as opposed to the lower rates paid by savings banks and trust companies, has contributed to their rapid growth. Moreover, the higher yield on bonus savings accounts in federal associations may partially explain the relative decline in the sale of serial shares among cooperative banks.

Actually the added dividend return on serial shares compared to paid-up or savings shares is narrowing, and at least 10 local cooperative banks are currently paying the same rate on all types of share accounts. This suggests either that systematic saving may be accomplished without the offering of special incentives or else that the serial share program no longer serves the changing needs of the community of savers. All cooperative banks continue to promote the personal gains from regular saving, but some no longer feel it essential or even desirable to offer extra dividend returns for this program. Even the attractive bonus plan of federals, whereby a positive inducement is guaranteed for systematic saving in contrast to the negative fine-penalty scheme of serial shares, has not enjoyed universal success among local associations.¹

Interest Elasticity

The role of the rate of interest in influencing the flow of savings into thrift institutions is difficult if not impossible to analyze. While most parties interviewed regard other factors, notably income levels, as more significant in determining the volume of new saving, some thrift institution executives frequently speak of a minimum return necessary to induce savers to part with their cash liquidity.² Even if the total volume of institutional savings inflow is little affected by moderate changes in rates of return, this factor continues to influence its allocation among competing depositaries. As hypothesized above, federals may have accelerated their growth pattern by paying generous dividends on accounts insured up to \$10,000. Furthermore, there is considerable evidence that savings inflows are definitely modified when some institutions raise dividend rates relative to competing associations. A Boston

¹Local Home Loan Bank examiners report that perhaps fewer than 12 federals in the New England District are promoting the bonus plan on a wide scale. Many more associations offer the program but are not anxious to push it, as they feel it appeals to but a small segment of the saving public.

²See, for example, Testimony of R. Rogers, TNEC Hearings, Part II.

cooperative bank doubled its aggregate savings share account from \$800 thousand within a month after dividend rates were raised from $2\frac{1}{2}$ to 3 per cent. Executives of the bank believe that only a portion of this increase was due to a transfer from rival city institutions, but was rather the result of a re-channeling of new savings.

Professor Lintner has investigated the sensitivity of savers to moderate interest rate changes in some detail. To test this relationship, he compared the relative growth of two nearby savings banks which had been paying the same dividend rate but during the time under consideration one of them changed its rate. This comparison must be made in the periods immediately preceding and following the common dividend periods, for any change in deposits during the given dividend period is strongly influenced by the volume of dividends credited to existing savings accounts. For this analysis, 66 individual cases were considered, where one of two nearby banks which had been paying the same rate raised or lowered its rate while the other bank maintained its existing rate schedule. In three-fourths of the cases examined, the institution paying the higher rate realized the greater relative gain in total deposits, thereby indicating that a significant share of the saving community is interest conscious.¹ Even where this pattern is not evident, special factors generally account for the discrepancy. It is impossible to determine whether the influence of raising dividend rates is of a permanent nature or merely a short-term matter. However, it is probable that most transfer of savings from the lower to the higher paying institution would probably occur promptly during the period of the rate change, so that depositors may realize the maximum interest gain from the change. Accordingly, any

¹Lintner, *op. cit.*, p. 141

significant shift in growth patterns in the succeeding period would largely reflect a change in the depositing of new savings, thus indicating a more permanent development.¹

It is perhaps possible that savings depositors are more sensitive to relative interest rate changes than to any existing differences in dividend schedules of alternate thrift institutions. In other words, depositors in institutions with a long-standing record of low dividend rates may come to recognize this possible sacrifice in yield as the cost of additional safety or convenience.² In conformity with this proposition, one of the largest Boston savings banks had been enjoying an average growth even though it had been paying below average dividend returns. As soon as rates were raised in this conservative institution, however, savings accounts increased at an accelerated pace. As a further illustration, one of the smaller federal savings and loan associations in Boston has consistently paid $\frac{1}{4}$ to $\frac{1}{2}$ of 1 per cent below the average dividend rate of all local associations. Nevertheless, its total resources have steadily advanced by 78.5 per cent since 1946 compared with a less spectacular 63 per cent increase for all 15 associations.³

Special factors may account for the continuing ability of commercial banks to maintain savings accounts despite the unusually low dividend returns. In 1950 dividends on savings accounts in savings departments of Massachusetts trust companies were paid at the rate of 1.27 per cent, slightly above the postwar low of 1.14 in 1946. Exact data on dividend

¹ Ibid., pp. 141-2n. This hypothesis of interest consciousness is also substantiated when one of two banks which had been paying different rates, adjusted its dividend structure to equal the other. pp. 142-3.

² Some depositors in commercial banks apparently regard a return of 1 per cent as equivalent to a $2\frac{1}{2}$ per cent rate in other depositaries when due allowance is made for the extra risk and possible illiquidity involved in the latter account. Such a position is hardly tenable in view of the disastrous loss experience among trust companies in particular as opposed to the enviable safety record of other thrift institutions. See below.

³ Federal Home Loan Bank of Boston.

rates paid by national banks are not available on a local basis, but existing evidence points to a rate considerably below the trust company level. For all insured commercial banks in Massachusetts, interest paid on time and savings deposits in 1950 amounted to 0.94 per cent of the total dollar value of their accounts.¹ The corresponding rate for national banks alone would be significantly less than this average, for, of the 174 banks insured by the FDIC, 58 are state-chartered trust companies and belong to the population of institutions paying a rate of 1.27 per cent.

Despite these unusually low dividend returns, savings deposits in commercial banks have grown rapidly at various times. During the war years 1941-1946, total resources of the 24- to 30 savings departments of local trust companies more than doubled in dollar value. Furthermore, the number of depositors also increased rapidly during this period, and has ordinarily exceeded the number of depositors in their respective commercial departments. Especially in the postwar period, however, competing thrift institutions have often promoted new savings through advertising their higher dividend rates, with the result that total resources of trust company savings departments have declined every year since 1946.

Safety motives may partially account for the continuing existence of substantial time and savings deposits in national banks. This factor, however, is much less justified in the case of trust companies in view of their relatively unfavorable depression experience. The universal adoption of state and federal insurance of savings accounts in higher dividend paying institutions actually diminishes the wisdom of depositing savings in either type of commercial bank on the basis of safety alone.²

¹Annual Report of FDIC, 1950, Table 117, pp. 266-7.

²As of December 30, 1950, deposits in all but 8 of 182 national banks and trust companies in Massachusetts were insured by the FDIC. Annual Report of FDIC, 1950, Table 103, pp. 226-7.

Convenience is undoubtedly an important factor underlying many such accounts. Individuals who perhaps conduct their ordinary commercial banking at a particular institution find it much easier to handle their savings business under the same roof as well, rather than to deal with a separate depository. Not only is it easier to make deposits in the "department store" bank, but also funds are generally assumed to be subject to withdrawal at any time. An individual who has a temporary surplus in his checking account may find it convenient to transfer it to a time or savings account for a small dividend return. Though maximum accounts in savings departments of trust companies are limited just as in savings banks, savings accounts in national banks are frequently quite large and highly fluctuating.¹

Despite the singularly low level of dividend returns offered by commercial banks, other elements in their cost structure effectively constrain them from setting mortgage interest rates well below the prevailing market level. As stated earlier, commercial banks, just as any privately incorporated business, must pay dividends to holders of capital stock as well as to holders of savings accounts. Moreover, these banks have always been liable in full to the federal corporate profits tax, the base of which obviously includes revenues from the operations of savings as well as commercial departments. Although the precise influence of these two elements is not known, the effective cost of loanable funds is probably little less for commercial banks than for other higher dividend-paying thrift institutions.²

One local trust company executive regards his \$5 million savings department as far too small to permit efficient operations. Furthermore,

¹This is merely an opinion expressed by some interviewed parties and lacks statistical backing. Individual accounts of \$100 thousand are not at all unusual.

²The maximum rate permitted by the FDIC on savings deposits of insured nonmember banks is $2\frac{1}{2}$ per cent. Annual Report of FDIC, 1950, p. 203.

savings deposits could be substantially increased only if dividend returns were raised from the current 1 per cent rate, a difficult task, as implied above. While a \$5 million asset size may not be optimal, the typical cooperative bank is less than one-half this size, and still continues to be active in the local market. Moreover, the savings departments of several local trust companies have resources exceeding \$5 million, but seldom do mortgage loans dominate their respective investment portfolios. Undoubtedly many, if not most, local commercial banks prefer not to compete vigorously in a mortgage market where mutual thrift institutions enjoy such a commanding influence. Accordingly, a substantial proportion of mortgage holdings of local national banks results from block purchases of FHA-insured and VA-guaranteed loans in other parts of the country.

MISCELLANEOUS MORTGAGE LENDING INSTITUTIONS

Life Insurance Companies

Mortgage lending operations of life insurance companies are much more significant throughout the nation than in the Boston area alone. The six insurance companies with home offices in Boston are heavy investors in mortgages, and in residential and commercial properties as well. In total mortgage holdings, these companies rank well ahead of commercial banks, and currently place more funds in mortgages than in any other investment.¹ Despite these impressive figures on holdings, local insurance companies are not an important factor in the Boston mortgage market. As indicated earlier, they have been tabbed as "fair weather lenders" who enter and leave the mortgage market on a straight relative yield basis. In the

¹Mortgage purchases accounted for 40 per cent of their new investments during 1950, Life Insurance Factbook, p. 70. This ratio applies to all companies in the nation, but appears to be equally applicable to local companies interviewed.

local money market center, existing thrift institutions are subject to rigid investment restrictions especially regarding geographic lending areas. This factor, along with other circumstances producing a relative abundance of mortgage capital, has led life insurance companies to look elsewhere for mortgage loans where net yields are more favorable. Consequently, whereas six local life companies hold over one-fifth of the total mortgage debt held by all Boston mortgage lenders, these and outside companies originate less than 5 per cent of all mortgage loans on local home properties.¹ A substantial proportion of their mortgage holdings are acquired through purchase rather than origination, but the extent of such purchases in the local market is negligible. Similarly, large insurance companies from other states acquire only limited amounts of mortgages on local properties operating through loan correspondents. On the whole, it may be safely assumed that the influence of insurance companies on the local home mortgage market is largely indirect and potential, contingent upon relative yields on similar mortgage investments throughout the country.

Fundamentally, life insurance companies collect countless small payments from millions of policy holders for whom life insurance is a principal method of protection. In addition to providing protection and a convenient means of saving, these companies also perform the economic function of combining such small payments into sizeable amounts of capital and directing them to their most productive use. By profitably investing these funds, the policy holder receives protection at a substantially lower net cost.

¹See Chapter 10.

Just as ordinary thrift institutions, life insurance companies are restricted in their real estate financing activities by statute and supervisory requirements of state banking and insurance authorities. Although most of these restrictions arise from regulations within the state of organization, frequently life companies are further limited by requirements in the various states in which they operate. These companies are generally restricted to loans on improved real estate, obviously designed in part to prevent dangerous land speculation. Typical of investment provisions in most states, Massachusetts life insurance companies are limited to mortgage loans equal to $66 \frac{2}{3}$ per cent of the appraised value of the property, somewhat more restrictive than corresponding savings bank and savings and loan regulations.

In regard to lending areas, insurance companies are free to place mortgage loans on properties located anywhere in the United States, provided these properties are unencumbered by prior liens.¹ Since these thrift institutions accumulate the savings of policy holders throughout the country, one might suggest they are morally justified, if not obligated, to seek a wide geographic diversification in their mortgage portfolio. Savings banks, on the other hand, may regard distant mortgages as safe and profitable, but the charge is frequently voiced that they are trying to export "hard earned local savings to foreign borrowers" instead of accommodating deserving home-town home buyers.²

In at least one other respect insurance companies operate within a more liberal framework than other local mortgage lending institutions. The aforementioned thrift institutions are restricted both in regard to maximum loan terms and the schedule on which repayments must be made. No

¹Annotated Laws of Massachusetts, Chapter 175, Section 63. Cf. restricted lending area of local savings and cooperative banks.

²Interviews. Undoubtedly such allegations generally arise from a bank's refusal of an unsound loan request.

such statutory limits are placed on most mortgage loans of Massachusetts life insurance companies, although they may require regular amortization of loan principal until it declines to 60 per cent of value.

Life insurance companies, just as many national banks, have re-entered the mortgage market since the depression years largely as a result of federal intervention. The above restrictions on mortgage lending are waived in the case of FHA-insured loans (and later of VA-guaranteed loans as well), a major investment outlet for insurance companies. Since these companies frequently prefer to acquire mortgages by purchase rather than by origination, the government insurance feature has performed an essential service in promoting a higher degree of mobility to long-term capital.

Credit Unions

Credit unions have never been an important institutional force in the home mortgage market. Introduced into this country during the second decade of this century, credit unions were organized primarily as a reform measure, to protect people from predatory "loan sharks." As a cooperative type of association, they may be chartered either by the state or federal government for the purpose of accumulating the savings of their members and of making loans to them for various reasons. In performing the latter function, credit unions provide personal loans at rates much lower than those charged by other loan agencies accessible to persons of small incomes. The coordinate function of promoting thrift is accomplished by selling shares and accepting the savings deposits of their members.¹

The members of a credit union must have some other common bond of association, such as similar employment, residence in same community,

¹J. L. Snider, Credit Unions in Massachusetts, Graduate School of Business Administration, Harvard University, Boston, 1939, Chapter I.

same national origin, etc. Since group interests are of paramount importance, earnings and profitability have generally been subordinate to service as a primary objective. Rates of interest charged on personal loans are limited to 1 per cent per month on unpaid balances under federal charter, while only a "reasonable" requirement is specified for state-chartered unions. Loan repayment is frequently accomplished on a weekly basis to coincide with pay day, and the maximum loan term is limited to 1 year.

Credit unions are severely restricted in their mortgage lending operations. Federal unions are effectively excluded from this market altogether by the highly restrictive provisions in their charters.¹ State-chartered unions may extend secured real estate loans, but again statutory requirements eliminate a large portion of them from active participation in this market. They may invest in mortgage up to 50 to 70 per cent of their assets, depending on the size of the credit union. Under no circumstances, however, can a single real estate loan exceed 5 per cent of total assets or \$8,000, whichever is the lesser. Within these limits, credit unions are authorized to make 60 per cent mortgages, provided the accompanying note is payable either on demand or within 3 years. Mortgages with loan amounts up to 80 per cent of value may also be written, so long as regular amortization is required until the loan balance is trimmed to 60 per cent of value.²

In view of these various restrictions, only one-fourth of the 215 credit unions in the Boston area hold any mortgage loans whatever. The average organization held total assets of \$150 thousand in 1950, hardly adequate to permit the maintenance of a sound, diversified mortgage port-

¹As of 1937, such loans were limited to \$200 or to 10 per cent of the union's unimpaired capital and surplus, whichever is greater, with a maximum term of 2 years. Snider, *op. cit.*, p. 17.

²These weekly, monthly, or quarterly payments must retire the principal at least 6 per cent per year. Annotated Laws of Massachusetts, Chapter 171, Section 24B.

folio. In Boston alone, there were 125 credit unions, only 6 of which held assets of over \$1 million.

During the early development of credit unions in Massachusetts, real estate loans were a major investment outlet, actually exceeding the volume of personal loans as late as 1925. Small personal loans, however, are the natural field for credit unions, and have generally dominated lending operations since the late 1920s. At various times, members have sought small second mortgages to supplement funds secured from conventional lenders, but this activity has not been extensive in recent years. Under current regulations, credit unions may make second mortgages only where the combined first and second mortgage loans do not exceed 80 per cent of value, or \$8,000, whichever is lesser.¹ As of December 1950, the 457 credit unions in Massachusetts had invested on the average 24.2 per cent of total assets in real estate loans, all but 0.33 per cent being in first mortgages.² Over one-third of the combined mortgage holdings of all credit unions in the Boston vicinity were held by a Malden association. This union, being the largest in the area with assets of \$2.6 million, held nearly \$1.4 million in mortgages in 1950. It appears as if credit unions concentrate on extensive mortgage lending only in neighborhoods or communities where conventional thrift institutions are less active.

As stated above, capital funds are acquired either through selling shares or accepting ordinary deposits. Dividends paid on these accounts have followed the same general pattern as those of other thrift institutions. After reaching a low level in 1946, rates on both capital accounts have gradually risen, and by 1950 amounted to 2.8 and 2.0 per cent

¹Annotated Laws of Massachusetts, Chapter 171, Section 24B.

²Annual Report, Massachusetts Commissioner of Banks.

on shares and deposits, respectively.¹

Other Mortgage Lending Institutions

In addition to the previously described institutions, several other types of lenders play a minor role in the local mortgage market. These latter are generally included in that heterogeneous category, "individuals and others," and very little is known about its composition. Perhaps most significant among this group are the various sorts of mortgage companies and brokers. These organizations specialize in real estate credit, buying up mortgages for resale to others or merely functioning as middlemen for lending institutions and prospective mortgagors. Such agencies ordinarily have limited equity funds of their own, and frequently rely on short-term advances from commercial banks for working capital whenever necessary. Because of their low capitalization, mortgage companies depend upon a fast turnover of mortgage inventories in order to enjoy economy operations.

So-called "mortgage companies" have become increasingly significant since the introduction of FHA-insured loans, and later on of the VA-guaranteed home loan. These agencies frequently collaborate with operative builders in arranging construction loans with nearby or distant commercial banks and in placing the permanent mortgages with outside institutions. They generally seek advance commitments from insurance companies, savings banks, and, until recently, the Federal National Mortgage Association,² selling the paper at above or below par depending on current market conditions. Although these sales commissions constitute an important source of income, mortgage companies depend upon servicing fees as a primary revenue

¹These dividend rates apply to all 457 credit unions in Massachusetts. Annual Report, Massachusetts Commissioner of Banks.

²See Chapters 8 and 14 for a description of FNMA and its operations.

producer. The mortgage purchaser ordinarily leaves all servicing functions with the mortgage company, and pays a fixed percentage fee for this detail, generally equal to $\frac{1}{2}$ or 1 per cent of the unpaid loan balance. Before an agency can operate as an originator or servicer of FHA-insured loans, it must first qualify as an FHA-approved mortgagee.

In the Boston area, such organizations function primarily as brokers, and seldom possess an inventory of mortgages on their own account. In areas where long-term credit is abundant, most home financing needs are met by local thrift institutions that both originate and service mortgage loans to maturity. Accordingly, servicing fees constitute a minor source of income for mortgage brokers in the Boston vicinity, except where the servicer is a loan correspondent for a life insurance company. Mortgage operations are frequently operated in connection with other real estate activity, thereby permitting the realtor to collect the customary sales commission from the previous home owner in addition to a possible mortgage fee. This latter compensation has become increasingly prevalent in the postwar period, ordinarily representing 1 per cent of the mortgage principal. Whether a brokerage fee, if any, is paid by the lender or by the borrower depends on the current competitive conditions existing in the local market.¹

Various creations of the federal government have also figured prominently in the local home mortgage market. As a direct lender, the government has intervened only through "emergency" measures, two such cases

¹See Chapter 12. As of May 31, 1951, the Federal Reserve found that there were 20 so-called "mortgage companies," 30 "mortgage brokers," and 306 "real estate brokers or agents" operating in Essex, Middlesex, Norfolk, and Suffolk Counties. Although these organizations represented nearly one-half of all mortgagees in the local market, their combined mortgage holdings accounted for only 0.5 per cent of the total mortgage debt held by all institutions. Across the nation, there were 26,734 such "non-institutional" mortgage lenders out of the grand total of 43,771 registrants as of mid-1951. In contrast to the local area, mortgage holdings of mortgage companies, brokers, etc., represented nearly 6 per cent of the aggregate nationwide mortgage debt.

involving HOLC loans during the depression and the current program of home loans to veterans. Through the ordinary FHA and VA home loan programs, the federal government has exerted a strong influence on the local market, although the FHA program has been more widely received in other sections of the country. Lastly, the Federal National Mortgage Association (FNMA) and RFC Mortgage Company have at various times purchased large quantities of FHA and VA mortgages, providing an effective secondary market for this paper. These federal government activities are considered in greater detail elsewhere in this study, and merit but brief mention here.

PART IV. THE METROPOLITAN BOSTON HOME MORTGAGE MARKET: A PREWAR SETTING

Although the primary emphasis of this study concerns the postwar market, it seems wise to present some of the institutional background underlying mortgage operations over the past two or three decades. Cyclical fluctuations have been unusually severe in the housing industry, with market valuations and the volume of new construction exhibiting violent swings. The severity of these movements has been aggravated by the varying qualification standards set up by mortgage lending institutions in passing on loan requests. In boom periods they abet the inflationary spiral through providing unjustifiably liberal credit, while in depressed periods many have virtually withdrawn from the market. Since the postwar economy has evidenced continuous prosperity and inflationary pressures, mortgage lending has been largely geared to these circumstances. To present a more rounded picture, brief mention should be made regarding lending practices during the depression of the early 1930s. Moreover, the major structural changes arising out of the depression experience must be recognized and analyzed in discussing the current operations. An additional reason for this historical summary concerns the long-term nature of mortgage lending: except for the new or rapidly expanding institutions, a significant proportion of existing portfolios consists of loans made in the prewar years. Among the institutions visited, one holds some mortgages which have been on their books since the late nineteenth century!

In this section, some characteristic weaknesses in the home mortgage network will be touched on, especially in the period prior to the depression of the early 1930s. Much of the descriptive material will be general in scope, and concrete reference to the local situation will be drawn only where relevant data are available. This discussion will be followed

by an outline of the salient features of various federal measures designed to promote a permanent improvement in urban real estate finance. Special consideration will be devoted to the FHA program and its influence on the local home mortgage market. Data on mortgage lending activities in the Boston area will be presented in later sections dealing with the postwar mortgage market.

CHAPTER 6. WEAKNESSES IN PRE-DEPRESSION MARKET

The unprecedented building boom of the 1920s brought to the forefront many glaring weaknesses in the whole mortgage network. Numerous speculators had seized the opportunity to reap quick profits during those buoyant days, taking full advantage of easy credit availability. Mortgage investment had long been regarded as a choice outlet for institutional funds, on both counts of yield and safety. Since business prosperity had provided them with an unprecedented inflow of savings, thrift institutions eagerly bid against each other in underwriting continued speculative activity. It was inevitable that their unsound lending practices would soon undermine the whole shaky credit structure.¹

Although lenders undoubtedly recognized the illiquid nature of such investment, many evidenced a blind faith in the ultimate soundness of any mortgage loan. Even if certain large loans to speculators would involve short-run foreclosure and loss, the undeniable long-run inflation in land values would guarantee eventual recovery. Temporary economic reversals would certainly give way to rising property values as a result of better standards of living, population growth, etc. While the history of land

¹It should be mentioned that not all speculative mortgage borrowing concerned the buying and selling of real estate. Many existing home owners took out mortgages on their property in order to secure funds for the purchase of consumer durables or for stock market speculation. Home Mortgage Lending, American Institute of Banking, New York, 1938, p. 12.

values would demonstrate a good deal of truth in such optimism, it is hardly a prudent investment policy. Numerous local real estate crises and, later on, the severe debacle of the early 1930s have shattered its universal validity. Furthermore, neighborhood blighting and economic degradation may be a permanent phenomenon, despite the fact that population and incomes continue to expand in adjacent communities.

It is perhaps unfortunate that competition among lenders did not assume the form of price concessions or, in other words, lower interest rates. Many local thrift institutions felt obliged to offer dividend returns of 5 or 6 per cent in order to maintain savings accounts in tact. At the same time they hardly felt justified in cutting interest rates below the customary 6 per cent, but preferred the more "ethical" technique of inflating property appraisals to place new loans.¹ From a sampling survey of mortgage lending on single-family homes during this period, Professor Tucker found the average nominal rate of interest on first mortgages in the country to be 6.2 per cent.² Among the 52 cities included in a nationwide study of urban housing finance in 1934, Wickens chose 4 New England cities.³ On first mortgages the weighted average nominal rate was 4.93 per cent for the New England cities, compared with a national average of 6.18 per cent. Contract rates appeared more concentrated about a single value in New England than elsewhere; three-fourths of all reported cases bore a 6 per cent rate in this region against one-half ratio across the nation. One-fifth of all loans in the country were written at 7 per cent, while rates as high as 12 per cent were reported.

¹See below. So long as the ratio of loan amount to "appraised" property value did not exceed a conservative 50 or 60 per cent, the mortgage was regarded as reasonably secure.

²A. F. Bemis, "The Economics of Shelter," The Evolving House, Technology Press, Massachusetts Institute of Technology, Cambridge, 1934, Appendix Chapter X, p. 582.

³These were Portland, Maine; Nashua, New Hampshire; Worcester, Massachusetts; and Providence, Rhode Island. For some data, Waterbury, Connecticut, was also studied. D. L. Wickens, Residential Real Estate, National Bureau of Economic Research, New York, 1941.

The actual costs of borrowing for home purchase far exceed nominal interest charges stipulated on loan contracts, on account of various forms of bonuses, commissions, discounts, renewal charges, and service charges. Wickens found the weighted average effective rate on first mortgages to be 6.17 per cent for the region and 6.54 per cent for the nation as a whole. As will be pointed out shortly, heavy charges in connection with junior financing sharply increased the overall costs of home purchase.

The risks involved in mortgage lending, in part because of the instability in real estate values, led institutional lenders to restrict first mortgage loans to rather low percentages of appraised property values. Legal and traditional limitations of 50 to 66 $\frac{2}{3}$ per cent of valuation were designed to protect the mortgagee and individual savings depositors from loss in case of default. Rather than defer home purchase until the necessary down payment had been accumulated, two options were frequently open to the buyer.

He could shop around from one institution to another seeking the largest possible advance to supplement his limited down payment equity. All too frequently the lender, eager to maintain his loan volume, permitted the overvaluation of property necessary to trim the loan-value ratio to a point where the required loan amount no longer appeared unreasonable. As mentioned above, the lender perhaps felt justified in extending such loans in order to keep funds actively employed and, in event of default, subsequent disposition of the property would be profitable in an inflationary economy. Since risk was assumed to vary directly with initial loan-value ratios, little weight was ascribed to the borrower's capacity to carry the debt burden or to environmental factors which might indicate a premature depreciation of mortgaged property. With such un-

scientific and unsatisfactory risk analysis,¹ it was inevitable widespread

¹The following statement was made during the FHA Hearings: "There is an erroneous opinion around that loans were made on a 50 or 60 per cent valuation. They were made on a 50 or 60 per cent selling price, not a valuation.

foreclosures would accompany any downturn in economic activity.

Despite the tendency toward liberal "curb appraisal" techniques, many home purchasers were compelled to resort to the second option of junior financing. The unsatisfactory, costly, and frequently illegal system of second and third mortgage lending has been a major cause of delinquency in fulfilling first mortgage obligations. Such credit has ordinarily been supplied by second mortgage companies, or by individuals or builders who are sellers of the property (involving purchase-money mortgages.) Although never common in this region, builders sometimes accepted a small equity payment and a land contract for the remainder.

In a sample survey, Wickens found weighted average contract rates of interest on second and third mortgages to be 6.76 per cent in New England and 6.44 per cent in all 52 cities surveyed.¹ These rates appear surprisingly low, for available records indicate nominal rates of 10 per cent plus substantial commissions, service charges, etc. Most contracts required monthly amortization over a period not exceeding five years, and any failure to make regular payments meant prompt foreclosure.² Speculative builders would take second mortgages only to consummate a sale, and would seek to free working capital from this risky operation by discounting them wherever possible. In the late 1920s when cash down payments dropped to as low as 5 per cent, builders could dispose of their second mortgage

¹Wickens, *op. cit.*, p. 252. The corresponding effective rates were 7.85 and 7.02 per cent, respectively. The reliability of these findings must be considered in the light of the smallness of the sample.

²Toward More Housing, Temporary National Economic Committee, Monograph No. 8, 1940, p. 79.

. . . I happen to be living in a house which I could reproduce today for \$18,000, that has a \$25,000 building and loan mortgage on it." Testimony of J. G. Caffrey (representing Ohio Association of Real Estate Boards), Hearings before the Committee on Banking and Currency, U. S. Senate, 73d Congress, 2d Session on 5,3603, 1934, p. 41. It should be noted in passing that the tenacity of such mortgagors to continue mortgage payments in face of severe market declines accounts in part for the preference of institutional lenders for loans on single-family, owner-occupied homes.

loans only at discounts of up to 50 per cent. In order to emerge with a profit, the builder began to price his product to cover this heavy discount. Thus a vicious race between home prices and mortgage discounts developed, rendering the combined mortgage obligations of the home buyer virtually prohibitive.¹

Further evidence of oppressive junior financing has been described by Albert Farwell Bemis.² Standard discounts to be deducted from the original loan amount ranged from 8-10 per cent on a one-year loan, up to 20 per cent on a five-year mortgage. Of course, the borrower was also obliged to make regular interest payments on the unpaid balance, in addition to paying an initial brokerage fee of 2 or 3 per cent.³ At least one of the local institutions visited suffered extraordinary depression losses resulting from the refinance of previous first and second mortgages into a single instrument. Even though the rewritten contracts provided for full amortization, the loans had been initially made on the basis of such inflated valuations (especially considering the builder's second purchase-money mortgages) that even regular principal amortization was inadequate to trim the outstanding balance to a safe figure by the early 1930s.

¹ Ibid., p. 79.

² Bemis, op. cit., pp. 368-9. The discount technique was often employed as a means of avoiding usury laws; since the purchaser of a second mortgage could sell it at any discount, a third "straw man" was frequently set up to initially take the lien thence endorse it over to a mortgage company which would sell it at a discount, turning over the proceeds to the borrower.

³ Ibid., p. 369. The company referred to is the U. S. Bond and Mortgage Company of New York.

Another basic source of weakness in the mortgage picture was the unsound practice of employing short-term contracts to finance essentially long-term obligations. Except for building and loan associations (i.e., cooperative banks), most institutions drew up straight mortgage notes with maximum terms of 3 to 5 years. It was rare indeed when a family could accumulate sufficient funds in such a short period to pay off its debt at the end of the term. Ordinarily, however, so as not to lose the loan via refinance, the lender would promptly renew the loan upon payment of various renewal fees, and might even include unpaid taxes and interest in the new principal. Although advances in property values frequently served to reduce outstanding loan-value ratios, the relation of the vast sums invested in real estate mortgages to the changing values of the underlying security was seldom examined carefully.

Lenders placed unwarranted confidence in the apparent liquidity of such investments. At least one-third of the outstanding balance became due every year, since the term rarely exceeded 3 years and renewal loans ordinarily stipulated repayment on call or merely extended the term one year.¹ Accordingly, thrift institutions accepting deposits from the public with an implicit responsibility to meet most withdrawal requests on demand, felt fully justified in investing in "liquid, convenient, high-yielding" mortgage loans. They had no scruples about renewing loans indefinitely, especially if interest and taxes were not in arrears, as the depositors' funds were continually employed with a minimum amount of effort. Interviews have revealed instances where local institutions had actually discouraged repayment in order to maintain steady income from sound loans;

¹ Colean suggests that repeated governmental efforts during times of distress to postpone or modify principal repayment had contributed to the practice of writing short-term mortgage loans, in hopes of completing payment before a new crisis and moratorium intervened. M. L. Colean, The Impact of Government on Real Estate Finance in the United States, pp. 80-81.

rather than repay the loan, the mortgagor was urged to augment his savings account as an emergency reserve. On the other hand, many borrowers perhaps looked upon eventual repayment as but a remote possibility. They felt that "when they succeeded in borrowing the money, that was all they had to do. . . . (if) they had to replace it they would replace it . . . by borrowing from somebody else, and they lost. . . the ambition to pay off their debt."¹

The artificially short-term character of mortgage loans served to aggravate the severity of economic crises. In many cases, frantic depositors would rush in to withdraw their funds from the thrift institutions in which their confidence had been shaken.² Supposedly liquid demand loans as well as fully amortized loans were of limited immediate assistance in meeting these heavy withdrawal requests. Since declining employment and incomes are characteristic of depression periods, the mortgagor was frequently unable to make substantial principal payments and, in the absence of government intervention, widespread foreclosures were inevitable. This procedure hardly solved the lender's acute liquidity problems, however, for foreclosed properties would bring in limited sales revenues in a depressed real estate market. Hence, it became apparent that short-term loans were no less damaging to the lender than to the borrower.

Another basic weakness in the mortgage contract concerned the lack of adequate repayment provisions. Except in building and loan associations where repayment was systematically accomplished through a sinking fund arrangement, most mortgage loans were written for a short-term with little or no principal amortization. The only regular payments made by mortgagors

¹Testimony of C. A. Miller, President of Savings Banks Trust Co., New York, FHA Hearings, op. cit. pp. 302-3.

²As pointed out in Part III, precisely the opposite tendency characterized local savings banks operations, as deposits increased steadily during the 1930s, while other institutions enjoyed less universal public confidence.

consisted of interest, usually on a monthly or semi-annual basis. This method of repayment, while extremely convenient (at least simple) for the individual lender, created serious problems for the borrower.¹ The capital outlay required at the end of the term was frequently so heavy that foreclosure was inevitable unless the loan could be extended or refinanced elsewhere. Undoubtedly, the "economic man" would accumulate a special fund out of current income to cover amortization, tax payments, etc. In real life, however, any such scheme is unlikely on a wide scale unless enforced on a compulsory basis.

The available data indicate that systematic amortization of principal has been less prevalent in New England than in the nation at large. Wickens reveals that less than one-fourth of all reporting loans were amortized in New England, while nearly two-fifths provided for contractual amortization among all 52 cities (in the early 1930s.)² This contrast reflects in large part the predominance of savings banks in the New England region, as these institutions wrote relatively few direct-reduction loans until the immediate prewar period. Their predominance is also manifest in Wickens' findings on frequency of principal and/or interest payment. Semi-annual payment was required in 31 per cent of the cases across the nation while in the 4 New England cities the corresponding proportion was 62 per cent. As stated earlier, monthly payment is most frequent among fully amortized loans, such as those made by savings and loan associations. Semi-annual remittance, on the other hand, was typical of straight-term mortgage contracts, such as those made by savings banks.³

¹ Unfortunately, the flat mortgage was well suited for speculative operators, who held title to a piece of property for a short period. Hoping to repay the initial loan with subsequent larger resale revenues, they would have found amortization requirements inconvenient.

²Wickens, op. cit., p. 278.

³Ibid., p. 280.

The failure of the mortgagor to accumulate reserves for real estate taxes on a systematic basis has also aggravated risks of default. Many local savings banks and cooperative banks suffered their greatest depression losses because of delinquent tax liability. Frequently foreclosed property would be burdened with tax liens of 5 or 6 years' standing, inasmuch as the mortgagee seldom bothered to investigate this matter so long as mortgage obligations were fulfilled.¹

As indicated above, the capacity of the borrower to carry the mortgage burden was rarely investigated on an objective basis. Since repayment was seldom accomplished through regular amortization, the whole transaction was not translated into income concepts. Retirement of the obligation was implicitly regarded as a contingent "wealth" or "asset" problem, while only interest and occasionally tax payments constituted an integral part of the family budget. Undoubtedly some mortgagors felt little motivation to fulfill the mortgage contract as stipulated. Particularly where straight-term mortgage was involved, the home owner frequently would lose little equity in the property even if it were taken over by foreclosure. Hence, he might have been relatively insensitive to minor differences in precise rates of interest and other contract terms; moreover, the impotency of deficiency judgments would safeguard him from more extensive personal loss.

An obstacle which has impeded the development of a nationwide mortgage market down to the present day has been the inherent localization in mortgage lending. Until recently at least, tradition and legal restrictions have prevented most institutions from operation over a wide area. As a result, mortgage portfolios have been denied a proper geographical risk distribution, and their soundness frequently depended upon the economic fortunes of a single industry or firm. Most lending agencies were isolated

¹Interviews.

from the capital markets of the country, and lacked any mechanism to facilitate transfer of funds from regions of surplus to those of dearth. Hence, all institutional lenders, with the notable exception of insurance companies, were primarily dependent upon the irregular and uncontrollable flow of local savings for home mortgage credit.

Undoubtedly this extreme localization is both a cause and a consequence of the poor marketability of mortgage paper. As will be discussed in Chapter 14, a product must be highly standardized before it can be freely bought and sold in an organized, impersonal market. In view of the haphazard methods of appraisal, the variety of loan contracts, repayment provisions, rights of parties, foreclosure regulations, etc., characteristic of mortgage lending, it was inevitable that the mortgage network would consist of many local, isolated markets. Especially during the late 1920s, it became more and more apparent that the home mortgage mechanism critically needed a major revamping, to safeguard the interests of both mortgagee and mortgagor, as well as to achieve a greater degree of stability and rationality in this important sector of the economy.

CHAPTER 7. GOVERNMENT INTERVENTION

The debacle of the early 1930s set the stage for a series of sorely needed remedies in the ill-fated mortgage market. Injudicious lending especially during the late 1920s culminated in an unprecedented wave of mortgage delinquency, foreclosure, and liquidity demands of depositors. Although foreclosed real estate remained a minor item in the asset structure of Massachusetts institutions throughout the 1920s, it is significant that the number of savings bank foreclosures tripled between 1925 and 1926 and increased steadily over the next decade. Despite these and other indications of impending trouble, most institutions did little to stem the inflationary spiral. New lending among savings banks began to decline after 1926, even though the average loan continued to rise and contractual amortization was rarely required.¹

During the early years of the depression, foreclosure accounts for both cooperative banks and savings banks rose steadily until 1936, when they constituted 11.86 and 6.73 per cent of total assets, respectively.² Cooperative banks, however, disposed of their foreclosed property more rapidly than savings banks, and by 1941 the corresponding ratios for these institutional groups were 5.84 and 4.08 per cent, respectively.³

There were a great many instances where foreclosure appeared unnecessary or unwise, especially where the mortgagor appeared to be in only temporary difficulty or where merely foreclosing a delinquent loan would not assist institutions in meeting critical liquidity requirements. In 1931 cooperative banks were granted limited permission to suspend temporarily the regular monthly payments on pledged shares.⁴ Relief was afforded many mortgagors

¹Lintner, op. cit., p. 273.

²Annual Reports, Massachusetts Commissioner of Banks.

³For a detailed analysis of mortgage foreclosure policies of Massachusetts savings banks, see Lintner, op. cit., Chapter X.

⁴Act of 1931, Chapter 365.

by this clause, and by 1936 such distress mortgages accounted for 15 per cent of the total assets of cooperative banks in the local area studied.¹ To determine the extent of substandard mortgages in the portfolios of savings banks, Professor Lintner analyzed the volume of loans earning current yields of 3 per cent or less during the depression and subsequent war years. Since few loans had been initially written at rates of interest as low as 4 per cent, mortgages yielding 3 per cent or less would indicate: (1) interest delinquency; (2) a voluntary reduction in rates charged on existing loans for distress purposes; or (3) concessions granted on purchase-money mortgages arising from the sale of foreclosed real estate. Substandard mortgages so delineated represented an increasing proportion of mortgage portfolios until 1943 when a peak of 14.34 per cent was reached.²

There is some evidence that depression foreclosure experience has been somewhat less favorable in New England than in other parts of the nation. Professor Saulnier found a foreclosure rate of 28.8 per cent among all loans made by 24 American life insurance companies on New England properties during the decade 1920-29, this rate being the highest among the 9 census regions in the country.³

By 1935, general business recovery appeared to be well underway, and real estate activity had begun to improve. Considerable damage, however, had already been inflicted upon the mortgage system, and the process of readjustment was necessarily a tortuous one. Continued unemployment threatened many mortgagors with foreclosure and existing home owners suffered a severe capital loss if they were compelled to dispose of their property. On the other hand, thrift institutions still held investment portfolios saturated with frozen mortgages and were struggling to remain solvent.

¹Computed from Annual Reports, Massachusetts Commissioner of Banks.

²Lintner, op. cit., pp. 277-8.

³Saulnier, op. cit., p. 87.

By this time, however, positive steps had already been taken by the federal and state governments to effect a permanent improvement in the mortgage market.

INTERVENTION BY STATE GOVERNMENTS

Intervention by state governments was necessarily limited in scope, inasmuch as their fiscal and credit regulatory powers are very similar to those of private parties. Most states enacted debtor relief legislation relative to mortgage moratoria, redemption periods, and the restriction of deficiency judgments. Massachusetts, however, took positive steps to restore and maintain public confidence in the existing state-chartered thrift institutions.

Before any public relief machinery could be set up, the Bay State Trust was organized in 1931 to prevent the suspension of several weak cooperative banks. The stronger members contributed about \$125,000 to a pool used for advances to banks in immediate danger.¹ This trust arrangement served as a stop-gap emergency measure until the Central Cooperative Bank was established in 1932.² This latter institution was designed to function as a central reserve agency to facilitate flexibility and elasticity in the operations of member cooperative banks. In practice, the limited resources in the Central Bank have permitted advances to member banks for emergency purposes only, and not merely to finance additional mortgage lending.³ A somewhat analogous institution was incorporated by savings banks in 1932, called the Mutual Savings Central Fund. In addition to the above functions, this agency with assets of \$3.7 million

¹Davenport, op. cit., p. 12.

²Acts of 1932, Chapter 45.

³On April 30, 1950, resources of the Bank totalled 9.4 million, of which \$340 thousand represented unsecured loans to member banks. During the year ending April 30, 1951, these advanced increased sharply to \$1,445 thousand. Annual Report, Massachusetts Commissioner of Banks.

assembles pertinent data on bank operations and undertakes various studies for member banks.

In 1934, the Massachusetts General Court provided for the establishment of share and deposit insurance funds for all savings and cooperative banks in the Commonwealth.¹ Both funds are managed by member banks under state supervision, and are an integral part of the two central reserve organizations described above. Supported solely by proportionate assessments of insured members, these funds differ slightly from corresponding federal schemes in that every deposit or share account in every bank is to be insured in full, with claims payable in cash. Although the distinction is popular advertising material, the apparent superiority of full over partial coverage (e.g., of all deposits up to \$5 or \$10 thousand) must be considered in the light of the average (and maximum) deposit or share account.²

The last important depression measure enacted by the Massachusetts legislature (considered here) authorized savings and cooperative banks to write mortgage loans on a direct-reduction basis.³ This type of mortgage had long been promoted by the federal government⁴, and its appearance in urban real estate finance was hastened by the efforts of the HOLC, FHA, Federal Home Loan Banks, and federal savings and loan associations.⁵ Immediate public acceptance of this type of contract compelled its adoption by cooperative banks, but savings banks wrote few direct-reduction loans until the late 1930s.⁶

¹Acts of 1934, Chapters 73 and 43, respectively.

²As of October 31, 1950, total assets of the Deposit Insurance Fund were \$22.4 million, while the corresponding April 30 figure for the Share Insurance Fund was \$6.4 million. Annual Report, Massachusetts Commissioner of Banks.

³Acts of 1935, Chapter 191.

⁴It had been used by Federal Land Banks since 1917.

⁵See below.

⁶See Chapter 11.

Many of the fundamental weaknesses in the home mortgage system demanded extensive public programs beyond the means of financially crippled state governments. Indeed, while state relief measures were at best alleviative, the persistent attempts at protecting the debtor at the expense of his creditor threatened to block recovery.¹ In order to stimulate the flow of private capital back into the mortgage field and to promote a sound, nationwide mortgage structure, vast programs would be required. It was soon apparent that such operations could be undertaken only by the federal government.

This study does not attempt to analyze or evaluate the contributions of all the various depression measures, whether they be permanent or merely relief in character. To avoid becoming lost in a maze of administrative detail, only the salient features of those programs directly related to home financing will be outlined here. These programs will be discussed under the following headings: The Federal Home Loan Bank System; refinance activities of the Home Owners Loan Corporation; federal savings and loan associations; Federal Savings and Loan Insurance Corporation; and lastly, the Federal Housing Administration. Only the last named, the FHA, will undergo a fairly detailed investigation in this and succeeding chapters. At the conclusion of this section, the Veterans Administration home loan program will be briefly reviewed.

FEDERAL HOME LOAN BANK SYSTEM

As early as 1918, building and loan associations began to agitate for the creation of a central agency to serve mortgage lending institutions much as the Federal Reserve and Federal Farm Loan Systems functioned in the fields of commercial banking and agricultural credit, respectively.

¹Coleman, op. cit., p. 94.

Interest in a central mortgage bank waned during the ensuing postwar expansion, but was quickly revived at signs of impending trouble in the late 1920s.¹ Small building and loan associations had traditionally borrowed from commercial banks to meet temporary cash requirements, but following the financial collapse of 1929, these institutions were forced to look elsewhere for funds.² At a widely publicized conference of leaders in the mortgage lending and real estate fields, President Hoover in 1931 proposed the creation of a system of home loan discount banks.³ His efforts bore fruit in the Federal Home Loan Bank Act of 1932,⁴ which sought a permanent strengthening of the shaken mortgage market through a regular examination of member institutions, and through making available central reserve funds to facilitate a free inter-regional flow of credit. In addition, it was hoped that the discount facilities would alleviate the acute liquidity pressures facing mortgage lenders, thereby providing a more satisfactory handling of borrowers in distress. This being accomplished, foreclosures would be minimized and the steady downward drift in real estate values checked.

The new System followed the analogous Federal Reserve and Federal Farm Loan Systems in that it was governed by a central board and a group of regional banks. After various amendments and modifications, the Home Loan Bank Board now consists of three members appointed by the President, and the country is divided up into 11 districts. As envisioned by President Hoover, membership is open to all qualified savings and loan associations, savings banks, and insurance companies. Unfortunately, however, banking and insurance interests from the outset opposed the extension of federal

¹Colean, op. cit., p. 92.

²TNEC Monograph No. 8, op. cit., p. 84.

³See Publications of the President's Conference on Home Building and Home Ownership, Vol. XI, Washington, 1932.

⁴47 Stat. 725-741, approved July 22, 1932.

control into the home mortgage field. Savings and loan associations, with much to gain and little to lose, took early command of the situation and have molded it to suit their own purposes. This unexpected concentration of membership in a single type of institution has severely handicapped the System's overall effectiveness in meeting national mortgage problems.¹

Member institutions are required to purchase stock in their regional Bank in an amount equal to at least 2 per cent of the unpaid balance of their mortgage holdings, but not less than \$500.² As in the case of land banks, Treasury stock subscriptions supplied most of the initial capital requirements, but, as a result of the increase in the number and asset size of members, total member-owned stock equaled Treasury holdings by late 1948. By December 31, 1950, member institutions owned 76.5 per cent of all stock in the System, and in February 1951, the Federal Home Loan Bank of Boston retired in full all stock owned by the Treasury.³

Services Rendered

Three services rendered by the Bank to member institutions merit brief description here.⁴ Perhaps most important to member associations is the loan service, whereby they may borrow up to 12 times their Bank

¹As of December 31, 1950, the distribution of membership in United States and Massachusetts was as follows:

	<u>All</u> <u>Members</u>	<u>Mutual</u> <u>Savings</u>	<u>Banks</u>	<u>Insurance</u> <u>Companies</u>	<u>Savings and</u> <u>Loan Associations</u>
United States	3,930	29		7	3,894
Massachusetts	158	7		0	151
Metropolitan Boston*	73	1		0	72

*Institutions located within 10 miles of Boston City Hall, as of December 31, 1951, including 16 federal savings and loan associations. United States and Massachusetts data derived from Statistical Summary, 1951, Home Loan Bank Board. Among all 5,980 savings and loan associations in the country, only 65 per cent have joined the Bank System, but their assets represented nearly 92 per cent of the grand total as of December 31, 1950.

²Annual Report of Housing and Home Finance Agency, 1950, p. 174. Up to June 27, 1950, the minimum subscription had been 1 per cent of the mortgages held.

³Ibid., p. 174 and Statement of Condition of Federal Home Loan Bank of Boston, December 31, 1951. All regional banks have now retired government stock investment.

⁴These services were outlined by Herbert N. Faulkner, President of the Boston Bank, in an address at the 63rd Annual Convention of the Massachusetts Cooperative Bank League, September 19, 20 and 21, 1951.

stock held.¹ Interest rates charged on these advances have recently risen from 1 3/4 to 2 1/2 per cent, but are certainly competitive in view of the upward drift in dividend rates. Member associations are sharply divided as to the desirability of extensive borrowing from the Bank. Some believe sound bank management permits borrowing from a central agency only in the event of real hardship, and are opposed in principle to pledging their own assets as security for loans, thereby creating a lien prior to the claims of shareholders. Such a view is not uncommon, for only 57.9 per cent of all member associations were Bank borrowers in 1950.² Other members, on the other hand, regard short-term borrowing from the Bank as a convenient and economical method of meeting annual property tax payments as well as handling unusually heavy loan demands. A large share of the \$50 million now advanced to New England member institutions undoubtedly provided working capital for aggressive federal savings and loan associations.³

The demand and time deposit facilities of the Home Loan Bank also provide an important service for member associations. The demand deposit service offers convenient checking facilities, and a telephone call is sufficient to transfer funds from one type of account to another. Ordinary time deposit accounts are widely used for accumulating tax and Christmas club payments. The right to require 30 days' withdrawal notice has not

¹In 1935 provision was made to permit advances to non-members on the security of FHA-insured mortgages. This privilege has rarely been used, and in 1950 only one non-member borrower was indebted to the Bank. Annual Report, HHFA, 1950, p. 172.

²Annual Report, HHFA, 1950, p. 172. Both secured and unsecured loans are included in this service.

³See Chapter 5.

been invoked as yet, and a generous dividend rate of $1\frac{1}{4}$ per cent is paid on these accounts. For funds left in the Bank for longer terms, deposit certificates are issued, which bear interest at $\frac{1}{2}$ of 1 per cent above the basic time deposit rate.

The Bank also provides members with statistical service and assistance in operational and administrative matters. Periodically, it conducts surveys on various issues of current interest to member institutions. At the same time, however, the local examining staff has found it advisable to render assistance to individual members only when requested and to minimize the administrative detail in their mutual undertakings. Recently the Bank has introduced a new service whereby it will act as an intermediary in the sale and purchase of mortgages.¹

Sources of Funds.

The Bank has three basic sources of funds, two of which, stock subscription and time deposits, have already been mentioned. To secure additional funds, consolidated notes are sold on the open market. These debentures are secured only by the 11 regional Banks, and bear interest yields of $\frac{1}{2}$ of 1 per cent above the corresponding government bond rate. Operating efficiently in a period of expanding economic activity, the Banks have been able to pay their own expenses, establish generous reserves, and consistently pay dividends to member stockholders.²

Although it gave promise of effecting permanent improvements in the defective mortgage structure, the System was ill-equipped to cope with the shattered mortgage market of 1932. As indicated above, only one branch of the mortgage lending fraternity chose to come under the regulations

¹ See Chapter 14.

² At a rate of $1\frac{1}{2}$ per cent during 1951.

of the new federal agency. Moreover, the Banks were granted little direct control over lending practices and interest rates charged by member institutions. Changing interest rates on Bank advances soon proved an ineffective tool in stimulating mortgage lending among member associations during the depression. The small amount of funds being advanced by the Banks, used almost exclusively to meet withdrawal demands of shareholders, could hardly promote a recovery. Section 4 (d) of the original Act had provided for direct loans to distressed home owners, but the necessary machinery to execute this emergency measure had not been set up before the Home Owners Loan Corporation was organized.¹ Board Chairman John Fahey testified that "the Bank System was unable to contribute in any important way toward relief,"² and that emergency machinery was urgently needed to stem the rising tide of foreclosures and to arrest the decline in real estate values.

HOME OWNERS LOAN CORPORATION

Under the leadership of the new administration, an appropriate emergency measure was rushed through Congress. In June 1933, the Home Owners Loan Corporation was established under the direction of the Federal Home Loan Bank Board, with a \$200 million capitalization and authority to issue bonds up to a limit of \$2 billion.³ The distressed home owner who was threatened with foreclosure or was already dispossessed could apply to the

¹ See below. This emergency clause was thence repealed in the Home Owners Loan Act of 1933.

² Hearings, Temporary National Economic Committee, Part 11, "Construction Industry", 1939, p. 5382.

³ 48 Stat. 128-135. The maximum bond authorization was subsequently raised to \$4.75 billion. Moreover, in order to provide a better market for these debentures, an amendment in 1934 extended the government guarantee to the principal as well as interest.

Corporation to refinance his obligation. At the same time, the mortgagee, receiving an HOLC bond for the outstanding balance up to a limit of \$14,000, was relieved of substantial frozen asset holdings. The HOLC as the new holder of the mortgage debt rewrote the contract on liberal terms, usually at a 5 per cent interest rate and repayable over a 15-year term with level monthly payments.¹

HOLC refinancing operations assumed gigantic proportions before terminating in 1936. More than one-third of the existing home mortgage debt had been the subject of an HOLC application, while one-sixth of the total debt, involving over a million home owners, was actually taken over by the HOLC.² Through June 27, 1935, it had made 20,713 loans in Massachusetts, in an aggregate amount of \$92.4 million.³ Since 1936, the HOLC has been in orderly liquidation, servicing its dwindling stock of mortgage loans and disposing of property where loans had become so hopelessly delinquent that foreclosure was necessary. The Corporation has always encouraged its borrowers to prepay their loans as rapidly as possible, or to refinance them with local thrift institutions. Beginning in June 1949, the HOLC began to sell its mortgage portfolios at public offerings, finding a strong market among thrift institutions and commercial banks. By May 29, 1951, this liquidation had been completed.⁴

The record of the HOLC has been a most favorable one. It was called upon to take over the least desirable of all possible home loans, where

¹ These provisions were further liberalized in 1939 to meet FHA terms, when rates on existing loans were rewritten at $4\frac{1}{2}$ per cent with the term extended to 25 years. Ratcliff, Urban Land Economics, op. cit., p. 260.

² E. S. Wallace, "Survey of Federal Legislation Affecting Private Home Financing since 1932," Law and Contemporary Problems, Autumn 1938, p. 492.

³ Annual Report, Massachusetts Commissioner of Banks, 1943.

⁴ Annual Report, HHFA, 1950, pp. 194-6, and Housing Statistics, January 1952. Between 1944 and 1950, the mortgage debt on 1-4 family homes held by the HOLC dropped from over \$1 billion to \$10 million. Statistical Summary, 1951, Home Loan Bank Board, p. 18.

both the borrower and pledged property were associated with heavy risk. The borrower appeared incapable of assuming even a generous long-term mortgage contract, and the mortgaged property could have found a buyer only at distress levels. Nevertheless, endowed with efficient management and the good fortune of operating during a period of improving business conditions and general prosperity, the HOELC has closed its books with a net profit over and above all expenses.¹

FEDERAL SAVINGS AND LOAN ASSOCIATIONS

When the creation of the Bank System was being considered, many building and loan leaders urged the establishment of federally-chartered institutions as well. They argued that the variety of existing regulations surrounding state-chartered associations would seriously impede the development of a sound, flexible nationwide mortgage structure. After the Bank System was established, these interests ascribed the disappointingly slow growth in its membership to the widespread lack of adequate mortgage lending institutions.² As a result of this agitation, the establishment of federal associations was authorized as a section of the ostensibly relief Home Owners Loan Act of 1933. These analogues of national banks in commercial banking are to be either newly-formed associations in underserved areas or merely converted state-chartered institutions. Examined and supervised by the Home Loan Bank Board, these local institutions are to "operate on a uniform plan embodying the best practices and operating principles of savings institutions specializing in the financing of homes."³

¹When liquidation was completed in May 1951, the HOELC had: retired all of the \$3½ billion of government guaranteed bonds; repaid in full the \$200 million of capital initially subscribed by the Treasury; paid all expenses without any general Treasury funds; and turned over a surplus of \$14 million to the Treasury. Annual Report, HHFA, 1950, p. 194, and Housing Statistics, January 1952.

²Shaw, Law and Contemporary Problems, Autumn 1938, p. 494.

³Annual Report, HHFA, 1950, p. 183.

As was explained in the previous chapter, federals are required to be members of the Bank System and to have their accounts insured by the Federal Savings and Loan Insurance Corporation.

As provided in the enabling act, applications for the chartering of new associations are considered in the light of all relevant information, such as: (1) the character and responsibility of the organizers; (2) the necessity for such an institution in the area to be served; (3) the probability of its success and usefulness; and (4) whether or not its formation would inflict undue injury or hardship on established thrift institutions in the community.¹ Substantial financial inducements were offered federal associations from the outset. The Treasury was authorized to subscribe up to one-half of the shares in any one institution, with an aggregate actual investment of \$50 million across the nation. When this Treasury investment was completed in 1935, the HOLC began to invest in federally- and state-chartered associations belonging either to the Bank System or to the FSLIC.²

Of the 1,526 federal savings and loan associations in the nation as of December 31, 1950, 663 were new associations, while the remaining 863 represented converted state-chartered institutions.³ Since this area has traditionally been well supplied with thrift institutions, all 16 federal savings and loan associations in the Boston area are former state-chartered cooperative banks. As discussed elsewhere in the study, the

¹ Ibid., pp. 183-4.

² Savings and loan shares in an aggregate amount of \$261 million were purchased by the HOLC.

³ Ibid., p. 184.

rapid growth and aggressive tactics of federals in Massachusetts as well as elsewhere have stirred up much unfavorable comment among state-chartered institutions. The latter publicize the virtues of time-tested cooperative banking, and have attempted to prevent further conversions by setting up various legal and administrative barriers. The Home Loan Bank Board, pursuing a strict policy of impartiality between the two types of institutions, applies the same eligibility standards whether an uninsured association (i.e., shares are not insured by the Federal Savings and Loan Insurance Corporation) seeks to convert to a federal or merely to qualify for share insurance under its state charter.¹ By preserving a balance of power between these two groups of thrift institutions, the Board feels that each may act as a healthy check on the operations of the other.

The ensuing chapters in this study will discuss the role of federals in the postwar mortgage market. It should be noted here, however, that these associations refinanced a great many mortgages in the depression, and undoubtedly contributed to general recovery through the investment of private funds.

FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION

Any serious financial crisis threatens thrift institutions with a devastating two-edged sword. Depositors clamor to withdraw their savings, either because of shaken confidence in the safety of their funds, or, what is equally likely, because that "rainy day" of reduced income and mounting debt has beset them. At the same time, thrift institutions in

¹ Ibid., p. 184. This procedure is of small import locally, as all cooperative banks have their share accounts insured by the State Insurance Fund.

meeting heavy liquidity demands of depositors and other creditors must frequently resort to extensive borrowing or to foreclosing on delinquent loans. The HOLC and other features of the Bank System were designed to rescue mortgagees from the evils of frozen assets holdings especially during the depression period. To abate the steady drain of deposited funds from thrift institutions,¹ the federal government took positive steps at insuring depositors in certain state- and federally-chartered institutions. The safety-fund idea is not a novel one, as 150 bills for this purpose were introduced into the Congress between 1886 and 1933.² The first such permanent measure set up the Federal Deposit Insurance Corporation,³ designed to insure deposits in all national banks and in qualified state commercial and mutual savings banks up to \$5,000.⁴

The FDIC was enthusiastically received from the outset by millions of depositors. Bank failures, especially among state-chartered commercial banks, provoked a mass exodus of funds into newly-insured institutions. During a one-week period, a solvent suburban trust company lost over a million dollars in savings deposits to a smaller national bank one block distant.⁵ As of December 31, 1950, all but 8 of the 182 commercial banks in Massachusetts (including 116 national banks) were covered by the FDIC, with the insured banks holding nearly 98 per cent of aggregate deposits in the Commonwealth. Although nearly half of the 742 mutual savings banks in the country are similarly insured, the 189 Massachusetts institutions continue to operate under their own Mutual Savings Central Fund exclusively.

¹Local savings banks constituted a noteworthy exception to this condition.

²Annual Report, FDIC, 1950, pp. 63-101.

³See Banking Act of 1933, 48 Stat. p. 168.

⁴Subsequently raised to \$10,000 in 1950

⁵The local bank executive reports that these savings deposits have not been regained down to this day, despite the fact that both banks are now covered by the FDIC.

Across the nation, federal insurance of bank deposits created additional liquidity problems for competing savings and loan associations. Unusually hard hit by the depression, these institutions lost over a billion dollars in share capital pursuant to the establishment of the FDIC.¹ To remedy the situation, these interests led by Chairman Fahey proposed and secured the establishment of the Federal Savings and Loan Insurance Corporation pursuant to Title IV of the National Housing Act in 1934.² The \$100 million capitalization was fully subscribed by the HOLC through an ingenious costless scheme whereby the stock of one corporation was traded for the bonds of the other.³ As is the case with the FDIC, insured members remit annual premiums based on average deposits, which to date have proved to be more than sufficient to cover all claims.⁴ In September 1950, the maximum insurance for each shareholder was raised from \$5,000 to \$10,000 under both FDIC and FSLIC programs.⁵

Insurance is mandatory for federal savings and loan associations but optional with state-chartered associations. To qualify for insurance, the latter must meet specified eligibility requirements and accept additional examination and regulation of their operations and policies. As of December 31, 1950, approximately 48 per cent of all savings and loan associations had contracted for share insurance with the FSLIC. With the notable exception of Massachusetts cooperative banks which are required to support their own Share Insurance Fund, most of the larger associations have applied for and qualified for FSLIC coverage, as the insured group constitutes 81 per cent of the asset holdings of all associations.⁶

¹Testimony of Morton Bodfish, Hearings, TNEC, op. cit. p. 5099.

²48 Stat. p. 1246-1265.

³Shaw, op. cit., p. 497. This "swindle" was attacked in the editorial comments of the 1943 Massachusetts Bank Commissioner, Annual Report, p. ix.

⁴The current assessment rate for both programs is 1/12 of 1 per cent of average shares or deposits, with various credit deductions, etc. See Rules and Regulations for FSLIC and latest FDIC Annual Report.

⁵Annual Report, HHFA, 1950, p. 190.

⁶Statistical Summary, 1951, Home Loan Bank Board, p. 8. As of December 31, 1950, (Footnote continued)

In Massachusetts there has frequently been heated controversy over the relative merits of the two types of share insurance, but there is every indication that the dual system will be retained, for the time being at least.

In the past, opponents of FSLIC have tabbed as most unsatisfactory the method by which settlement payments were to be made to shareholders of an insolvent institution.¹ Inasmuch as share investment in savings and loan associations has often been regarded as less liquid than an account in a savings bank, FSL insurance was supposedly designed only to guarantee solvency while the FDIC specifically assured liquidity for all depositors.² The State Share Insurance Fund allegedly contained the desirable liquidity features of the latter in that all settlements were paid in cash. Although there have been minor variations regarding precise methods of making payments,³ present regulations prescribe the identical procedure for the two Corporations:

(The Corporation is authorized to make payment of the insured account) "(1) by cash or (2) by making available to each insured member a transferred account in a new insured institution in the same community or in another insured institution in an amount equal to the insured account of such insured members."⁴

¹ See Editorial Comments in the 1943 Massachusetts Commissioner of Banks' Annual Report, pp. ix-x.

² See Robert H. Skilton, The Government and the Mortgage Debtor, University of Pennsylvania, Philadelphia, 1944, Chapter X.

³ Earlier regulations of the FSLIC offer each saver in an insolvent institution either (1) an account in another insured, solvent association, or (2) 10 per cent in cash, 45 per cent in non-interest bearing debentures payable within one year, and 45 per cent in similar debentures payable within three years.

⁴ Sec. 405(b) of the National Housing Act as Amended.

total assets of all insured 2,860 associations aggregated \$13.7 billion, whereas 13,640 commercial and mutual savings banks insured under the FDIC had total assets of \$182.7 billion. Statistical Summary, and Annual Report of FDIC, 1950.

At any rate, the FDIC and FSLIC programs curbed much of the panic-withdrawal activity during the early depression years, and undoubtedly contributed to a more rational policy of handling temporarily delinquent mortgage loans among insured members. Enjoying nearly two decades of rising economic activity, their economic soundness has never been put to a severe test. Nevertheless, the public has enjoyed the confidence of placing their funds in guaranteed safekeeping, and, as a consequence, safety alone is perhaps less of a competitive attraction than it was 20 years ago. Undoubtedly, profitability and convenience play an increasingly prominent role in determining the allocation of savings funds among competing thrift institutions.¹

¹ See Chapter 5 above.

CHAPTER 8. FEDERAL HOUSING ADMINISTRATION

With the sole exception of the FDIC, the aforementioned measures were all established under the aegis of the Home Loan Bank Board. The Board supervises operations of the 11 Home Loan Banks, charters and examines federal savings and loan associations, and controls the policies of the HOLC and FSLIC. While some aspects of these programs were ostensibly relief in character, their long-run objective was to augment permanently and stabilize the flow of credit into real estate finance. Stress was laid upon strengthening the position of existing mortgage lenders, especially savings and loan associations, through regular examination and limited central supervision, insurance of share capital, and accessibility to a common pool of funds for additional liquidity.

Although positive steps had been taken toward rescuing millions of distressed home owners from foreclosure and toward relieving institutions of frozen asset holdings, the stimulation of new mortgage lending had been largely overlooked. The many segments of the vast home building industry, especially including labor organizations, supply and equipment manufacturers and dealers, real estate agents, etc., eagerly sought new construction and a restoration of full employment. Enthusiasm for new building was not universally shared by mortgage lending institutions, however, particularly those holding large amounts of foreclosed real estate during this period of depressed values. Mr. Orrin C. Lester testified at the FHA Hearings as follows:

. . . . (Any) lending institution will be relatively prejudiced on (the idea of new building), because the institutions hold the bag of existing investments, and therefore it takes a good deal of courage. . . to initiate the thought that there is a need for a large amount of new construction in this country . . . ¹

¹ FHA Hearings, op. cit., pp. 318-9. Mr. Lester was vice-president of the Bowery Savings Bank of New York City.

At least two different modes of attack were proposed to revive the idle construction industry. In order to further strengthen their own position, saving and loan interests proposed that the HOLC program be expanded to provide earmarked funds for direct utilization in new home building. By purchasing insured shares in these truly "building" and loan societies, federal funds would earn a 3 per cent interest return until disbursed. They insisted that only through the encouragement of sound cooperative institutions would federal intervention promote their avowed long-run objectives.¹

Others proposed federal intervention of a different nature, perhaps less direct but certainly capable of wielding a powerful influence on every phase of the home mortgage structure. The vast amounts of mortgage credit required for a real recovery in home construction were not to be found among the hard-hit savings and loan associations. Hence, if these needs were to be met out of private funds, it appeared essential to tap the huge idle reserves of commercial banks and life insurance companies, which had largely retreated from active mortgage lending during the early 1930s. The FHA insurance program provided a means of drawing out these funds once again:

There is an undoubted dearth of mortgage money in most urban centers. . . and the only way to restore long-term credit facilities and reduce the rate to borrowers, is for the Government to throw the weight of its credit behind the mortgage structure, not as a taker of mortgages, but as a supporter and protector of the investment itself.²

Shifting the focus of federal intervention from the lending institution to the individual mortgage loan itself, the Federal Housing Administration was established pursuant to the National Housing Act of 1934. By insuring private institutions against loss on certain mortgage loans,

¹Ibid., pp. 251, 257.

²Testimony of Walter S. Schmidt, Chairman of the Mortgage Finance Committee of the National Association of Real Estate Boards, Ibid., p. 424.

this vast program was designed "to encourage improvement in housing standards and conditions and to guide the creation of a sound mortgage market."¹ It was not set up to make direct loans or to plan and build homes; neither did it seek a short-cut solution to the acute housing needs of low-income groups. However, by underwriting lending operations of various types of private mortgagees, the FHA sought a renewed interest in new lending and home construction, thereby effectively promoting individual home ownership on a wide scale.

MUTUAL MORTGAGE INSURANCE SYSTEM

This permanent feature of the FHA program provides for the insurance of approved mortgagees against loss on home mortgage loans. Inasmuch as the FHA was initially designed to interest existing and potential mortgage lenders in stimulating new home construction and purchase, only 1- to 4-family structures were eligible for insurance. However, in the 1938 amendments to the National Housing Act, private rental housing was afforded similar coverage in a separate insurance fund. Since the present study is concerned primarily with home mortgage loans, the latter Section 207 will not be described in detail.

For the purposes of this introductory analysis, three aspects of home loan program merit examination: the mutual mortgage insurance fund; the risk analysis prescribed; and, lastly, the specific contract terms required or recommended.

The Mutual Mortgage Insurance Fund

Private lending institutions may theoretically set up their own self-insurance schemes, but the execution of such a program would be extremely difficult. Most progressive mortgage lenders seek to minimize

¹Annual Report, HHFA, 1950, p. 211.

loss by proper diversification and scientific risk analysis, but their only efforts toward setting aside funds to cover contingent mortgage losses consist of accumulating surplus reserves out of current earnings. Many lenders simply build up these reserves until the legal limit has been reached, after which time an extra dividend must be declared. If, on the other hand, a bank's investment portfolio is dominated by government bonds and other low-risk investments, a lower surplus-savings capital ratio may be most satisfactory.

There are many practical impediments to the establishment of a systematic self-insurance program. If accomplished, interest rates would have to include a specific insurance premium adequate to meet the expected risk inherent in the particular type of lending concerned. Unfortunately, very little actuarial data have been compiled from the mortgage loss experience of various types of lenders throughout the country. Even if relevant statistics were readily available, however, the problem of formulating an actuarially sound insurance premium for each particular lending institution would remain. In solving this problem, due allowance would have to be made for the major variables influencing mortgage risk, such as location, age and type of property, credit rating of borrower, relation of unpaid loan balance to current property value, etc. Furthermore, before the law of large numbers could be used to advantage, any insuring agency would have to pool together risk premiums for a great many individual insured event.

Mortgage lending may be more difficult to insure than most other random events, since such loans are seldom independent of one another. While one premature death may have no connection whatever with the life expectancy of others, mortgage default tends to be a cumulative phenomenon. Prudent lenders strive to develop a degree of independence in their portfolio by deliberate diversification among loan types. So that overall lending

risk is subject to a variety of economic forces, they avoid excessive lending in single industry towns, on single purpose properties,¹ on extreme, non-conventionally designed homes, etc. Even after these precautions are taken, however, there generally persists one economic phenomenon against which hedging is extremely difficult. Lenders may attempt to stagger new lending and maturity dates uniformly over the years, but any severe economic recession tends to be accompanied by a wave of mortgage foreclosure and loss. As far as the individual mortgagee is concerned, perhaps the fundamental advantage of the vast government-sponsored FHA program over any self-insurance arrangement concerns the minimization of loss from loans defaulting during depression periods.

In spite of the difficulties in formulating insurance premiums, institutions with a consistent record of sound lending policies and practices may accumulate adequate contingency reserves quite easily. Not only is such a procedure possible, but its widespread adoption should be encouraged. Professor Lintner has attributed the uneconomic foreclosure-loss policy of Massachusetts savings banks during the recent depression largely to their failure to establish adequate loss reserves on a systematic basis. Indeed, even where they had accumulated sizeable reserves in their guaranty fund and profit and loss accounts, many banks were still reluctant to draw on them to cover current losses, largely because of a fear of revealing weakness in published reports.² Since a share of any mortgage portfolio is almost certain to entail a real loss, the current practice of valuing these assets as the unpaid balance of all loans is questionable. Professor Lintner likens this procedure to the truly more defensible practice of carrying premium bonds at original purchase prices until sold.³

¹Such as churches, hospitals, hotels, race tracks, etc.

²See Lintner, op. cit., Chapter X.

³Ibid., p. 322.

He concludes that if Massachusetts savings banks had set aside an amount equivalent to 0.6 per cent of the outstanding mortgage portfolio each year between 1906 and 1945, the accumulated reserves would have covered all net losses arising out of these holdings during the entire 39-year period.¹ Guaranteed Mortgages and Mortgage Bonds. The notion of creating a special agency to insure mortgage loans, such as the FHA, reminded many people of their recent disastrous experience with guaranteed mortgages and participation certificates. Especially after 1920, title guarantee companies in New York found a booming business in making mortgages for various building promoters and thereafter reselling them as fully guaranteed mortgages. They applied a portion of the interest payments toward an insurance pool and found a ready market for their paper at $\frac{1}{2}$ to a full 1 per cent below current mortgage yields.² Savings banks, particularly in outstate New York, regarded guaranteed mortgages as a rich opportunity to hold metropolitan mortgages without the nuisance or expense of making direct contact with the mortgagor. By 1930, the volume of all such guaranteed mortgage obligations in New York had reached \$3 billion.³

These unregulated operations soon became associated with graft and misrepresentation as the building promoter and mortgage guarantor were virtually the same party in many cases. Collateral underlying these obligations became impaired, and unsuspecting investors suffered heavy losses of principal and interest in the ensuing depression.

¹Ibid., p. 339.

²Welfling, op. cit., pp. 57-59.

³Fisher, Urban Real Estate Markets and Their Financing Needs, op. cit., Chapter II.

The experience with mortgage bond issues was no more favorable. This type of financing also flourished during the 1920s, partly because of the popularity of government bond financing during World War I. Both individual and institutional investors could purchase mortgage bonds in convenient denominations, for various maturity dates and with relatively high rates of return. Often the willingness of the issuing house to repurchase its own bonds added both support for and confidence in its paper.

As with guaranteed mortgages, however, the trustee and issuing company shared mutual interests, and often funds were allegedly used for stock market speculation rather than for real estate improvement. Not only was graft and corruption rampant, but frequently the continuing existence of the issuing house depended upon the satisfactory fulfillment of a single large income-property loan. The default of such a contract spelled certain disaster for the issuing house and the mortgage bonds widely distributed throughout society became practically worthless. Following a series of spectacular failures among issuing houses, the Congress intervened through the Securities Exchange Act of 1934 in subjecting the remaining companies to more rigid governmental regulation.¹

FHA Insurance System. To gain widespread public acceptance, the FHA had to demonstrate its superiority over the latter two schemes in remaining solvent in the face of an economic downturn. The mutual insurance system has sought to do this in four distinct ways: (1) by excluding large properties from the eligibility lists, where overvaluation is common; (2) by prescribing a more scientific and conservative method of risk rating; (3) by distributing overall risk among many individual properties; and (4) by securing the backing of the federal government, which is financially able to hold foreclosed properties off the market until a satisfactory

¹Ibid., Chapter II.

price can be realized.¹

The FHA program provides for a self-supporting mutual mortgage insurance system,² whereby approved lenders can convert certain mortgage risk elements into an explicit cost. Although risk may represent an inherent characteristic of mortgage lending, an individual institution can minimize mortgage loss by shifting such elements to a specialized insuring agency.

The mutual insurance fund (associated with Section 203) is subdivided into group accounts, each with insured mortgages displaying similar risk characteristics and maturity dates. In practice, a new set of group accounts is opened at the beginning of each calendar year and the mortgages insured during that year are appropriately classified according to maturity and risk function. The risk-rating technique prescribed by the FHA is used as the basis for assigning loans into the three quality groups.

Each group account is credited with the income and charged with the expenses and losses of all mortgages in the group. If such income exceeds all expenses and losses, the resultant credit balance is distributed in the form of participation payments to mortgagors, either upon payment of their mortgages in full, or upon termination of the group account. Such termination is effected when the amounts to be distributed are sufficient to pay off the unpaid balance of all remaining mortgages in the group, or when all outstanding mortgages in the group have been retired. To provide a reserve to absorb the deficits of the less fortunate group accounts, and also to cover general operating expenses, terminating

¹Skilton, op. cit., Chapter X.

²The "reinsurance fund" of \$10 million (see below) was initially supplied by the government, to cover excessive losses and a share of administrative expenses during the early years. Since July 1, 1940, all FHA operating expenses have been paid out of its own funds. Annual Report, HHFA, 1950, p. 232.

groups are required to allocate a share of their insurance payments to the reinsurance account.¹

The opportunity to share in these mutual insurance refunds serves to emphasize the importance of appropriate allocation of individual mortgage risks among the three quality groups. The segregation of risk categories also obviates the practice of charging varying insurance premiums, a task beset with serious administrative difficulties. Mortgage loans accepted for FHA insurance may or may not represent a random sample from the population of all home mortgages. Strict risk-rating techniques may permit only the choicest loans to be eligible for insurance among the many applicants. On the other hand, there is reason to believe that many lenders submit a mortgage to the FHA for insurance only where risk appears too severe to accept the loan application on a conventional basis.² Any significant bias might affect the soundness of the insurance fund itself, although in practice the existing premium schedule appears to be adequate to cover most contingent losses.

Adequacy of FHA Insurance Premiums. Mortgage insurance premiums are remitted to the FHA by the lender, but are to be shifted directly to the borrower. The annual premium, currently set at $\frac{1}{2}$ of 1 per cent of the unpaid principal, is expected to more than cover any anticipated losses.³ Proponents of the mutual insurance program demonstrated how loss reserves could permit full retirement of many 20-year mortgages after 17 years.

¹Annual Report, HHFA, 1950, p. 345. Reimbursement to mortgagors was first made in 1944, and by late 1950 over \$23 million had been paid on 250 thousand insured loans. p. 233.

²See Chapter 13.

³Although actuarial validity could not be assured, FHA analysts based these premiums on limited data available, including: experience of life insurance companies for the period, 1913-35; records of building and loan associations in Boston, Cleveland, Georgia, and St. Louis; and the study of the Home Title Guaranty Company of Brooklyn by Lodge. Insured Mortgages Portfolio, FHA, July 1937, p. 22.

Furthermore, even if 25 per cent of the insured loans were to default after little principal repayment and if the foreclosed property were sold in a depressed market, the fund would still remain solvent and group participants would become debt-free in the nineteenth year.¹

In order to avoid paying the mutual mortgage insurance premium, the borrower may prefer to have his mortgage obligation rewritten on a conventional (i.e., uninsured) basis after a substantial portion of the original debt is retired. To prevent the loss of this profitable premium revenue, FHA regulations may require a prepayment premium of up to 1 per cent of the principal value.² In addition, the mortgagor may lose a contingent refund from the mutual insurance fund. These refinance penalties are not designed to discourage prepayment in general. On the contrary, mortgagors are encouraged to prepay up to 15 per cent of the original loan each year whenever possible. During the war years, all prepayment penalties were dropped as a counter-inflationary measure, except where refinance was the sole motive. Incidentally, the FHA will insure refinanced mortgage loans only where the mortgagor is unable to secure equally favorable accommodations on a conventional basis.

Other features of the FHA program further attest as to the adequacy of the premium schedule. The elaborate risk analysis prescribed and the custom-tailored mortgage contract written serve to minimize risk of default when the loan is initiated. Moreover, with full amortization of principal required, foreclosure revenues would ordinarily be sufficient to cover the unpaid principal and most foreclosure costs, especially if the loan is well-seasoned.

¹FHA Hearings, *op. cit.*, p. 19. These calculations were apparently based on the higher premium schedule referred to in the original bill, namely 1 per cent of the original principal amount.

²Or the sum of all subsequent insurance premiums, whichever is smaller.

In the event foreclosure on an insured loan does become necessary, the mortgagee may either transfer title to the FHA or retain it himself. If the former option is chosen, the FHA issues to the mortgagee debentures for the loan balance and a certificate of claim to cover his foreclosure expense in the event subsequent sale of the property produces an excess over the loan balance. These debentures are negotiable instruments maturing 3 years following the maturity date of the foreclosed mortgage. The principal and interest (not exceeding 3 per cent, currently at $2\frac{1}{2}$ per cent) are to be disbursed out of the appropriate group account, but are unconditionally guaranteed by the United States government.

The FHA may improve, repair, or retain foreclosed property until market conditions warrant its sale at a reasonable price. By thereby disposing of the property at the opportune moment, the FHA can inject an element of stability into an otherwise helpless real estate market. If a surplus still remains after all foreclosure costs are met, the defaulting mortgagor may share in the proceeds.

FHA insurance does not eliminate all lending risk, but the range of probable mortgage yields is substantially narrowed. The maximum yield is roughly equal to the interest rate stipulated in the contract,¹ while the minimum is largely governed by two principal deductions in the event of foreclosure. If the property is turned over to the FHA for settlement, the mortgagee risks the loss of part or all of the costs of foreclosure. Furthermore, instead of receiving cash upon the sale of foreclosed property as would ordinarily be the case under conventional financing, he gets low-interest debentures for the unpaid balance maturing 3 years after the

¹Unless foreclosed property is sold by the mortgagee in an inflated market at a price which far exceeds the loan balance and all expenses.

mortgage maturity date. The extent to which this latter factor reduces net yields depends upon the interest rates concerned, mortgage term, and date of foreclosure. (See Table I.)

TABLE I. NOMINAL ANNUAL YIELD, CONVERTED SEMI-ANNUALLY, OF 5 PER CENT
FHA-INSURED LOANS PURCHASED AT PAR AND EXCHANGED FOR 2 3/4
PER CENT DEBENTURES

<u>Exchanged at</u> <u>End of Year</u>	<u>10</u>	<u>15</u>	<u>20</u>	<u>25</u>
1	2.97	2.91	2.89	2.87
5	3.97	3.63	3.46	3.36
10	5.05*	4.52	4.18	3.97
15	-	5.05	4.76	4.50
20	-	-	5.05	4.88
25	-	-	-	5.05

Source: Insured Mortgage Portfolio, FHA, October 1938, pp. 14-15.

* Exceeds nominal 5 per cent rate because of semi-annual conversion.
See below.

Perhaps this arrangement of joint assumption of mortgage risk is truly an element of strength of the FHA program, for it may instill a genuine interest on the part of the lender to minimize mortgage loss on insured loans.

Even up to the present time, the true adequacy of the mortgage insurance premium is largely an academic question. Income has exceeded all expenditures for many years, leaving sizeable funds for reserve accumulation and dividend payment. By 1950, the Mutual Mortgage Insurance Fund stood at \$133 million, out of which few loss claims have been met. The FHA has, however, operated in an expansionary period, and will perhaps not be subject to a true test until a serious recession is encountered.¹

Risk Analysis Prescribed By The FHA

When selecting eligible loan applicants, the FHA faced a task unique in American urban mortgage history. By prescribing liberal contract terms,

¹See Chapter 13 for data on FHA operations locally and nationally.

it sought to enlarge the opportunities of home ownership to millions previously denied the privilege. At the same time, however, it was to be relatively free of government subsidy, operating on a businesslike, self-supporting basis. In view of this responsibility the FHAdministration set up an organization for the purpose of appraising dwellings offered as security and of rating the risks involved in proposed mortgages.¹ The purpose of the Underwriting Manual is to state the principles and to establish uniform methods and procedures to be followed in selecting qualified mortgage applicants across the nation with minor adaptations to meet local conditions.

The risk-rating procedure is based upon the individual evaluation of many separate factors affecting the risk involved in the proposed mortgage. The purposes of the system are twofold, namely, (1) to determine whether or not any given mortgage transaction is economically sound, and, if so, (2) to determine and ascribe to the mortgage a numerical rating of the relative degree of underlying risk.² Since every transaction involves some risk, the FHA system sets up a technique whereby the extent of this risk can be uniformly determined.

In analyzing the "economic soundness" of a proposed transaction, the Administration delineates three groups of risk elements. In contrast to prevailing practices in many quarters, the FHA elevates the importance of borrower risk analysis up to a par with property requirements. The strategic position of the mortgagor warrants careful examination of his past, present, and expected future willingness and ability to meet his financial obligations.

¹The risk rating process follows many of the principles set forth in earlier writings of the Director of The Underwriting Division, F. M. Babcock. For example, see Real Estate Valuation, Bureau of Business Research Studies, Vol. 4, No. 1, University of Michigan, Ann Arbor, 1932.

²Underwriting Manual, FHA, Revised January 1947, paragraph 201. The second purpose serves to assign mortgages into appropriate quality groups.

The possibility of mortgagor default should not be disregarded in risk analysis, however, so the mortgaged property and its location are also rated according to many criteria, including appraised value, income potentialities, probable future life, marketability, etc. Except for minor physical improvements in the property itself, these risk elements are largely fixed in character, and a low score means an unquestioned rejection of the application.

While the above risk elements are relatively fixed, the degree of overall mortgage risk can usually be changed if the loan contract itself is changed as to amount, repayment period, or method of repayment. This is true because risk depends in large part upon the relation between various contract elements and the present and prospective characteristics of the borrower, property, and its location. Consequently, the probability of incurring mortgage loss is effectively minimized through a proper adjustment of contract terms for each individual case. By refraining from the time-honored practice of regarding debt-value ratios as the sole criterion of soundness, the FHA relies upon the appraisal of various risk elements to secure a well-balanced analysis.

Before a mortgage application is approved for loan insurance, the underlying security must meet certain minimum property requirements. The attractiveness and livability of the home as well as its structural and durability qualities are carefully rated. Moreover, certain adjustments must frequently be made for non-conventionality in regard to design, construction methods or materials, etc., especially where the marketability of the property may be impaired. Furthermore, some properties may be entirely appropriate in certain neighborhoods but decidedly out of favor in others, because of architectural design, size or price class of home, etc. These property requirements benefit borrower as well as lender. The

borrower is protected against purchasing a property with decidedly inferior design, shoddy construction, or undesirable location, while the lender benefits by dealing with a satisfied customer in a marketable home.

The valuation process described in the Underwriting Manual merits brief comment here. The concept of value for homes relates to that price "which typical prospective owners are warranted in paying for long-term occupancy in the case of an amenity-income property. . . ."¹ This "value," arising from the prospective flow of services from the property, may deviate widely from actual market valuations, as has frequently been the case in the post-war inflationary period.

Three "independent" methods of appraisal are employed by the FHA in arriving at a true estimate of value. Since the buyer is not justified in paying more for a property than it would cost him to provide a reasonable substitute, current costs of replacement new and the market price of comparable properties set upper limits to appraised value. The third method of evaluation utilizes a variant of the capitalization process, whether the income from the property accrues in the form of amenities or net money returns. In the case of owner-occupied homes, the FHA underwriting staff first makes an estimate of the monthly rent that the property would bring in the market. As a second step,

the risk and burdens of ownership are compared with the security and benefits arising therefrom.² Further, investigations into the market will show a relationship between the monthly rent that similar types of property will bring and the price paid for the title. Stated differently, the purchase price will be found to be in a range of so many times the monthly rent. (This number is termed). . . a rent multiplier.³

¹ Manual, paragraph 1134.

² This intricate provision is designed to make due allowance for amenity income as opposed to satisfactions derived by tenants.

³ Underwriting Training Handbook, FHA, "Valuation," pp. 13-14.

These three estimates provide the "brackets of value," from which the lowest is generally taken as the final valuation. Despite the detailed procedures prescribed by the FHA, however, any property evaluation still depends in large part upon the subjective judgment of experienced appraisers. Indeed, the reliability of any appraisal based on a comparable sale depends upon the recentness of this sale, the similarity of properties and locations, and the circumstances or motives underlying the transaction (e.g., whether or not the property was dumped on a singularly depressed market, etc.) On a more abstract level, the analytical inter-dependence among the three "independent" approaches to "value," especially where a comparison of similar properties is dictated, raises serious doubt as to the net contribution of the ambitious capitalization procedure described above. For instance, the conversion factor or rent multiplier depends upon relationships derived from "typical properties" in the market. Obviously these standard properties have been valued by some unmentioned method other than that of using gross rentals and conversion factors. Hence, the capitalization process is hardly a distinct method of evaluation, but is merely a corollary of the earlier methods.¹

Taken as a whole, the FHA risk-rating technique stands out as a notable pioneer achievement in a hitherto helter-skelter activity. Its objective approach has contributed to the development of a sound mortgage market, through its application to conventional as well as insured lending. Nevertheless, the goals as portrayed by the most sanguine proponents of FHA have failed to materialize. Some undoubtedly looked for a uniform, sound, and objective method of valuation and risk analysis which could be

¹ See Laura M. Kingsbury, The Economics of Housing, op. cit. pp. 126-132.

readily used not only by housing officials but also by the consumer-purchaser. As stated above, the subjective element in such analyses is still an essential ingredient requiring the expert judgment of an experienced appraiser. Moreover, the FHA program has not been hailed with enthusiasm in all quarters. Especially in the local Boston area, insuring operations have been so slight that the influence of the aforementioned techniques on local lending practices is negligible.¹

Mortgage Contract Required or Recommended

Once again it should be mentioned that the FHA is not engaged in the business of making home loans. It operates more or less as any private insurance agency, setting up acceptability standards, collecting insurance premiums, and indemnifying the insured against loss. In performing the first of these functions, establishing acceptability standards, the FHA may exert an indirect, though certain, influence on the lending practices of insured mortgagees. Although the latter are free to set specific contract terms within broad limits, eligibility standards can often be molded to effectively modify these terms. While these standards are designed primarily to put insurance operations on a sound business footing, they have allegedly been used as a tool to accomplish broader social and political ends as well.² The basic philosophy underlying government intervention in home mortgage finance is beyond the scope of the present study, and will accordingly receive but passing reference here.

¹See Chapter 13.

²The literature on this issue is too voluminous to permit reference here. For instance, see Colean, The Impact of Government on Real Estate Financial in the United States, op. cit., and Abrams, The Future of Housing, op. cit.

Interest Rates. When the mutual insurance program was initiated in 1934, the maximum interest rate (exclusive of insurance premium) on insured loans was limited to 5 per cent per year of the unpaid balance, except in certain areas where the Administrator was authorized to set a maximum of 6 per cent.¹ Mortgage insurance premiums were set at $\frac{1}{2}$ of 1 per cent of the original principal amount, and, in addition, lenders were permitted to charge an extra $\frac{1}{2}$ of 1 per cent as a service charge. Consequently, total mortgage debt charges could have been as high as 7 per cent per year on certain FHA-insured loans.

Since the mid-1930s, debt charges on insured loans have been reduced on all three counts. Maximum interest rates were cut to $4\frac{1}{2}$ per cent in 1938, thence to $4\frac{1}{4}$ per cent in 1950.² Insurance premiums have also been liberalized, and under current regulations the lender is required to make an annual remittance equivalent to $\frac{1}{2}$ of 1 per cent of the average unpaid balance.³ Moreover, the provision for a service charge on a continuing basis has been dropped. At the present time, the mortgagee may levy an initial service fee against the borrower of 1 per cent of the original principal,⁴ but competition among lenders has rarely permitted its imposition in the local capital surplus area.

The FHA strives to adjust rates of interest on insured loans to changing market conditions, both locally as well as nationally. It should be repeated that specified rates are price ceilings, and may or may not coincide with market rates of interest. In practice, however, FHA maximum rates are virtually minimums as well, except in certain money market centers. Under static economic analysis assuming a high degree of homogeneity among

¹National Housing Act, Section 203b.

²Except under extraordinary conditions where an additional 1 per cent is warranted.

³The premium was reduced to $\frac{1}{4}$ of 1 per cent on certain mortgages for a short period after 1939.

⁴A charge of $2\frac{1}{2}$ per cent is permitted if the mortgagee makes both construction and permanent loans.

loans, competition among lenders would result in limited insured lending, if the ceiling FHA rate (including mortgage insurance) were significantly above the market rate of interest. Conversely, a ceiling set far below the market level might produce a surge of buyer demand for insured loans, but once again lenders would promote conventional lending as far as possible. Of course, mortgage loans are inherently heterogeneous and "the competitive" price is hardly a realistic concept even for loans with basically similar risk characteristics. The relative contract provisions on insured and uninsured loans in the Boston area will be analyzed in Chapter 13 of this study.

The substitution of a small certain cost for a possible greater loss may effect an outward shift in the lender's supply schedule. His policy regarding insured lending may depend in large part upon the relative net yields on the two types of mortgage loans. Net yields on uninsured loans for purposes of this comparison would be computed by deducting from gross contract interest rates the estimated costs of accumulating adequate loss reserves. As discussed in an earlier analysis of mortgage risk, many lenders have undoubtedly shunned away from risk repayment functions with wide dispersion. If such loans were made at all, lenders perhaps felt justified in charging almost prohibitively high rates of interest. If this practice were widespread, the opportunity to narrow such dispersion by using FHA insurance might be expected to stimulate a renewed interest in home mortgage lending.

When the FHA program was launched, few conventional mortgage loans in the country were written at interest rates of less than 6 per cent. Even though Massachusetts has characteristically been regarded as a capital-surplus area, the average rate of interest on real estate loans held by all cooperative banks in 1934 was 6.03 per cent. The average rate on savings

bank loans was nearly a full 1 per cent lower, in part because of the presence of large income-property loans as well as some loans carried at abnormally low distress rates. Most lenders were writing new mortgages at interest rates below their respective average levels, however, so that maximum rates on FHA loans conformed rather closely with interest movements in the local market.

In other areas, however, FHA "ceiling prices" have consistently fallen below corresponding interest rates on conventional loans, in the postwar as well as prewar periods. The current agitation to increase FHA maximum rates serves to illustrate the effects of any continuing unbalance between rates on conventional and insured loans.¹ Inasmuch as the FHA strives to promote individual home ownership through liberalizing mortgage credit availability, it is hardly surprising that maximum rates on insured loans have become minimum in practice in many quarters.

Length of Loan Term. The FHA program has further facilitated home purchase through extending the average term of insured loans. Up to the recent depression, commercial and savings banks rarely wrote loans with terms exceeding 3 to 5 years, and the typical cooperative form mortgage was retired in 12 or 13 years. The evils of financing a home purchase with a short-term instrument were undoubtedly recognized long before this, but the universal adoption of long-term loans had to await positive federal intervention and direction. The HOLC, federal savings and loan associations, and the FHA all promoted home mortgage loans with terms extending up to 20 years. Beginning in 1938, the maximum term on insured loans was increased to 25 years, provided the property was new and cost no more than \$6,000, and provided it was purchased for owner-occupancy.²

¹For example, see "Mortgage Crisis," The Magazine of Building, pp. 121-124, August 1951.

²Amendment to National Housing Act, 1938.

This preferential treatment for low-cost homes still exists, although the precise terms are adjusted to conform with Regulation X and other emergency measures.¹

While lengthening the contract life of a single mortgage facilitates the purchase and ownership of residential properties, overall mortgage risk may not diminish correspondingly. Certainly short-term mortgage loans have not been satisfactory to either party in the contract, but merely extending the term carries no assurance of reduced risk. First of all, the risk of mortgage default may actually be heightened as terms are indefinitely extended, for the greater probability of death, periods of unemployment or deflation, etc., may impair the mortgagor's ability to continue contractual obligations.² Furthermore, the marketability of the mortgaged property may become seriously impaired over a long period of time, so that a subsequent foreclosure sale would produce insufficient revenues to cover the unpaid loan balance and foreclosure costs. These risks are effectively minimized, however, when the mortgage contract provides for full amortization, as will be shown later.³

Although the lender is able to shift most of these risks to the FHA through loan insurance, he must still incur the risks associated with tying up loanable funds for long periods of time. Lacking full knowledge of developments in the capital market, he may forego long-run income maximization in the event of material advances in interest rates. Moreover, even if the paper were reasonably marketable, the mortgage holder would still incur a capital loss if he elected to convert his holdings into higher income-earning assets. This condition is not reversible, however,

¹Current regulations limit the term to 25 years for properties valued at \$12,000 or less, and to 20 years for more expensive properties.

²In order to allow for the eventuality of mortgagor death, most lenders deliberately adjust the term of the loan in accordance with the age of the borrower, while insurance companies have vigorously promoted package arrangements whereby both mortgage loan and a life insurance policy are included in the same unit. See Chapters 11 and 12.

³Another advantage of long-term mortgages concerns the lender's opportunity to spread loan acquisition costs over a longer period of time. Although

for interest rate declines subsequent to the issuance of a long-term mortgage would merely entail its rewriting at the new lower rate.

Amount of Loan. As the third major element in the mortgage contract, maximum loan amounts and loan-value ratios have been liberalized to facilitate home purchase without resort to junior financing. Under original regulations, maximum loan amounts were limited to 80 per cent of the FHA-appraised property value or \$16,000, whichever amount was the smaller. Following the 1938 amendments, purchasers of new small homes could obtain insured loans up to 90 per cent of value, with maximum loan-value ratios declining progressively as more expensive properties are mortgaged.¹ At the present time, insured loans on single-family properties are limited to \$14,000, and maximum loan-value ratios are subject to changing emergency credit controls.² Operative builders may also qualify for insured loans, but maximum loan-value ratios are 5 percentage points less for builders than for owner-occupiers in each price bracket.

The promotion of 90 per cent loans represented a radical departure from the hitherto conventional 60 per cent savings bank loan. Hence, it is not surprising that these generous contract provisions would arouse some skepticism as to the overall economic soundness of insured loans. Although debt amortization mitigates the dangers involved, a slight decline in real estate values might entail severe loss upon an early foreclosure.

¹ Especially when only first mortgage loans are obtainable, raising maximum loan amounts from 80 to 90 per cent may have quite a stimulative impact of home buying. This apparently small change in loan-value ratios effectively doubles the purchasing power of a prospective home buyer's down payment. Provided the additional burden of servicing a larger debt is not excessive, the purchaser may be quite willing to pay much more for a home than otherwise.

² As of September 4, 1951, maximum loan-value ratios declined gradually from 90 per cent on properties worth up to \$7,000, to 50 per cent on homes costing \$24,500 or more. Effective June 11, 1952, these maximum ratios were raised to 95 and 60 per cent, respectively.

Certain initial costs are shifted to the mortgagor through special fees, the share borne by the lender is often substantial. See Chapter 11.

The case for high loan-value mortgages appears much stronger when these funds constitute the only borrowed funds present in the home purchase. "Conservative" 3-year mortgage loans were extremely hazardous, because many borrowers had to supplement limited equity resources with costly second mortgage loans. The debacle of the early 1930s, however, brought heavy loss and liquidation among second mortgage companies, making home purchase all the more difficult. The subsequent efforts of the FHA and other federal agencies toward larger first mortgage loans have eliminated much of the need for junior financing. Except during the early postwar years when the Veterans Administration guaranteed second mortgages up to 20 per cent of value, the FHA has insured loans only where there are no other mortgage liens on the property.

Mortgage insurance on 90 per cent loans is deemed prudent only on small, new, owner-occupied homes where estimated mortgage risk is at a minimum. New homes perhaps depreciate less rapidly than existing properties, and are usually located in growing, well-planned neighborhoods. Moreover, lower-cost homes ordinarily enjoy a ready market, while more expensive, individualistic properties may be extremely difficult to sell, especially during depression periods. Owner-occupants are assumed to be preferred credit risks on grounds that their incentives for mortgage compliance are more deeply-rooted than are those of other investors in urban properties. On the other hand, the social aim of more widely diffused home ownership has undoubtedly been an important factor underlying this favorable treatment.

Method of Repayment. Although many thrift institutions had long regarded regular debt retirement as a desirable practice, the FHA made full amortization a prerequisite for insurance eligibility. Direct-reduction loans, sponsored by the FHA as well as other newly-created federal agencies enjoyed an immediate public acceptance. Shortly thereafter, state-chartered

thrift institutions were authorized to make direct-reduction loans, whether insured or not. For cooperative banks, the change did not appear too significant at the outset, since their cooperative form note had always provided for equal monthly payment until the debt was retired. As explained earlier, however, the repayment term on such mortgages depended upon the bank's dividend rates and hence profitability, while the direct-reduction type specifies the maturity date on the contract itself.

Direct-reduction type loans offer real advantages to lender and borrower alike in that debt service is put on an income basis. Since the lender is kept in constant touch with the home owner, delinquency in regard to property tax liability as well as mortgage debt service is effectively minimized. Furthermore, contractual debt amortization may engender a more genuine borrower's "insurable interest" in the outcome of the insured event. Although the lender is the insured party,¹ the borrower foregoes an increasing equity upon foreclosure as maturity is approached.² The significance of this "insurable interest" is substantially weakened in cases where the mortgaged property depreciates nearly as rapidly as equity accumulates.³

A steady and fairly predictable inflow of mortgage principal and interest payments enables lending institutions⁴ to adjust their investment policies to changing interest rates, price levels, and new investment opportunities. Moreover, whenever debt service is put on a monthly payment basis, a slight discrepancy between nominal and effective rates of interest

¹ In theory, this would be true whether the loan were insured by the FHA or covered by self-insurance.

² Home Mortgage Lending, op. cit., pp. 146-7.

³ Indeed, it is quite possible that the rate of depreciation might actually exceed equity accumulation.

⁴ In contrast to the simple administrative detail involved in straight term lending, economies in servicing monthly payment type mortgages generally accrue only to large-scale operations. Accordingly, individual lenders seldom achieve a scale of operations sufficient to warrant their qualification as FHA-approved mortgagees.

arises in the lender's favor. Because of the frequency of conversion, a nominal 5 per cent rate on a 20-year amortized mortgage loan with level monthly payments of \$6.60 is equivalent to a 5.05 per cent rate payable semi-annually (as most bond yields are quoted.)¹

A possible limitation of the level payment plan concerns the ability of the mortgagor to meet all recurring obligations over a period of 20 or more years. Actually total housing costs mount during the later years of the repayment term, because of necessary repair and maintenance expense. To provide for constant housing costs over the life of the contract, perhaps mortgage payments should be larger during the earlier years. On the other hand, if home purchase is to be made easier for young families, the existing system is quite satisfactory in that prospective incomes will be rising over the loan term.

EMERGENCY ASPECTS OF THE FHA PROGRAM

In addition to the permanent mortgage insurance system, the initial FHA legislation set up machinery to promote certain emergency relief and recovery objectives as well. Title I of the National Housing Act was aimed directly at solving the acute unemployment problems prevailing in the building industry. Lending institutions were to be insured against loss on unsecured loans made to finance the alteration, repair, improvement, or conversion of existing structures. The insured portion of each loan was initially limited to 20 per cent of original loan amount, but was subsequently reduced to 10 per cent in 1936. During the early period of the FHA, the maximum insured loan was set at \$2000, on which no insur-

¹ The corresponding effective yield y on an annual payment basis is nearly 5.12 per cent, as found by solving the following equation in i :

$$y = \left(1 + \frac{.05}{12}\right)^{12} = (1+i)$$

ance premium was levied.¹

Although this initial authorization terminated in 1937, Congress reactivated the emergency Title I program to stave off another impending recession one year later. Institutional lenders, building supply dealers, and other groups reaping the benefits of the program eagerly supported its restoration. Provision was made for an insurance premium of up to $3/4$ of 1 per cent of the proceeds of the loan. This premium was borne by the lender, and was paid into a non-mutual fund used to defray the administrative expenses of Title I. On all property improvement loans, the maximum discount rate was \$5 per \$100 per year of the face amount, with the loan term limited to 3 years and 32 days. Stated differently, the maximum effective yield on these short-term loans was a generous 9.72 per cent.

Although Title I was originally designed as an emergency depression measure, it proved to be too popular among interested business groups to be dropped lightly. The wartime housing shortage presented another emergency situation during which time Title I was reinstated as an aid in remodeling and converting existing residential properties. In the early postwar period, the Class 3 small home loan program was also set up under Title I as a part of the Veterans Emergency Housing Program, designed to apply to situations where ordinary Title II standards could not be met. On these home loans, the maximum rate of interest was $4\frac{1}{2}$ per cent, plus $\frac{1}{2}$ of 1 per cent mortgage insurance premium on the face value of the loan, with a term not exceeding 20 years and 5 months.²

¹Moreover, the initial act provided for direct government loans to institutions on the security of insured Title I loans. This emergency Section 3 was repealed on April 3, 1936.

²Ratcliff, op. cit., pp. 264-5

Since the average loan has been about \$400 with a term of less than 3 years, Title I has had only limited connection with the long-term mortgage structure. Most loans have been made to finance structural alterations, heating and plumbing installations, insulating and roofing, etc., frequently arranged through contractors and dealers.¹ Nevertheless, Title I has been widely used in certain areas to assist in low-cost home construction. At the present time, Section 8 provides for FHA insurance on new home loans, with contract provisions very similar to those of Section 203. As with earlier Class 3 loans, Section 8 is designed to cover loans on properties in areas "where it is not practicable to obtain conformity with many of the requirements essential to the insurance of mortgages on housing in built-up urban areas."²

To assist in the housing of war workers migrating into war production centers, the FHA set up a new emergency Title VI program.³ Meeting these critical demands through ordinary investment channels might entail a high degree of mortgage risk, as housing was quickly required in areas with an uncertain future. Title VI provided for the establishment of a non-mutual insurance system with a special fund to insure certain 90 per cent mortgage loans, either to builders or home buyers. Except for the omission of the "economic soundness" requirement in defense housing, similar rules and regulations applied to insured lending under both Titles II and VI. Mortgage loans on single-family homes (Section 603) were restricted to a maximum of \$5,400 for a term of 25 years.⁴ Title VI provided the bulk of

¹ Annual Report, HHFA, 1950, p. 229.

² Title I, Section 8(a) of National Housing Act as amended April 20, 1950. Statistics on postwar FHA activity in Metropolitan Boston will be presented in Chapter 13.

³ Approved March 28, 1941.

⁴ In 1942 Title VI was expanded to provide insurance for 90 per cent mortgages on new rental housing, Section (608), with a maximum loan amount of \$1,350 per room.

FHA operations during the war years and by 1944 nearly 235 thousand mortgages had been insured, three-fourths of which involved single-family homes.¹

The return to peacetime presented another critical housing problem, this time to accommodate the acute needs of millions of returning veterans. As an important phase of the emergency housing program for veterans, the Title VI program was continued well into the postwar period. Maximum interest rates were reduced to 4 per cent, and allowable mortgage loan amount were raised to \$8,100 in keeping with inflated costs. These emergency provisions (of Sec. 603) terminated in April 1948, but shortly thereafter the mutual insurance program (Section 203) was substantially liberalized.²

The past discussion illustrates the versatility of the loan insurance principle in implementing federal housing policies. Within its short life, the FHA has already set up emergency machinery to stimulate an economic recovery, to provide for civilian wartime housing needs, and to assist in postwar readjustment programs.

FEDERAL NATIONAL MORTGAGE ASSOCIATION

The final feature of the FHA program described here relates to the establishment of an effective secondary mortgage market, within which mortgage investors may freely trade in their paper. If such a market were attained, lenders in capital-deficient areas could sell their mortgage holdings either to gain added liquidity or to make more loans. At the same time, mortgage investors in surplus areas would be afforded an opportunity to maintain sound, diversified portfolios at all times.

¹Ratcliff, op. cit., p. 209.

²See above.

The activities of mortgage bond houses represented a dismal attempt at solving the secondary market problem.¹ Aside from the weaknesses mentioned above, bond companies gave little promise of facilitating single-home purchase, in that their activities were concentrated almost entirely on farm and urban income-producing properties. Moreover, the paper was never freely traded in the open market. The issuing house provided the primary support for its own paper, and no exchange developed whereby issues of various houses could be objectively weighed and valued.²

The first serious attempt by the federal government at establishing an effective secondary market came as an important corollary of the Home Loan Bank Act. By standardizing and strengthening mortgage lending institutions, it sought to facilitate a free inter- and intra-regional flow of funds through making secured and unsecured advances. As pointed out above, however, only saving and loan interests chose to enter the System in force. Furthermore, affiliated institutions were unable to sell their mortgage holdings outright, but could only borrow against them to gain immediate liquidity from an otherwise illiquid instrument.

Supporters of the National Housing Act foresaw an acceptable, standardized mortgage loan as an essential ingredient of a sound secondary market. Once such an instrument were devised, it was hoped that new specialized mortgage institutions would find it profitable to implement this development by trading in mortgage paper. Such private institutions under federal supervision would make, purchase, and sell home mortgages and, on the basis of such security, offer their debentures to the public. FHA sponsors hoped that the insurance feature would facilitate this development,

¹ See description of these operations on p. 39.

² M. L. Colean, "What Makes a Secondary Market Tick," Savings and Loan Annuals, 1948, pp. 147-153.

especially since insured loans appeared to offer an attractive investment for commercial banks and life insurance companies.

To encourage the establishment of private national mortgage associations, substantial financial inducements were offered under Title III of the National Housing Act. Despite these inducements as well as subsequent relaxations of qualification standards, no privately-capitalized institutions were organized by 1938. The first step toward establishing a federal agency to deal in mortgage exchange was the creation of the RFC Mortgage Company in 1935. Originally designed as an HOLC for income property, this Company began to purchase insured mortgages on new homes as a stimulus for the depressed housing industry.

As a more permanent measure, the Federal National Mortgage Association was formed with RFC capital in 1938. This instrumentality was organized to stimulate insured mortgage lending by providing a secondary market for such paper, particularly for newly-authorized 90 per cent loans.¹ From that time on, these two agencies operated jointly in the secondary market until the RFC Mortgage Company was terminated in June 1947. During the 10-year interval, the Company dealt with mortgages on homes built before 1937 and, later on, with Title VI and VA-guaranteed loans, while the former concentrated on trading mortgages on new small homes. The market for VA loans slipped drastically following the termination of the RFC Mortgage Company, but support for the paper was restored one year later when FNMA operations were extended to cover certain VA-guaranteed loans.² Especially in regard to FNMA purchases of VA loans, the advance commitment procedure assumed a significant role in the rapid expansion of mortgage credit. Until such purchases were restricted to an over-the-counter basis

¹ Ratcliff, op. cit., p. 275.

² Annual Report, HHFA, 1950, pp. 70-71.

by the Housing Act of 1950, many nominal mortgagees looked upon the FNMA as a virtual primary source of unlimited mortgage credit.¹

Under current regulations, the FNMA offers to purchase certain insured and guaranteed mortgages at no more than par from approved mortgage originating institutions. The mortgaged properties must meet prescribed construction requirements and original principal amounts must not exceed \$10,000 for each single-family dwelling. Total purchases are limited to 50 per cent of the total volume of otherwise eligible insured loans originated by the seller-mortgagee.² Usually the mortgage originator retains all servicing functions, and receives as compensation therefor $\frac{1}{2}$ of 1 per cent of the unpaid balance.³ Statistics regarding the operations of these two federal agencies will be reviewed in Chapter 14, at which time the current status of the secondary mortgage market will be analyzed.

VETERANS ADMINISTRATION HOME LOAN PROGRAM

The guaranty of home loans was one among many benefits afforded veterans under the Servicemen's Readjustment Act of 1944. Veterans returning to civilian life faced a critical housing shortage and frequently lacked the down payment necessary to buy a home under conventional financing methods. To cope with these problems, the Act provided means whereby the veteran could become a home owner with little or no equity down payment and with moderate monthly debt service. The primary loan plan, under Title III, authorized the guaranty of home mortgages up to \$2,000 for qualified veterans, with the interest rate limited to 4 per cent and the loan term to 25 years. The inflation in real estate values had so boosted home

¹See Chapter 14.

²VA-guaranteed loans were exempt from this limitation as of December 1950. After June 29, 1951, all FNMA purchases were restricted to mortgages insured or guaranteed on or after March 1, 1951.

³Annual Report, HHFA, 1950, pp. 72, 75.

prices that the \$2,000 limit failed to enable the veteran with limited cash resources to buy the home he needed. Accordingly, in December 1945, this entitlement maximum was raised to \$4,000 or 50 per cent of the loan, whichever amount was the smaller.¹

A second plan under the Servicemen's Readjustment Act provided for combination loans whereby the first mortgage was insured by the FHA and the second guaranteed by the VA. The guaranteed second mortgage was limited in amount to \$2,000 or 20 per cent of the cost or purchase price of the purchased property. This section gave the veteran a tremendous advantage in the housing market by making possible a loan covering the total purchase price of the property. Roughly one-sixth of all VA home loans closed were of this combination variety until the Housing Act of 1950 provided for its termination by December 31, 1950.²

A third major phase of the VA program is perhaps yet in its initial stages. The Housing Act of 1950 authorized the Veterans Administration to make direct loans to veterans in areas where 4 per cent mortgages are unobtainable through usual lending channels.³ These loans are limited to a maximum amount of \$10,000 and are to be made only to veterans who have not previously used their entitlement and who appear to be a good credit risk to carry the proposed mortgage obligation.

A few unique features of the VA home loan program merit brief mention here. To protect the veteran from paying an excessive price for his home, the VA initially required appraisers to determine the "reasonable normal value" of the property. Since this criteria constrained appointed appraisers from permitting current market conditions to dominate their

¹ The Housing Act of 1950 further increased this maximum to \$7,500 or 60 per cent of the loan amount. Veterans who had used part or all of their entitlement under earlier regulations could seek another loan guarantee for the difference between \$7,500 and the amount already used. Housing Statistics, HHFA, September 1951, pp. VII-IX.

² The actual termination occurred during late October 1950. Housing Statistics, September 1951, p. IX.

³ Sec. 512 of this Act provided for the expiration of this authority on June 30, 1951, but the Defense Housing Act in September 1951, revived

findings, the term "normal" was subsequently deleted. For a short time, the VA sought to speed up operations by permitting lenders to select an appraiser from an approved panel. This procedure, however, invited a certain amount of laxity in appraisal technique. Although the veteran was forbidden to pay more for a property than the VA appraisal dictated, neither the lender nor borrower would complain if the chosen appraiser were to wink at the term "reasonable."¹ As a result, present regulations stipulate VA-appointed appraisals once again.²

The settlement procedure pursuant to default on VA home loans differs somewhat from that on FHA-insured loans. At the option of the VA, one of two plans is to be followed. The first provides for cash payment to the holder of a defaulted loan in an amount not exceeding the guaranteed amount of the original loan, but shall be less (or more) according to the extent of subsequent loan repayment (or increase).³ On the other hand, the Administrator may choose to take over the defaulted mortgage by assignment and pay off the obligation in full. From an economic point of view, the relative preference for the two options may depend upon the state of the real estate market at the time of foreclosure. If the VA were operating as a "profit maximizer" it would take over a mortgage by assignment only when property values were at a sufficiently high level to permit its disposition at a profit. Whether or not such criteria have been or will be adopted is not entirely clear as yet.

¹Federal Home Bank Review, January 1947, pp. 101-104.

²Maximum permissible loan-value ratios have been abnormally liberal; as of June 11, 1952, no down payment was required on properties costing \$7000 or less.

³The criteria used by the VA in providing "upset prices" on foreclosed property, etc., are beyond the scope of this study.

the provision. The initial appropriation for direct lending was limited to \$150 million.

Since the 4 per cent limit on interest rates has been far below prevailing rates on conventional loans in many areas, lenders have at various times been reluctant to participate in the VA program. To provide a ready market for this paper, both the RFC Mortgage Company and FNMA have been authorized to purchase VA-guaranteed loans at different times in the postwar period. The significance of this support is amply demonstrated by the critical shortage of such 4 per cent credit which developed during the interval between the termination of the RFC Mortgage Company in 1947 and the rechartering of FNMA in July 1948. Subsequently, between January 1949 and October 1951, FNMA purchases of insured or guaranteed mortgages amounted to more than \$2.2 million, of which 85 per cent represented VA home loans.¹ As revealed in later analyses, the Boston market has typified a capital-surplus area during the postwar period, and as such has had little difficulty in providing the veteran with 4 per cent mortgage credit.

Although slow in gaining momentum, the VA home loan program has played a major role in postwar mortgage lending activity. By granting singularly generous credit to many veterans who were otherwise destined to remain as tenants, home construction and owner-occupancy have risen to unprecedented levels. During its first 6 years of operation, the VA program was involved in over one-sixth of all 1- and 2-family starts across the nation. The participation of local mortgage lenders in these operations will be summarized in Chapter 13.

¹ Housing Statistics, September 1951. Most of these purchases were initiated through the inflationary advance commitment procedure. As stated above, the Housing Act of 1950 restricted the Association to over-the-counter purchases exclusively after that time.

PART V. HOME MORTGAGE LENDING IN THE BOSTON MARKET

The preceding chapters in this study have been concerned with the principal institutional forces operating in the Boston mortgage market. In Part II some of the major economic variables underlying the demand for housing assets and home mortgage credit were summarized, with special reference to the local market. Following this, some elementary risk theory and circular flow analysis were applied to mortgage lending. The development of mortgage lending institutions in the Boston area was briefly sketched, including the relative growth patterns and investment policies of the various mortgagee types. Part IV considered the efforts of the federal government in promoting a permanent strengthening of the disorganized, undisciplined mortgage market. The balance of this study consists of an analysis of the mortgage operations of lenders in the Boston area. Data on mortgage holdings and new lending will be presented first, followed by a discussion of lending practices and specific contract terms. As indicated in the introductory section, the postwar mortgage market is the primary focus of the study. Preceding this analysis, however, brief reference will be given to the local market in three selected prewar years: 1927, 1936, and 1940. These particular years were chosen as representative of three phases of mortgage operations in the interwar period: the booming 1920s; severe depression slump; and prewar recovery.

CHAPTER 9. MORTGAGE LENDING IN THE BOSTON MARKET UP TO 1946

The spectacular growth in total resources experienced by all local thrift institutions during the prosperous 1920s has already been charted. No less significant was the rise in mortgage portfolios, with total mortgage holdings of cooperative banks increasing nearly threefold during the decade. Savings banks had dominated mortgage lending in this area for a

much longer period, but their portfolios still more than doubled in dollar volume during the 11-year span through 1931. Commercial banks also figured heavily in this real estate boom, as trust companies in particular invested their rapidly increasing savings deposits in high-yielding mortgage loans. These various thrift institutions felt they were providing a valuable community service by financing an unprecedented volume of new residential construction during these buoyant days. At the same time, they felt justified from a business standpoint in investing heavily in real estate loans inasmuch as their experience with these profitable investments had been singularly successful up to that time. In so performing these moral obligations, local mortgagees abetted the dangerous inflation in real estate values by neglecting sound lending practices and vigorously competing for the available business.

The year 1927 has been chosen as representative of this boom era. By that year, the peak in real estate activity had already been reached, as foreclosures among savings banks had begun to turn up and the volume of new construction to decline. Nevertheless, prices continued to spiral upward and new mortgage lending while proceeding at a reduced rate, involved progressively larger loan amounts. Total mortgage holdings of local thrift institutions continued to increase slightly through the end of the decade, and even through 1931 in the case of savings banks.

COOPERATIVE BANKS AND FEDERALS

In 1927 the aggregate mortgage debt held by the 103 cooperative banks in the Boston area had reached \$254.6 million (See Table I), a dollar level not surpassed again until 1951 by the 76 remaining banks.¹ These portfolios

¹ Annual Report, Massachusetts Commissioner of Banks. When federals are included, as is perhaps the only valid basis for comparison, this level had been exceeded as early as 1946.

consisted almost entirely of small residential mortgages, written on the traditional sinking fund basis. Since these loans were written primarily to finance small home purchase, the average mortgage balance was valued at \$3.87 thousand. Although this value may appear conservatively low, the average principal amount on new loans was perhaps considerably higher, and continued to rise further through 1930. Moreover, the 1927 level for average mortgage balance was not reached again until 1950 during the current postwar housing boom.¹ While share capital was rising at a rapid pace, mortgage holdings increased even faster, absorbing a dangerously high proportion of cooperative bank assets during the 1920s. In 1927, real estate loans represented 93.6 per cent of aggregate assets held by all local cooperative banks, with the ratio exceeding 98.6 per cent for at least one institution. Although cooperative shares were generally regarded as less liquid than savings bank accounts, the inherent dangers in investing so heavily in long-term mortgages were soon brought to the forefront. When economic activity abruptly slackened in the early 1930s, mortgagors encountered serious difficulty in maintaining regular monthly payments, and the contractual inflows from self-liquidating cooperative form mortgages were sharply reduced. As a result many banks were extremely hard pressed to meet shareholders' demands for withdrawals and share loans during the early depression years.

¹ Annual Report, Massachusetts Commissioner of Banks. The real or effective mortgage debt under the cooperative form contract was somewhat less than these book figures; even though these loans are regarded as amortized, the repayment sums were accumulated as pledged share capital and were not applied to debt retirement until maturity. Hence, the 1927 level was undoubtedly reached much earlier than 1950, since nearly all mortgages are now written on a direct-reduction basis. The same explanation applies to the above figures on total mortgage portfolios.

TABLE I.. TOTAL MORTGAGE PORTFOLIOS OF COOPERATIVE BANKS, FEDERAL SAVINGS AND LOAN ASSOCIATIONS, SAVINGS DEPARTMENT OF TRUST COMPANIES, AND SAVINGS BANKS IN THE BOSTON AREA, SELECTED YEARS, 1927-1951.

(Millions)

Year	Cooperative Banks	Federal Savings and Loan Ass'ns	Savings Dept. of Trust Companies	Savings Banks	Total
1927	\$ 254.6	\$ -	\$ 81.7	\$470.6	\$ 806.9
1936	191.2	2.5#	35.5	483.1	712.3
1940	173.7 ^x	52.1	38.0	441.3	705.1
1946	204.3	87.0	46.9	380.8	719.0
1947	216.8	n.a.	55.5	406.9	679.2*
1948	235.9	n.a.	58.7	449.8	744.5*
1949	252.8	n.a.	60.1	499.6	812.5*
1950	252.8 ^e	151.9	60.2	623.6	1,088.5
1951	273.8	165.8	n.a.	761.7	1,201.3*

Source: Annual Reports, Massachusetts Commissioner of Banks; Annual Reports, Federal Savings and Loan Associations.

Represents an approximation from available data on assets of the 4 associations concerned.

x Of this amount, \$25.5 million represents mortgages held by the 12 banks converting in 1937.

n.a. not available.

* In years where data are incomplete, total figures are likewise understated.

e As of April 30, 1950. Reporting date changed from October 31 after 1948 to present date of April 30.

Previous discussions have referred briefly to the unfavorable depression experience of cooperative banks. In 1936 real estate held by foreclosure represented roughly 7 per cent of total assets, with mortgages on which dues were temporarily suspended accounting for an additional 6 per cent of assets. At the same time when foreclosure accounts mounted and debt repayments continued at a reduced but steady pace, local cooperative banks found a negligible demand for new home mortgage credit. As a result, total mortgage holdings fell more rapidly than total resources, so that the average mortgage-assets ratio dropped to 72.8 per cent by 1936.

Of the new mortgages written during this period, a substantial proportion undoubtedly consisted of purchase-money mortgages taken back on

sales out of foreclosure. Frequently written on a straight-term basis, such common form mortgages in 1936 represented 4 per cent of total assets. Cooperative form mortgages were waning in significance as a result of the growing popularity of newly-authorized direct-reduction loans, the latter accounting for 4 per cent of total assets as early as 1936. The average loan balance had declined to \$3.17 by this latter year, an 18 per cent drop from the 1927 level. This rather significant decline reflects the substantially lower valuations on real estate and consequently on new loan amounts, but it also stems from continued repayment on existing mortgages and the low volume of new loans written.¹

Recovery Period

By 1936 the worst of the depression appeared to be over, and foreclosure accounts and delinquent mortgages represented a progressively smaller proportion of total assets. Perhaps profiting from their past errors and shortcomings, local cooperative banks, and particularly their newly-chartered federal counterparts, re-entered the mortgage market with caution and a certain degree of confidence. The level of new mortgage demands had recovered somewhat from the early 1930s, but was far below that of the previous prosperity period. The number of permit applications for residential building in Massachusetts had doubled between 1934 and 1936, but, even as late as 1940, this index of construction activity was still far below one-half that of the mid-1920s.² Although the volume of new home building was on a limited scale during the prewar recovery, cooperative banks and federals were able to enlarge their mortgage portfolios each

¹The same factors, in addition to foreclosures mentioned above, serve to account for the 25 per cent decline in total mortgage holdings. Beginning in 1936, these figures on outstanding mortgage amounts had a progressively downward bias, as a result of the rewriting of old cooperative form notes on a straight-term or a direct-reduction basis. As explained earlier, pledged share capital was directly applied against principal repayment when rewritten.

²See Table VII, Part II.

year after 1936. A significant proportion of this increase reflected refinancing of existing mortgages which had been held by other local thrift institutions, notably savings banks.¹

By 1940 local cooperative banks and federal savings and loan associations had greatly strengthened their overall position in the mortgage market. As a proportion of aggregate holdings of local thrift institutions, portfolios of savings and loan associations declined slightly during the early depression years but had recovered to a significantly higher 32 per cent by 1940.² The 17 per cent increase in outstanding mortgage holdings between 1936 and 1940 is indicative of an even greater relative increase in new lending, for cooperative banks and federals were almost alone in writing new loans on a direct-reduction basis. In contrast to straight-term loans, direct-reduction mortgages supply lenders with a steady inflow of principal repayment sums, thereby necessitating a continual writing of new loans in order to maintain existing mortgage levels, let alone increase them.³

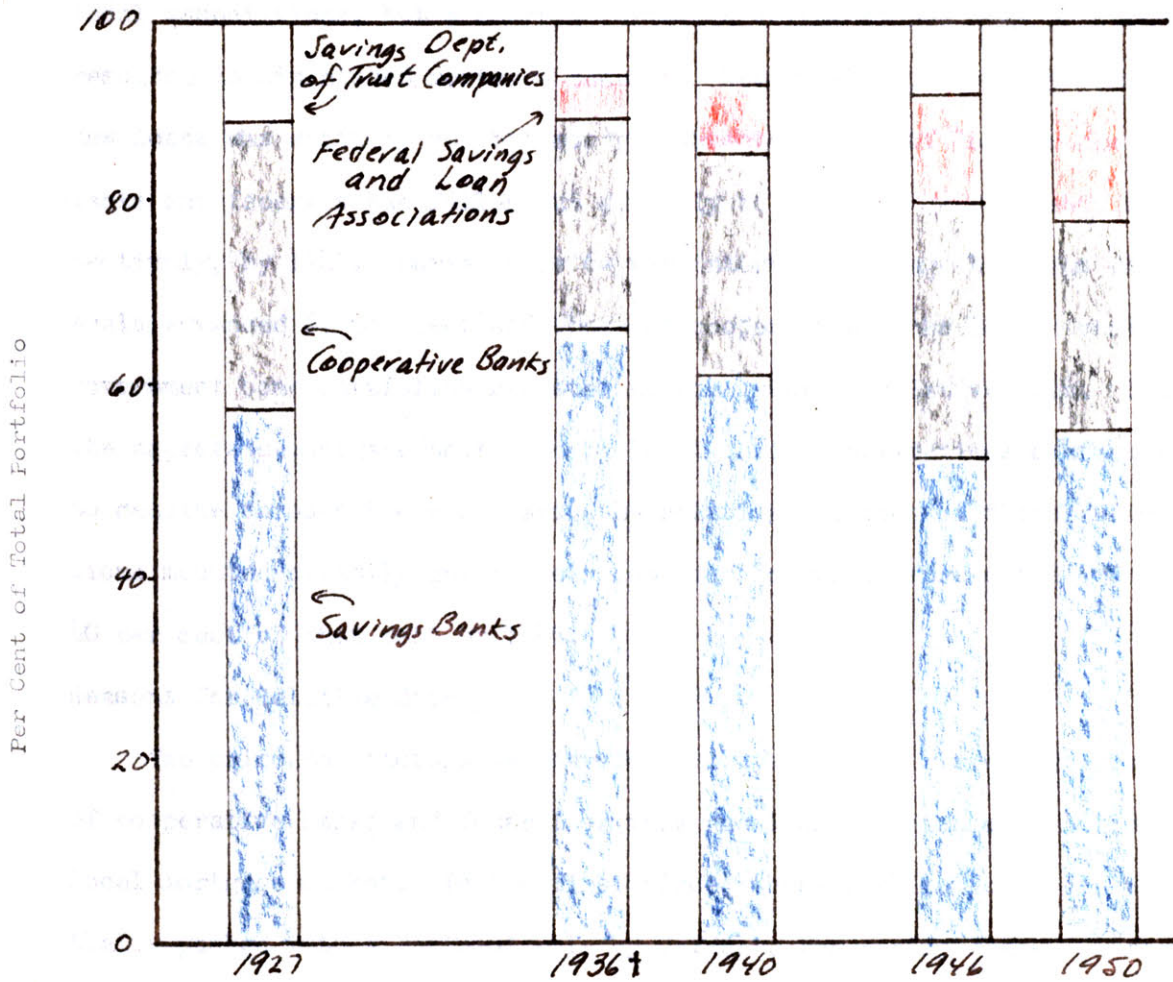
Mortgages represented an increasing proportion of total assets among local cooperative banks and federals during the immediate prewar years. Of the cooperative banks that did not convert, total resources increased only \$2 million between 1936 and 1940, but mortgage portfolios increased fully \$8 million, thereby raising mortgage-asset ratios from 72.8 to 75.2

¹Unfortunately, data are entirely lacking as to the volume of local refinancing activity. Although perhaps most refinancing by a new mortgagee arose out of the sale of mortgaged properties, a significant proportion reflects a rewriting of the loan without change in ownership. As will be indicated later, federals in particular recast many savings bank mortgages on the popular direct-reduction basis.

²Chart I. The drop from 31.6 to 27.2 per cent between 1927 and 1936 perhaps reflects a relatively heavy repayment on amortized loans, especially where pledged share capital was applied to the retirement of cooperative form loans.

³Compare straight-term and amortized loans by means of the circular flow analysis. Chapter 5.

CHART I. PERCENTAGE DISTRIBUTION OF THE AGGREGATE MORTGAGE PORTFOLIO HELD BY SAVINGS BANKS, COOPERATIVE BANKS, FEDERAL SAVINGS AND LOAN ASSOCIATIONS AND TRUST COMPANIES IN THE BOSTON AREA, 1927-1950



Source: See Table I.

†Mortgage holdings of cooperative banks converting in 1937 are included only with federals in 1936.

per cent.¹ The 16 local federal savings and loan associations registered a far more spectacular growth during the 4-year period through 1940, as total assets rose from \$37.6 to \$63.0 million, and mortgage portfolios from an estimated \$28.2 to \$52.1 million.²

During the ensuing war years share capital continued to accumulate in local associations, but a sharply curtailed volume of new home construction resulted in diminished mortgage demands. Nevertheless, a steady volume of new loans was written, so that mortgage-assets ratios of local cooperative banks and federals had fallen but slightly to 74.5 and 71 per cent, respectively, by 1946. During this 6-year interval mortgage holdings of federals advanced 67 per cent and those of cooperative banks 18 per cent, with government bond portfolios registering the greatest relative gain. Since the aggregate mortgage debt held by local thrift institutions continued to decline through the war years, the relative position of these associations mounted steadily until their combined holdings represented over 40 per cent of that debt by 1946.³

Reasons for Relative Gain

Two principal factors may have contributed to the rising importance of cooperative banks and federal savings and loan associations in the local mortgage market. In the first place, these institutions were virtually pushed into a dominant role by default, for savings banks retreated

¹See Table I. The \$17.5 million drop in cooperative bank mortgage portfolios merely reflects the conversion of 12 additional local banks. Only 4 small institutions had federalized by the 1936 reporting date.

²Mortgage-assets ratios increased from 74.4 to 82.6 per cent. The 1936 data for the 12 associations which had not yet converted are taken from their respective annual reports as cooperative banks. For the 4 federals which had converted, data are taken as of the date of conversion.

³Chart I.

from their previous active participation in the mortgage market.¹ At the same time, cooperative banks and federals saw rich opportunities in sound mortgage lending during the prewar recovery period. Although they were authorized to make FHA-insured mortgage loans with a minimum of risk, most local associations preferred to select and carry their loans on a conventional basis. Uninsured mortgage loans offered attractive yields and, what was most important for the borrower, they were written with many of the same liberal provisions as FHA-insured loans, at least so far as loan-value ratios and loan terms are concerned. As pointed out in Part III, both cooperative banks and federals were permitted to write 80 per cent loans with terms ranging up to 20 years. Furthermore, both groups concentrated almost exclusively in the popular direct-reduction type of mortgage, in contrast to the straight-term loans still characteristic of savings bank lending.² By 1940 this newer mortgage type accounted for 31 per cent of total cooperative bank mortgage holdings, while the share represented by the cooperative form note had fallen to 57 per cent. This trend indicates that nearly all new loans were written on a direct-reduction basis, as the 12-14 year term on the older variety would account for its continuing, but declining, predominance during these years. During the war years, most cooperative form mortgages were either paid off or rewritten on a direct-reduction basis, and their proportionate share fell to 21 per cent by 1946. Common form mortgages also steadily waned in importance, as existing loans were repaid and few purchase-money mortgages were written after depression foreclosure activity subsided.³

¹ See "Savings Banks" below.

² See pp. 253-4, for specific reference to debt-value ratios on mortgages held by local savings and loan associations in 1940.

³ Owing to the substantial inflow of amortization payments as well as the moderate level of property valuations, the average mortgage balance among cooperative banks continued to fall through 1940 to \$2.98 thousand. By 1946 new loans written for progressively higher amounts had produced a slightly higher average balance of \$3.28 thousand. Computed from Annual Report, Massachusetts Commissioner of Banks.

Federal savings and loan associations were far more aggressive than cooperative banks in promoting their mortgage operations. Taking advantage of liberal lending opportunities, including the permission to make individual loans up to \$20,000, local associations were a major source of home mortgage credit for both home purchase and refinancing purposes. Although data are not available on new loans made, interviews indicate that federals made solid contracts with local home builders and contractors during this period and accordingly placed a significant share of all mortgages on new homes. Construction activity and demands for short-term construction loans were not extensive, but the willingness, and desire as well, of federals to supply these credit needs proved to be an invaluable asset in the postwar period.¹ Perhaps most of their mortgage lending activity concerned the purchase of older properties and the rewriting of existing mortgages held by other lenders. Much of this business was achieved through ambitious advertising programs, publicizing the benefits accruing to the "newer-type" mortgage. Promotional literature informed prospective home buyers as well as existing mortgagors of the dangers involved in straight-term lending, under which repayment might be required on demand. In a similar vein, federals undoubtedly hastened the decline in holdings of cooperative form mortgages among local cooperative banks, for the assurance of a definite maturity date on direct-reduction loans enjoyed popular appeal among mortgagors. All in all, local federals assisted a great many new and existing home owners in retiring mortgage obligations through making convenient monthly payments over an extended

¹ See "Construction Loans," Chapter 12.

term.¹

COMMERCIAL BANKS.

Little specific data are available on the mortgage operations of local commercial banks. Until the depression years, national banks were severely restricted in making urban real estate loans on grounds that such long-term investment was not an appropriate activity for an institution specializing in short-term credits. In 1935 all banks were given limited authorization to make conventional loans on a 10-year, 60 per cent basis and FHA-insured loans without regard to these restrictions. In spite of their enlarged lending opportunities, national banks have continued to play a subordinate role in permanent mortgage financing in the local money market center. Trust companies, on the other hand, have traditionally operated in a more liberal legal framework, investing quite heavily in real estate loans, especially during the 1920s. Rapidly increasing savings accounts in their newly-formed savings departments were promptly placed in mortgage channels. In 1927 the 42 local state-chartered institutions with savings departments held \$81.7 million in mortgages, representing 59 per cent of total assets. This dollar volume in the late 1920s is at least one-third greater than total mortgage holdings in any succeeding year, including the postwar period when total assets reached an all-time high in 1946.²

¹More specific data on new lending by all cooperative banks and federals throughout the Commonwealth are presented under "Savings Banks" below. The following data on new loans made by all savings and loan associations in the nation portray the relative importance of new construction and refinancing (Dollar amounts in millions):

Year	Total Loans	Purpose of Loan			
		Construction	Home Purchase	Refinance	Other
1936	\$ 755	\$178	\$230	\$178	\$169
1937	897	234	327	181	155
1938	798	220	265	160	153
1939	986	301	340	182	163
1940	1,200	399	426	198	177

Source: Housing Statistics, HHFA, January 1951, p. 60.

As described earlier, trust companies suffered heavy casualties during the early depression years, and liquidation and merger activity stepped up considerably. By 1936 mortgage portfolios of the remaining 30 savings departments had fallen to \$35.5 million, accounting for 44 per cent of total assets.¹ In the prewar recovery period, savings deposits began to rise and trust companies once again proceeded to build up mortgage portfolios on a limited scale. During the war years, however, savings capital more than doubled and, although mortgage portfolios continued to rise, the mortgage-assets ratio for all local companies fell to 24.4 per cent by 1946. Despite this decline in mortgage-assets ratios, trust companies had actually strengthened their relative position in the local mortgage market since the mid-1930s, largely because of the retreat of savings banks from the mortgage market.²

SAVINGS BANKS

Although new lending operations of cooperative banks and trust companies reached unprecedented heights during the 1920s, mortgage holdings of local savings banks consistently exceeded the combined portfolios of the former. Mortgages held by local savings banks continued to increase through 1931, but net increments diminished markedly after 1925. In 1927 mortgage holdings of the 61 savings banks in the Boston area aggregated \$470.6 million, constituting 52.2 per cent of total assets. Not until 1949 was this peak dollar volume exceeded again, while the mortgage-assets ratio has never been approached since that time. New Loans amounting

¹Computed from Annual Report, Massachusetts Commissioner of Banks.

²See Table I, Chart I.

²The mortgage debt perhaps rose slightly through 1929, although these data have not been computed on a local basis.

to \$78.1 million were written in 1927, a volume equivalent to one-sixth of the year-ending portfolio. The average loan balance of \$7,930 reflects the dominant influence of new loans made at existing high valuations as well as the absence of systematic amortization provisions in mortgage contracts. The fact that average loan balances were considerably higher in savings banks than in cooperative banks is largely explained by the relatively more important role played by large income-property loans in mortgage portfolios of the former.

As indicated earlier, the year 1931 marked a major turning point in the mortgage and overall investment policies of local savings banks. In contrast to the previous decade when mortgage loans and high-yielding private securities dominated investment portfolios, the depression years and the subsequent wartime period as well witnessed a virtual retreat from these markets altogether. Steadily increasing deposit liabilities as well as funds released from other investments were placed almost entirely in government bond portfolios. The ratio of mortgage loans to total assets among local savings banks fell continuously to 41.7 and 36.9 per cent by 1936 and 1940, respectively; and at the close of the war in 1946, real estate loans represented an all-time low of 23.5 per cent of total assets.¹

Mortgage-asset ratios declined not only because of steadily advancing savings capital but also because of a substantial dollar reduction in mortgage holdings. By 1936 mortgage portfolios had fallen from their previous peak amounts as a result of foreclosures, etc., but remained slightly above the 1927 level. Whereas mortgage holdings of all other thrift institutions mounted steadily from their depression depths, savings

¹Computed from Annual Report, Massachusetts Commissioner of Banks.

banks' portfolios continued to decline through the balance of the decade and on through the war years as well. By 1946 the outstanding mortgage debt held by the 56 savings banks in the Boston area had dropped to \$380.8 million, more than 20 per cent below the corresponding 1936 level.¹

Reasons for Decline in Mortgage Portfolios

As in the case of cooperative banks, foreclosures undoubtedly contributed to the sharp decline in mortgage portfolios held by local savings banks. During the 15-year period through 1945, total foreclosures among all savings banks in the Commonwealth amounted to nearly 45 per cent of the beginning portfolio. This substantial foreclosure activity does not spell complete loss for the mortgagee, however, for nearly all such property had been sold by the end of the period, frequently entailing a purchase-money mortgage at the time of sale. The net drain on mortgage portfolios because of foreclosures was significant during the early depression years, contributing approximately 60 per cent of the net decline for the 5-year period through 1936.² During the succeeding 9 years, however, foreclosure operations continued at a rapid pace, but had a negligible effect on the progressively declining mortgage portfolios. Indeed, during the early war years, the volume of purchase-money mortgages written in connection with foreclosure sales actually exceeded the dollar amount of mortgage principal foreclosed, with the result that foreclosure activity tended to increase rather than reduce existing mortgage holdings.³ At any rate, it seems clear that only a

¹ See Table I.

² Lintner, *op. cit.*, p. 228.

³ *Ibid.*, pp. 228-9.

small part of the decline in mortgage portfolios between 1931 and 1946 is to be ascribed to mortgage foreclosure activity. Furthermore, its influence progressively declined after 1936, while mortgage portfolios continued to fall through 1945 just as rapidly as during the early depression years.¹

Principal repayment constituted another drain on mortgage portfolios, undoubtedly more significant than mortgage foreclosure. Professor Lintner has calculated repayment sums for all Massachusetts savings banks, relating them to outstanding portfolios at the beginning of each year.² As might be expected, loan repayment was of negligible importance during the early depression years, and never approached the 10 per cent level of the middle 1920s until the late war years. Most mortgages had been written on a straight-term or demand basis, and savings banks rarely asked for debt repayment unless additional liquidity were sought or more profitable investment opportunities appeared elsewhere. As explained earlier, loans called during the depression generally found the mortgagor having serious liquidity problems as well, and foreclosure, loan extension, or some other adjustment was a more likely result than loan repayment. During the war years, however, rising incomes coupled with more extensive amortization provisions resulted in heavier inflows of mortgage repayment. Over the 15-year period, as a whole, repayments

¹

Although most mortgage losses originated during the early depression years, a large proportion of these were not charged off until the later war years. While small residential properties were readily sold during the 1930s, the market for larger income properties remained weak until 1940 at least. Accordingly, most savings banks retained these latter foreclosed properties until their sale appeared expedient, but unfortunately failed to write off most of these losses until the time of sale. See Ibid., pp. 285-298.

²Ibid., pp. 229-230.

probably averaged less than 5 per cent per year of outstanding mortgage portfolios.¹

The relatively low level of principal repayment during the 1930s is reflected in the steady but decidedly slow decline in average loan balances. The \$8.0 thousand value for 1936 is slightly higher than that of 1927, owing in part to the influence of larger loans written during the late 1920s. Heavier repayments as well as smaller new loans resulted in progressively lower average mortgage balances, falling to \$7.15 thousand in 1940 and to \$6.03 by 1946. This decline in average new loan amounts reflects a change in the composition of mortgage portfolio as well as lower real estate valuations. Whereas many savings banks made a substantial volume of mortgages on large income properties during the booming 1920s, post-depression lending was concentrated primarily on smaller 1- to 4-family properties.²

The extremely low level of demand for new mortgage credit was a significant contributing factor in the decline in mortgage portfolios. The volume of mortgage loans written by local savings banks in 1936 represented but 4.7 per cent of the year-ending outstanding balance, and was less than one-third of the total volume written in 1927. When allowance is made for the fact that purchase-money mortgages perhaps accounted for two-thirds of all new loans made during the early depression years, the drop in "original" lending was even more striking. Even when mortgage demands appeared to be on the upswing again, however, savings banks continued to invest in government bonds instead of home

¹ Ibid., p. 230.

² See Chapter 12 for an analysis of the reasons underlying this shift in investment policy.

mortgages. The moderate recovery in new construction and real estate transfer activity prompted but a minor response in new mortgage lending by local savings banks. As late as 1940, all new loans written totaled less than \$33 million, representing 7.5 per cent of year ending debt balance and two-fifths of the 1927 volume of new loans.¹

Whereas mortgage portfolios among all local thrift institutions registered heavy depression losses, all but savings banks took positive steps toward a strengthening of their position during the prewar recovery period. As pointed out above, federal savings and loan associations in particular conducted extensive promotional campaigns in order to attract new mortgage business. Inasmuch as data on new lending by federals and cooperative banks are not available on a local basis, exact comparability with savings bank activity during the prewar period is not possible. The declining share of the aggregate mortgage debt held by savings banks does, however, provide a rough indication of the relative volume of new loans handled by these and competing thrift institutions. Whereas the outstanding mortgage debt held by local savings banks in 1936 was 2.5 times that held by cooperative banks and federal savings and loan associations, this ratio fell sharply to 1.95 by 1940 and by the end of the war in 1946, to 1.31.² The 1940 Census ascribed an even greater predominance to savings banks as holders of first mortgages on owner-occupied 1- to 4-family properties, the ratio being 3.15 for the "Boston Metropolitan District" as defined in that year.³

¹Even as late as 1941, Lintner estimates that the volume of purchase-money mortgages exceeded that of original loans written, op. cit., p. 231.

²See Table I, Chart I.

³This discrepancy in ratios arises largely from the fact that cooperative banks and federals tend to be more heavily concentrated near Boston proper and, hence, to the restricted area chosen for the present study. The Census definition of the District covers an area several times as large as this, including communities where savings and commercial banks are relatively more significant. For further evidence of this relative concentration, see "Other Lending Institutions" below.

In contrast to their predominance in "stock" held, the "flow" of new loans made by all savings banks in Massachusetts was consistently smaller than that made by all savings and loan associations through 1946. From data on mortgage recordings of \$20,000 or less, it is clear that until the war began the dollar volume of new home loans made by the latter institutions was more than twice that made by savings banks. (See Table II.) Moreover, the share of total recordings represented by savings banks actually appeared to be increasing through 1941; accordingly, it may be surmised that, if data were available, the retreat of these institutions from new home mortgage lending was even more striking in the immediate post-depression period.¹ To summarize, since the volume of new loans written by local savings banks was only about one-third that of competing institutions holding but a fraction of the aggregate mortgage debt, the relative decline in savings banks' portfolios was inevitable.

In terms of new lending, these data indicate that commercial banks were also losing ground to savings and loan associations, although less markedly than in the case of savings banks. In 1940 national banks and trust companies held over 16 per cent of the aggregate mortgage debt on owner-occupied home properties in the "Boston Metropolitan District" as well in the Commonwealth, this ratio being somewhat higher than that for all savings and loan associations.² During the years under consideration, however, commercial banks accounted for roughly 8 per cent of new home mortgage recordings while the corresponding ratio for cooperative banks and federals exceeded 40 per cent. Life insurance companies, on the other hand, participated in the prewar mortgage market nearly as

¹By considering only those recordings of \$20,000 or less, it is to be understood that these data refer primarily to mortgages on 1- to 4-family properties.

²See Table III below.

TABLE II. TOTAL DOLLAR VOLUME AND PERCENTAGE DISTRIBUTION AMONG VARIOUS INSTITUTIONS OF MORTGAGE RECORDINGS OF \$20,000 OR LESS ON NON-FARM PROPERTIES IN MASSACHUSETTS, 1939-1946

Year	Total (Millions)	Percentage		Recorded Insurance Companies	By Commercial Banks	Indi- viduals	Others
		Savings Banks	Savings and Loan Ass'ns				
1939	\$164.4	20.1%	44.7%	5.1%	8.2%	12.4%	9.5%
1940	202.0	21.9	46.7	4.0	7.3	12.4	7.8
1941	236.3	24.8	47.6	1.2	6.5	17.4	2.6
1942	186.2	24.6	45.2	1.6	6.4	18.4	3.8
1943	164.7	24.1	43.1	1.6	6.1	15.5	9.5
1944	196.3	23.6	45.1	0.9	6.4	14.9	9.2
1945	242.6	27.3	44.5	0.6	7.5	13.5	6.6
1946	497.7	32.8	41.3	0.5	9.5	9.9	6.0

Source: Federal Home Loan Bank Review, and Statistical Supplement, 1947; reprinted in Lintner, op. cit., p. 234.

heavily as commercial banks, although their portfolios as reported by the 1940 Census were but one-eighth as large. Perhaps the more widespread utilization of FHA-insurance provisions among insurance companies accounted for their renewed interest in new mortgage lending during the prewar period.¹

As remarked earlier, savings and loan associations and insurance companies strengthened their foothold in the local mortgage market both by lending on new properties as well as in financing the purchase of older homes or in refinancing activities. A crude indication of the relative contribution of these lender groups toward the recovery in new home building is found in Census data pertaining to the age of mortgaged properties. In 1940 homes built within the preceding 10 years constituted 21.4 per cent of all owner-occupied, 1- to 4-family properties on which savings and loan associations held first mortgages. The corresponding ratio for life insurance companies was 64 per cent, with all but 10 per cent of the remaining properties being built since 1920. For savings banks, properties less than 10 years old represented only 16.7 per cent

¹See Chapter 13.

of all mortgaged properties, thereby indicating a much smaller emphasis in financing the purchase of new homes.¹

A significant factor underlying the relative decline in new mortgage lending by savings banks relates to the types of mortgage contracts offered by the various lending institutions. Whereas savings and loan associations and insurance companies wrote nearly all of their new home loans on the popular high-percentage, direct-reduction basis, savings banks continued to make traditional straight 60 per cent mortgages. It is perhaps true that these institutions have been more restricted in making liberal mortgages than cooperative banks and federal savings and loan associations. Whereas the latter had long made 80 per cent loans, savings banks were authorized to make 70 per cent, 20-year loans only in 1937, and 6 years later this permission was extended to cover loans representing 75 per cent of appraised value. Even today, they may write 80 per cent mortgages only if the loan amount does not exceed \$12,000, as opposed to a \$20,000 limit for all savings and loan associations. Nevertheless, in addition to this successive liberalization in lending opportunities, savings banks have been authorized since 1935 to make liberal FHA-insured loans regardless of loan-value ratio or loan term.

In spite of the growing popular acceptance of direct-reduction mortgages, most savings banks during this period refused to depart from the non-amortized, low-percentage loan, whereby repayment could be demanded at any time after a 3-year term. In 1940, out of over 30 thousand home mortgages held by savings banks in the Metropolitan Boston District, fully two-fifths required no principal payments whatever. When contractual amortization was not provided, nearly all mortgage contracts

¹1940 Census of Housing, Volume IV, part 2, Table E-4.

specified interest remittance on a quarterly basis. Indeed, even where principal payments were required, regular monthly payment was only slightly more common than quarterly payment. Reflecting in large part the traditional cooperative form mortgage, savings and loan associations almost universally insisted on regular principal repayment throughout the entire term, usually on a monthly basis.¹ The lack of interest among savings banks in the newer direct-reduction type loan undoubtedly figured prominently in rapid rise of competing lending institutions. Professor Lintner observes that, even as late as 1942, less than $6\frac{1}{2}$ per cent of outstanding mortgage portfolios of Massachusetts savings banks consisted of 70 per cent, 20-year mortgages and FHA-insured loans.²

Loan-value Ratios in 1940

The 1940 census sheds some light on average debt-value ratios among the mortgage portfolios of local lending institutions. Perhaps the most striking observation from these data is the marked similarity among all mortgagees in this regard. The only exception concerns the HOLC, which granted long-term, high-percentage loans to distressed home owners during the early depression years. By 1940 the average HOLC loan in the Boston Metropolitan District had been paid off to some extent so that outstanding first mortgage balances on single-family properties represented 67.4 per cent of estimated value. For all other types of mortgages the ratio of the current unpaid balance on first mortgages to the appraised property value ranged from 54.1 per cent for savings banks and commercial banks to 59.0 per cent for life insurance companies.

¹1940 Census, op. cit., Table E-5. Among the latter institutions, principal amortization was required in over 90 per cent of the cases.

²Lintner, op. cit., p. 236.

The tendency for loan-value ratios to be closely grouped together perhaps results from various conditions. In the first place, any such ratios are reliable only to the extent that "value" represents a valid, realistic estimate. The home owner's appraisal of his own property may bear a variable and unpredictable relation to what it would bring in the actual market. However, assuming these ratios represent valid estimates, the cited loan-value ratio for savings banks probably reflects few high-percentage loans and a heavy concentration about the 60 per cent figure where systematic amortization requirements were rare. On the other hand, the average debt-value ratio for savings and loan associations was 55.3 per cent, resulting from a well-seasoned portfolio of loans which were initially made at high percentages but have subsequently been paid off by varying degrees. Perhaps average ratios are singularly high among insurance companies for analogous reasons. That is, these latter institutions concentrated on high-percentage, direct-reduction type mortgage loans, with monthly payment required in 90 per cent of all cases. Since a significant proportion of their portfolios consisted of loans on new properties and consequently were relatively new loans, only a small share of original principal amounts had been paid off by 1940.¹

The failure to write the type of mortgage loan sought by the home buying community suggests a more fundamental reason for the relative decline of savings banks in the local mortgage market. During the pre-war and war years alike, these institutions were reluctant to make new loans under either type of contract, except for purchase-money mortgage

¹Census of Housing, *op. cit.*, Table E-3. Corresponding debt-value ratios on 2- to 4-family properties were slightly higher among each major type of mortgagee except savings and loan associations. For all types, the ratios were 55.3 and 58.0 per cent, respectively, on single- and 2- to 4-family dwellings.

or for applicants displaying exceptionally desirable credit elements. Just as all mortgage lending institutions, local savings banks were busily engaged in handling delinquent and defaulted loans and in disposing of foreclosed properties during these years. Nevertheless, the heavy volume of foreclosures and subsequent losses taken on account of loans made earlier convinced many lenders, particularly savings banks, that mortgage lending was an unsound investment per se and hence was not an appropriate outlet for depositors' funds at that time. As Professor Lintner conclusively demonstrates, most mortgage losses sustained during the depression and early war years resulted from unsound mortgage lending practices during the previous boom period, and that risks associated with current lending operations have little connection with the handling of such losses. On the contrary, mortgage risks appear to be relatively low during depression years and in early recovery periods as well. Hence, largely because of improper and occasionally inadequate provision for the absorption of mortgage losses, mortgage lending policies of savings banks became dangerously distorted. Not only were these institutions reluctant to assume the risks associated with conventional lending, but they were equally disinterested in making FHA-insured loans where most risks could be shifted to another party. As indicated earlier, even if the latter mortgages ended in default and foreclosure, the mortgagee could exchange the property for marketable debentures, and in any event would receive a net yield over and above rates on long-term government bonds. To summarize, local savings banks

" . . . largely withdrew from the mortgage market at the time when the risks on new lending were relatively smallest and when they most needed the income both to maintain more nearly the ratio of dividend payments to their depositors¹ and to absorb losses arising out of their past mistakes."

¹ Lintner, op. cit., p. 237.

OTHER MORTGAGE LENDING INSTITUTIONS

Before proceeding with an analysis of postwar mortgage lending, brief reference will be made to the mortgage holdings of other types of institutions in 1940. Some of the data in Table III have been used in connection with the preceding analysis of the local mortgage market.

TABLE III. TOTAL AND PERCENTAGE DISTRIBUTION AMONG MORTGAGE TYPES OF FIRST MORTGAGES ON 1- TO 4-FAMILY OWNER-OCCUPIED NONFARM PROPERTIES, BOSTON METROPOLITAN DISTRICT, 1940

<u>Type of Property</u>	<u>Total Debt</u> (000,000)	<u>Savings and Loan</u>	<u>Percentage Share Savings Bank</u>	<u>Commer- cial Bank</u>	<u>Life In- surance Company</u>	<u>Mort- gage Company</u>	<u>HOLC</u>	<u>Indi- vidual</u>	<u>Oth- ers</u>
1-4 family	\$426.9	13.6	42.8	17.1	2.3	0.8	7.2	7.7	8.5
1- family	271.4	16.7	37.8	18.5	3.0	0.9	6.3	7.1	9.7
2-4 family	155.5	8.2	51.4	14.6	1.1	0.7	8.8	8.7	6.5

Source: 1940 Census of Housing, Volume IV, Part 2, Table E-3.

These data indicate some relationships which may appear at first to be inconsistent with those drawn from data presented earlier in Table I and Chart I. Most discrepancies, however, can be resolved when the bases of the two tabulations are made clear. First of all, Table I relates to aggregate mortgage portfolios of four major types of lending institutions whose home offices are located within 10 miles of the Boston City Hall. The 1940 Census data refer to certain properties within the Boston Metropolitan District as defined at that time, including roughly all communities within a radius of 20-25 miles of the City Hall. Whereas the former data apply to all real estate loans held regardless of property type of location, Census data refer only to mortgages on "1- to 4-family owner-occupied nonfarm properties without business" located within the given area.

Perhaps the most striking difference between the two tabulations concerns the relative importance of savings and loan associations and commercial banks as compared with savings banks. The primary factor accounting for the smaller significance of commercial banks in Table I is the absence

of data on national bank portfolios. Another factor explaining the heavier influence of both commercial and savings banks relative to savings and loan associations in Census data relates to the differences in geographic areas considered. As stated earlier,¹ cooperative banks and federal savings and loan associations tend to be more heavily concentrated in the immediate Boston vicinity, in contrast to the more even distribution of commercial and savings banks throughout the Census District as well as the Commonwealth. In 1940 only 58 of the 192 savings banks in Massachusetts, compared with 85 of the 183 cooperative banks, were included within the immediate "10-mile" area. Furthermore, 16 of the 27 federals in Massachusetts were within this restricted Boston area, with only one additional association located within the whole Census Metropolitan District. Not only were savings banks more evenly distributed in numbers and presumably total resources, but their relatively heavier concentration in suburban sections may also have increased the relative importance of loans on owner-occupied homes in their respective portfolios. As pointed out in previous demand analyses, large population centers such as the immediate Boston vicinity tend to have a high proportion of rental units in their housing stock. Hence, inasmuch as lending operations of cooperative banks in particular have tended to be highly localized, properties mortgaged by them would display a heavy concentration within the immediate Boston area. There is also reason to believe that the methods of enumeration produced a bias understating the holdings of savings and loan associations in favor of commercial and savings banks.²

¹Footnote, p. 249.

²See Census of Housing, Volume IV, Part 1, United States Summary, p. 4. Perhaps home owners were frequently confused as to whether a cooperative bank was a savings and loan association or an ordinary savings or commercial bank.

The Census data bring out clearly the relative importance of single-family and multi-family units among the various mortgage portfolios. In the case of savings and loan associations, the dollar volume of loans was fully twice as large on single-family than on 2- to 4-family properties. This reflects a basic policy among these institutions, as well as among life insurance companies, in that concentrating on loans on small residential properties is a primary method of minimizing overall mortgage risk.¹ Mortgages on 2- to 4-family properties were much more significant among savings banks' portfolios, aggregating nearly 40 per cent of their total 1- to 4-family holdings. Many local savings banks also held a substantial volume of mortgages on large income properties in 1940, holdings which are obviously excluded from this Census coverage.² The HOLC has held a steadily diminishing share of the total mortgage debt, standing at 7.2 per cent in 1940 and falling to zero before the termination of all liquidation proceedings. The fact that the HOLC was relatively more prominent in holding loans on 2- to 4-family than on single-family properties perhaps reflects a more severe depression experience among the former property owners.

It is likely that mortgage holdings of mortgage companies and individuals are slightly overstated in Table III because of a bias in enumeration procedures. Each home owner was asked to identify the current holder of the mortgage, whether or not it had been assigned to a different party subsequent to its origination. Frequently, however, he could only give the name of the individual or mortgage company initiating the loan, with the

¹See "Loan Amount and Mortgaged Properties," Chapter 12.

²It is interesting to note, however, that even after making this latter deduction from mortgage portfolios, savings banks' share of the combined 1-4 family debt held by all savings banks and savings and loan associations in the Boston Metropolitan District was larger than their corresponding share of aggregate holdings (including income-property loans) within the immediate Boston vicinity. As indicated above, this rather surprising observation either reflects an extreme dissimilarity in the two geographic areas with respect to the relative importance of savings banks and savings and loan associations, or else the inherent bias in overstating the role of savings banks in Census data.

result that the importance of other mortgagees, notably insurance companies, is understated.¹ Perhaps the mortgagor continued to make monthly payments to the mortgage broker from the outset, and never discovered that the latter was simply a loan correspondent and servicing agent for a life insurance company.

¹1940 Census, Volume IV, part 1, p. 4.

CHAPTER 10. POSTWAR HOME MORTGAGE LENDING IN THE BOSTON MARKET.

The postwar period has witnessed a tremendous surge of demand for new home purchase and hence for home mortgage credit. As millions of returning war veterans sought adequate housing accommodations, a feverish scramble for existing stocks of both rental and single-family units soon developed. Critical housing shortages appeared in many areas, and demands for new home construction reached unprecedented levels. Accordingly, in 1950 alone, 1.4 million new dwelling units were completed, a volume over half again as high as the peak level of the 1920s.

While the postwar housing boom in the Boston area has perhaps been less spectacular than in other sections of the country, new construction activity has surpassed all previous records, both in terms of number of units as well as total estimated cost.¹ Although current mortgage portfolios of local thrift institutions reflect highly inflated property valuations, new lending has attained record heights in number of loans as well as dollar amount. The growth in mortgage holdings of local savings banks, savings and loan associations, and trust companies has been indicated in Table I.² Before considering the postwar operations of these major lender groups in greater detail, it may be helpful to present the overall distribution of mortgage debt held by all mortgagees in this area. Unfortunately, until findings of the 1950 Census on home mortgages are available, any analysis of significant shifts in mortgage holdings or loan contracts over the past decade will lack full statistical verification.

DISTRIBUTION OF THE OUTSTANDING MORTGAGE DEBT

Although Census data are incomplete as of this writing, a rich source

¹See Table III, Part II.

²P. 236.

of supplementary data has arisen as a by-product of Regulation X and its enforcement by the Federal Reserve Board. Under the provisions of this regulatory order, all lenders extending real estate credit (1) three or more times, or (2) in amounts aggregating more than \$50,000 a year are required to register with the Federal Reserve Bank in their district. The initial registration statement required lenders to specify the amount of different types of mortgages held on May 31, 1951, together with the volume of mortgages serviced for others. It should be strongly emphasized that these data relate to mortgages held by local institutions, regardless of the location of property underlying the debt, and accordingly do not necessarily represent indebtedness in the restricted area under consideration. This method of reporting corresponds to that used by the State Bank Commissioner in the various Annual Reports, but is unlike that of the Census Bureau, where property location is used as the basis of classification. The implications of this distinction are highly significant, and will be taken up more fully in subsequent analyses of the secondary mortgage market. At this point, it is sufficient to point out that, although the four counties for which these data are available represent but 1.9 per cent of the nation's population, their mortgage holdings account for fully 3 per cent of the aggregate nonfarm residential mortgage debt. This observation reflects the national significance of Boston as a mortgage money center with its vast amounts of life insurance company and savings bank funds.

For the purposes of the present analysis, four counties in northeastern Massachusetts are considered, the population of which is 82 per cent within the "Metropolitan Boston Area" as defined by the 1950 Census. As of May 31, 1951, there were 786 individuals or institutions which indicated that they either owned or serviced mortgages, as defined above.

(See Table IV.) These registrants held about \$2.2 billion in mortgages for their own account, and serviced an additional \$92 million for others. In terms of number of registrants, "real estate brokers" constituted the largest single lender type, although in terms of mortgage holdings they were of minor significance. These and other types of brokers strive to minimize portfolio holdings, preferring to concentrate on other phases of their real estate operations. Indeed, over half of such agents registering with the Federal Reserve in New England held no mortgages whatever in mid-1951.¹ Especially in other parts of the country, such non-portfolio lenders are engaged in extensive servicing operations for distant mortgagees, and even in the local area they account for 82 per cent of the limited amount of "servicing for others."²

On the basis of dollar value, four groups of institutional lenders dominate mortgage holdings in this area, accounting for nearly 99 per cent of the total outstanding debt held by all registrants in mid-1951. Mutual savings banks constituted the largest block, holding 41.1 per cent of the residential mortgage debt and 36.7 per cent of the grand total mortgage debt. (See Table IV.) Insurance companies were not far behind, holding 22.2 per cent and 31.6 per cent of these respective totals. The significantly higher showing of insurance companies in the grand total, of course, reflects the relatively more important role of loans on farm and commercial properties in their respective portfolios. This is in direct contrast to local federal savings and loan associations and cooperative banks, which held 28.6 per cent of the residential mortgage debt but only 22.3 per cent of the aggregate debt. As the fourth major type of institutional lender in the local mortgage market, commercial banks held 6.9 per cent of the

¹See "Mortgage Holdings of New England Lenders," Monthly Review, Federal Reserve Bank of Boston, February 1952, p. 6.

²The economic factors underlying this geographic variation in servicing operations are explained in Part VII.

total residential debt and 8.1 per cent of the aggregate mortgage debt.

TABLE IV. NUMBER OF REGISTRANTS, PRINCIPAL TYPES OF MORTGAGES HELD,
AND VOLUME OF MORTGAGES SERVICED BY EACH LENDER GROUP IN
FOUR MASSACHUSETTS COUNTIES,* MAY 31, 1951

Type of Lender	No.	Mortgages (in Million of Dollars)			Total ^A	Serviced for Others	Ave. Res. Mortgage Portfolio
		Resi- dential Property	Farm Property	Other Property			
Commercial Banks	63	\$115.5	\$ 0.5	\$ 62.1	\$178.9	\$ 3.5	\$ 1.84
Trust Depart- ments of Com- mercial Banks	12	1.6	-	0.9	2.5	1.7	0.13
Savings Banks	69	689.1	0.5	114.0	803.7	0.9	9.99
Federals and Cooperative Banks	105	479.0	0.0	10.4	489.5	2.0	4.56
Life Insurance Companies	7	371.9	96.4	226.3	694.6	6.5	53.13
Sales Finance Companies	6	0.0	0.0	0.0	0.1	0.0	0.01
Small Loan Companies	23	1.4	-	0.1	1.6	-	0.02
Mortgage Companies ^x	20	4.1	0.0	0.2	4.2	0.2	0.20
Mortgage ^x Brokers	30	0.3	-	0.0	0.3	29.1	0.01
Real Estate Brokers ^x	306	2.0	0.0	0.6	2.6	46.1	0.01
Builders	25	0.2	-	0.0	0.2	0.1	0.01
Contractors	3	0.1	-	-	0.1	-	0.01
Schools, etc.	5	1.0	-	0.2	1.2	-	0.20
Investors	44	4.5	-	1.1	5.6	0.1	0.10
Trustees	8	0.2	-	0.3	0.5	0.3	0.03
All Others	60	5.4	0.0	0.6	.1	1.5	0.09
Total	786	\$1,676.3	97.5	\$417.0	\$2,190.7	92.0	\$ 2.13

Source: Registration Reports from Federal Reserve Bank of Boston.

^A Figures may not add up to stated totals because of rounding.

* Includes Essex, Middlesex, Norfolk, and Suffolk Counties.

^x The distinguishing features of these three groups are not always clear. Real estate brokers generally bring the buyer and seller together, whereas mortgage brokers bring borrower and lender together; mortgage companies invest funds either on their own account or for the account of others, but usually hold mortgages for short periods of time only. Since some firms perform all three of these functions, classification is not always uniform, and hence a joint category would perhaps be preferable for purposes of analysis.

The remaining 1.2 per cent of the mortgage debt was held by a variety of registrant types, notably trust departments of banks, mortgage companies, and individual investors.¹ It is quite likely that the role of individual investors is understated in these data, inasmuch as a great many home sellers or builders are forced to take back small second purchase-money mortgages in order to make a sale. Since such individuals may lend only infrequently and in small volume, their operations do not warrant registration under Regulation X. No specific data are available on this matter, but the role of individuals in recording new mortgages indicates that their mortgage holdings are quite significant in the aggregate.²

As explained above, these data on mortgage holdings do not necessarily reflect the relative importance of the various registrant types in local lending activity. Life insurance companies in particular strive to maintain a mortgage portfolio with national coverage, seeking to place loans on properties where net yields are optimal. As indicated in Table VI, new lending operations of all insurance companies, whether they be organized locally or elsewhere, are of minor significance so far as local home properties are concerned. In 1940 all insurance companies held but 2.3 per cent of the total mortgage debt on 1- to 4-family, owner-occupied properties in the Boston Metropolitan District,³ and it is doubtful if this percentage share has increased substantially during the postwar period.

¹The concentration of mutual savings banks in the Northeast is demonstrated by comparing the above mortgage distribution with that of the nationwide 1- to 4-family mortgage debt. In 1950, the \$46.9 billion debt was held as follows: savings banks, 8.2 per cent; insurance companies, 17.9 per cent; savings and loan associations 29.3 per cent; commercial banks, 20.2 per cent; and individuals and others, 24.4 per cent. Survey of Current Business, October 1950.

²See Table VI.

³Table III.

Hence, the fact that locally organized life insurance companies in 1951 held 22.2 per cent of the residential mortgage debt and a substantially higher share of the aggregate mortgage debt does not imply a corresponding dominance in local mortgage activity.¹

It has become increasingly necessary to make a similar allowance for mortgage holdings of Massachusetts savings banks. Since 1949, when these institutions were authorized to make a limited investment in mortgages on out-of-state properties, the non-local component of their mortgage portfolios has risen sharply. Consequently, the fact that the 69 savings banks held 41.1 per cent of the total residential mortgage debt slightly overstates their relative prominence in the local area by virtue of their acquisition of \$100 million in out-of-state mortgages.² Similar to life insurance companies, national banks have always been free to make mortgage investment without regard to geographic location, but the extent of their out-of-state lending activity is not known.

Of the four major mortgagee groups, only savings and loan associations have depended upon local mortgage demands almost entirely in maintaining their portfolios. Although some large federal savings and loan associations are becoming increasingly interested in outside mortgages, the primary focus of most associations concerns placing loans in their immediate communities. Cooperative banks are perhaps more circumscribed in their geographic coverage, both by custom and statute, than any other major type of lender.³

In summary, the fact that some, but not all, local lending institutions are permitted to make mortgage investment anywhere in the country has tended to distort their relative importance on the local level. Although

¹See Table IV. Actually only 6 of the 7 companies reported mortgage portfolios in 1951, all of which are located in Suffolk County (Boston).

²See Part VII.

³For specific reference to this localization, see "Lending Area" below.

such an inter-regional flow of mortgage credit constitutes a two-way avenue, existing supply-demand relationships have resulted in a minimum amount of capital inflow into this money market center. Perhaps most of this latter activity arises out of mortgages originated or purchased through loan correspondents of outside life insurance companies. Although this activity is relatively small in the aggregate, its competitive influence in the local market has been quite significant at various times, especially where the refinance of well-seasoned mortgages is concerned.¹

TABLE V. PERCENTAGE DISTRIBUTION OF THE PRINCIPAL TYPES OF MORTGAGES HELD BY THE MAJOR LENDING GROUPS, IN FOUR MASSACHUSETTS COUNTIES, MAY 31, 1951

<u>Type of Mortgage</u>	<u>Type of Lender</u>				<u>Total</u>
	<u>Commercial Banks (incl. Trust Dept.)</u>	<u>Savings Banks</u>	<u>Federals and Coop. Banks</u>	<u>Life Insurance Companies</u>	
Residential Property	64.9%	85.7%	97.9%	53.6%	76.5%
FHA-insured	12.4	9.7	1.2	16.8	10.2
VA-guaranteed	13.6	24.8	32.0	8.0	20.0
Conventional	38.9	51.2	64.7	28.8	46.3
Farm Property	0.2	0.1	0.0	13.9	4.4
All other Property	34.9	14.2	2.1	32.5	19.1
Grand Total	100.0	100.0	100.0	100.0	100.0

Source: Table IV.

Types of Mortgaged Properties

Loans on residential properties predominate in the portfolios of all major lender types and in mid-1951 accounted for 76.5 per cent of aggregate mortgage holdings. (See Table V). This proportion would be significantly higher if it were not for the substantial investment by insurance companies in loans on farm and commercial properties, ordinarily located outside the Boston area. Savings and loan associations more than any

¹See "Rate Cutting" below.

other group concentrate almost exclusively on small residential properties, with such loans constituting 97.9 per cent of their respective mortgage holdings in 1951. Loans on commercial properties are perhaps less important among all local mortgage portfolios than would be expected in view of the high rate of construction activity in this field. This development perhaps reflects the use by business of retained earnings and other sources of funds as well as the introduction of novel financing methods, such as special sale and lease-back schemes.¹ On the other hand, many local lending institutions, particularly among the savings banks, have abandoned their previous high esteem for large income-property loans where servicing costs are admittedly minimized but where overall risk may be significantly higher.² A policy of preferring loans on small residential properties with few exceptions appears to have been widely followed among most lenders in the postwar period. Such a policy has not been difficult to pursue in view of the unprecedented wave of new home construction and the attendant demands for home mortgage credit since 1946.

NEW MORTGAGE LENDING SINCE 1946

Combined mortgage portfolios of savings banks, cooperative banks, federals, and trust companies in the Boston vicinity have nearly doubled in the postwar period, rising from \$719 million in 1946 to an estimated \$1,260 million in 1951.³ During this 5-year span, the volume of loans made to finance new construction as well as the purchase of older properties has far exceeded gross inflows of repayment sums. This phenomenal rise in out-

¹"Mortgage Holdings of New England Lenders," Monthly Review, February 1952, p. 6.

²See "Loan Amounts and Properties Mortgaged," Chapter 12.

³Table I above. Mortgage portfolios of trust companies are taken at roughly \$60 million.

standing debt has taken place despite the increasing importance of compulsory amortization payments on a monthly basis. Complete data on new lending operations are not available for the immediate Boston vicinity alone, but mortgage recordings of principal lender groups have been tabulated for the four Massachusetts counties referred to earlier. These data have been collected on a county basis by the Boston Home Loan Bank, taking the weekly figures on mortgage recordings as reported by the Banker and Tradesman. So that the influence of loans on commercial and large residential properties are minimized, only mortgage recordings of \$20,000 or less have been considered in this tabulation. Furthermore, it should be repeated that although the included counties are the same in either case, the data in Table VI refer to loans on local properties whereas Federal Reserve data in Table IV relate only to aggregate mortgage holdings of local institutions. Furthermore, data on mortgage recordings do not necessarily represent the acquisition of new mortgages, as a significant proportion undoubtedly results from the transfer of property from one mortgagor to another with the total debt remaining relatively unchanged.

These data in Table VI as well as the accompanying Chart II demonstrate the varying degrees to which local lending institutions have participated in the recent housing boom. Since the immediate postwar days, at which time lending patterns for the four counties corresponded quite closely with those for the entire Commonwealth,¹ some institutions have actively expanded mortgage portfolios while others have remained relatively dormant. Except during early 1949, total recordings by all mortgage lenders increased every year both in number as well as dollar volume. Much of this advance in dollar volume, however, merely reflects rising real estate

¹Cf. Table II, p. 251.

TABLE VI TOTAL VOLUME AMONG VARIOUS INSTITUTIONS OF MORTGAGE RECORDINGS OF \$20,000 OR LESS ON NONFARM PROPERTIES IN FOUR MASSACHUSETTS COUNTIES,* MIDYEAR 1946 - EARLY 1952
(DOLLAR AMOUNTS IN THOUSANDS)

<u>52-Week</u> <u>Period</u> <u>Through</u>	<u>Member Of</u> <u>Cooperative</u> <u>Banks</u>	<u>Of</u> <u>Savings</u> <u>Banks</u>	<u>Home Loan Bank</u> <u>Federal</u> <u>Savings &</u> <u>Loan Ass ns</u>	<u>Non-Members Of</u> <u>Cooperative</u> <u>Banks</u>	<u>Savings</u> <u>Banks</u>	<u>Home Loan</u> <u>Commercial</u> <u>Banks</u>	<u>Bank</u> <u>Individuals</u> <u>and Others</u>	<u>Total</u>
7/26/47	No. 16,036	+	5,274	4,673	16,821	5,003	11,465	59,272
	Amt. \$ 80,985		35,505	20,084	102,107	32,139	49,313	320,133
7/31/48	No. 17,795	+	5,459	4,899	19,675	5,001	11,580	63,409
	Amt. \$ 87,866		38,180	20,706	122,253	31,471	49,235	349,711
7/30/49	No. 15,712	+	5,485	4,143	19,775	4,111	11,435	60,614
	Amt. \$ 82,193		38,827	17,982	128,841	26,463	48,299	342,605
7/29/50	No. 17,245		6,273	3,368	21,893	4,559	11,715	66,475
	Amt. \$ 90,128	1,422	45,379	15,606	146,415	28,777	49,417	386,533
7/28/51	No. 16,927	1,369	5,972	2,959	23,991	4,210	11,332	66,760
	Amt. \$ 100,285	10,623	48,009	16,265	178,590	29,091	53,274	436,137
26 Weeks thru 2/2/52	No. 8,300	406	3,275	1,633	12,926	2,232	5,752	34,524
	Amt. \$ 51,668	3,164	26,201	9,536	99,786	15,810	25,773	231,935

Source: Banker and Tradesman, compiled on county basis by Home Loan Bank of Boston.

* Essex, Middlesex, Norfolk, and Suffolk Counties.

+ Included in data for member cooperative banks; there were two member savings banks in 1951.

prices, for during the 5-year period ending July 1951, total dollar recordings increased 36.2 per cent while the number of loans written rose only 12.6 per cent. The pattern of mortgage recordings has followed to some extent the course of new home construction, with a temporary decline in both indices occurring during the recession of early 1949.¹ During the year ending July 1949, the number of mortgages recorded by cooperative banks and commercial banks was fully 20 per cent below the level of the preceding 52-week period, and the upward drift in new lending among savings banks and federal savings and loan associations was temporarily retarded.

COOPERATIVE BANKS

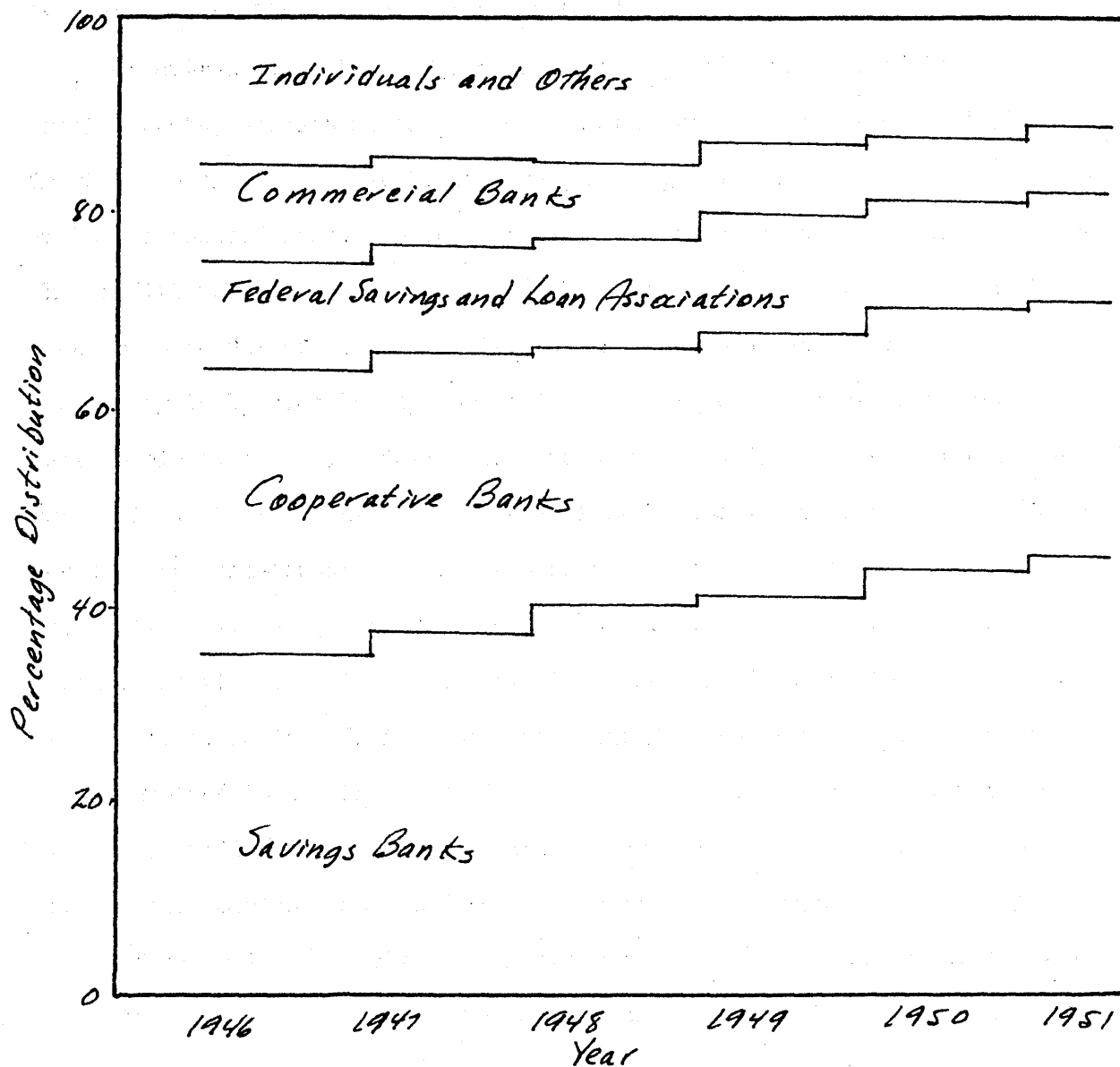
Local cooperative banks have invested an increasing proportion of their share capital in home mortgage loans. From a level of \$204.3 million in 1946, mortgage portfolios of these 76 institutions increased to \$273.8 million by 1951, representing an advance in mortgage-assets ratios from 74.5 to 79.6 per cent. Despite this active participation in postwar mortgage lending, cooperative bank recordings have represented a diminishing share of aggregate recordings, this share having fallen from 29 per cent in 1946 to 27.4 per cent by late 1951.² This relative decline largely reflects the vigorous mortgage programs of competing institutions, notably federal savings and loan associations and savings banks.

Cooperative banks continue to function primarily as local community institutions, operating on a modest scale and lending on small residential properties. In 1951 average mortgage holdings were \$3.6 million, while at least 11 of the 76 local banks had portfolios of less than \$1

¹Cf. p. 55.

²Table VI.

CHART II. PERCENTAGE DISTRIBUTION AMONG MAJOR LENDING GROUPS OF MORTGAGE RECORDINGS OF \$20,000 OR LESS ON NONFARM PROPERTIES IN FOUR MASSACHUSETTS COUNTIES, MIDYEAR 1946 - EARLY 1952



Source: Table VI

Mortgage recordings for Home Loan Bank member savings banks estimated from available data.

million. Although cooperative banks are authorized to make 80 per cent loans up to \$20,000, they concentrate primarily on less expensive properties, generally located in a community adjacent to the bank office.¹

Average loan amounts have consistently been less than the average for all lenders, ordinarily by a margin of at least 10 per cent.²

Direct-reduction loans dominate the mortgage portfolios of local cooperative banks, accounting for 92 per cent of aggregate holdings in 1951. Roughly one-third of these loans were partially guaranteed by the VA, while FHA-insured loans represented less than 1 per cent of the total.³ The traditional cooperative form loan has continued to decline in significance as a result of gradual retirement and recasting on a direct-reduction basis. By 1951, such loans constituted 6.5 per cent of aggregate mortgage holdings, with practically none being written during the entire post-war period. Most of the local bank officials interviewed indicate that a few of these old-fashioned mortgages remain on their books, but that every effort is being made to eliminate them. The added interest returns, received by virtue of the differential between dividend and mortgage interest rates, is insufficient to compensate for the extra administrative costs involved in holding a small volume of such loans. Frequently it is extremely difficult to convince existing mortgagors that the share-accumulation mortgage subjects them to unnecessary expense and risk. Instead of accepting a rewritten contract specifying a definite maturity date and total debt service, these die hards prefer the old pledged serial share method of accumulating a separate repayment reserve until the entire debt is retired.

¹See "Lending Area" below.

²Table VII, Page 274.

³See Part VI.

TABLE VII. AVERAGE LOAN AMOUNTS ON MORTGAGES OF \$20,000 OR LESS RECORDED BY VARIOUS LENDERS IN FOUR MASSACHUSETTS COUNTIES, MIDYEAR 1946 - EARLY 1952.
(Thousands of Dollars)

<u>52-Week Period Through</u>	<u>Cooperative Banks</u>	<u>Federal Savings & Loan Associations</u>	<u>Savings Banks</u>	<u>Commercial Banks</u>	<u>Individuals and Others</u>	<u>Total</u>
7/26/47	\$ 4.88	\$ 6.73	\$ 6.07	\$ 6.42	\$ 4.30	\$ 5.40
7/31/48	4.78	6.99	6.21	6.29	4.25	5.52
7/30/49	5.04	7.08	6.52	6.44	4.22	5.62
7/29/50	5.12	7.23	6.75	6.31	4.22	5.82
7/28/51	5.87	8.04	7.47	6.91	4.70	6.53
2/2/52*	6.16	8.00	7.72	7.09	4.48	6.72

Source: Table VI. Data for the first three periods on cooperative banks includes member savings banks.

* 26-week period only.

Straight-term mortgages are of negligible importance among local cooperative bank portfolios. Purchase-money mortgages arising out of depression foreclosure sales have been largely retired, and converted mortgages have never been widely sought by holders of amortized loans. Mortgage delinquency appears to have risen slightly during recent years, as "mortgages on which principal payments are temporarily suspended" doubled between early 1950 and 1951. Delinquency was not a serious problem in the latter year, however, as such loans represented but 0.5 per cent of aggregate portfolios, compared with a peak ratio of 6 per cent in 1936.

Although cooperative banks ordinarily write smaller mortgage loans than any other major lender type, average loan amounts have followed upward movements in market valuations rather closely. Average new loan amounts increased from \$4.88 thousand in 1946 to \$5.87 thousand in 1951, while average outstanding balances advanced from \$3.28 thousand to \$4.20 thousand.¹ Indeed, whenever amortized loans predominate, average loan amounts on new mortgages tend to exceed average outstanding balances so long as market

¹Table VII and Annual Report, Massachusetts Commissioner of Banks.

valuations are not declining.. As might be expected, loan amounts tend to be considerably higher among those banks which are also members of the Home Loan Bank System. Nonmembers tend to be included among the smallest banks in the area, and have perhaps participated less actively in securing new mortgages.

FEDERAL SAVINGS AND LOAN ASSOCIATIONS

In the postwar period, operations of local federals have evidenced the same active interest in expanding mortgage portfolios that has characterized their operations since the mid-1930s. Except during the war years, mortgage holdings have mounted more rapidly than share capital, and short-term advances from the Home Loan Bank have frequently been used for supplementary mortgage credit. During the first 5 postwar years, mortgage portfolios nearly doubled to \$166 million and mortgage-assets ratios rose from 71 to 83 per cent. In 1951 average mortgage holdings among the 15 federals were slightly above \$11 million, over 3 times the corresponding average holdings of cooperative banks.

In spite of this spectacular postwar growth, however, federals in the local four-county region have not strengthened their relative position in terms of dollar mortgage recordings. As seen in Table VI, in each postwar year through 1951, federals consistently accounted for approximately 11 per cent of total dollar recordings. These dollar recordings reflect the continuing upward trend in property valuations, for the number of recordings in 1951 was but 13 per cent above the corresponding number in 1946. If data were available for the immediate Boston area alone, lending operations of federals would perhaps appear more significant in every year because of

a relatively heavy concentration of these associations within the restricted 10-mile area.¹

Federal savings and loan associations have taken full advantage of their liberal mortgage lending opportunities, especially with regard to making 80 per cent loans up to \$20,000 without limit. Furthermore, they have conducted extensive merchandising programs, and have taken an active role in financing new home construction.² A heavy concentration of high-percentage loans on expensive as well as low-cost home properties has accounted for relatively large average loan amounts. As shown in Table VII, average principal amounts have consistently been higher among federals than among any other major lender type, this margin being at least 20 per cent above the corresponding cooperative bank level. As in the case of cooperative banks, however, average outstanding balances are undoubtedly considerably smaller than new loan amounts, for full amortization is required on nearly all mortgages held by federals.

SAVINGS BANKS

Perhaps the most significant development in the postwar mortgage market has concerned the rejuvenated interest in mortgage lending among local mutual savings banks. In a complete reversal of investment policy, these institutions abandoned their 15-year virtual withdrawal from the market and rebounded with an unprecedented enthusiasm for this investment outlet. During the decade ending 1946, total assets of the 56 savings banks in the Boston vicinity rose steadily from \$1.16 billion to \$1.62 billion, while mortgage portfolios dropped from \$483 to \$381 million. At the end of this period, mortgages accounted for only 23.5 per cent of total assets, with government bonds occupying the predominant role.

¹See p. 257 above.

²See "Construction Lending" below.

In contrast to the rapid growth of savings capital during the war years when civilian buying was severely curtailed, the postwar period has witnessed a much slower advance. During the 5 years ending October 1951, total assets among the local savings banks increased by 13 per cent to \$1.83 billion. This relatively minor increase in total resources undoubtedly reflects a far less significant advance in net savings inflows. Indeed, among all savings banks in the Commonwealth, total deposit liabilities have risen steadily during the postwar period, but for 3 successive years through 1950 aggregate dividend payments on existing accounts exceeded the gross increase in total deposits.¹ The fact that cooperative banks and federals enjoyed a net increase in share capital each year undoubtedly stems in part from the relatively higher dividend rates offered by these institutions.²

Against this background of slowly rising savings capital, local savings banks have rapidly expanded mortgage portfolios. Indeed, during the first 5 postwar years, total mortgage holdings doubled in dollar volume to a level of \$761.7 million by October 1951. Inasmuch as total resources had increased by only \$210 million during this interval, a significant proportion of this new mortgage investment entailed substantial declines in government bond portfolios. While home mortgages appeared to be an attractive investment for local savings banks, new government bond issues declined abruptly after the end of the war. In addition to their increasing availability, new mortgages and private securities, by virtue of their relatively high yields, offered local institutions an opportunity to reverse the steady decline in bank earnings. Until early 1951 at least, conversion of government portfolios was accomplished with a minimal sacrifice, as the federal bond support program assured their sale at a premium. Since this artificial support was removed, however, shifting of assets from bond to mortgage

¹ Annual Report, Massachusetts Commissioner of Banks.

² See "Dividend Returns" in Part III.

portfolios has involved the possibility of substantial capital losses on the former.¹

The consequent shift in investment portfolios among local savings banks is readily demonstrated by changing mortgage-assets ratios as well as by data on new lending operations. From the historic low level of 23.5 per cent in 1946, mortgage-assets ratios mounted steadily to 41.6 per cent by 1951. During the same 5-year period, average mortgage holdings of local banks doubled to a level of \$13.6 million, and average residential portfolios of banks in the entire four-county area had reached nearly \$10 million by mid-1951.²

In the local four-county region, savings banks have become increasingly dominant in financing the purchase of local home properties. As indicated in Table VI and Chart II, the share of total mortgage recordings of \$20,000 or less represented by savings bank lending rose from an estimated 34.5 per cent in 1946 to 44.5 per cent by late 1951. In every respect, the role of these institutions in the mortgage market has advanced more rapidly than that of any other type of lender. Whereas cooperative banks and particularly federals had dominated new mortgage lending during the prewar recovery period, savings banks had once again surpassed the combined dollar recordings of these institutions by early 1949. In terms of dollar volume, the rate of new mortgage recordings by savings banks in late 1951 was nearly twice that of 1946. Furthermore, savings banks were alone among the various institutions in recording a successively larger number of new loans in each postwar year. The average loan amount on new mortgages appears to

¹This eventuality was especially applicable to certain large insurance companies which had vast sums pre-committed for investment in low-yielding VA and FHA loans at the time when the government bond market dropped.

²Annual Report, Massachusetts Commissioner of Banks; and Table IV. Although data on average residential holdings are not available for federals alone, it appears as if these values are roughly the same for local federals and savings banks; in terms of average total resources, however, the latter are more than twice as large.

The rather substantial difference between average residential and average total mortgage holdings reflects in part the influence of large income-property loans in the latter. Perhaps a more significant factor, however,

(Footnote continued)

have corresponded rather closely with rising home prices, advancing nearly 30 per cent over the 5-year interval.

The unprecedented volume of new mortgage lending by local savings banks includes not only loans on local residential properties, but also an increasing volume of out-of-state home loans as well as some large income-property loans. Local banks have recently made substantial purchases of insured and guaranteed loans in the secondary market, with the pledged properties being located primarily in the South and Southwest. This out-of-state mortgage investment largely accounted for the accelerated increase in mortgage-assets ratios between 1949 and 1951.¹ As reported in their published annual reports, the aggregate dollar volume of new loans made by local savings banks has increased steadily during each postwar year. As early as 1946, new loans had surpassed the previous all-time highs recorded in the 1920s, and by 1951 this volume had reached \$228.1 million. This latter volume was nearly as large as the combined mortgage portfolios of all 76 cooperative banks in the Boston vicinity, and was 10 times the corresponding volume recorded by savings banks in 1936.

While new mortgage loans were being made at an unprecedented rate, aggregate portfolios increased at a more moderate pace as a result of heavy repayment inflows. During periods of rising incomes and employment, mortgagors frequently accelerate mortgage principal repayment wherever possible.

¹See Part VII. During this 2-year span, mortgage-assets ratios jumped from 28.9 to 41.6 per cent.

²is the difference in geographic coverage of the two figures; the \$10 million average refers to all savings banks in the four-county area, whereas the \$13.6 value is restricted to banks within the immediate Boston vicinity and thus affords added weight to the importance of the large Boston banks.

Furthermore, homes are more commonly resold during boom periods, with the result that existing mortgages are prepaid and perhaps taken elsewhere by the new buyers. Existing portfolios are also trimmed down by a continual inflow of regular amortization payments, a requirement on most new loans.

(See Table VIII.)

TABLE VIII. POSTWAR MORTGAGE LENDING ACTIVITY OF SAVINGS BANKS IN THE BOSTON AREA, 1946-1951.
(Dollar Amounts in Millions)

<u>Year</u> <u>Ending</u> <u>October</u>	<u>Portfolio at</u> <u>beginning</u> <u>of Year</u>	<u>New Loans</u> <u>Written</u>	<u>New Loans</u> <u>Beginning</u> <u>Portfolio</u>	<u>Gross</u> <u>Repayment</u>	<u>Year</u> <u>Ending</u> <u>Port-</u> <u>folio</u>	<u>Net</u> <u>Increase</u>
1946	\$ 310.8	\$ 92.0	-	-	\$380.8	-
1947	\$380.8	99.8	26.2%	\$73.7	406.9	\$ 26.1
1948	406.9	101.7	25.0	58.8	449.8	42.9
1949	449.8	111.9	24.9	62.1	499.6	49.8
1950	499.6	208.1	41.7	84.1	623.6	124.0
1951	623.6	228.1	36.6	90.0	761.7	138.1
1952	761.7	-	-	-	-	-

Source: Computed from Annual Report, Massachusetts Commissioner of Banks.

During the war years, outstanding average loan balances decreased steadily, reflecting a combination of heavy principal repayment on existing holdings and a small volume of new lending. In the postwar period, however, new loans have dominated savings bank portfolios and average balances have evidenced a steady upward tendency, rising from \$6.03 thousand in 1946 to \$7.28 thousand by 1951. Original principal amounts on these new mortgages have followed the general upward movement in real estate prices quite closely, and have thus tended to increase average loan balances. The fact that new loan amounts on small residential properties have been only slightly larger than average outstanding balances reflects in large part the preponderance of relatively unseasoned mortgages among the portfolios of local thrift institutions. ¹ The existence of substantial holdings of large income-property loans among certain savings banks also accounts for a relatively high average outstanding loan balance.

¹Cf. Table VII.

Whereas savings and loan associations insist on full amortization in nearly all mortgage contracts, the traditional straight-term instrument continues to occupy an important position among the mortgage portfolios of many savings banks. As late as 1947, such 60 per cent loans still represented 39.1 per cent of total real estate loans held by all savings banks in Massachusetts. When considering new lending alone, direct-reduction loans are undoubtedly far more significant, owing in large part to the predominance of loans on small home properties. Many banks, nevertheless, are still reluctant to write high-percentage, long-term contracts unless the loan is partially guaranteed by the VA.¹ In 1947, conventional 80 per cent, 20-year loans accounted for a negligible 0.4 per cent, and 75 per cent, 10- to 20-year loans another 4.4 per cent of aggregate mortgage holdings of all savings banks in the Commonwealth.²

COMMERCIAL BANKS

In terms of home mortgage recordings, commercial banks have steadily declined in relative importance since 1946. As indicated in Chart II, the share of total dollar recordings accounted for by national banks and trust companies fell from 10.04 per cent in 1946 to 6.67 per cent in 1951. Lending operations of these institutions declined in absolute terms as well, for mortgage recordings in 1951 were 16 per cent less in number and 10 per cent less in dollar volume than in 1946.

¹See Part VI.

²These data refer to all savings banks in Massachusetts. From Mutual Savings Central Fund, reported in a survey conducted by the Worcester County Institution for Savings, 1948. It will be shown later in the study that there is reason to believe that liberal conventional mortgages are more prominent today than in the early postwar period, especially in regard to new construction.

Although new lending operations were on a modest scale, mortgage-assets ratios among local trust companies rose steadily during the early postwar period, largely because of the sharp decline in savings capital. Indeed, between 1946 and 1950, total assets of these savings departments fell 20 per cent to \$154 million while mortgage portfolios advanced over 25 per cent to \$60 million. As a result of this combination, the average mortgage-assets ratio increased from 24.4 to 39.0 per cent.¹

Among the major lender types, mortgage holdings of commercial banks are perhaps least concentrated in the hands of large lenders. Within the local four-county region, average holdings of residential mortgages among the 63 commercial banks were \$1.83 million, compared with an average of \$6.78 million for the four major lender groups. In terms of aggregate holdings of all types of mortgages, the corresponding average amounts were \$2.83 and \$8.88 million, respectively.² As stated earlier, some of the largest trust companies in Boston have no savings departments whatever and time deposits of the largest national banks are relatively small. Most of their participation in the real estate market concerns the financing of large-scale housing projects where the permanent mortgages are taken by other mortgage lending institutions. Only in suburban communities where conventional thrift institutions are less predominant do commercial banks play a significant role in the local long-term mortgage market. Indeed, in 1950 only three trust companies in the Boston area held over \$5 million in mortgages, and of these banks none was located in Boston proper.³ Furthermore, out of 510 commercial banks in New England, only three with

¹The decline in total savings deposits is discussed in Part III under "Dividend Returns."

²See Table IV. The former value corresponds quite closely with average holdings of local trust companies in December 1950, the latter value being \$2.74 million, Annual Report, Massachusetts Commissioner of Banks.

³The largest portfolio had loans amounting to \$12 million. Annual Report, Massachusetts Commissioner of Banks.

combined portfolios of \$139 million held over \$25 million in mortgages of all types.¹

Average loan amounts on new mortgages written by commercial banks have consistently exceeded the average for all lenders, but this margin has narrowed substantially since 1946. (See Table VII.) Perhaps this narrowing margin reflects a policy of approving relatively large loan requests only where such amounts bear a conservative ratio to appraised property values. Furthermore, these institutions, generally less anxious to enlarge portfolios than other lenders, have perhaps refused to permit current inflated market valuations to dominate their appraisals. Consequently, average loan amounts have risen very slowly during the recent expansionary period.

Specific information is not available as to the various types of mortgage contracts written by commercial banks. In communities where competitive conditions appear favorable, these institutions function much as any other thrift institution in making popular high-percentage, direct-reduction loans. In other communities where savings banks and savings and loan associations predominate, commercial banks are less ambitious in their mortgage operations and frequently refer business to these competing institutions. One local trust company visited continues to write only 60 per cent demand mortgages, except for a few VA-guaranteed loans.²

INDIVIDUALS AND OTHERS

In terms of mortgage recordings the miscellaneous "individuals and others" category has steadily declined in relative importance since the immediate postwar period. The share of total dollar recordings represented by this category dropped from 15.4 per cent in 1946 to 11.1 per cent

¹"Mortgage Holdings of New England Lenders," *op. cit.*, p. 7. Undoubtedly a significant proportion of these mortgages were on distant properties.

²The mortgage officer of this bank realizes that this old-fashioned mortgage
(Footnote continued)

in late 1951. The dollar volume of such recordings has not kept pace with rising market valuations, and the annual number of loans made has declined somewhat since the early postwar era.

It is interesting to note that this catch-all group includes mortgage lenders at the two extremes in terms of asset size. At one extreme are the various insurance companies which occasionally make mortgage loans on local properties. As explained earlier, these companies figure prominently in aggregate nationwide mortgage holdings, but are of negligible importance in this money market center. As concluded from scattered information available, life insurance companies make approximately 2 per cent of all home loans in the local four-county region.¹ At the opposite extreme are the various individual lenders who operate in the mortgage market for a variety of reasons. Their mortgage activities are generally confined to making small loans, frequently involving either a purchase-money mortgage or an ordinary second mortgage. Individuals undoubtedly dominate this miscellaneous category and largely account for the fact that average loan amounts are substantially below the average for all lenders.²

¹This impression is confirmed by tabulations taken from Banker and Tradesman by the local Home Loan Bank.

²The average home loan made by insurance companies is comparable in amount with that of federals and savings banks. From data compiled by Metropolitan Mortgage Bureau.

is outdated, but prefers its simplicity. Moreover, he feels that borrowers should have enough "confidence" in the bank to realize that repayment would not be called for at an inopportune moment.

CHAPTER 11. PRICE OF HOME MORTGAGE CREDIT

The remaining two chapters in Part V are concerned with more detailed analyses of the postwar lending practices and policies of local mortgage lending institutions. The present chapter will briefly review available data on the various price elements associated with mortgage financing. Some of the primary economic variables influencing the determination of these price elements among the various institutions will thence be analyzed in the succeeding chapter.

INTEREST RATES

Very little aggregate data are available to indicate either nominal or effective interest rates charged on new mortgage loans. All interviewed parties have discussed existing rate patterns freely, but it has been extremely difficult to assemble more than informed impressions about rates charged by all lenders in the local mortgage market. Overall trends in interest rates may be gathered from the annual reports submitted by all state-chartered thrift institutions to the Massachusetts Bank Commissioner. Accordingly, Tables IX and X indicating average contract interest rates on aggregate mortgage holdings have been prepared for savings banks and cooperative banks operating within the immediate Boston area. The steady downward movement in average rates over the past quarter century appears to have followed quite closely the path charted by dividend rates as well as interest rates in other capital markets.

Little data are available on interest rates charged by other mortgage lenders in the Boston area. The Housing Census of 1940 tabulated existing rates paid on single-family home loans by owner-occupants within the Boston Metropolitan District. Unfortunately, findings of the 1950 Census

TABLE IX. AVERAGE CONTRACT RATES OF INTEREST ON REAL ESTATE LOANS HELD BY COOPERATIVE BANKS IN THE BOSTON AREA, SELECTED YEARS, 1927-1951

<u>Average Rate of Interest</u>	<u>Number of Banks at Each Annual Reporting Date*</u>							
	<u>1927</u>	<u>1936</u>	<u>1940</u>	<u>1946</u>	<u>1947</u>	<u>1948</u>	<u>1950</u>	<u>1951</u>
4.00-4.24				2	2	2	2	5
4.25-4.49				4	13	14	18	19
4.50-4.74				10	17	27	31	31
4.75-4.99				29	26	21	15	14
5.00-5.24			7	17	12	9	6	5
5.25-5.49	1	2	13	11	4	2	2	2
5.50-5.74		71	56	4	2	2		
5.75-5.99	25	15	6					
6.00-6.24	39	12	3	1	1			
6.25-6.49	26							
6.50-6.74	8							
6.75-6.99	3							
7.00-7.24	1							
Total	103	100	85	78	77	77	76	76
Average Rate	6.20	5.72	5.59	4.98	4.82	4.74	4.69	4.59
Ave. Dividend Rate**	5.65	3.84	3.73	3.32	3.23	3.20	3.19	3.17
Rate Spread	.55	1.88	1.86	1.66	1.59	1.54	1.50	1.42

Source: Annual Report, Massachusetts Commissioner of Banks.

* As of October 31, through 1948; as of April 30 thereafter.

** Average dividend rates on serial shares for all banks in Massachusetts.

have not been published as yet, thereby precluding a definitive comparison of the current with the prewar interest rate structure. Perhaps the most striking observation of the 1940 picture is the similarity of rates charged by the various lender types. Except for life insurance companies and the HOLC, average rates ranged between 5.40 and 5.47 per cent for all groups. As of 1940, all HOLC mortgages were written at rates of 4.50 per cent, while the average rate among insurance companies was 5.06 per cent. The highest average rate among all lender groups was 5.47 per cent, charged both by savings and loan associations and commercial banks. There is no breakdown available to indicate rates charged by federals and cooperative banks individually, but from interviews with various local officers there appears to be little difference between these groups in the aggregate.

Because of the paucity of relevant data, the following analysis of interest rates refers primarily to local cooperative banks and savings banks.

TABLE X. AVERAGE CONTRACT RATES OF INTEREST ON REAL ESTATE LOANS HELD BY SAVINGS BANKS IN THE BOSTON AREA, SELECTED YEARS, 1926-1951

<u>Average Rate of Interest</u>	<u>Number of Banks at Each Annual Reporting Date*</u>								
	<u>1927</u>	<u>1936</u>	<u>1940</u>	<u>1946</u>	<u>1947</u>	<u>1948</u>	<u>1949</u>	<u>1950</u>	<u>1951</u>
3.75-3.99			4	5	4	3	4	2	1
4.00-4.24		2	4	13	18	19	20	23	28
4.25-4.49		2	2	11	19	25	24	26	22
4.50-4.74		3	5	18	11	7	6	3	3
4.75-4.99	1	4	7	6	2	2	2	2	2
5.00-5.24	1	5	12	3	2				
5.25-5.49	1	26	21						
5.50-5.74	2	14	2						
5.75-5.99	19	1	1						
6.00-6.24	36	1							
6.25-6.49	1								
Total	61	58	58	56	56	56	56	56	56
Average Rate	5.99	5.28	4.96	4.45	4.33	4.31	4.30	4.29	4.27
Average Dividend Rate**	4.70	2.87	2.33	1.86	1.90	1.97	2.03	2.19	2.32
Rate Spread	1.29	2.41	2.63	2.59	2.43	2.34	2.27	2.10	1.95

Source: Annual Reports, Massachusetts Commissioner of Banks.

* As of October 31.

** Average dividend rates for all savings banks in Massachusetts.

A perusal of Tables IX and X suggests a few immediate observations. First to be noted is the substantial decline in average interest rates, continuing down through 1951. Between 1927 and 1951, average rates on portfolios of local savings banks fell from 5.99 to 4.27 per cent, while the corresponding decline among cooperative banks was from 6.20 to 4.59 per cent. If data were available on new loans alone, the decline would be much sharper, for mortgage portfolios in any given year included many loans which had been written in previous years of higher rates and were still carried at those rates. Until recent years at least, however, the continuing decline in average interest rates has reflected in part a

rewriting of such existing mortgages as well as the writing of new loans at prevailing lower rates.

Although average interest rates have fallen steadily over the past quarter century, corresponding rates among the individual institutions have varied widely. This continuing phenomenon reflects variations in mortgage lending policy as well as an unequal distribution of mortgage origination and maturity dates in the portfolios concerned. The former factor will be considered more fully in succeeding chapters, while the latter will be briefly described here. As indicated earlier, since new lending operations of local savings banks were sharply curtailed during the prewar years, mortgage portfolios reflected an abundance of loans still carried at the 6 per cent level of the 1920s. At the same time, other savings banks were perhaps more active either in making new loans or in rewriting existing mortgages, thereby accounting in part for the wide variation in average rates both in 1936 and 1940. By the postwar period, old high-rate loans were either rewritten or paid off and, by 1951, 90 per cent of all loans lay in the 4 - 4½ per cent category.¹

Cooperative bank data have followed a somewhat different pattern. By 1936, the upper extremes had been trimmed through refinance and repayment so that average rates covered a narrow 1 per cent range. During the postwar years, however, this spread broadened considerably, with average rates distributed over a range of 1½ per cent. This reflects a varying emphasis upon 4 per cent VA-guaranteed loans as well as a continuing

¹Competitive aspects of writing down interest rates are analyzed more fully in "Rate Cutting" below in Chapter 12.

differential in interest rates charged on new conventional mortgages. Many banks insist on a 5 per cent interest return on all new loans, while others and most savings banks are quite willing to charge a lower 4 or $4\frac{1}{2}$ per cent rate. The reasons for as well as the consequences of these continuing differentials will be brought out in subsequent analyses.

Although rates have continued to fall among all local institutions, average interest rates charged by cooperative banks have consistently exceeded those of savings banks. This margin has ranged from 0.21 per cent in 1927 to 0.63 per cent in 1940. This significant differential is due in part to the relative importance of income-property loans among the portfolios of the larger savings banks, where rates are generally up to a full 1 per cent below conventional home mortgage rates.¹ Costs of servicing per dollar of loan amount are no doubt substantially lower on large income-property loans than on single-family home loans.² The element of administrative cost may also account for an interest rate differential on small residential mortgages, inasmuch as savings banks wrote most such loans on a straight-term basis until the postwar period. Cooperative banks, on the other hand, have always arranged mortgage debt service on a monthly basis, despite the admittedly more expensive servicing procedures. In addition to a differential in administrative expense, there is some evidence to indicate that home mortgages made by cooperative banks tend to be associated with more substantial risk elements than corresponding savings bank mortgages.³

¹The fact that relatively few local banks had substantial holdings of income property loans perhaps accounts in part for the wide variation in average rates in 1936 and 1940. Cf. p. 287.

²Cf. similarity of interest rates on single-family mortgage loans held by savings and loan associations and savings banks in 1940 Census tabulations. For the Boston Metropolitan District, average rates were 5.47 and 5.42 per cent, respectively.

³See Chapter 12.

During the postwar period, average interest returns on the portfolios of savings banks and cooperative banks have grown more closely together, the absolute margin having declined from 0.52 per cent in 1946 to 0.32 per cent in 1951. This development reflects in large part the prominent position of 4 per cent VA-guaranteed home loans among the mortgage holdings of both types of institutions.¹ Moreover, certain of the above factors accounting for the continuing differentials are perhaps waning in significance. In the first place, the recent expansion in mortgage portfolios of local savings banks has been concentrated on small residential properties, because of relative shifts in market demands as well as in bank investment policies.²

In the second place, whereas amortization was required in little over one-tenth of all residential loans made during the 1920s, it is now almost universally specified in new loans written by savings banks.³ In the past, such requirements were perhaps most common among loans on large income properties and least common among single-family loans. The increasing significance of direct-reduction mortgages results in part from a universal public preference for monthly debt service, especially in the purchase of home properties. In addition, lenders have come to realize that overall risk of mortgage loss tends to vary inversely with the extent of contractual amortization provisions within their respective portfolios.⁴ At the present time, amortization is required under provisions of Regulation X whenever loan-value ratios exceed 50 per cent. The extent of this regular repayment

¹See Part VI.

²See "Loan Amounts and Properties Mortgaged," Chapter 12.

³Amortization was required in less than 12 per cent of the loans made between 1918 and 1931 included in the sample used by Professor Lintner, op. cit., p. 410.

⁴Among single-family loans made during the years 1918-1931, subsequent losses were 30 per cent greater when no amortization was required than otherwise. Ibid. p. 413.

must either reduce outstanding principal balances 5 per cent each year or fully liquidate the loan at maturity. Most institutions also require that real estate taxes be included in aggregate monthly payments, while hazard insurance premiums are frequently handled by the mortgagor directly so long as no delinquency appears. The added expense involved in servicing monthly-payment mortgages as compared with straight-term loans has not been calculated precisely. Furthermore, even if the cost differential were significant, it would be difficult to analyze its influence upon the narrowing spread between savings bank and cooperative bank mortgage rates. To partially offset a probable larger cost of servicing, the lender realizes a higher nominal annual yield on monthly-payment type loans.¹ At least one local cooperative bank attempts to minimize administrative expense in servicing direct-reduction loans through promoting a special cost-saving arrangement. Although all mortgage contracts specify level monthly payments on the basis of a 5 per cent interest rate, borrowers from this bank are afforded a 10 per cent discount in total interest charges by agreeing to prepay on a quarterly basis. This scheme does not imply a $4\frac{1}{2}$ per cent rate of interest, however, because of a substantial prepayment of both principal and interest.² At any rate, the offering of this

¹ See Chapter 8 above.

² The precise extent of this discount over the entire repayment term can be demonstrated by considering an illustrative case. Assume that the bank makes a \$1,000 loan on a 5 per cent, 20-year basis, calling for a contractual monthly payment of \$6.60. Ordinarily, total interest payments over the entire loan term would amount to \$584. If the borrower agreed to prepay two months' debt charges four times each year (i.e., pay \$19.80 at the end of the first, fourth, seventh, and tenth months, instead of \$6.60 at the end of each month), he would receive a 10 per cent "discount," equal to a total of \$58.4 in this case.

Inasmuch as the mortgagor prepays both principal and interest, the present cost of each quarterly payment when made is necessarily larger than the absolute amount of \$19.80 paid. Assuming a 5 per cent "internal discount rate" or "opportunity rate," the total effective cost of each payment when made would be \$19.88: on the first such quarterly remittance, the cost of the first month's payment would be exactly \$6.60; for the two prepaid amounts, the present cost would be $\$6.6275 \left[6.60 \left(1 + \frac{.05}{12} \right) \right]$ and $\$6.6550 \left[6.6275 \left(1 + \frac{.05}{12} \right) \right]$,

special discount has attracted new business to this bank and has minimized the loss of choice loans to rival lenders through rewriting at lower rates.

OTHER FEES

As indicated in previous theoretical analyses, nominal interest rates are but one fundamental factor determining total mortgage costs. Various fees and special charges are generally required at the time of origination, and many others may be levied in the event the mortgage contract is not fulfilled as stipulated. That the combination of such fees may be equivalent to a significant advance in effective interest rates has already been shown.¹ Almost without exception, local institutions insist that the prospective mortgagor share in the costs entailed in processing the loan application, and in inspecting the underlying property. Accordingly, many banks charge an initial application fee of \$10 or \$20, which may or may not be returned in the event the mortgage request is rejected.² Title search and other legal fees constitute the major element in this miscellaneous category, ordinarily amounting to \$75-\$100 or roughly 1 per cent of the original loan amount.³

¹ See Table I, Chapter 2.

² The Cooperative Bank League has urged its members to refund this fee only if the request is granted, and not offer a free ride to any applicant who has extreme difficulty in securing a loan and consequently makes an attempt at many institutions.

³ Operative builders are generally required to pay a flat fee of \$3 - \$5 per unit for each bank inspection made during the construction period. On the other hand, lenders appear to absorb the small costs involved in obtaining a professional credit report on the borrower, whenever such a report is deemed necessary.

respectively. The effective cost of these quarterly payments over the entire 20-year term would be \$1,591, with the interest component being \$591. By deducting the \$58 discount, total effective interest charges would become \$533 net. A total interest payment of \$533 on a \$1,000 loan over a 20-year term is equivalent to a level monthly payment of \$6.386. By interpolation, the effective rate of interest is thus found to be 4.717 per cent.

Some interviewed lenders express a preference for enlarging the extent of these extra charges following the present policy of most commercial banks. These officials believe that each borrower should be assessed the full amount of the direct costs entailed with the loan origination, with an aim toward reducing nominal interest rates on all new loans. At the present time, however, most lenders continue to absorb a substantial share of the various origination costs, thereby reducing net yields below contract rates. A local cooperative bank executive has estimated that it takes 9 months of monthly interest payments before the non-shiftable origination costs are covered.¹

In order to spread out these absorbed costs over a sufficiently long period of time, many lenders impose special penalties whenever prepayment exceeds a certain amount. A common practice is to permit prepayment up to 15-20 per cent per year of the original principal amount without penalty. Beyond that point, however, the mortgagor may be liable to a penalty equivalent to 1 - 2 per cent of the original loan amount or the sum of all remaining interest charges, whichever is lesser.² Such penalties are designed primarily to prevent the loss of choice loans to rival lenders via refinancing at lower interest rates, longer terms, etc.³ Local lenders are perhaps most likely to enforce prepayment penalties in situations where, after financing a new site development, the ensuing home buyer seeks to take the permanent mortgage to a rival institution. Inasmuch as fairly

¹See H. R. Andrews, "Prepayment vs. Cost," Cooperative Banker, April 1945, pp. 2-3.

²Under current regulations, federals may require up to 6 months' advance interest on that part of the aggregate prepayment which exceeds 20 per cent of the original loan amount, provided the loan contract makes specific reference to this penalty. Rules and Regulations, Section 145.6-12.

³Some institutions enforce the same prepayment provisions in the event the mortgagor resells the property before the initial loan is retired.

heavy costs are absorbed in financing site developments, many institutions actually forbid the sale of the completed home unless the long-term mortgage is retained.¹ If the prospective buyer fails to meet the necessary credit standards or else refuses the contract terms offered, the builder must seek a new buyer.

Even though lenders tend to maximize net profits when loans are carried to maturity, provided interest rates do not rise materially during the term, moderate prepayment is ordinarily encouraged as a desirable practice. Mortgagors should be afforded an opportunity to secure a debt-free home as soon as their means permit, whether the additional funds arise out of enlarged incomes, an inheritance, or other windfall gains. Accordingly, after a loan has been repaid to a considerable extent, some institutions are inclined to waive all penalties if valid reasons are offered to account for its refinance.²

To avoid later misunderstanding, most lenders find it advisable to specify in writing the various prepayment opportunities, especially with regard to possible penalties. Indeed, some mortgage lenders indicate that their long-standing policy of imposing no penalties at any time has proved to be a valuable business asset. Such an assurance has attracted a steady volume of sound loan requests and has resulted in a minimum loss to rival lenders via refinance, even where new construction is involved. Even in the absence of refinancing penalties, however, the mortgagor is ordinarily obliged to pay the requisite initial legal and servicing fees to the new mortgagee.³

¹See "Construction Loans" in Chapter 12.

²Or if they feel unable to make similar concessions.

³Although these fees may be absorbed in full or part, if competitive conditions warrant. See "Rate Cutting" below.

LOAN-VALUE RATIOS

Overall costs of mortgage debt service have been effectively reduced through the adoption of high-percentage, long-term loans. Mortgagors are spared expensive renewal fees every 3 - 5 years¹, and are less frequently forced to seek costly second mortgage loans. Little precise information is available on mortgage contracts written in the Boston area, but the following discussion summarizes impressions gained from interviews as well as some limited data.

Loan-value ratios are heavily influenced by custom and a multitude of legal restrictions and federal interventionary measures. As indicated earlier, all local thrift institutions except life insurance companies are currently authorized to make certain conventional loans up to 80 per cent of appraised value. Inasmuch as conventional loans written by insurance companies are limited to $66 \frac{2}{3}$ per cent of value, the bulk of their home mortgage funds are invested in other sections of the country where interest yields are more generous and high-percentage conventional loans less common. Insurance companies, however, have found FHA-insured and VA-guaranteed loans to be highly attractive investments, in which case the above restriction on loan-value maximums is waived.² In the local market, they have achieved a large proportion of their home loans through refinancing well-seasoned mortgages held by local thrift institutions, where the new loan amount is seldom as high as the conventional two-thirds limit. This constitutes an attractive investment, as risk is low and the companies are prepared to make substantial concessions in interest rates and loan term if necessary.

¹Renewal fees were undoubtedly less common when loan extension was merely a verbal agreement between the two parties involved.

²See Part VI.

While other institutions are permitted to grant 80 per cent mortgages, the actual ratios are substantially below this figure. From data on 1509 mortgage recordings and home sales compiled by the Metropolitan Mortgage Bureau, the following table has been prepared. The number of cases included in this sample is perhaps too small to warrant conclusive generalizations and, in addition, current conditions may vary somewhat from those prevailing in the immediate postwar period. Nevertheless, these data suggest some relationships which are substantially borne out today as well, considering impressions gained from interviews as well as data for individual lenders.

TABLE XI. LOAN-VALUE RATIOS FOR SMALL RESIDENTIAL PROPERTIES PURCHASED AND MORTGAGED IN THREE TYPES OF COMMUNITIES IN THE BOSTON AREA, LATE 1945 - EARLY 1946.

<u>Institution</u>	<u>Loan Amount as Percent of Value</u>			<u>Total and</u>	
	<u>A</u>	<u>B</u>	<u>C</u>	<u>No. of</u>	<u>Cases</u>
Savings Banks	65.0%	67.0%	73.0%	69.9%	456
Cooperative Banks	76.5	76.4	77.8	77.2	715
Federal Savings and Loan Associations	78.5	78.6	78.3	78.5	258
Commercial Banks	60.5	39.5	72.6	66.0	80
Total	72.0%	73.4%	76.2%	74.6%	
No. of Cases	469	137	903		1509

Source: Computed from original records of Metropolitan Mortgage Bureau, Boston.

* Communities are classified according to average purchase price:
A - Belmont, Newton, Winchester; B - Arlington, Lexington;
C - Dorchester, Quincy

In the first place, there appears to be a significant difference in average loan-value ratios among the various lender types. Without exception, federal savings and loan associations granted the highest percentage loans during this period, slightly exceeding 78 per cent of purchase price in each of the three community groups.¹ Next in order were the local cooperative banks which also made high-percentage loans but loan-value ratios were consistently below those of federals. Both types of institutions

¹Indeed, the executive officer of one local federal expressed the opinion that 90 per cent loans are inherently no less desirable in terms of overall mortgage risk than 50 - 60 per cent loans. So long as the ratio of debt service to income appears manageable, he regards the loan-value ratio as of minor significance in screening applications. It should be added, however,

(Footnote continued)

specialize in facilitating small home purchase for families of moderate means, and approach their legal loan-value limit in accomplishing this objective. Undoubtedly a significant proportion of these loans were written under the loan guaranty program of the Veterans Administration, in which case loan-value ratios approach 100 per cent. Nevertheless, conventional loans written by these savings and loan associations have also been considerably larger in relation to purchase price than those of either savings or commercial banks. The proposition that larger debt-value ratios involve a higher risk assumption on the part of the lender undoubtedly contributes to the existing rate differentials among the various institutions.¹

At the end of the war, savings banks were perhaps still writing a great many loans on the old 60 per cent basis, but VA-guaranteed home loans as well as higher percentage conventional loans were becoming increasingly common. Hence, since the time period covered in Table XI, local savings banks have undoubtedly narrowed the spread between their loan percentages and those of federals. Nevertheless, it is reasonable to presume that the latter continue to offer more liberal loan amounts than the more conservative, though progressively more active, savings banks.² The smallness of the sample precludes a valid appraisal of commercial bank activity, although local banks have perhaps followed the same basic policy as savings banks in preferring conservative loan-value ratios. The abnormally low ratio of 39.5 per cent arises out of a small sample of 4 loans.

¹See "Variable vs. Fixed Rates," below. Professor Lintner has compared savings banks' experience with 50-60 per cent loans against those of 40-50 per cent, and found that with regard to each type of residential property, "both the proportions foreclosed and the net loss ratios were only about half as large on the loans having the lower debt-value ratio." Lintner, op. cit., p. 418.

²Cf. data on average loan amounts granted on new local mortgages, Table VII.

that this federal writes nearly all loans (except VA) at a 5 per cent rate. See following footnote.

At the present time, debt-value maximums are established in accordance with the provisions of Regulation X. These provisions are enforceable only in the purchase of dwelling units constructed since mid-1950, although a voluntary credit restraint program has been set up to impose similar restrictions on transfers of older properties. These counter-inflationary measures have undoubtedly produced a general lowering of loan-value ratios, although substantially less rigid limitations are imposed on VA home loans.¹

The Bureau of Labor Statistics has conducted sample surveys of new home construction and attendant mortgage financing within the Boston Metropolitan Area. One such survey covered homes completed during the fourth quarter of 1950, a period when the above emergency controls had not yet become fully effective. The findings of this survey covered a wide range of topics, some of which are particularly relevant for this and the succeeding discussion of FHA and VA home loan activity in the local area. (See Table XII.)

TABLE XII. NEW SINGLE-FAMILY HOUSES COMPLETED IN THE FOURTH QUARTER OF 1950, BY TYPE OF MORTGAGE TRANSACTION, AND BY AVERAGE PURCHASE PRICE, LOAN-VALUE RATIO, AVERAGE MONTHLY PAYMENT, DURATION, AND INTEREST RATE, BOSTON METROPOLITAN AREA

<u>Mortgage Status and Type</u>	<u>Number of Houses</u>	<u>Average Purchase Price (000)</u>	<u>Loan- Value Ratio</u>	<u>Average Monthly Payment</u>	<u>Average Duration in Years</u>	<u>Average Interest Rate</u>
All 1-family houses	2200					
Unmortgaged houses	160					
Mortgaged houses	1950	\$ 13.2	69.2%	\$54.0	21.9	4.1%
Unknown	90					
Primary mortgage only	1890	13.3	69.0	54.7	21.9	4.1
FHA-insured	230	18.2	55.1	67.6	20.3	4.1
VA-guaranteed	970	11.7	82.8	52.3	24.9	4.0
Uninsured	690	13.7	58.6	51.7	18.1	4.2
Combination FHA-VA Mortgage	60	12.2	76.8	56.7	21.7	4.1

Source: Computed from data compiled by Bureau of Labor Statistics, released August 14, 1951.

¹Also homes costing up to \$12,000 receive favorable treatment.

Lenders are generally inclined to permit higher loan-value ratios in connection with the purchase of newly-constructed than in the transfer of older properties. Moreover, market price is perhaps taken as the lender's "appraised value" more frequently in the case of a new home purchase, particularly if it is included in a large-scale site development, than where an existing property is sold without nearby comparable sales. In order to make foreclosure an effective hedge against loss, lenders base their maximum loan offering upon the relation between the anticipated market value of the property and the outstanding loan balance at some future date when default might occur. Inasmuch as new homes are generally assumed to be fairly marketable for several years at least, a relatively high initial loan-value ratio may be most satisfactory, provided regular amortization is required. Even if default should occur during the early years of the repayment term when the loan balance is still quite large, a reasonably steady market would serve to minimize risk of mortgage loss. On older construction, however, lenders may regard current market valuations as unjustifiably high in relation to the long-run marketability of the property, and accordingly reduce allowable loan-price maximums. At any rate, it seems likely that the loan-value ratios as reported in Table XII are significantly higher than would be the case if loans on older properties were also included in its coverage.

Although the BLS data refer to new home purchases before Regulation X became fully effective, the conservative average loan-value ratio of 58.6 per cent on conventional mortgages was well within the provisions of this regulation. The VA home loan program in particular has heavily influenced overall ratios, as these liberal provisions were used in 53 per cent of all cases considered. The FHA home loan has been less widely received in this area, constituting 12 per cent of all loans on new properties and involving loan-value ratios somewhat more conservative than those on

uninsured loans.¹

Home purchasers tap two primary sources in order to meet down payment requirements. In the above survey of new home construction in late 1950, the BLS found that accumulated savings were used in 73.5 per cent of the known cases. Revenues from the sale of previously owned real estate were next in importance, representing 17.8 per cent of the total. Undoubtedly this latter source of funds accounted in large part for the fact that 7 per cent of all new home buyers required no mortgage financing whatever. Sale of securities, gifts, other borrowing, etc., constituted the remaining sources of down payment funds.

LOAN TERM

The average loan term is also dominated by the generous provisions of federally-sponsored programs, although conventional mortgages have steadily approached these levels. On new properties in particular, local institutions are inclined to lend up to the limit of 20 years permitted by statute and Regulation X, provided all other risk elements are favorable. As seen in Table XII, conventional loans on homes completed in late 1950 had an average term of 18.1 years, while terms on insured or guaranteed loans ranged up to nearly 25 years. This represents a radical departure from even the traditional long-term cooperative form mortgage, where repayment was generally completed within 13 years. The trend toward longer terms has gained momentum in the postwar period, and the data of Table XII indicate a significant extension from findings of a similar survey one year earlier. For homes constructed during late 1949, average terms ranged from 17.0 years on uninsured loans to 21.0 years on VA-guaranteed loans.² Whereas most new loans

¹See Part VI.

²Unpublished report of the Bureau of Labor Statistics. Over the same one-year interval, average interest rates on uninsured loans declined from 4.5 to 4.2 per cent.

are written for terms of 15-20 years, extensive prepayment, refinancing with rival institutions, etc., have resulted in an average mortgage life of only 7-10 years.¹

Although local thrift institutions are increasingly willing to write loans with terms up to 20 years on newly-constructed properties, they prefer to restrict the term maximum on older homes to 12-16 years. Just as loan-value ratios are frequently tailored to suit properties of varying ages, terms should be so adjusted that the property value will always exceed the outstanding loan balance over the repayment period. Inasmuch as the probability of a continuing ready market tends to decline as older properties are considered, maximum loan terms are shortened accordingly. A local mortgage broker and insurance company correspondent follows the following guide in establishing term maximums: 25 years if the property is not over 5 years old; 20 years if 6-15 years old; and beyond this point, the loan should be fully amortized before the dwelling is 35 years old.²

Another vital element influencing loan term maximums relates to the adequacy of the borrower's anticipated income stream to cover the proposed debt service over the entire repayment term. A primary risk concerns the possible death of the home buyer before repayment is completed and where supplementary incomes are insufficient to continue the debt service. In order to minimize this risk, nearly all lenders adjust repayment periods in accordance with the life expectancy of the mortgagor. Life insurance companies meet this problem by offering a package mortgage deal whereby the mortgagor receives a life insurance policy covering either the outstanding loan balance or a specified amount equal to the original loan amount.³

¹Interviews. On the other hand, an institution may hold a mortgage on a given property for far more than 20 years if the property is sold, improved, or converted, or if the loan term is extended for any other reason.

²Interview.

³The Federal Reserve estimates that, as of early 1951, roughly 42 per cent of all families with married persons within the 18-44 age category had mortgage debts amounting to 40 per cent of more of property value; for persons 45 or over similar mortgage obligations were assumed by 12 per cent of all cases.

As mentioned earlier, the lending institution risks the loss of long-run income maximization by tying up loanable funds for a 20-year term. Especially where interest rates appear abnormally low, there might be some hesitation in writing only 20-year loans for fear of substantial hikes in rates in the near future. To minimize this risk, some lenders write out their loan contracts at a 5 per cent rate but agree to charge only $4\frac{1}{2}$ per cent so long as the current market conditions remain unchanged. Others write mortgage contracts at a 4 per cent rate but reserve the right to alter the billing rate at any time, provided the mortgagor is given fair notice and is granted the option to refinance his obligation elsewhere if more favorable provisions are available. A third method used by a local national bank calls for a mortgage drawn up on a 5-year demand basis, but providing for monthly repayment on a 12-20 year amortization schedule. After the minimum 5 years, the instrument becomes an "open mortgage" by which the lender reserves the right to change interest rates, call for repayment or, if so desired, permit the borrower to continue monthly repayment until the debt is retired. A leading savings bank in Boston grants 20-year loans for most new home purchases, but prefers to be more conservative in lending on older properties. So that the buyer is not forced to pay an excessive monthly debt service and also so that the lender can adjust contract provisions reasonably soon, the note is written for a 10-year term, but payments are made on a 20-year amortization schedule.¹

VARIABLE VS. FIXED INTEREST RATES

The influence of varying the loan term, amount, and contract interest rate upon total debt service has been analyzed in some detail in Part II.

¹Interviews.

Now that nearly all mortgage contracts are written on a monthly payment basis, lenders are able to offer borrowers considerable flexibility in regard to specific repayment provisions.

Undoubtedly many, if not most, lending institutions continue to regard the value of the pledged property and its relation to loan amount as the supreme criterion of risk rating. Nevertheless, lenders are increasingly aware of the importance of properly relating monthly debt service to prospective incomes as a means of minimizing mortgage default in the first place. For a young family purchasing a new home, the lender may feel justified in granting an unusually long-term loan, inasmuch as the relatively low monthly payments may be conveniently handled during the early years when incomes are at a minimum. In later years when maintenance and improvement expenses mount, aggregate housing costs will be easily handled as the family's long-run income prospects appear favorable. Most lenders regard a mortgage application as a sound risk only if total housing costs, including mortgage principal, interest, insurance, and real estate taxes, do not exceed 20-25 per cent of the borrower's anticipated income over the entire loan term. Such rules must not be adhered to indiscriminately as worthy exceptions are entirely probable. Furthermore, even though monthly carrying charges decline as terms are extended, the inherent dangers in pushing this dimension too far in order to accomplish a given debt service-income ratio need not be repeated.¹

The matter of adjusting mortgage contracts to suit individual home buyers suggests the continuing controversy over variable vs. fixed interest rates. This issue generally arises from a lender's method of treating two

¹In the BLS survey referred to above, monthly mortgage payment as a proportion of income ranged from 19 per cent where incomes were less than \$2 thousand to 10 per cent in the \$6-\$7.5 thousand bracket.

important components in interest rate determination, particularly whether differences in these implicit cost components should be reflected in interest rate differentials, or whether interest rates should be invariant to such differences. Differences in the risk component will be considered immediately while administrative cost differentials will be analyzed briefly in a succeeding section.¹

Preference for fixed or variable rate determination in accordance with differentials in mortgage risk is not peculiar to any lender type in the Boston area, but the variable rate idea is perhaps most common among savings and loan interests. Those favoring standardized rates regard the component for risk compensation as analogous to an insurance premium and as such should be the same for all qualified loan applicants who meet the minimum requirements. A leading Boston savings bank stands ready and willing to grant 4 per cent loans to all qualified applicants on this basis, whether the requested loan amount represents 40, 60, or 80 per cent of property value. The mortgage officers of this bank feel that a policy of discrimination according to varying degrees of risk invites favoritism and results in undue embarrassment and administrative detail. They believe that by offering a standard minimum rate to all their qualified borrowers, they can select only the most desirable among all applicants and maintain a sound, well-diversified portfolio.

Other local institutions regard a variable rate structure as the only fair way of handling the wide variety of loan requests. Even if the attendant monthly carrying charges are not excessive in relation to prospective income, a high-percentage, long-term loan ordinarily subjects the lender to greater overall risk than a loan with more moderate contract

¹See "Loan Amounts and Properties Mortgaged" below.

provisions. These groups feel it unjust to charge the latter mortgagors the same risk premium, while the corresponding risk elements are significantly lower. Whereas the fixed rate school would refuse a mortgage application altogether if the requested loan amount appeared unusually high in relation to property value, variable rate advocates would perhaps accept it if a higher interest return were available. Several local institutions consistently follow a policy of offering loans at 4 per cent only if the initial loan-value ratio does not exceed 60 per cent. For higher percentage loans, rates of $4\frac{1}{2}$ and 5 per cent are charged but only if the term appears reasonable and debt service manageable. It is true, however, that a small institution is hardly justified in extending a loan to a person with a decidedly inferior risk rating, even at interest rates of 6 and 7 per cent.¹ One local cooperative bank had considered making a group of such loans some time ago, but the investment board rejected the idea as unsound for borrower and lender alike.

Some variable rate advocates believe that their scheme, should apply not only to new loans made, but also to existing mortgages held in portfolios. As mortgages are gradually amortized and current loan-value ratios decline, interest rates should be progressively reduced in accordance with the decreasing risk. Such a system is actually employed with notable success by a federal in Milwaukee. This association charges \$6.55 per month per \$1,000 for a 20-year term and realizes a net weighted interest yield of 4.90 per cent. The interest pattern proceeds as follows:

- 6 per cent for the first 30 payments,
- 5.4 per cent for the next 30 payments,
- 4.5 per cent for the next 60 payments, and
- 3.6 per cent for the last 120 payments.²

¹The dispersion on such a small sample would be too great even where using notation from Part III, P is sufficiently high to provide an acceptable expected value \bar{X} .

²Letter of G. L. Bliss, reprinted in Cooperative Banker, April 1945, p. 6.

Such a variable rate structure would effectively eliminate portfolio raiding of well-seasoned loans by rival lenders, inasmuch as rates are automatically reduced as soon as refinance would appear profitable.

Just as some institutions grant loans at 4 per cent to all acceptable applicants, others refuse to slip below their established minimums of $4\frac{1}{2}$ or 5 per cent under any conditions. A cooperative bank had a conservative loan request of \$12 thousand in connection with the purchase of a desirable \$40 thousand residence. This particular bank had a policy of charging no less than $4\frac{1}{2}$ per cent, even if the accompanying risk would easily warrant a lower rate. Largely because of ignorance of alternative opportunities, the home buyer willingly paid the $4\frac{1}{2}$ per cent rate despite the fact that nearby savings banks would have gladly made the same loan at 4 per cent.¹ By and large, however, the fact that some institutions continue to find an ample force of home buyers willing to pay interest rates of 5 per cent is due in large part to the availability of higher loan-value ratios or longer loan terms at the higher rate. Specifically, this explains to some extent the continuing differential in average rates charged by savings banks as opposed to federals and cooperative banks, the latter institutions ordinarily permitting more liberal loan-value ratios.²

Summarizing, it appears quite compatible with a moderate degree of competition that two institutions may exist side by side and still charge a different price for their output. Actually a one price market is hardly to be expected, inasmuch as the products sold may be quite dissimilar for the two institutions. The institution lowering its rates or maintaining the lower rate structure may attract the bulk of the loans associated with a

¹On the other hand, a suburban savings bank, preferring not to make an exception to its existing $4\frac{1}{2}$ per cent minimum, actually referred a highly desirable loan applicant to a Boston bank where he could receive the 4 per cent loan to which he appeared justified.

²See Table XI.

minimum of risk, while the other may grant higher percentage loans, etc. The advocates of variable rates, however, believe it most desirable to accommodate both types of mortgagors for the well-being of all parties concerned. The following chapter will summarize some additional factors accounting for the continuing co-existence of thrift institutions with significantly different interest rate structures.¹

¹Another interesting aspect of the mortgage interest rate structure concerns the almost universal use of conventional "price lines." Similar to most capital markets perhaps, the 1940 Census reveals that well over 90 per cent of the mortgagors in the Metropolitan Boston District were paying interest at rates of whole numbers or full halves -- i.e., 4, $4\frac{1}{2}$, . . . $6\frac{1}{2}$, 7 per cent, etc. This is certainly a convenient procedure for lender and borrower alike, making interest and amortization calculations simple. Nevertheless, a $\frac{1}{4}$ of 1 per cent shading of interest charges results in substantial savings to the borrower over a 20-25 year repayment term. (See Part II.) Especially since FHA maximum rates are set at $4\frac{3}{4}$ per cent, it may be advisable for some lenders to consider raising or lowering its rate by this smaller amount if a full $\frac{1}{2}$ of 1 per cent change appears unnecessarily high.

CHAPTER 12. OTHER LENDING PRACTICES

Mortgages constitute an essential and highly desirable investment outlet for local thrift institutions. Even after due allowance is made for the additional risk and administrative expense involved, mortgage lending on a sound basis constitutes a most profitable investment activity. As indicated above, net yields generally compare favorably with returns on long-term government bonds or high-grade corporate securities.

Although there is no specific statutory limit, federals and cooperative banks generally regard a mortgage portfolio equivalent to 80 - 85 per cent of total assets as an optimal condition. Beyond that point, an institution runs the risk of lacking sufficient liquidity and flexibility either to meet sudden withdrawal demands or to take advantage of new, highly profitable investment opportunities. Indeed, surplus reserves and borrowed funds constitute such a substantial proportion of total liabilities among local federals that aggregate mortgage portfolios frequently exceed share capital. Both cooperative banks and federals must rely heavily upon the continual inflow of repayment sums to provide them with the requisite liquidity for normal bank operations. It should be borne in mind, however, that any significant economic recession might seriously impair this prospective income stream, thereby rendering a bank's borrowing capacity as an indispensable liquidity hedge.

Savings banks are permitted to accumulate mortgage holdings only up to a limit of 70 per cent of total savings deposits. This restriction, as indicated earlier, is designed to protect their depositors' funds by promoting a well-balanced investment portfolio. Inasmuch as savings deposits are ordinarily payable on demand, it has been considered poor investment policy to place these funds too heavily in illiquid mortgages, especially where amortization provisions are lacking. With the increasing importance of compulsory amortization and government-insured loans, however, this statutory

requirement is perhaps less essential. Especially where an institution is active in purchasing loans in the secondary market, the dangers of accumulating unsound mortgage portfolios at unjustifiably low interest rates are materially lessened. From an economic point of view, a savings bank may find it prudent to sell low-yielding government securities and place the proceeds as well as new savings inflows into government-insured loans so long as net yields on the latter exceed those on alternate investments. This, of course, is true only after the necessary allowance is made for the possible added risk and servicing expense involved in any mortgage investment. Although the secondary market is discussed more fully later,¹ it should be pointed out here that such buying and selling operations perform the economic function of narrowing the spread between net yields on various investments. By selling low-yielding governments and buying higher-yielding FHA-insured loans, effective returns tend to become equalized through a corresponding adjustment in current market prices. Under existing conditions, savings banks are effectively constrained from investing over 60-65 per cent of savings capital in mortgage loans, for an institution approaching the 70 per cent limit may be unable to exploit new profitable mortgage investment opportunities as they arise. Furthermore, when considered as a share of total resources, mortgages are virtually limited to 50-55 per cent, since surplus funds account for 10 per cent of total liabilities.

METHODS OF OBTAINING MORTGAGE BUSINESS

Construction Loans

Financing the construction of new homes either on a contract or operative basis has provided local institutions a primary means of enlarging mortgage portfolios. The home building industry is somewhat unique in that entrance

¹See Part VII.

and continuing operations are possible with a minimum of equity capital, as nearly all (and sometimes more than all) costs of construction are generally provided by credit. In most types of short-term business lending, the producing firm is afforded a considerable degree of latitude in determining pricing policies, marketing methods, and specific output characteristics. In the case of home construction financing, however, credit extension revolves about the product itself rather than the producing firm. The lender generally looks upon the housing project as the primary credit element and the general risk rating of the builder, while important, is frequently of secondary concern. This unique circumstance is due in no small part to the localized, undisciplined, and disorganized state of the home building industry itself. Entrance is easy, as any boom period finds a vast army of newly-converted carpenters and others who are able to commence operations with a negligible capital investment. Exit may be equally prompt, for the small operator, frequently inexperienced in business management, may be forced to desert a partially-completed project at any time if faced with adversity.¹ Jerry-building and fly-by-night operations are not limited to small concerns, however, for boom organizations frequently become dangerously over-expanded and infested with mismanagement.

The construction lender must insist that the builder always retain some equity in the undertaking in order to guarantee his continued interest in its satisfactory completion. Accordingly, project credit is a complicated matter to handle, ordinarily involving periodic installment payments as work progresses. Since the lender has such a dominant financial interest in the project, he must make periodic inspections to check on the quality of construction as well as to see if loan disbursements are properly employed. Because of the complexity of such lending as well as the attend-

¹Since his equity capital is severely limited, the typical builder is rarely able to embark upon truly large-scale operations, a factor perhaps impeding the introduction of major cost-saving devices.

ant risks involved, many mortgage lending institutions have refrained from construction financing altogether, preferring to take the permanent mortgage when the home is finished and sold. As a consequence, builders have frequently had to resort to less responsible and more costly sources of construction financing.¹

The introduction of FHA-insured loans and the accompanying issuance of firm commitments have induced lenders in many areas to engage in construction financing on a wide scale. In the Boston area, however, many thrift institutions have begun to extend such short-term credit only during the postwar period, and then primarily on an uninsured basis.² As indicated earlier,³ new property is generally regarded as highly desirable loan security, especially where the construction is supervised and periodically examined. Hence, local institutions have found construction lending a convenient and sound method of enlarging and maintaining mortgage portfolios. Furthermore, competitive elements in the local capital-surplus area have perhaps induced lenders with abnormally small mortgage portfolios at the end of the war to grant substantial concessions to acceptable builders in order to expand their holdings.

Relatively few lenders in the Boston area have engaged in construction financing on an extensive scale. Indeed, only the largest lending institutions possess the necessary resources to finance site developments

¹ See below, pp. 314-15.

² See Part VI.

³ See pp. 299-300. Professor Lintner observes that of the 1- and 2-family loans made in the period 1918-31, loans made on new or recent construction consistently had a far superior loss experience relative to principal amount than did loans on older properties. This favorable experience on new properties resulted primarily from relatively smaller losses on loans taken in foreclosure, not from a smaller foreclosure account itself. Actually foreclosure was twice as common with loans on new than on older 2-family properties. On single-family loans, the net loss ratio was less than 3.5 per cent on properties built after 1920, but over 6 per cent on older properties. Lintner, op. cit., pp. 401-6.

including 25-100 individual units. In addition, most operative builders lack the requisite equity capital and business acumen to embark on such an undertaking. Many lenders, even if their asset size were sufficiently large, refuse to assume the heavy risks involved in financing developments where more than 2 - 4 units are put up at one time. Inasmuch as construction lending is highly specialized and requires close control over building operations, institutions underwriting large projects must maintain a staff of trained experts who concentrate on this activity. These experts must be thoroughly versed with the procedures involved in site developments and must generally make weekly inspections of the new construction in order to determine the appropriate installment payment. Even when all reasonable precautions have been taken, housing projects occasionally fail and the builder is forced in to bankruptcy, thereby forcing the lending institution to complete the project on its own account. This contingency illustrates the point that extensive construction lending should be ventured only if a properly staffed mortgage department can be maintained, a requirement that is either impossible or inadvisable for all but the larger banks.

Many of the smaller cooperative banks are effectively eliminated from financing speculative builders by virtue of a statutory provision limiting the total lending to any one party to \$25,000 or 1 per cent of total assets, whichever amount is greater. Perhaps this limit is rarely reached among local institutions, as construction lending by small banks is restricted primarily to contract-built homes for owner-occupiers. Indeed, some of the lenders interviewed are reluctant to finance speculative builders to any extent, firmly believing that the shoddy construction techniques so characteristic of site developments seriously impair the security of the loan.

Short-term construction credit may be handled in a number of ways.

Some banks write a blanket mortgage for the entire housing development, while others prefer to make a separate contract for each individual unit. In the former case, suppose the project when completed is to contain 30 houses selling for \$10 thousand each, on the security of which the mortgage lender is prepared to extend 80 per cent, 20-year loans to qualified buyers. Thence the lender draws up a blanket mortgage of \$240 thousand in the name of the builder, who in turn will receive installment payments as work progresses. As homes are completed and sold, generally with the stipulation that the permanent mortgage be retained, the builder receives the balance of the purchase price and the outstanding construction loan balance is correspondingly reduced.

Local lending institutions differ in regard to possible penalties in the event the buyer does seek to take the permanent financing elsewhere. Many Boston banks refuse to release the mortgage under any circumstances, demanding that the builder must find another buyer for the home. Others are prepared to make exceptions provided most buyers agree to stay with the construction lender, although prepayment penalties of 1 - 5 per cent of the mortgage amount are commonly imposed. Lenders argue, with some justification, that construction lending per se is a losing proposition and that the long-term mortgage must be retained if a profit is to be realized from the operation. Furthermore, they maintain that if a buyer cannot qualify for the proposed mortgage contract, the interests of builder, buyer, and community at large are best served if a new buyer is sought.

The mechanics of construction lending cannot be described in detail in this study. It will be sufficient to add that, although procedures and fee schedules vary somewhat among the various thrift institutions, most appear to offer substantial financial inducements to eligible home builders. No principal payments are required during the first 6 months of the term,

and interest rates are generally identical to those on the permanent instrument, that is, 4 - 5 per cent. Interest charges are commonly paid on a quarterly basis and are payable on the borrowed funds only as they are disbursed. Furthermore, the builder is often spared from paying title search and certain other legal and servicing fees, as these fees are borne primarily by the home owner at the time of sale. In the case of FHA-supervised developments, however, the builder is required to pay a \$45 application fee to the local insuring office. If the final home mortgage is also insured by the FHA, \$25 of this fee is refunded, but not otherwise. In the latter case, some lenders, especially where prepayment penalties are not strictly enforced, offer a brokerage fee of 1 per cent of loan amount to the builder if the uninsured permanent mortgage is retained.

Savings banks in particular have found liberal construction lending almost indispensable in realizing a rapid growth in mortgage holdings, while still maintaining a sound portfolio. Indeed, several of the larger savings banks have realized fully one-half of their postwar mortgage expansion in this manner. One of the large banks visited consistently maintained an outstanding construction loan balance of \$4 million until its 70 per cent mortgage limit was approached. During the late 1930s, federals were perhaps the only institutions who genuinely encouraged new construction and mortgage lending, and builders encountered considerable difficulty in securing suitable financing elsewhere. Hence, in entering the postwar era, federals retained these solid contacts made earlier and already had a firm foothold in the market. During the 12-month period through February 1951, the 15 associations in the Boston vicinity relied upon construction lending for 32.8 per cent of all new mortgages made. Among the three largest federals, all located in Boston proper, construction loans actually exceeded the dollar volume of new loans written to finance the purchase of older

properties.¹ Savings banks, on the other hand, armed with vast sums of loanable funds, faced the difficult task of re-entering the market after years of relative inactivity. Disbursement schedules and other contract provisions have been continually modified to fit the needs and desires of operative builders. These disbursements are generally made in 5 - 7 installments, but one of the savings banks visited has subdivided its payment schedule into 33 individual items.

Although thrift institutions are perhaps more active in construction financing today than in prewar years, many builders are still forced to tap other sources for short-term credit. In many communities, commercial banks have extended construction loans to builders strictly on a commercial-loan basis not desiring to hold the permanent mortgage. As of June 30, 1950, secured construction loans held by all insured commercial banks in Massachusetts comprised 6.2 per cent of aggregate holdings of secured residential loans.² In addition, specialized realty companies have frequently been organized to extend short-term credit to speculative builders and to operate as brokers in placing the permanent mortgage elsewhere. Since their equity resources are ordinarily quite limited, these companies depend upon a fast turnover of working capital for optimal operations. In construction lending they are prepared to suit the special needs of builders who are perhaps inexperienced or otherwise unacceptable to thrift institutions. Such non-portfolio lenders maintain an extremely close watch over the projects which they are financing, and accordingly feel justified in demanding generous compensation for the added service and risk involved. Although the average life of such an organization is perhaps rather short,

¹Data computed from monthly reports of federals to the local Home Loan Bank.

²Operating Insured Commercial and Mutual Savings Banks, FDIC, p. 8. This practice is especially common in other sections of the country where there is a relative shortage of long-term capital. Undoubtedly a significant proportion of the short-term construction loans held by local banks refer to distant site developments.

one company interviewed has successfully financed operative builders for over 25 years. This company writes most construction loan contracts on a conventional discount basis under which the builder agrees to pay, for example, \$10,000 at the end of 6 months for the use of \$9,700, disbursed in installments throughout the interval. Although the nominal rate may be regarded as slightly over 6 per cent, the effective rate is considerably higher, as the builder is charged for the full 6 months' use of the funds.¹

Brokers.

Real estate and mortgage brokers of various sorts have provided local thrift institutions with a continuing inflow of new mortgages. These private agencies frequently combine selling operations with the placement of home mortgages, a natural union in that the latter is ordinarily an indispensable element in consummating a property sale. Such middlemen play a vital role in joining together buyer, seller, and financier in urban real estate activity. Indeed, a leading expert in housing economics has ascribed the role of the salesman as more important in this than in any other field of economic activity. Such an agent is frequently able to induce the prospective buyer to pay a slightly higher purchase price if in so doing more convenient financing can be arranged.²

The existence and incidence of brokerage fees have reflected changing competitive conditions in the local market. During the prewar period when mortgage lenders, notably savings banks, were indifferent toward making new loans, individual home buyers were often obliged to pay a fee of 1 - 2 per cent in order to secure the requested mortgage.³ Especially since the war,

¹If progress payments were evenly spread out over the 6 month term, the builder would be paying roughly 12 per cent; indeed, if the company had a great many similar loans outstanding, the average amount disbursed on each would approximate \$5,000.

²Interview with Prof. E. M. Fisher, Columbia University.

³Interview with a Boston mortgage broker. Data are not available to determine the precise extent of this practice.

however, an active competition for new mortgage loans has changed the picture, and home buyers are now forced to pay a brokerage fee only if certain elements of the mortgage request are unacceptable to most lenders because of abnormal risk, etc.

The practice of imposing a brokerage fee upon the institution making the loan has been largely promoted by some of the larger savings banks in Boston proper. These institutions, situated at a considerable distance from areas of brisk housing activity, sought an effective means of enlarging their sorely depleted mortgage portfolios at the end of the war. Some banks were interested in raising their total mortgage holdings by over \$50 million, an overwhelming task especially considering their previous years of inactivity. Construction loans have been an invaluable aid in securing mortgages on new properties, while brokers have been particularly helpful when the transfer of older properties is concerned. Many local officers indicate that these two sources have accounted for a heavy majority of all new mortgage loans, and that the offering of a 1 per cent origination fee has been of inestimable assistance. Although most if not all mortgage officers interviewed are opposed to the principle of paying such a commission, many have felt obliged to honor the practice as a "necessary evil."

It is interesting to note that brokerage fees, while highly significant among banks in or adjacent to Boston, have found only scattered acceptance among suburban institutions. A large Boston bank had initially planned to pay origination fees for new loans only until aggregate mortgage holdings had reached a desired level. After this level had been reached, however, the bank found that its portfolio could be maintained in tact only by continuing the practice. Several suburban lenders, on the other hand, have paid brokerage fees on various occasions when a rapid inflow of new mortgages was sought, but suffered no undue hardship upon its suspension. These latter institutions

undoubtedly enjoy a significant geographic advantage in being located so close to the properties on which the most desirable mortgages are being written. Home buyers prefer to deal with their own community institutions in many cases, even though monthly payments are ordinarily handled by mail. Accordingly, they may insist on a local mortgagee despite the fact that the broker could perhaps secure an additional 1 per cent fee if the mortgage were placed in a Boston bank.

The large Boston institution with a heavy inflow of amortization payments every day may find brokerage service well worth the nominal fee in order to keep savings capital fully employed. Since many of these mortgages are written on a long-term basis with enforceable prepayment penalties, net yields are not seriously diminished.¹ In the case of larger banks, brokers perform vital functions which would perhaps otherwise be handled by their own salaried personnel. As soon as a broker has brought in several loans to a particular institution, he gradually ascertains the various standards employed by the lender in selecting eligible applicants. Thereafter, he is more discriminating in channeling loan requests to the various institutions, and places them where approval appears most likely. In cases where no application fees are charged, lenders occasionally are flooded with a mass of loan requests from suburban brokers seeking the 1 per cent origination fee. This eventuality is generally minimized, however, after a broker receives a series of flat rejections. The president of a Boston savings bank indicates a heavy reliance upon 2 or 3 brokers for

¹The nominal annual yield (converted semi-annually) on 5 per cent direct-reduction mortgages purchased at a 1 per cent premium and held to maturity varies as follows:

<u>Term in Years</u>	<u>Yield</u>
5	4.63%
10	4.83
15	4.90
20	4.93
25	4.95

bringing in new mortgage loans. These individuals carefully analyze the property value and the buyer's capacity to carry the debt burden before referring the application to this institution. Hence, a continuing relationship is built up, with the lender regarding the commission fee as just compensation for this preliminary screening. Brokers in suburban communities frequently prefer to concentrate on selling real estate exclusively, and prefer not to bother with shopping around for mortgage financing anymore than is necessary.

Some brokers advertise the availability of 4 per cent mortgage credit to home buyers, without "red tape, fees, or other charges." If the loan request is less than $\frac{2}{3}$ of appraised value and superior in every respect, brokers frequently channel the mortgage to a correspondent life insurance company, collecting the origination fee and frequently retaining all servicing functions as well.¹ If the broker is not so affiliated and is not a servicing agent, he may refer the request to one of several savings banks. If, however, the required loan amount appears unusually large in relation to property value, it may be referred to a federal savings and loan association, in which case a higher interest rate is usually charged. A suburban broker has indicated that every request he has sent to a Boston savings bank paying a commission has been rejected because the desired loan amount was excessive. Hence, he now refers all home buyers to nearby suburban lending institutions for mortgage financing, where incidentally a higher interest rate is charged. Brokers frequently prefer dealing with small suburban institutions because of the quick and convenient manner in which their loan requests are processed. Such institutions rarely offer broker commissions

¹ Some brokers have found insurance companies reluctant to pay any premium unless the mortgage is written at $4\frac{1}{2}$ per cent.

nor do they compete with Boston savings banks on interest rates, but a record of satisfactory service is of prime importance to brokers and home buyers alike. One cooperative bank visited has a policy of making a preliminary decision on a mortgage application within 24 hours, while other larger institutions may require a full week at times.

A final appraisal of existing practices in regard to the payment of brokerage commissions is difficult to formulate. Certainly the fact that some but not all local lenders have felt obliged to pay a finder's fee reflects a degree of imperfect competition in the market. On the other hand, there is some evidence, though not subject to statistical verification, that the offering of this premium by certain lending institutions has attracted choice loans as well as provided essential merchandising functions in their behalf. Some lenders point to the possibility that this practice may eventually be extended to all local mortgages, in which case the competitive advantage of its offering would be lost. From the lender's point of view, the "compulsion" of paying commissions merely reflects the competitive aspects of a capital surplus area, and as such constitutes a mild form of price shading. It would be far more desirable, however, for this price shading to take a more positive and overt form so that the home buyer-mortgagor would reap the savings.

Price Cutting.

Outright price cutting, while perhaps rarely promoted as a virtuous practice, has not been altogether absent from the local market. Indications of price shading have assumed many different forms, most of which cannot be verified statistically but depend upon the reliability of impressions gathered from various interviews. The payment of broker fees as well as the offering of highly attractive construction loans as described above constitute mild forms of price shading, and have played a prominent role in postwar mortgage

operations of large savings banks. Another technique frequently employed by local lenders involves the absorption of various initial charges ordinarily borne by the borrower. Particularly where a highly desirable housing development is considered as a package deal, the lending institution may agree to waive certain legal and servicing fees in order to secure the business.

At the end of the war, some of the large savings banks in the local area sought to attract a considerable volume of loans held by other institutions through the offering of lower rates.¹ Boston banks in particular publicized the availability of 4 per cent loans, and offered brokers (and allegedly using some salaried personnel as well) the customary commission for bringing in this business. A favorite target consisted of well-seasoned mortgages written at $4\frac{1}{2}$ and 5 per cent by other institutions, frequently located in suburban communities. This portfolio-raiding became a serious problem in the case of some smaller banks, as a significant proportion of their most desirable mortgages were lost. Prepayment penalty clauses had not been written into many of these contracts, and the victims were compelled either to give up the loans or else make similar concessions.² To provide an added inducement for refinance, the new mortgagee frequently offered to absorb part or all of the various legal and inspection fees, which would otherwise be borne by the mortgagor. Portfolio-raiding is perhaps less prevalent today than in the early postwar years, partly because of a smaller spread in mortgage interest rates among rival lenders as well as the effectiveness of the above described techniques in building up portfolios. Fur-

¹Once again it should be repeated that this information is acquired from executives of suburban cooperative and savings banks who have supposedly been victims of this practice.

²Several suburban lenders interviewed apparently make substantial "price" concessions on existing holdings only if the mortgagor is offered an equivalent concession by a rival institution, but not otherwise.

thermore, savings banks are now authorized to invest considerable sums in insured and guaranteed mortgages throughout the country. As a consequence, they are perhaps more anxious to achieve a widely-diversified portfolio than to further antagonize other members of the lending fraternity.¹ At one time, however, portfolio-raiding became such a serious matter that the State Bank Commissioner was obliged to urge its discontinuance.

Although portfolio-raiding is not a common practice today, the rate differential between Boston and suburban banks has persisted throughout the postwar period. The largest savings banks in Boston seeking a rapid and continuing inflow of new mortgages have felt it advisable to maintain interest rates on prime loans at 4 per cent. When this rate was initially established, many seasoned mortgages held by suburban banks were still carried at higher rates of 5 and even 6 per cent. This spread was sufficient to prompt a considerable volume of refinance activity, for the savings to the mortgagor would readily cover the various conversion costs within a relatively short period as well as compensate for the possible inconvenience involved. Suburban institutions, however, began to write down rates on existing mortgages and to make new uninsured loans at rates as low as $4\frac{1}{2}$ per cent, but seldom lower. When rate differentials decline to $\frac{1}{2}$ of 1 per cent, refinance is far less attractive or profitable from the mortgagor's point of view.

Actually some mortgage officers in Boston regard a differential of $\frac{1}{2}$ of 1 per cent as not only the minimum spread for refinance but it also spells the minimum compensation necessary to offset the geographic advantage enjoyed by suburban banks. Except where precluded by tying agreements between the operative builder and lending institution extending construction

¹Some smaller, less strategically located savings banks allegedly persist in portfolio-raiding, but the extent of such activity is slight.

credit, the typical home buyer ordinarily prefers to patronize his own community institutions.¹ Whether he be a depositor or not, the buyer perhaps appreciates the friendly, cooperative atmosphere of the small suburban bank, a spirit which is difficult to instill in larger city banks. Furthermore, he may regard the local community association as more inclined to ease the debt burden in the event of hardship or depressed income. Actually, however, it is possible that the reverse conclusion is more likely, because large mortgage lenders are perhaps better equipped to make concessions in view of their well-diversified portfolios. If a small institution felt constrained by custom or other factors to lend primarily in its immediate vicinity, hardship cases may arise from the same source and hence be cumulative.

By and large, suburban banks continue to make sound loans at rates of $\frac{1}{2}$ to a full 1 per cent above those charged by the large Boston savings banks. As stated earlier, the narrowing rate differential on new loans made by local savings and cooperative banks as implied by data on average rates is influenced heavily by the existence of 4 per cent VA home loans.² Similarly, even if average rates charged on all new loans by suburban banks exceed those of large Boston institutions by a declining margin, a significant differential may still persist on uninsured loans. Within Boston proper, competition among the several large savings banks has made the existing 4 per cent rate an essential ingredient in maintaining mortgage

¹This preference is substantially overcome, however, when a mortgage broker affiliated with a city bank paying a finder's fee convinces the buyer on the relative advantages of a 4 per cent interest rate.

²Tables IX and X.

portfolios in tact.¹ One institution, upon approaching its legal limit in mortgage holdings, attempted to remain at this plateau with a higher $4\frac{1}{2}$ per cent rate and without any aggressive merchandising efforts. This policy was short-lived, however, as brokers who had played such a prominent role in the past merely by-passed this bank in favor of others who willingly made new loans at 4 per cent. Hence, although individual home buyers rarely shop around in quest of the lowest interest rate, brokers are forever checking on current rates charged by various institutions. Inasmuch as brokers frequently advertise the availability of 4 per cent mortgage money, they will naturally channel all prime loan requests to the bank offering the most satisfactory provisions.² As stated earlier, where the loan amount requested is larger than these banks would grant, brokers generally refer the application to a federal or a cooperative bank where interest rates are correspondingly higher. The latter institutions rarely pay finder's fees, but the willingness to write higher percentage loans, when such are necessary to complete a home sale, accounts in part for their continuing ability to attract new loans at 5 per cent, even where adjacent savings banks write lower-percentage loans at a full 1 per cent lower rate.³

¹ In the late 1930s, the Bowery Savings Bank of New York attracted considerable new mortgage business by cutting rates on FHA-insured loans from the maximum 5 to $4\frac{1}{4}$ per cent. These rates do not include the mortgage insurance premium, an item conspicuously absent from promotional literature publicizing this rate cut. Mr. Henry Bruere of the Bowery believes this move attracted nearly \$10 million of loan applications, although most of this volume reflected refinancing or taking new business from rival lenders rather than the stimulation of new home construction. TNEC Hearings, Part 11, op. cit., pp. 5116-7.

² In cases where the broker is also a loan correspondent, he may refer a choice mortgage to the affiliate life insurance company at a 4 per cent rate, thereby injecting another competitive element into the market. Loan correspondents often seek to service as many mortgages as possible and accordingly refer most acceptable requests to their affiliate company, even if a finder's fee is not included.

³ See "Lending Area" below.

When mortgage lending institutions enter a new market area, they generally endeavor to create a minimum of ill-feeling by meeting rather than materially undercutting prevailing interest rate structures. For example, local federals and savings banks have recently extended their operations into the Cape Cod region, where the going rate on prime loans had been 5 per cent. Most institutions merely met this rate, but at least one invading Boston savings bank has offered the same 4 per cent loan provisions on the Cape as in the Boston market. The overall effectiveness of this overt price-cutting is not known, but some interviewed mortgage officers have regarded these tactics as both undesirable and unnecessary at this time.

Some local federal savings and loan associations continue to write a limited volume of mortgages through refinancing, but the extent of this activity is perhaps significantly less today than in the prewar era. When a change in mortgagee is involved, the federal has often secured the loan by offering a special type of price concession, such as a larger loan amount or longer term, but often including a higher interest rate as well. During the 12-month period ending February 1951, refinance constituted 7.6 per cent of all loans made by the 15 local associations.¹

A form of portfolio-raiding is still pursued by certain outside life insurance companies operating in the local area through loan correspondents.² These agents contact existing home owners through the mails or door-to-door canvassing in order to determine their current mortgage status. If the mortgage is well-seasoned and the mortgagor appears to be a sound credit risk, the agent may offer to refinance the obligation so as to reduce monthly

¹Home Loan Bank of Boston. It will be recalled that refinance may merely involve the rewriting of any existing mortgage, regardless of any possible change in property ownership.

²See "Modern Banking in a Changing World", an address by J. E. Perry, Commissioner of Banks, reprinted in The Savings Banker, October 1940, p. 4.

carrying charges far below existing levels. This reduction may result from lower interest rates, but it results primarily from a substantial extension of loan term. Furthermore, while monthly mortgage payments are reduced, aggregate monthly payments are maintained, the balance consisting of premiums on an accompanying life insurance policy. These so-called package mortgages provide ordinary life insurance protection for the mortgagor, allegedly at no extra cost. Although the merits of this combination arrangement will not be analyzed here, it should be mentioned that local mortgage lenders decry the promotional tactics employed as full of misrepresentation and as such constitute a real menace to a stable mortgage market.¹

Advertising and Nonprice Competition.

Advertising budgets of the various thrift institutions have been reviewed in Part III, so only brief reference will be made here. Federals continue to spend the largest proportionate amount on advertising, although cooperative banks and certain savings banks have greatly expanded these programs in recent years. Federals and cooperative banks advertise quite heavily in local newspapers, ordinarily stressing the availability of savings accounts earning generous dividends, but frequently mentioning home loan plans as well. In addition, savings banks and federals sponsor various public service radio programs, either individually or collectively as trade associations. As in most business pursuits, however, personal contact and satisfied customers are regarded as essential ingredients for a continuing success in mortgage lending. To this end, individuals who utilize other services of the institution are frequently flooded with promotional literature stressing its expert mortgage department and urging them to share the word with friends and neighbors. Furthermore, certain

¹Savings banks can and do perhaps offer essentially the same arrangement to home buyers, via combining a conventional mortgage and a life insurance policy.

federals and cooperative banks have at various times offered special inducements to persons who would open up a new savings account or merely return a self-addressed envelope. The prizes offered range all the way from an address book or wallet to membership in the "Hopalong Cassidy Club."

Although these gifts have undoubtedly assisted in attracting new savings accounts, there is some evidence pointing to an increasing consumer sensitivity to relative dividend returns.¹ At any rate, non-price competition has provided an effective means of securing new business in both savings and mortgage departments, and its significance should not be overlooked.

Before leaving this discussion, the increasing importance of joint advertising efforts of builders, realtors, and lenders should be mentioned. The interdependence of the operations of these three groups has been amply demonstrated by various newspaper advertisements as well as other promotional media. Indeed, builders frequently ally themselves with real estate agents in marketing their homes, the former preferring to concentrate on construction activities alone. The indispensability of mortgage lenders in providing adequate financing is reflected both in construction lending as well as in granting long-term home mortgages. Hence, it is only natural that each leg of the triangle promotes its own self-interest by promoting the continuing success of all three. Frequently a different "development corporation" is established to handle the affairs of each individual housing project, operating as a collective unit. In promoting the sale of these homes, neither the builder putting up the property nor the institution financing it is mentioned by name. Furthermore, newspaper advertisements, while stressing the desirable features of the new homes and their location, often fail to mention selling price. The direct-reduction mortgage has

¹See "Elasticity," Part III.

become so widely accepted that the low monthly payment is frequently the only price element referred to in the advertisement. For example, an attractive spread in a Boston newspaper mentions only the \$628 down payment and the popular phrase, "monthly payments less than rent." Another case gives somewhat more complete information, noting in small print that the \$400 equity payment and \$60 monthly payment is computed on a 25-year, 4 per cent basis. Still another mentions the monthly payment of \$73.92 but makes no reference whatever to selling price, loan amount, interest rates, or loan term.¹ These illustrations serve to emphasize the elements foremost in the minds of prospective home buyers. Quite justifiably, two primary considerations are adequacy of equity savings and the relation between monthly debt service and prospective incomes.

It is difficult, if not impossible, to analyze the net effect of the various advertising schemes on the local home mortgage market. Although the mere existence of advertising evidences a degree of imperfection in the competitive market, its overall stimulative effect is dependent in large part upon the extent of this imperfection. The increasing rivalry among competing institutions for new mortgage business has manifest itself in expensive advertising campaigns, but it has also resulted in tangible price concessions to prospective customers. Interest rates have been reduced, loan terms extended, loan-value ratios heightened, and debt amortization arranged on a convenient, monthly-payment basis. So long as the home buying community is largely ignorant of alternative mortgage plans offered by various lenders, a moderate volume of "informative" advertising may truly improve the competitive structure of the market. Tenants who heretofore were unaware of the relative ease with which home purchase can be

¹From Boston Sunday Herald, Real Estate Section, November 18, 1951, and January 6, 1952.

financed become active demanders for mortgage credit. Provided the advertising copy makes specific reference to interest rates, loan terms, etc., he will also be sensitive as to the relative merits of alternative loan plans available.

If, on the other hand, the local market has adequate housing accommodations and new home building falls off drastically, the net stimulative effect of advertising on overall mortgage demand is severely diminished. From this point on, it becomes more "manipulative," and merely results in a redistribution of the existing mortgage debt. Provided price concessions are included, this activity may continue to benefit the home owner, but there is a real danger that non-price elements may become the dominant selling point. Mortgagors may be induced to refinance their obligation elsewhere solely because of a lower monthly mortgage payment. What is not emphasized, however, is the considerable extension in repayment term and a possible advance in interest rates. The lower mortgage monthly service is undoubtedly a primary selling point for package mortgage deals promoted by certain life insurance companies. Similarly, joint advertising efforts of builders, realtors, and lenders frequently play down certain essential parts of the mortgage contract, notably interest rate and loan term. Hence, there is the danger that home buyers are induced to select their new home on the basis of monthly payment and initial equity requirements alone without carefully examining other essential mortgage elements.¹ At the same time, however, the widespread utilization of the VA home loan program locally and of the FHA plan elsewhere has instilled a certain degree of sensitivity among new home buyers as to the merits of alternate mortgage plans. The maximum 4 per cent rate on the former loans has become general knowledge among

¹Indeed, the apparent ease with which home ownership may be accomplished has perhaps prompted a certain amount of unjudicious purchasing. Mortgage credit is offered individuals who may be better advised to remain as tenants unless circumstances change in the future. Unfortunately, the prospective purchaser deals only with parties standing to gain from an affirmative decision, and does not often receive the judgment of an impartial counsel.

veterans and non-veterans alike, and has undoubtedly created an increasing awareness of mortgage interest rates.

LOAN AMOUNTS AND PROPERTIES MORTGAGED

As mentioned earlier, a policy of making larger loans on residential and commercial properties partly accounts for the characteristic lower interest rates charged by local savings banks. Cooperative banks and federal savings and loan associations, on the other hand, have generally concentrated their mortgage lending on 1- to 4-family residences, although the latter have loaned relatively large amounts on these properties.

Undoubtedly administrative costs per dollar of loan amount decline steadily over a wide range of possible loan amounts. Total costs of servicing are but little more for a \$10,000 loan than for one half that size, for the detail involved in processing monthly payments is little affected by the dollar amount concerned. Hence, if risk and other mortgage elements remain unchanged, the lending institution is justified in charging higher interest rates on unusually small loans in order to compensate for the added costs involved.

Some institutions have adopted a variable rate schedule which reflects this differential cost factor. One federal savings and loan association visited charges 6 per cent on all loans up to \$2,000, and 5 - $5\frac{1}{2}$ per cent for loans up to \$5,000. A progressive savings bank officer has examined the element of administrative cost very carefully in determining a sound interest rate schedule for postwar mortgage operations. By constructing a series of cost charts, he ascertained the appropriate interest rate required to cover the costs involved in making and servicing loans with various original principal amounts. Although minimum rates vary inversely with loan amount, the entire rate schedule itself supposedly falls as

total mortgage holdings increase. At the close of the war when this bank's portfolio was sorely depleted and overburdened with small loans on run-down properties, handling costs per dollar of loan amount were unusually high and so also were minimum interest rates. In expanding its mortgage portfolio, this institution has offered liberal credit availability to new home purchasers in growing communities, where both risks and servicing costs per dollar of loan amount are minimized. Now that this program has been in effect several years, mortgage holdings have more than doubled, administrative costs per dollar of loan amount have fallen substantially, and minimum interest rate requirements have been correspondingly reduced within each loan amount category.¹

While administrative costs per dollar of loan amount tend to be a decreasing function of loan amount, overall lending risk appears to work in the opposite direction. In regard to lending activities of Massachusetts savings banks, Professor Lintner observes that both risks of foreclosure and risks of loss tend to increase as larger loan amounts are considered.² Among all loans written during the years 1918-1931, overall mortgage experience was uniformly most favorable when original principal amounts did not exceed \$25 thousand. This observation does not infer that size of loan

¹It should be pointed out that such a method of setting interest rates hints of a variant of the traditional "full-cost" pricing. In other words, this bank may be reducing rates on relatively "high-cost" small loans in accordance with falling overall average costs per dollar of loan amount, but the decline in average costs may be due only to the increasing significance of choice "low-cost" large loans. Under the preferred "marginal" pricing scheme, the bank would be justified in reducing rates on small loans only if economies arising out of large-scale lending operations actually reduced the direct costs attributable to handling loans within each loan amount category.

²See Lintner, op. cit., pp. 390-401.

per se is the primary criterion for risk rating, but rather that the most desirable property types for security purposes tend to fall within smaller value groups. For example, loss experience appeared to be far less favorable on income-property loans than on residential loans, but for reasons other than mere size alone. On the contrary, whereas loans on stores, stores and offices, stores and lofts had the largest average size (\$59.4 thousand), their loss ratio of 10.6 per cent was the lowest among all loans on income properties.¹ The corresponding net loss ratio for single-family loans was 4.6 per cent, compared with slightly higher ratios of 6.1 and 8.6 per cent for loans on 2-family and 3- to 4- family properties, respectively.

Professor Lintner has pointed out that, even if risks of foreclosure and loss were no greater on each individual large loan than on each small loan, the former in general would still be less desirable as a bank investment. Because of the operation of the law of large numbers, a bank can expect a much more predictable loss experience if a given sum of money is spread over a great many small loans rather than a few large individual mortgages.² The probability of complete loss is progressively lessened, and aggregate losses would be spread out over a longer period of time, thereby permitting a more rational handling of loss reserves and overall foreclosure policies. Furthermore, a well-diversified mortgage portfolio is more easily attained if a great many small loans are distributed over a wide variety of risk elements. This factor is particularly relevant in the case of moderately-sized institutions, which lack the necessary resources to achieve a properly diversified portfolio by making only large loans. Nevertheless, the inherent danger in concentrating on large income-property

¹Lintner, op. cit., pp. 395-6. The average for all income properties was 15.7 per cent, with loans on garages least favorable with a net loss ratio of 34.9 per cent.

²See "Mortgage Risk and Probability Theory," Part III.

loans does not imply that a thrift institution should make only loans on single-family properties. A well-diversified portfolio should be well fortified against possible shifts in public preferences or changing neighborhood trends, and should accordingly include a limited volume of loans on 2- to 4-family residences. Similarly, large institutions may find it prudent to invest a modest proportion of their savings capital in loans on large income properties, rather than concentrate on home properties exclusively.

The trend away from large individual loans has been most marked among some of the largest savings banks in Boston proper. During the booming 1920s, these institutions invested heavily in such mortgages, so that by 1927 average outstanding loan balances exceeded \$20 thousand in the portfolios of four local savings banks. Indeed, the largest bank in the area had so concentrated its investment efforts in this direction that in 1927 average loan balances had reached \$77.3 thousand in a portfolio of 309 loans. Most of these large individual mortgages have been eliminated from local bank portfolios via repayment and foreclosure, and have subsequently been replaced by smaller home loans. As a consequence, average loan balances are materially lower among the four savings banks mentioned above, the value being less than \$15 thousand in each case. Among those banks which continue to make a limited number of loans on income properties, small business properties used for chain stores and supermarkets have appeared singularly attractive.

Local institutions have adopted a variety of rules and principles to follow in regard to making large individual loans. Some have a blanket policy of refusing all mortgage applications where the requested loan amount exceeds \$50 thousand on single parcels of real estate. Others place

a limit on the total number of mortgages over a specified amount, such as \$20 or \$25 thousand. Regarding the type of property accepted as collateral, most local institutions shun away from single purpose buildings, such as churches, hospitals, hotels, etc. Foreclosure is frequently difficult or unwise in the event of delinquency and, even if the property is acquired via foreclosure, poor marketability would seriously impair its sale at a satisfactory price. Many of the local cooperative and savings bank officers interviewed indicate a definite preference for loans on small, single-family homes. Past experience has demonstrated a relatively low risk attached to such mortgages, and this preference is further strengthened by the availability of federal guaranty and insurance provisions.

Most local lenders, on the other hand, have no objection to lending conservative amounts on 2- to 4-family residences, and some may even prefer such loans to all others. Provided the properties are properly constructed or reconverted to accommodate more than one family, such investments are desirable in that the mortgagor can apply rental incomes toward making monthly mortgage payments. Opinion appears to be sharply divided on this matter, however, for some lenders will accept a moderate volume of multi-family loans only if property location and other risk factors are superior. These latter lenders fear that the resale market on such properties may be less stable than for single-family homes, and that the possibility of widespread vacancies may impair the mortgagor's ability to maintain regular payments throughout the loan term. Owner-occupiers of single-family properties do not risk this loss of rental income, and may have a more deeply rooted incentive to prevent mortgage default.¹

¹Professor Lintner found that in every case, whether the loans were on 1-, 2-, or 3- to 4-family properties, foreclosure was little more than one-half as prevalent among owner-occupied than among tenant-occupied properties. Lintner, op. cit., pp. 409-10.

Insurance companies, for example, weigh the intangible benefits accruing to owner-occupancy quite heavily in selecting mortgage portfolios. Inasmuch as most properties underlying insurance company mortgages are located at a considerable distance from main headquarters, risks of default can be minimized only by a proper motivation on the part of the mortgagor. Indeed, servicing agents can hardly be expected to exercise the same discretion in handling loan delinquency, etc., as would an ordinary portfolio lender. Past lending experience has shown the superiority of combining a predominance of single-family loans with a conservative volume of large income-property loans in attaining a proper portfolio distribution. Indeed, a large company with main offices in Boston has concentrated primarily on the former, and has encountered only one default among 25 thousand uninsured loans made in recent years.¹ Further reference to the geographic distribution of mortgaged properties will be made immediately below.

LENDING AREA

In formulating overall policy in regard to lending area, mortgage lending institutions must reconcile at least two opposing tendencies. In the first place, most thrift institutions have traditionally considered the immediate community as their natural lending area. Provided the safety of depositors' funds is not impaired, they have perhaps felt a moral obligation to provide financing needs for their own depositors and other members of the community before accepting any outside business. Furthermore, the typical lender is most familiar with the risk elements involved in lending in the immediate vicinity, as he is well acquainted with local sources of income,

¹This company has but one home mortgage in the Boston area. Another insurance company differs from most in its mortgage investment policy; whereas small home mortgages constitute a majority of the number of loans, income property loans dominate the portfolio as the average loan amount is over \$200 thousand.

long-run neighborhood trends, general credit rating of residents, etc. Not only does he possess a more intimate insight into the various forces affecting risk, but he can exert a positive influence in minimizing default. The community institution is readily accessible to local mortgagors both for making monthly payments as well as for working out any unexpected problems which might develop during the repayment period. Administrative expense is undoubtedly lessened if mortgage properties are located near the bank, for initial and subsequent inspections are more conveniently made and extensive advertising and promotional effort outside the community is minimized.

Professor Lintner has dealt with the issue of lending areas in connection with the mortgage loss experience of Massachusetts savings banks on loans made in the years 1918-1931. His findings in regard to loans on 1- to 4-family residences indicate rather conclusively that proximity of mortgaged property to the lending institution has a favorable influence upon lending risk. For every \$100 thousand loaned on single-family properties in their own or adjacent town, the banks incurred subsequent net losses of \$3.8 thousand. Where the dwellings were located 2 or 3 towns away, average net losses were \$7.1 thousand; and finally, average losses on more distant properties were \$10 thousand for each \$100 thousand of principal loaned.¹ These results point to a positive correlation between proximity and lending risk, thereby indicating a decided advantage in concentrating lending operations on a bank's immediate vicinity.

In spite of these advantages, lending in a narrowly limited area subjects the mortgagee to significant inherent risks because of this concentration. First of all, the above discussion refers only to uninsured

¹Lintner, op. cit., pp. 406-7.

lending, and does not suggest a preference for local properties when the mortgage is insured or guaranteed by a federal agency. Indeed, there are decided advantages in spreading out latter mortgages not only throughout the metropolitan area but across the nation as well.¹ Even with conventional lending, most interviewed lenders regard a proper geographic distribution of mortgaged properties as an indispensable element in maintaining well-diversified portfolios. They severely limit their operations in communities dependent upon a single company or industry, and prefer to hedge themselves against adverse neighborhood movements, etc. In so doing, however, they must be aware of the hazards involved in invading a new distant region in which their past experience and insight may be of limited application. Such dangers, on the other hand, are seldom so severe as to preclude a wide diversification of mortgage properties throughout a given metropolitan area. Indeed, depositors in most institutions are scattered over wide areas. Frequently a family has done business with a particular bank for several generations, and continues this patronage regardless of its changing residence. Others prefer to deposit savings funds near their place of business rather than of residence. Furthermore, depositors in local mutual-type institutions are little concerned with the identity of borrowers so long as their qualifications measure up to accepted standards. Only in cooperative banks is the borrower required to be a shareholder as well, and even this nominal regulation is frequently met through the purchase of one share at the time of mortgage origination.

Mortgage officers endeavor to keep a close check on the locations of mortgaged properties, so as to insure a proper geographic distribution. Several indicate that these properties are spread over as many as 50 separate communities, although the immediate vicinity generally receives the heaviest concentration. At the same time, however, the prominence of local thrift

¹ See Part VII.

institutions as mortgage lenders in their own immediate communities varies considerably, both regarding type and size of institution as well as main location. To demonstrate these relationships, consider the proportion of all home mortgages recorded in various communities accounted for by local institutions. Primary data for Table XIII have been gathered by the Metropolitan Mortgage Bureau from the registry of deeds, and have been grouped according to community and lender type. The 10 communities are classified into four groups, A - D, arranged in descending order according to average purchase price of home properties. To maintain comparability, mortgage lending operations of each type of institution are included in the community totals only if a member of this type is located within the given community. For example, data on federals are excluded from communities A and B because there are no federals located in any of the 5 cities and towns concerned.

Several interesting observations may be drawn from this tabulation. The data are fairly complete so far as lending activities of these institutions within the given areas are concerned, and appear to have followed a similar pattern during each postwar year. Within each community type, local cooperative banks account for a higher proportion of total mortgage recordings by all such banks than do local savings banks relative to total recordings by all savings banks. This difference narrows steadily as one moves from the A to D communities, although the absolute percentage share of total recordings represented by local institutions among either type remains roughly the same in all but the D communities.¹ Data on federals are perhaps too small to permit much generalization, but their attitudes and policies toward lending areas appear to lie between those of savings banks and cooperative banks.

¹See p. 341.

TABLE XIII. NUMBER OF MORTGAGES RECORDED BY SAVINGS BANKS, COOPERATIVE BANKS, AND FEDERAL ASSOCIATIONS ON PROPERTIES WITHIN CERTAIN COMMUNITIES OF METROPOLITAN BOSTON, CLASSIFIED ACCORDING TO LOCATION OF LENDER AND LOCATION OF PROPERTY, 1946-1951

<u>Type of Lender</u>	<u>Rating of Community*</u>				<u>All</u>
	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	
<u>Locally-Located</u>					
Savings Banks	3,259	1,934	4,030	390	9,613
Cooperative Banks	3,086	1,684	4,473	557	10,092
Federals ^x	-	-	1,385	245	1,630
Total	6,345	3,618	10,180	1,192	21,335
<u>All Locations</u>					
Savings Banks	8,511	4,661	9,531	1,557	24,260
Cooperative Banks	5,318	3,355	9,435	2,041	20,149
Federals ^x	-	-	3,167	405	3,572
Total	13,829	8,016	22,133	4,003	47,981
<u>Ratios: Local</u>					
All Locations					
Savings Banks	38.1%	41.5%	42.3%	25.0%	39.6%
Cooperative Banks	58.0	50.2	47.5	27.3	50.1
Federals	-	-	40.9	60.5	45.7
Total	45.8	45.1	44.6	29.8	44.5

Source: Computed from primary data compiled by the Metropolitan Mortgage Bureau.

- * Including: A - Belmont, Newton, Winchester; B - Arlington, Lexington; C - Dorchester, Medford, Quincy; D - Roxbury, Somerville
- x Because there are no federals located in any A or B communities, or in Roxbury, data on federals are excluded accordingly.

Cooperative banks perhaps more than any other type of thrift institution continue to function in much the same manner as their early predecessors. Both in regard to selling shares and in making loans to shareholders, most such banks strive to accommodate their own community first and foremost.¹ Among the 10 communities referred to in Table XIII, local cooperative banks in all except Roxbury and Somerville dominate lending by such associations, and in Arlington and Lexington the single cooperative bank in each town wrote more local loans than any other coop-

¹ There are some notable exceptions among those banks with less desirable locations. See below.

perative bank in every quarter during the 5-year period.

Savings banks, on the other hand, have traditionally been more fluid in regard to placing mortgage loans and proximity of property per se is perhaps of lesser significance than among local cooperative banks. Nevertheless, it is entirely possible that both types of thrift institutions display the same preference for local loans, with the significant difference in ratios as indicated in Table XIII being due largely to the influence of large Boston institutions. While local savings banks made more loans than non-local banks in communities A, B, and C in over 80 per cent of the quarters concerned, they were followed very closely by several Boston banks in every case. Especially within the choice residential areas of Belmont, Newton, and Winchester, the latter banks are anxious to place as many mortgages as possible. This enthusiasm perhaps wanes gradually as communities B and C are considered, thereby accounting in part for the increasing importance of local as opposed to non-local savings banks, as well as the narrowing margin between corresponding cooperative and savings bank ratios.

The preference of savings banks for loans on properties within the more exclusive sections has been amply demonstrated by the data in Table XIV. In order to secure this choice business, savings banks have been compelled to pursue vigorous merchandising campaigns, utilizing both price and non-price competitive tactics in its accomplishment. Especially after their virtual retreat from mortgage lending during the preceding 15 years, this postwar task appeared doubly difficult. These institutions publicized a 4 per cent rate on prime loans and offered a 1 per cent finder's fee to brokers bringing in the business. As indicated earlier, extending liberal construction credit to large-scale operative builders has also provided Boston savings banks in particular a steady inflow of new permanent mortgages.

TABLE XIV. NUMBER OF MORTGAGES RECORDED BY VARIOUS TYPES OF LENDING INSTITUTIONS ON PROPERTIES LOCATED WITHIN CERTAIN LOCAL COMMUNITIES, 1946 - 1951

<u>Type of Lender</u>	<u>Per cent of Total Represented by Each Lender Type</u>					
	<u>A</u>	<u>B</u>	<u>C</u>	<u>D</u>	<u>Per cent</u>	<u>No. of Loans</u>
Savings Banks	44.7	45.5	39.9	33.0	41.8	24,260
Cooperative Banks	28.0	32.7	39.3	43.2	34.7	20,149
Federal Ass'ns	12.0	13.4	14.1	20.6	13.8	8,013
Commercial Banks	10.7	6.6	6.2	3.0	7.5	4,336
Life Insurance Companies	4.6	1.8	0.7	0.2	2.2	1,257
Total - per cent	100.0	100.0	100.0	100.0	100.0	-
No. of Loans	19,016	10,252	24,025	4,722	-	58,015

Source: See Table XIII. Total mortgage recordings are included, whether or not all lender types are located within each of the 10 communities.

Inasmuch as most new home construction has been concentrated in suburban areas, the relative importance of savings banks is strongly felt in such communities as A and B.

Mortgage lending operations of commercial banks and life insurance companies are even more concentrated in the A communities than are those of savings banks. In fact, the concentration among the former groups of institutions is so marked that the share of total recordings made by savings banks is higher in B than in A communities. Commercial banks have received this choice business either through construction lending, mortgage brokers or, perhaps even more likely, through personal contact.¹ It should be noted that the most active commercial banks are outside Boston proper, notably in Newton and Quincy, in which communities their mortgage recordings frequently exceed those of local cooperative banks and federals. In almost every suburban community, local commercial banks dominate lending activity by such institutions, and the large Boston banks are virtually excluded in all communities except Roxbury and Dorchester, where branch offices are

¹The latter generally involving requests from existing bank customers.

numerous. Life insurance companies undoubtedly realized some of their loan volume through refinancing mortgages held by other institutions, as described earlier. On the other hand, loan correspondents frequently operate as short-term construction lenders, and in extending such credit retain some rights in regard to placing the permanent mortgage.

The declining relative importance of the aforementioned institutions as lenders in the less exclusive communities is matched by a corresponding rise among cooperative banks and federal savings and loan associations. As seen in Table XIV, the share of total recordings made by each of the latter groups increased steadily as one moves from left to right. In community-type A, the combined share of all federals and cooperative banks is roughly $2\frac{1}{2}$ times that of commercial banks and insurance companies, while in D it is nearly 20 times as large. Similarly, their combined mortgage recordings were but 90 per cent of savings bank recordings in type A but nearly twice as large in D.

With the possible exception of federal savings and loan associations, this striking contrast in lending areas is not due to the relative availability of the various lender types in these communities.¹ The absence of loans on properties in D communities among many mortgage portfolios is hardly due to accident, but rather reflects a definite investment policy. Although there are certain districts within which such rules do not apply, many savings banks have a blanket policy of refusing all loan applications where the property is located in less desirable communities. They shun away entirely from the lower-income districts of Boston, such as the South End, Charlestown, Roxbury, etc., and concentrate on communities such as A, B, and C.

¹Indeed, thrift institutions are distributed in the four community types as follows:

	A	B	C	D
Savings Banks	5	2	3	5
Cooperative Banks	6	2	11	4
Federals	0	0	3	2

These institutions regard mortgage lending in lower-income districts as a death trap, for both borrower and pledged property are generally assumed to be associated with high risk. In the event of default, the mortgagee takes over the property, but can perhaps find a buyer only if another risk-laden purchase-money mortgage is taken back as part payment. Thus once an institution sinks its funds into such a neighborhood, an easy loss-free withdrawal is seldom possible. Hence, such loan requests are refused as a matter of principle, regardless of interest rate or loan-value ratio.

Not only do many outside savings and cooperative banks prefer to stay clear of such lending operations, but institutions situated within these restricted areas also appear to have similar notions. Referring back to Table XIII, it is clear that the share of all loans made by savings and cooperative banks in Roxbury and Somerville represented by local institutions is significantly lower than the corresponding share in the remaining community groups. Indeed, local institutions made only about one-fourth of all mortgages in D communities, and were the dominant lender in roughly one-fourth of all quarters during the 5-year period concerned. In the 21 postwar quarters for which this information is available, the two Roxbury cooperative banks have never written as many loans on local properties as has a cooperative bank in downtown Boston.¹

The executive officer of a Roxbury cooperative bank indicates that mortgage lending has been singularly difficult during recent years. This bank has a moderate one-half of its total resources invested in real estate loans compared with a four-fifths ratio for all banks in the area.² Furthermore, its portfolio is overburdened with inferior mortgages on local dwellings, many of which have been on the books for decades although ownership

¹See below. In 4 quarters a Roxbury savings bank was the largest savings bank lender in the Roxbury section.

²This ratio would perhaps be considerably lower if the bank offered ordinary savings share accounts, but this will be done only when and if a need for added share capital appears.

has changed hands rather frequently. Most residential properties consist of 2- to 4-family flats and converted single-family dwellings constructed shortly after the Civil War. Rather than continue entertaining new loan requests on local properties, this bank as well as other savings and cooperative banks in the community have sought to replenish portfolios with loans on newer homes in other communities. The cooperative bank official visited has encountered considerable difficulty in entering suburban residential areas, however, for existing institutions have already made firm contacts with builders and real estate agents operating in these areas. Small banks are not equipped to finance large site developments and, unless shareholders or bank officers possess an inside track on such transactions, prime loans can often be secured only through real estate agents. Cooperative banks, however, have generally been most unreceptive to the notion of paying finder's fees, so even brokers are of limited assistance in expanding mortgage portfolios, especially where the bank does not enjoy a choice location. The mere availability of a 4 per cent rate on prime loans does not insure a prompt response among the home buying community unless it is accompanied by an effective merchandising policy.

The mortgage officers of a nearby savings bank faced the same problem at the end of the war, but have worked toward its solution in a more positive manner. In 1946 its mortgage portfolio, amounting to less than one-fourth of total assets, consisted largely of loans on local run-down properties, many being written on the traditional straight-term basis. To work its way out of this trap, the bank refused all but the most promising requests for local loans and vigorously invaded new territories. It not only honored broker fees, but also financed operative builders on a wide scale, frequently taking advantage of the FHA-insurance program.¹ Furthermore,

¹A rather unique approach in this area. See Part VI..

after such purchases were authorized in 1949, this institution has invested rather heavily in insured loans in other sections of the country. To better accommodate new and existing customers, an attractive branch office was established at a convenient downtown location. As a result of this multi-pronged attack, mortgage holdings have more than doubled, while loans on local properties have actually diminished somewhat. At the present time more than 56 per cent of its resources are invested in mortgage loans, over half of which are FHA-insured or VA-guaranteed.¹

While the above mentioned institutions have shunned away from lending in such districts as Roxbury, Charlestown, etc., others have found this to be good business provided certain precautions are taken. These latter lenders gradually acquire a certain degree of expertness in appraising risk elements involved in lending in lower-income districts, and can accordingly gain from this specialization. Indeed, certain Boston institutions, including some of the largest cooperative banks, have consistently loaned on properties located in relatively undesirable sections, and give every indication of continuing this practice. Among the larger savings banks, however, only two Boston institutions appear to lend heavily in such communities, and then only if loan-value ratios are unusually conservative.² When only low-percentage loans are written, junior financing is practically inevitable in many cases, constituting a possible source of strength for the lender³ but certainly

¹ A neighboring Roxbury savings bank, somewhat larger in terms of total resources; has been less active in building up its mortgage portfolio. Between 1927 and 1951, its total assets nearly doubled while mortgage holdings were halved. Furthermore, despite the relatively low volume of new loans made, it has consistently made more mortgages on Roxbury properties than has the above more aggressive institution.

² This impression has been gathered from interviews as well as data on mortgage recordings compiled by Metropolitan Mortgage Bureau.

³ As explained by a local savings bank executive, the existence of a junior lien does not impair the security of the first mortgage as much today as when straight-term loans predominated. Under present conditions, the first mortgagee receives regular amortization inflows and delinquency is effectively minimized by the close watch maintained by the third party who has only a secondary lien on the property.

a costly burden for the borrower.

Cooperative banks which willingly operate in lower-income sections have no difficulty in charging a minimum of 5 per cent on all new mortgage loans, except where a VA-guarantee is involved. This substantial margin over prevailing rates on prime loans is taken as more than sufficient to cover the added risk and administrative expense involved. The Boston bank which consistently makes more loans in Roxbury than any other cooperative bank has effectively compensated for any inherent high-risk elements through proper servicing. The old multi-family flats in the Roxbury community are regarded as stable in value and a steady revenue producer for the property owner.¹ In order to minimize mortgage delinquency on such multi-family loans, the bank stresses upon the borrower that monthly mortgage payments must be taken out of rental income before anything else. Furthermore, any indication of non-compliance must be promptly investigated and remedied, and the property itself must be inspected periodically. The treasurer of this cooperative bank reports that its specializing in loans frequently unacceptable to other institutions has actually paid off well. Not only does the bank enjoy a margin in gross interest yields of up to 1 per cent, but as a result of efficient, sound operations its delinquency ratio has consistently remained below the state average.²

It is noteworthy that rarely is an institution a dominant lender in both A and D community groups. Two of the largest cooperative banks and one federal in Boston are consistently the major mortgage lenders in Roxbury, but are almost totally absent from recordings in Belmont and Newton. Loan

¹The net vacancy ratio in Boston proper (including Roxbury) as of April 1950, was only 0.9 per cent, against a ratio of 1.0 per cent for the entire Metropolitan Area. Corresponding ratios for Medford, Somerville, Newton, and Quincy were 0.4, 0.7, 1.1, and 2.0 per cent, respectively. Preliminary Reports of the 1950 Census, Series HC-7, No. 21.

²Minority groups are frequently included among the mortgagors in the lower-income sections of Boston. Although there appears to be little indication of outright discrimination, some interviewed officers feel that these borrowers must be carefully watched so that they do not commit themselves too heavily in other installment obligations.

amounts are ordinarily considerably lower on Roxbury properties, but loan-value ratios and overall risk are not correspondingly reduced. The relative concentration of their lending in lower districts is reflected in the differential in average interest rates charged by these institutions as opposed to most savings banks. Among the large Boston cooperative banks visited, only one makes uninsured loans at rates below 5 per cent, and this particular bank finds the $4\frac{1}{2}$ per cent market more receptive in B and C communities than in such A residential areas as Newton and Belmont. These scattered bits of data thus point to a positive correlation between interest rates and the relative risks and costs involved in making the loan.

INDIVIDUALS AS LENDERS IN CERTAIN COMMUNITIES

As discussed earlier, individuals as a source of mortgage credit have been gradually supplanted by specialized institutions of various sorts. The latter, by pooling together the savings of thousands of individual depositors, are better equipped to achieve and maintain well-diversified mortgage portfolios. The individual lender has not dropped out of the picture in all communities to the same extent, however. As suggested in the preceding discussion, most local institutional lenders prefer to operate in such communities as A, B, or C above, and frequently shun away from loans in D communities. As a consequence, prospective or existing home owners in Roxbury, for instance, may be able to secure only part, if any, of a loan request through conventional channels. In this event, they are obliged to look elsewhere for mortgage credit, either for a primary loan or for supplementary funds. As stated earlier, the latter may involve either a second mortgage from an outside party or a purchase-money mortgage taken back by the seller. The singularly significant role played by individual investors in extending mortgage credit in Roxbury is indicated in Table XV.

It may truly be questioned, however, whether private lenders perform a real service to the prospective or existing property owner if the loan request has already been flatly rejected by conventional thrift institutions. Perhaps he is best advised to refrain from borrowing altogether, as the attendant risks are dangerously severe for both parties concerned. To compensate for the risk involved, such individual lenders, frequently organized as realty companies, generally write the loan contract on a costly discount basis. Nominal rates are perhaps little above those charged by federals and cooperative banks operating in the same community, but effective rates are substantially higher because the discount is taken on the full loan amount before monthly principal payments are begun.¹ Mortgage recordings reported in the Banker and Tradesman frequently include the contract interest rate as well as loan amount, especially where an individual is the lender. In the quarters where rates for both individuals and institutions are reported, the former are consistently higher but generally by a margin of less than 1 per cent. Undoubtedly if complete data were available regarding repayment terms, renewal fees, etc., the margin between their corresponding effective rates would be substantially wider.²

As indicated in Table XV, individuals continue to be a primary source of mortgage credit in the old Roxbury section of Boston. Except in communities such as this, however, the proportion of total mortgage recordings made by individuals has fallen significantly over the past quarter century. In the relatively stable community of Dorchester, this ratio dropped from 60.4 per cent in 1927 to 19.8 per cent in 1951. In areas such as Newton and

¹This scheme is similar to that used by the private construction lender described earlier. p.314-15.

²Loan terms are apparently relatively short under these discount-type mortgages.

TABLE XV. PROPORTION OF TOTAL MORTGAGE RECORDINGS MADE BY INDIVIDUAL LENDERS IN FOUR COMMUNITIES, AS REPORTED DURING THE FIRST WEEK OF EACH QUARTER IN SELECTED YEARS, 1927 - 1951

Year	Community							
	Winchester		Newton		Dorchester		Roxbury	
	Total No.	Individuals Total	Total No.	Individuals Total	Total No.	Individuals Total	Total No.	Individuals Total
1927	17	35.3%	188	41.5%	305	60.4%	163	70.6%
1936	28	28.6	143	36.4	145	42.0	55	45.5
1940	11	22.2	117	28.0	104	29.8	48	62.5
1945	19	10.5	117	16.2	90	28.9	42	56.6
1946	30	0.0	161	10.6	189	21.2	64	39.1
1947	32	6.2	143	14.0	216	24.1	95	41.0
1948	25	0.0	150	17.2	216	19.0	111	47.8
1949	19	10.5	80	15.0	168	21.4	84	40.5
1950	28	0.0	195	7.7	193	18.1	103	39.8
1951	51	3.9	233	15.0	201	19.8	75	50.7

Source: Computed from recordings reported in Banker and Tradesman, using the first issue of January, April, July, and October for each year concerned.

Winchester, where new construction and overall housing activity have been more extensive, ratios fell from 41.5 and 35.3 per cent to 15.0 and 3.9 per cent, respectively, over the same interval. In Roxbury, however, individuals have consistently accounted for roughly one-half of all mortgage recordings, the ratio being 50.7 per cent in 1951, a postwar high. The relative growth patterns of these four communities are indicated by the underlying trends in the total number of recordings reported.¹ For the A communities, the 1951 total was substantially above the 1927 level, while the opposite situation prevailed in the C and D communities, where the 1927 volume has not been approached in the postwar period.

It should be repeated that the data in Table XV refer to the total number of recordings, and not dollar volume. Since individuals frequently make small second mortgages, the corresponding ratios based on dollar volume would reveal a far less significant role played by such lenders. In any event, however, Roxbury home owners are strongly dependent upon non-portfolio lenders

¹ See Table XIV.

for mortgage funds to a far greater extent than are those in more progressive districts.

It is perhaps noteworthy that the ratio of individual to total recordings has risen rather sharply between 1950 and 1951 among all four communities. This shift may merely reflect a spurious movement resulting from the small sample considered. On the other hand, the restrictive provisions of Regulation X and of the Voluntary Credit Restraint Program, as well as a tendency to discount current inflated prices for appraisal purposes, may have produced a more conservative mortgage lending policy on the part of some thrift institutions. If maximum loan-value ratios are lowered on first mortgages, home owners may resort to outside sources for first and particularly second mortgage credit.

ADDED COMMENTS ON LARGEST MORTGAGE LENDERS

The preceding analyses of interest rates and mortgage lending practices have made frequent reference to the largest institutions, especially where their behavior differs from that of the others. The present section will summarize some of these observations by charting the relative growth patterns of the five largest savings and cooperative banks against those of all such institutions in this vicinity. The three largest federals are similarly analyzed, while the small degree of concentration in mortgage lending among local commercial banks has already been discussed.¹ For this summary analysis, total assets will be used as the standard for determining the "Big Five." The same individual banks would be similarly classified if mortgage holdings were the standard, except in the case of one large savings bank which had an unusually small portfolio in the early postwar period.

¹p. 281.

Savings Banks

Among all savings banks in the Boston vicinity, the Big Five have consistently included the same institutions, although their relative ranking has shifted slightly. The two largest banks have exchanged positions, while the next three, currently grouped closely together at an asset level more than \$100 million below the leaders, have frequently changed their respective ranking. Total resources as well as mortgage holdings of each of the Big Five stood at a higher level in 1951 than in the previous boom year, 1927. Over the same 24-year interval, however, total assets have risen less rapidly for these five than for all savings banks in the area, while the opposite is true of mortgage portfolios. (See Table XVI.)

The relative growth patterns of the Big Five compared with all banks have differed considerably over the past quarter century. Until recently, the Big Five relative to all banks have figured more prominently as a depository than as a source of mortgage funds. During the prosperous 1920s,

TABLE XVI. COMPARISON OF MORTGAGE ACTIVITY OF THE FIVE LARGEST SAVINGS BANKS WITH THAT OF ALL SAVINGS BANKS IN THE BOSTON AREA 1927 - 1951
(Dollar Amounts in Million)

Year	Five Banks with Largest Dollar Assets			New Loans	All Banks Mortgages Assets	Ratio of Five Largest to All Banks		
	Assets	Mortgages	Mortgages Assets			Assets	Mortgages	New Loans
1927	\$373.0	\$162.7	43.6%	\$23.4	52.2%	41.3%	34.6%	29.9%
1936	480.4	170.8	35.5	7.2	41.7	41.5	35.4	31.6
1940	480.6	148.7	30.9	12.7	36.9	40.2	33.7	38.7
1946	589.0	127.7	21.7	30.9	23.5	36.4	33.5	33.7
1947	611.9	135.0	22.1	34.2	24.3	36.6	33.2	34.3
1948	627.8	150.4	23.9	33.9	26.4	36.8	33.4	33.4
1949	636.9	170.5	26.8	40.5	28.9	36.8	34.2	36.3
1950	654.6	234.2	35.8	93.6	34.9	36.6	37.6	45.0
1951	668.9	298.5	44.6	96.8	41.6	36.5	39.2	42.4

Source: Annual Report, Massachusetts Commissioner of Banks.

this difference was most pronounced, as in 1927 the Big Five held 41.3 per cent of total assets but only 34.6 per cent of aggregate mortgage holdings.

Furthermore, they were less active in enlarging their portfolios, as new

loans represented a low 29.9 per cent of the aggregate volume. During the subsequent depression and wartime periods, mortgage holdings of all banks declined steadily, with mortgage-assets ratios falling to all-time low levels. In both savings and mortgage markets, the Big Five were relatively more significant in 1936 than in 1927, but over the succeeding decade the remaining banks showed important relative gains.¹

During the postwar years, the large Boston savings banks have assumed a leading role in the gigantic mortgage expansion. In fiscal year 1950, the Big Five made new loans in a dollar amount nearly equal to that of the remaining 51 banks in the area. In addition, the mortgage-assets ratio reached an all-time high for the Big Five in 1951, while that of all banks was yet slightly below the 1927 level. In 1950 the share of total mortgages held by these five banks exceeded their share of aggregate asset holdings for the first time. Indeed, between 1949 and 1951, their share of total mortgage holdings increased from 34.2 to 39.2 per cent while their share of total assets actually dropped from 36.8 to 36.5 per cent. The rapid increase in mortgage portfolios since 1949 is due in large part to extensive purchases of insured mortgages on properties in other sections of the country.² Nevertheless, most savings banks, especially including the Big Five, have aggressively sought new loans in the local mortgage market through the various methods described earlier.

In view of previous analyses of lending practices, it is not surprising that the Big Five tend to charge relatively low rates of interest on their mortgage loans. In 1951 the weighted average rate on all mortgages held

¹The decline among the Big Five was most pronounced in the savings market, as their share of total savings capital fell from 41.5 to 36.4 per cent between 1936 and 1946, while their share of mortgage holdings dropped slightly from 35.4 to 33.5 per cent.

²See Part VII.

by these institutions was 4.07 per cent, while the unweighted average rate for all 56 savings banks was 4.27 per cent.¹ Furthermore, only two of the remaining 51 banks showed an average rate below this 4.07 per cent figure. As stated earlier, large Boston banks have generally been more receptive to making loans on large income properties than have smaller suburban institutions. Moreover, although nearly all lenders have become increasingly interested in smaller residential loans, the average new loan made by the Big Five continues to be slightly larger than the average for all 56 savings banks. Between 1927 and 1951, the average outstanding balance for the former declined from \$20.2 to \$9.2 thousand, and for the latter, from \$7.9 to \$7.3 thousand. The only savings bank currently earning an average rate of less than 4 per cent on its mortgage loans is a member of the Big Five. As might be expected, this bank has consistently held the portfolio with the highest average loan balance over the past quarter century, amounting to \$14.7 thousand in 1951.

Another factor accounting for their relatively low interest rates concerns the geographic area served by the lending operations of the large Boston savings banks. As analyzed in the preceding section, these institutions have been particularly active in financing construction operations of speculative builders. Furthermore, they have widely publicized the availability of 4 per cent credit on choice loans, and have offered a 1 per cent finder's fee to brokers bringing in such business. By offering such attractive mortgage programs, these savings banks not only hoped to re-enter the market they had so recently abandoned, but they also sought to enrich their portfolios with prime mortgages. Many banks have refused to write any loans whatever on properties in Roxbury and other lower-income communities.

Not all savings banks in the Boston area have enjoyed a continuing growth in mortgage holdings. Indeed, fully one-fourth of the 56 institutions

¹The unweighted average for the Big Five was 4.09 per cent.

had not approached their 1927 level by 1950. Since that time, however, many of these relatively less active banks have expanded their portfolios through making extensive mortgage purchases in the secondary market. Among the institutions which have failed to keep pace with the average, most have either traditionally concentrated on large income-property loans or have operated in communities with relatively little new construction or transfer activity. In the former case, the institutions concerned have perhaps found a less promising demand for income-property loans or else have adopted a policy of seeking smaller home loans. Average interest rates among such institutions are ordinarily quite low, but they have not succeeded in gaining a firm foothold in the postwar home mortgage market.

Many savings banks which are either unfavorably located or else concentrate mortgage lending in relatively undesirable sections have not shared to any great extent in the postwar mortgage boom. Two members of the Big Five, both having offices in the hub district, have tended to specialize in lending on older 2- to 4-family properties in established sections which have become progressively less desirable in recent years. Average interest rates on their real estate loans have consistently exceeded those for all of the Big Five, with the average rate for one such bank being 4.28 per cent in 1951. Furthermore, total mortgage portfolios of these two Boston savings banks increased only 15 per cent between 1927 and 1951, while those of the remaining three banks rose 137 per cent. As indicated earlier, institutions frequently find it extremely difficult to withdraw from lending in less desirable communities once they are firmly embedded therein. Some banks located in such communities perhaps prefer to remain in the immediate mortgage market and, as sound mortgage demands dwindle and new construction vanishes, they experience a gradual decline in total mortgage holdings. These institutions, as well as others located at a considerable distance from communities with brisk housing activity, maintain portfolios in part by retaining existing mortgages after the property changes ownership

and the new buyer seeks added mortgage credit. Indeed, unless such banks engage in extensive construction lending or else secure firm contacts with active real estate agents, they face a difficult task in placing mortgages in choice residential suburban communities. Inasmuch as savings capital continues to mount despite a dearth of local mortgage demands, such institutions may now partially expand portfolios through secondary market purchases if they are unable or unprepared to seek conventional loans outside their immediate community.

Gross operating income as a percentage of total assets tends to vary inversely with the size of savings bank concerned. As of October 31, 1951, "total ordinary income" represented 3.230 per cent of total assets among all 188 banks in Massachusetts, while the corresponding ratio for the 14 banks with assets of \$50 million or more was 3.199 per cent. The smallest banks (up to \$2 million) had the highest income-assets ratio, and the largest of the 8 size groups ranked seventh.¹ This observation is not at all surprising in view of the smaller average interest return on mortgage loans held by the largest savings banks. At the same time, however, total expense ratios fall continuously as larger banks are concerned and costs accordingly absorb a diminishing share of the above mentioned "total operating income." As indicated earlier, savings banks undoubtedly enjoy certain economies in large-scale operations, as evidenced by the steadily declining proportion of total assets represented by salaries, the largest single expenditure item. Dividend payments accounted for 2.01 per cent of total assets among the largest 14 savings banks, but only 1.93 per cent among all 188 institutions.²

¹From an analysis prepared by the Savings Banks Association of Massachusetts.

²The relatively higher dividend disbursement among the largest banks does not necessarily indicate a corresponding differential in dividend rates. Actually, the margin is narrowed by virtue of the relatively higher proportion of deposits to assets among these banks (88.1 vs. 87.6 per cent).

The residual component of gross income is allocated primarily to surplus, representing 0.689 per cent of total assets among the 14 largest and 0.768 per cent among all banks in 1951. Book surplus also represents a relatively smaller proportion of total savings capital among the largest banks in the Commonwealth. In 1951 guaranty fund and profit and loss reserves aggregated 12.001 per cent of total deposit liabilities among all banks, and 11.793 per cent among the 14 largest. Indeed, this ratio exceeded 12 per cent among the banks in all but two of the 8 asset-size categories. Consequently, future net profits will be subject to the federal corporate income tax for many if not most savings banks in the Commonwealth.¹

Cooperative Banks.

In contrast to savings bank experience, the largest cooperative banks have played a relatively minor role in the postwar mortgage expansion. Indeed, while mortgage portfolios of all cooperative banks in the Boston area increased 7.5 per cent between 1927 and 1951, holdings of the Big Five actually dropped 10.3 per cent. (See Table XVII.) The increase in aggregate portfolios is far more significant if due allowance is made for the banks which converted into federal associations during the prewar period. Combined portfolios of local cooperative banks and federals in 1951 were 73 per cent larger than the 1927 level.

The Big Five cooperative banks have held a steadily declining share of aggregate assets and mortgage portfolios among all local banks over the past quarter century. This decline in mortgage holdings has become increas-

¹The Congress in 1951 amended existing tax laws to apply to mutual thrift institutions as soon as reserves represent 12 per cent of total deposit liability. As of this writing, it is still too early to comment on the impact of this provision on local bank operations. As a matter of fact, regulations surrounding the levy are not completed and there is some doubt as to its effect on earmarked loss reserves. Some banks may seek to avoid this tax payment through expanding advertising budgets, raising dividend rates, reducing interest rates, etc. Others may continue as at present, paying the required tax and adding the remainder to reserves, thereby further fortifying themselves against contingent losses.

ingly pronounced in the postwar period, in direct contrast to the continuing relative growth of large savings banks. Mortgage-assets ratios for all cooperative banks have exceeded those for the Big Five by a progressively wider margin, and since 1946 the share of aggregate mortgage portfolios held by the latter has fallen from 30.2 to 26.1 per cent.

TABLE XVII. COMPARISON OF MORTGAGE PORTFOLIOS OF THE FIVE LARGEST WITH THOSE OF ALL COOPERATIVE BANKS IN THE BOSTON AREA, 1927 - 1951
(Dollar Amounts in Millions)

Year	Five Banks with Largest Dollar Assets			All Banks Mortgages Assets	Ratio of Five Largest to all Banks	
	Assets	Mortgages	Mortgages Assets		Assets	Mortgages
1927	\$85.4	\$79.5	93.2%	93.6%	31.4%	31.2%
1936	74.5	51.8	69.7	72.8	28.3	27.1
1940	76.4	52.5	68.6	75.2	33.0	30.2
1946	84.8	61.6	72.8	74.4	30.8	30.2
1947	89.6	62.4	69.6	74.4	30.7	28.8
1948	90.4	65.8	72.9	77.5	29.7	27.9
1950	93.5	67.8	72.5	77.7	31.4	26.8
1951	96.5	71.3	74.0	79.7	28.1	26.1

Source: Annual Report, Massachusetts Commissioner of Banks.

The individual institutions included in the five largest cooperative banks have displayed widely differing growth patterns. Although four banks have figured in this group in each reported year, their relative ranking has varied somewhat. Institutions in Boston proper have consistently occupied the first and second positions by a wide margin, while the remaining three posts have been held by banks in Boston, Lynn, Malden, Quincy, and Watertown at various times. Of the four banks included each year, all but one held smaller mortgage portfolios in 1951 than in 1927, the combined decline of these three banks being 23.0 per cent. In contrast to this unimpressive record, mortgage holdings of the remaining two banks in the Big Five of 1951 were 35.4 per cent above their corresponding 1927 level.

Some of the primary factors accounting for this rather curious development have been discussed in detail earlier in Part V. Geographic lending areas have perhaps been far more restricted among cooperative banks than among local savings banks. Whereas the latter have aggressively expanded mortgage portfolios through various means, including purchases in the secondary market,¹ cooperative banks appear to be less mobile in selecting lending areas. As indicated earlier, many leading mortgage lenders in Boston became active in districts such as Roxbury when they were yet highly desirable residential communities. However, as properties depreciated and neighborhoods blighted, some institutions effectively withdrew and entered newer more progressive sections of the metropolitan area. Others, however, have continued to operate in these increasingly less desirable neighborhoods, and consequently have not shared in the postwar mortgage boom. The three relatively inactive cooperative banks mentioned above continue to dominate lending operations in such districts and have rarely placed many loans in areas of extensive home building activity.² One of these banks has quite consistently made more loans in the Roxbury section than any other thrift institution.

The fact that some of the largest cooperative banks continue to lend in lower-income districts does not necessarily signify uneconomic mortgage operations. Their static condition may merely reflect the virtual absence of new construction as well as the relatively low level of sound mortgage requests in such areas. Nevertheless, they ordinarily

¹It will be remembered that cooperative banks have not been authorized to make out-of-state mortgage investment whatever.

²One of these banks, however, is the only cooperative bank visited which has financed speculative building to any great extent. Hence, this bank has at various times operated in more progressive communities, but a significant proportion of their 5 per cent loans are still made in the districts described in this paragraph. This latter observation is confirmed by data from the Metropolitan Mortgage Bureau.

realize a slightly higher interest return on their real estate loans, and are able to minimize mortgage default through proper risk analysis and servicing technique.¹ In 1951 average rates on their respective portfolios ranged from 4.61 to 4.82 per cent, while corresponding rates for the Big Five and for all 76 institutions were 4.58 and 4.59 per cent, respectively. If it were not for the substantial volume of 4 per cent VA home loans within their respective portfolios, average interest rates would be considerably higher, as the three banks concerned apparently charge a minimum of 5 per cent on all conventional loans. Furthermore, reserve funds aggregated nearly 10 per cent of total assets for the three relatively static banks, as opposed to a state average of 9 per cent and an average of 7.3 per cent for the largest bank in the area.² The loss experience of individual banks has not been examined in any detail, so little can be said regarding the adequacy of their respective surplus reserves. Thus far in the postwar period, however, mortgage delinquency has not been a serious problem among any institutions visited.³

This discussion of relative growth patterns suggests an issue which is somewhat more philosophical in nature, namely, what are thrift institutions seeking to maximize? If they are supposed to achieve as rapid a growth as possible, many large cooperative banks, and savings banks as well, have failed in their mission. According to this standard, local federals have been most successful, as their combined mortgage portfolios have increased more than fivefold since their respective conversion dates. Others perhaps regard continual growth as a healthy and even enviable condition, but place other objectives as supreme to growth per se. Indeed,

¹See pp. 345-346.

²These data refer to their respective operating positions in April 1950.

³See Chapter 15.

they may seek to maximize dividend returns provided depositors' funds are properly protected through prudent investment and adequate loss reserves. Still others may strive to facilitate home purchase by reducing interest rates as low as practicable, so long as dividend returns are sufficient to maintain savings capital in tact.

Undoubtedly many institutions pursue the relatively easy course of entertaining mortgage applications whenever tendered, but rarely go outside their own community to attract business. Banks belonging to this category encounter little difficulty in maintaining a sound, well-diversified portfolio if they are located in most suburban residential communities. Such cooperative banks rarely lend to speculative builders, but do finance contract home building on a wide scale through making long-term loans to new home buyers. Other mortgage loans on new or older properties are acquired through local real estate agents, shareholders, or personal contact. These institutions are conveniently located for mortgage operations, and can ordinarily be quite selective in granting loan requests. Certain suburban banks have consistently charged lower rates on real estate loans than have the largest Boston cooperative banks. One bank in an exclusive community west of Boston charges a flat rate of 4 per cent on all new loans, whether they be VA-guaranteed or not. Another realizes an average return of 4.04 per cent on its mortgage holdings, far below the 4.47 per cent earned by the largest cooperative bank in the area. The latter bank charges a minimum of $4\frac{1}{2}$ per cent on uninsured loans, and has enjoyed a continuous growth in mortgage holdings in the postwar period. Within the relatively exclusive A and B communities referred to earlier, however, this institution has generally been less active than smaller local banks which may or may not charge a lower interest rate.

If a bank is less favorably located, mortgage investment poses serious problems. As stated earlier, cooperative banks rarely honor broker commis-

sions, and are prevented by statute or custom from financing speculative builders on an extensive basis. In addition, several Boston banks, large and small alike, are still housed in upper stories of large office buildings, hardly a convenient location for expansion purposes. Other cooperative banks, and particularly federals, which have moved into more adequate business quarters have realized an immediate improvement in operating conditions. The failure of certain institutions to make such a move perhaps reflects a basic indifference toward savings and lending operations in general. Some such institutions record a progressively smaller mortgage portfolio at each reporting date, as old loans are paid off and new ones are rarely made to replenish the stock. Undoubtedly these portfolios would decline even more rapidly if it were not for a considerable volume of refinance activity whereby mortgaged property is sold before maturity with the new buyer seeking a rewriting of the contract. Among the less progressive institutions, share-accumulation loans and traditional serial share capital are still relatively significant. Indeed, one small Boston bank held only cooperative form mortgages in its portfolio as late as 1950, all being carried at a $5\frac{1}{2}$ per cent nominal rate of interest.¹

In summary, proper mortgage investment constitutes an increasingly complex problem for many small cooperative banks in the Boston area. Unless they are fortunate enough to enjoy a favorable location or else possess other unique advantages, they find it extremely difficult to continually make sound new loans on desirable properties. Within Boston alone there are 14 cooperative banks each with total resources under \$3 million. One of these institutions has a portfolio of 90 loans and total

¹As indicated earlier, these smaller banks are rarely members of the Home Loan Bank System.

assets of \$290 thousand. When so few loans are handled, with an average balance of less than \$2,700, the continuing existence of such an institution is somewhat surprising, as economy operations are difficult if not impossible to realize.

Federal Savings and Loan Associations.

Data on mortgage operations of local federal savings and loan associations are scattered and incomplete, so little can be said in regard to specific lending practices. As indicated earlier, growth patterns of the 15 local associations have been most spectacular since the depression years, and by 1951 only two federals had assets of less than \$5 million. While share capital has risen rapidly, mortgage portfolios have risen even more sharply, with the result that all associations have frequently resorted to seeking advances from the Home Loan Bank for supplemental funds. As of December 31, 1951, mortgage portfolios exceeded share capital among 10 local federals, including the three largest members. All but the smallest federals have achieved a significant proportion of their postwar mortgage expansion through financing new construction, whether it be on an operative or contract basis. During the 12-month period ending February 1951, new home construction accounted for a larger proportion of all loans made by the three largest federals than did the purchase of older properties.

The three largest members accounted for 43.5 per cent of aggregate mortgage portfolios held by all 15 local federals in December 1951. Mortgage-asset ratios were roughly 83 per cent among both groups of federals, being slightly above the corresponding ratios for cooperative banks. Although the three largest have borrowed somewhat more heavily than the remaining federals,¹ their current mortgage lending operations appear to somewhat below the average rate for all associations. During the year

¹As of December 1951, Home Loan Bank advances represented 12.3 per cent of total share capital among the Big Three, and 10.0 per cent for all 15 associations.

ending February 1951, new loans among the former accounted for 38.6 per cent of aggregate recordings, thus slightly less than their corresponding share of aggregate portfolios. Federals have aggressively expanded mortgage portfolios in varying degrees since the immediate post-depression period. In recent years, however, the rejuvenated interest in mortgage lending by savings banks has perhaps been more spectacular. During the fiscal year 1950, new mortgage loans made by the 56 local savings banks represented 33.4 per cent of the year-ending portfolio, while the corresponding ratio among the 15 federals was a lesser 30.4 per cent.¹

¹The latter referring to the 12-month period through February 1951.

PART VI. CHAPTER 13. UTILIZATION OF FHA AND VA HOME LOAN PROGRAMS IN BOSTON AREA

Across the nation the home loan programs of the Federal Housing Administration and Veterans Administration have played a prominent role in the postwar housing boom. The former agency has insured institutions against loss in mortgage lending since 1934, while the latter was initially established in 1944 to assist war veterans in purchasing their own homes.

NATIONWIDE DATA

Since the late 1930s, these federal programs have been involved in approximately one-fourth of all mortgage loans made on 1- to 4-family properties. Their importance is far more pronounced in terms of new construction alone, however, as both FHA and VA programs have provided a real stimulus for new home building since the depression period. During the war years, the emergency Title VI provisions were used in most private housing starts, as conventional civilian activity practically came to a standstill. In the postwar years, the FHA and VA programs have assisted in nearly half of all private nonfarm starts across the nation. (See Table I.) Slightly more than half of the loans guaranteed by the VA and slightly less than half of those insured by the FHA have been for existing homes. Since the end of the war, however, the proportion of loans for new homes has risen steadily, representing two-thirds of total recordings in both programs during 1950.

FHA Program

By the end of December 1950, the FHA had insured over 14 million property improvement and home mortgage loans, totaling over \$19 billion.¹

¹Annual Report, HFFA, 1950, pp. 242, 314.

TABLE I. PROPORTION OF MORTGAGE LOANS ON 1- TO 4-FAMILY DWELLINGS AND OF PRIVATE NONFARM STARTS UTILIZING FHA AND VA PROGRAMS, 1936-1951

Year	Total Mortgage Loans Made on 1- to 4-Family Homes (CCO)	Percentage Using FHA Insurance	Percentage Using VA Guarantee	Total ELS Private Starts (CCO)	Percentage Using FHA Insurance	Percentage Using VA Guarantee
1936	2,232	13.8%		304	16%	
1938	2,399	20.1		399	28	
1940	3,287	23.2		530	32	
1942	3,201	30.4		301	54	
1943	3,252	23.5		184	79	
1944	3,857	18.3		139	67	
1945	4,721	10.8	1.5%	208	20	3%
1946	9,470	4.5	11.5	662	10	13
1947	10,657	8.4	14.6	846	27	25
1948	10,834	19.5	8.6	914	32	11
1949	10,820	20.5	6.7	989	36	11
1950	14,800	16.9	11.2	1,353	35	15
1951	n.a.	n.a.	n.a.	1,023	26	15

Source: Housing Statistics, Housing and Home Finance Agency.
n.a. - not available.

Unsecured property improvement loans written under Title I accounted for four-fifths of the number but less than one-fourth of the total dollar volume of insured loan recordings. Such loans have ordinarily been used in connection with the modernization and improvement of single-family homes, with the average loan proceeds being \$406 during the 16-year period through 1950. Among the home mortgages insured by the FHA, three-fourths have been processed under the permanent Section 203 program, while most of the remaining loans were written during the war and early postwar period under Section 603.

As explained in Chapter 8, loan insurance may be terminated in a number of ways. By the end of 1950, over 1.1 million out of the 2.6 million home mortgages insured by the FHA had been terminated, with prepayment in full accounting for over four-fifths of these cases. Most of the remaining terminations resulted from the placement of a new insured mortgage on the property, superseding the old contract. During the 16-year period through 1950, mortgage default and foreclosure occurred in 0.62 per cent of all

insured home loans written, with title to the property being acquired by the FHA in three-fourths of the cases.¹ Foreclosure has been far more prevalent among loans written under provisions of the emergency Section 603 than under the more permanent Section 203. Through 1950, Section 603 loans accounted for two-thirds of all foreclosures despite the fact that their cumulative total represented only one-fourth of all insured home loans written up to that time. A cumulative total of 4,333 small homes insured under Section 203 had been acquired by the Mutual Mortgage Insurance Fund by 1950, for which debentures and cash adjustments had been issued in an amount of \$20.4 million. Of these home properties, 4,172 had already been sold at prices which left a net charge of \$2.4 million against the Fund, or an average of approximately \$585 per case. Certificates of claim issued to the mortgagee holding the defaulted loan were paid off either in full or in some part thereof in nearly 40 per cent of all property acquisitions. In addition, mortgagors shared in any subsequent excess proceeds in 15 per cent of the cases, receiving an average refund of \$264.²

Total losses sustained by the Mutual Mortgage Insurance Fund during the first 16 years of operation were \$2.4 million, representing 0.02 per cent of the aggregate principal amounts insured.³ While this represents an impressive record of achievement, it must be recalled that the FHA has been operating during a period of rising real estate prices and incomes. The real test as to the adequacy of loss reserves, of course, must await a general recessionary period when mortgage delinquency and default become more widespread. Serious administrative problems would undoubtedly arise if the

¹It will be recalled that the mortgagee may elect to retain the foreclosed property himself and thereby terminate the FHA insurance.

²Annual Report, HREFA, 1950, pp. 243-4, 351-3.

³Ibid., p. 346.

FHA were compelled to acquire and handle hundreds of thousands of fore-closed properties, in which event it would function much as another HOLC. At any rate, however, mortgage lending institutions are well protected against loss even if the Fund cannot cope with the task, for FHA debentures are unconditionally guaranteed as to principal and interest by the United States government.

VA Program

Through providing an outright guaranty of up to 60 per cent of an approved home loan, the VA program has aided more than 2½ million returning war veterans in purchasing new and older properties. Through November 1951, home loans with an aggregate principal volume of nearly \$16 billion had been closed, with the guaranteed portion accounting for slightly over half this total. Out of the 2.54 million loans closed, 84 per cent have involved first mortgages, with most of the remainder being of the combination FHA-VA variety.

The VA program differs from that of the FHA in that neither mortgagor nor mortgagee pays any insurance premium whatever,¹ and all loss liability must be assumed by the VA itself. The VA guaranty is automatically terminated when the loan matures or is prepaid in full. On the other hand, lenders frequently relinquish the guaranty if the veteran requests a larger loan or term extension which would be quite acceptable on a conventional basis. Local mortgagees report that seeking the necessary VA approval on such refinance operations entails considerable red tape and is hardly worth the added security gained. When the VA guaranty is dropped, the home owner receives a prompt approval of his request, but frequently is obliged to pay a higher interest rate than the maximum 4 per cent on VA loans. Mortgage default constitutes the remaining major cause for termination of a VA loan guarantee.

¹Most lenders shift all application fees charged in connection with VA loans to the borrower, generally amounting to about \$20.

Through November 1951, over 312 thousand VA-guaranteed loans had been retired in full, representing 11 per cent of all loans closed up to that time. The total number of reported defaults has been nearly as great, although most have been subsequently cured or otherwise withdrawn. By late 1951, claims had been paid on 23 thousand guaranteed loans, with the net amount after refunds aggregating \$23 million.¹ The loss experience on VA home loans, while quite satisfactory, has been far less favorable than that on FHA-insured Section 203 loans. Foreclosure has been necessary in 0.83 per cent of all home loans closed under the VA program, compared with a 0.32 per cent ratio among insured loans. Moreover, net loss sustained as a percentage of original principal amounts guaranteed or insured has shown an even greater contrast between the two programs.² This rather sharp difference in mortgage default and loss perhaps reflects the more liberal appraisal standards of the VA, which approves most loans acceptable to the mortgagee so long as the purchase price does not exceed the VA appraised value. The FHA, on the other hand, has provided a more rounded program, designing and supervising new housing developments as well as underwriting individual mortgage loans.³

Participating Lending Institutions

The offer of mortgage insurance or guarantee has appealed to many mortgage lending institutions across the country. As mentioned earlier, sponsors of the FHA program had hoped that the uniform standards and procedures

¹Finance, Veterans Administration, November 1951. This latter amount is subject to further downward revision from "liquidation of tangible security."

²Net loss on VA loans has represented 0.14 per cent of original principal, but 0.27 per cent of the guaranteed portion; on insured Section 203 loans, the corresponding ratio was .02 per cent through 1950.

³The implications of this distinction will be brought out more clearly throughout this and the succeeding chapter.

prescribed would attract certain large institutional lenders back into the market, especially life insurance companies and commercial banks. By certifying the quality of mortgage credit, the FHA, and recently the VA as well, has induced these institutions to lend on properties located a considerable distance from their respective offices. As seen in Table II, life insurance companies in 1950 were more than twice as important as holders of FHA-insured home loans than as holders of the aggregate mortgage debt on 1- to 4-family properties. In 1949 FHA mortgages comprised 29.6 per cent and VA loans 10.5 per cent of the aggregate nonfarm mortgage debt held by all life insurance companies in the nation.¹

Commercial banks have also invested heavily in insured mortgages, and in 1950 held 30 per cent of all home mortgages insured by the FHA, compared with a 20 per cent share of the total 1- to 4-family mortgage debt. During the immediate postwar period, they were extremely active in the VA program, accounting for nearly 40 per cent of all VA loans closed through 1947. This share has fallen sharply since that time, although guaranteed loans continue to occupy a more prominent position among commercial bank home mortgage portfolios than do FHA-insured loans. In 1950 the former constituted 30.2 per cent and the latter 27.2 per cent of aggregate commercial bank mortgage holdings on 1- to 4-family properties.²

Especially since their respective lending areas have been enlarged, savings banks have become increasingly significant as investors in FHA and VA mortgages. Accordingly, by 1950 these institutions were relatively far more important as holders of insured and guaranteed loans than as holders

¹Life Insurance Factbook, Institute of Life Insurance, 1951, p. 72.

²This refers to all FDIC-insured commercial banks in the country. Operating Insured Commercial and Mutual Savings Banks, FDIC, June 30, 1950, p. 8.

of the aggregate home mortgage debt.¹

The aforementioned institutions, life insurance companies, commercial banks, and savings banks, frequently buy insured or guaranteed mortgages in the secondary market, and are accordingly less important as mortgage originators than as holders of the outstanding debt. By the same token, mortgage companies play a prominent role as originators of both FHA and VA loans, but are relatively unimportant as permanent mortgagees.²

Savings and loan associations have never figured prominently in the FHA insurance program, either as mortgage originators or as permanent mortgagees. The relatively low yield of $4\frac{1}{4}$ - $4\frac{1}{2}$ per cent on such loans, coupled with other equally important factors, has resulted in a minimum of enthusiasm for the whole program.³ These associations have been far more active in extending VA-guaranteed home loans despite the still lower interest return of 4 per cent. Since the early postwar period, the share of total VA loan recordings accounted for by both savings and loan associations and commercial banks has fallen steadily. During the first two years of the VA guaranty program, each of these lender types accounted for nearly 40 per cent of total recordings, but by 1950 their combined share had dropped to 43.3 per cent. This significant continuing trend is perhaps due both to the increasing interest in VA loans among other institutions, especially in the secondary market, as well as to the general tightening in interest rates. Rising dividend rates and yields on alternative investments, including prime conventional mortgage loans, have made the fixed 4 per cent

¹See Table II.

²These agencies initiated 27.6 per cent of all FHA home loans during 1950, but held only 4.1 per cent of the total insured debt.

³See pp. 391 below.

TABLE II. PARTICIPATION OF VARIOUS LENDING INSTITUTIONS IN THE OVERALL HOME MORTGAGE MARKET, FHA, AND VA HOME LOAN PROGRAMS, IN THE UNITED STATES, 1950

Mortgage Item	Total (Millions)	Savings & Loan Ass'ns.	Percentage Distribution					Indi-viduals	Other Mortgages
			Insurance Companies	Commercial Banks	Mutual Savings	Mortgage Companies			
1-4 Family Debt Held	\$46,941	29.3	17.9	20.2	8.2	x	x	24.4	
Dollar Amount of Recordings of \$20,000 or less	16,179	31.3	10.0	20.8	6.6	x	14.2	17.1	
FHA Mortgages Originated	338	10.8	20.8	29.6	7.6	27.6	x	3.6	
FHA Mortgages Held	1,473	8.4	41.9	30.0	11.8	4.1	x	7.9	
VA Mortgages Originated	3,073	21.9	8.0	21.4	9.1	39.1	x	0.5	

Source: Statistical Summary, Home Loan Bank Board; Annual Report, HHFA; Housing Statistics, HHFA.

x - included with "other mortgagees"

return on VA-guaranteed loans progressively less attractive, especially among savings and loan associations. Unlike insurance companies and savings banks, savings and loan associations have seldom purchased insured mortgages in the secondary market to any appreciable extent. They have generally been constrained by custom or statutory regulation from operating beyond their immediate lending area.

Considering the country as a whole, the FHA and VA home loan programs have been a boon for the urban real estate interests. In the first place, home builders have found a vastly expanded market for their product, both in the prewar and postwar periods. Individuals who were otherwise destined to be tenants became active bidders for new and existing homes, providing a vital demand factor in the unprecedented postwar housing boom. Secondly, mortgage lending institutions have become increasingly interested in mortgage investment, whether the properties be located near or far. Indeed a leading savings bank president has characterized Title II loans as "the

answer to a mutual savings banker's prayer."¹ Especially when an FHA firm commitment has been obtained, commercial banks in particular have played a vital role in financing site development operations of speculative builders throughout the country. Even in cases where conventional thrift institutions have been unable or unwilling to take over the permanent mortgage, the mortgage company or builder concerned has often been able to rely upon the FNMA for relief. Up to 1950, this latter eventuality became so widespread via the advance commitment procedure that the FNMA functioned as a virtual first mortgagee.²

FHA OPERATIONS IN THE BOSTON AREA

In sharp contrast to its widespread utilization throughout the nation, the FHA home loan program has been received with limited enthusiasm in the Boston area. A similar indifference to making FHA-insured loans appears to be prevalent throughout much of New England, as data on Massachusetts and adjacent states reflect the same relationships as those for the Boston area alone.

Whereas FHA insurance is currently employed in roughly 1 out of every 6 home mortgages recorded throughout the nation, the corresponding utilization ratio for the Boston area is hardly 1 out of a 100.³ The significant difference in utilization ratios is due in part to the varying rates of new construction activity locally and elsewhere.⁴ As pointed out earlier, the availability of loan insurance has been a boon to home construction across the nation, with the result that new properties were involved in nearly

¹Speech of Levi Smith at 1951 Maine Savings Bank Convention, reprinted in Savings Bank Journal, October 1951, pp. 64-65.

²The role of the FHA in the secondary mortgage market will be considered in the succeeding Chapter 14.

³Interview with Boston FHA officials.

⁴For other perhaps more significant reasons see below.

65 per cent of all insured loans written in 1950. In the local area, on the other hand, new home building has proceeded at a less rapid pace, and was accordingly found in only 42 per cent of the modest 2,178 insured loans made in the Commonwealth in 1950.¹

From its inception the FHA home loan program has played a minor role in the local mortgage market. Indeed, during the entire period 1934-1950, fewer than 16 thousand home mortgages on Massachusetts properties had been insured by the FHA, slightly more than four-fifths of which were written under Section 203. While the Commonwealth houses approximately 3 per cent of the nation's population, its local properties have been represented in but 0.6 per cent of all FHA mortgages. Actually Massachusetts ranks last among the 48 states in terms of dollars of insured home loans made per capita. Although 1949 represents the peak year for insured lending in the Boston Metropolitan Area in terms of absolute dollar volume, the FHA plan was relatively more significant during the prewar and early war years.² When the program was launched, insurance against mortgage loss appealed to many depression-stricken lenders, and accordingly nearly a thousand insured home loans were recorded in 1936. New construction activity was practically at a standstill, so existing properties accounted for a large majority of all insured loans until the late 1930s. Perhaps the FHA amendments of 1938 granting special treatment for new, owner-occupied homes influenced in part the abrupt upward shift in the ratio of "new to all homes" in that year.³

As mentioned above, civilian home construction was sharply curtailed during the war years, with the critical housing needs of war workers receiving the bulk of this diminished volume. In the Boston area, Title VI was widely

¹Annual Report, HHFA, 1950, p. 241. As indicated in Table XII, Chapter 11, the FHA program was utilized in 12 per cent of all new single-family purchases in the Boston Metropolitan Area during late 1950 and early 1951. The combination FHA-VA loan was found in 3 per cent of the cases.

²See Table III.

³See Table III.

used during this period, and in 1942 a peak of 1219 insured loans were made on local 1- to 4-family properties. Eligibility standards on Section 603 loans were significantly relaxed and other concessions were made on such mortgages to make them singularly attractive to local mortgage lending institutions.¹

TABLE III. YEARLY VOLUME OF FHA-INSURED HOME MORTGAGES* MADE ON 1- TO 4-FAMILY DWELLINGS LOCATED IN THE BOSTON METROPOLITAN DISTRICT, SELECTED YEARS, 1935-1950

<u>Year</u>	<u>Number of Mortgages</u>	<u>Number of Units</u>	<u>Amount</u>	<u>Ratio of New to all Homes</u>
1935	565	n.a.	\$3,072	13.5%
1936	970		5,211	34.6
1937	572		2,979	24.2
1938	628		3,374	66.5
1939	440		2,249	61.8
1940	747		3,516	69.4
1941	565		2,429	n.a.
1942	1219		5,680	
1945 ^x	63		272	
1946 ^{xx}	22	23	98	
1947	60	82	501	
1948	448	466	3,402	
1949	917	985	6,968	
1950	667	727	5,095	

Source: Federal Housing Administration, Division of Research and Statistics

* Refers to net firm commitments under Sections 203 and 603.

^x Includes only July through December data for Section 203.

^{xx} Includes only July through December data for Section 603.

n.a. - not available.

In the postwar era, insured lending has continued at a modest pace while the local market has witnessed a housing boom of unprecedented proportions. Indeed, the number of loans made under Sections 203 and 603 was smaller in 1949 than in 1936, the latter year hardly being one of brisk housing activity. Though data are not available on a local basis, it is likely that existing construction has accounted for a majority of the postwar volume of insured loans, in contrast to the predominant role of new

¹See Chapter 8.

construction during the prewar years. The reasons for this rather unusual observation will be advanced shortly.¹ Single-family dwellings have predominated postwar insured lending under Sections 203 and 603 in the local area. During the 5-year period through 1950, the ratio of "units" to "number" of mortgages was roughly 1.1, indicating that single-families have accounted for over 90 per cent of all home mortgages insured.²

Title I Activity in the Boston Area

Insured lending under Title I of the FHA program has received a much wider acceptance in the local area than has either Title II or VI. In Massachusetts, 26 thousand Title I loans were made during 1950, nearly all of which concerned the repair, alteration, and improvement of existing properties. New low-cost homes have been eligible for long-term insured loans under this title also, but the bulk of this activity has been confined to the states of California, New York, and Texas.³ While Massachusetts ranked 35th in terms of insured mortgages written on local home properties during the 16-year period through 1950, it was 10th among the 48 states in terms of Title I operations. By 1950, over 325 thousand home improvement loans had been made in Massachusetts, over 20 times the cumulative total of insured home loans written. Despite the fact that the average amount was \$404 on Title I loans against \$5.7 thousand on Sections 203 and 603 loans, the former has actually been more important in terms of total dollar volume. Local Title I loans had aggregated \$132 million through 1950, while insured home mortgages had reached only \$87 million.⁴

¹See "FHA as an Aid in New Construction" below.

²This corresponds rather closely with the structural breakdown of new housing in the Boston area, (see Chapter 3), but places a greater emphasis upon single-families in relation to the distribution of existing properties.

³Accounting for over one-half of all such new home loans. Annual Report, HHFA, 1950, p. 315.

⁴Ibid., pp. 242, 314.

Generally written for terms of less than 3 years, Title I home improvement loans have appealed to commercial banks in particular as a profitable and safe investment outlet. When due allowance is made for the discount procedure prescribed, the effective yield on such insured loans is well over 9 per cent. Throughout the nation, national banks accounted for nearly half of all Title I loans made between 1934 and 1950. State banks, industrial banks, and savings banks accounted for another 28 per cent of this cumulative total, with finance companies dominating the remaining portion.¹ Ordinary thrift institutions, including savings banks as well, have concentrated their lending operations on long-term mortgages, and have not been equally active in making unsecured home improvement loans. Local thrift institutions are authorized to make these latter loans whether they be insured or not, but such activity is supplementary to their other mortgage operations.

Local Thrift Institutions in Insured Home Mortgage Lending

Very little data are available regarding the geographic area covered by the insured loans held by local thrift institutions. It is known, however, that loan insurance has rarely been sought in connection with the purchase of local home properties. As a result, loans on properties located outside the immediate vicinity as well as in other regions throughout the country dominate insured portfolios of local lenders. Largely because of the increasing significance of purchases in the secondary market, the geographic distribution of insured mortgage holdings may bear little or no relation to the location of secured properties.²

The relative importance of insured, guaranteed, and conventional loans among residential mortgage holdings of the major lender types in the Boston area is indicated in Table IV.

¹Ibid., p. 316.

²See pp. 376-377 below.

TABLE IV. RESIDENTIAL MORTGAGE HOLDINGS OF MAJOR LENDER TYPES IN ESSEX, MIDDLESEX, NORFOLK, AND SUFFOLK COUNTIES, MAY 31, 1951
(Dollar Amounts in Millions)

<u>Lender Type</u>	<u>FHA- Insured</u>	<u>VA- Guaranteed</u>	<u>Conventional</u>	<u>Total</u>
Commercial Banks*	\$ 22.3	\$ 24.5	\$ 68.7	\$ 115.5
Savings Banks	77.6	199.5	412.0	689.1
Savings and Loan Associations	5.9	156.3	316.8	479.0
Insurance Companies	116.6	55.6	199.7	371.9
All Others	0.4	1.3	19.1	20.8
Total	\$222.8	\$437.2	\$1016.3	\$1676.3

Source: Federal Reserve Bank of Boston

* Does not include trust departments.

As of May 31, 1951, insurance companies held slightly over half (52.4 per cent) of all FHA-insured loans held by mortgage lenders in the local four-county area. At the same time insured mortgages accounted for 31.4 per cent of the residential mortgage debt and 16.8 per cent of the aggregate mortgage debt held by these companies.¹ That these loans are primarily secured by distant properties is suggested by the fact that loans on Massachusetts properties accounted for 0.17 per cent of all FHA-insured loans owned by all U. S. life insurance companies in 1949.² Furthermore, the FHA plan was used in 3.3 per cent of all nonfarm loans on Massachusetts properties, while the corresponding ratio for the country as a whole was 29.6 per cent.

Next in importance as holders of FHA-insured loans are the local savings banks, which held 34.8 per cent of the outstanding insured mortgage debt in the four counties in 1951. This volume also represents 11.2 per cent of the residential mortgage debt held by the savings banks included in this group. The exact proportion of these holdings related to local properties is not known, but it is probably less than 20 per cent of the total. In 1951 only

¹Undoubtedly large multi-family properties are far more important among insured holdings of insurance companies than of other local thrift institutions. In the case of one local company visited, Section 608 loans were over 4 times as large in dollar volume as all insured home loans combined. Hence, these data above perhaps exaggerate the importance of insurance companies in the FHA home mortgage program.

²Life Insurance Factbook, 1951, p. 72.

14 savings banks in the immediate Boston vicinity held any FHA-insured loans whatever on in-state properties, with the volume of such loans representing 2.3 per cent of aggregate mortgage holdings of all 56 banks.¹ Furthermore, out of these 14 savings banks, local insured loans represented over 4 per cent of aggregate portfolios in only three cases, with the ratio being 18 per cent in the case of one of the Big Five.² Many of these insured loans were written under the emergency Title VI program during the war and early postwar years, with the result that outstanding balances are declining steadily. Indeed, only one local bank, a \$25 million institution, appears to be consistently active in originating and holding insured loans on Massachusetts properties.³ Some of the larger savings banks have never originated local insured loans on a large scale, but have frequently made block purchases in the local secondary market. Although this activity has not been extensive in the Boston area, the FNMA and lenders seeking added liquidity have a various times sold such loans on the open market.⁴

Life insurance companies and savings banks held over 87 per cent of the FHA-insured mortgage debt held by all local mortgage lenders in 1951, with an additional 10 per cent being held by commercial banks. Insured loans, as mentioned earlier, hold an especial appeal for commercial banks and insurance companies, as the quality of the mortgage is essentially underwritten by the government. Accordingly, insured loans represented 19.3 per cent of aggregate mortgage holdings of local commercial banks in 1951, a proportion

¹Even where in-state properties are involved, a significant proportion is located outside the immediate area.

²Insured holdings on in-state properties exceeded \$100 thousand in only 9 savings banks and were less than \$10 thousand in 4 cases.

³The latter bank has used the FHA program to great advantage in connection with financing site developments.

⁴In the 3 years for which these data are available, 1942, 1947 and 1950, savings banks accounted for 43 per cent of all purchases of insured loans from FNMA on Massachusetts home properties; next in importance, in order, were insurance companies, savings and loan associations, and national banks. FHA, Division of Research and Statistics.

exceeded only by insurance companies. Once again, these extensive insured mortgage holdings are concentrated primarily on properties located outside Massachusetts. Whereas FHA-insured loans accounted for 27.2 per cent of aggregate mortgage holdings of all insured commercial banks in the country in 1950, the corresponding ratio for Massachusetts 1- to 4-family properties was 6.1 per cent.¹

Last to be considered here as permanent FHA mortgagees are savings and loan associations. These associations, both state- and federally-chartered, held 2.6 per cent of the total insured mortgage debt held by all local lenders in 1951. At the same time, insured loans comprised only 1.2 per cent of aggregate residential mortgage holdings of all local savings and loan associations. In contrast to other major FHA-mortgagees, however, lending operations of savings and loan associations are largely confined to properties located near the lending institutions. Hence, if only in-state properties are considered, insured loan holdings are but slightly less significant among local savings and loan associations than among savings and commercial banks.

Among the 15 federals organized within the Boston vicinity, seven held some FHA-insured loans in their respective portfolios in 1950. These loans represented 3.6 per cent of aggregate mortgage holdings for the entire group, and exceeded 7 per cent in the case of three local associations. A large proportion of these insured loans were undoubtedly placed on the books before the postwar period, with the result that the outstanding balance is steadily declining. At least four federals, however, did add to their respective insured loan balances during 1950, either through origination or through the purchase of existing mortgages from other associations seeking added liquidity.

¹ Operating Insured Commercial and Mutual Savings Banks, op. cit. p. 8.

Cooperative banks have perhaps participated in the FHA home loan program less than any other major institutional group in this area. In 1951 only 14 of the 76 cooperative banks in the Boston vicinity held any insured loans whatever, with their modest value of \$1.4 million representing 0.5 per cent of aggregate mortgage holdings. These ratios were considerably smaller during the early postwar years, as insured loans constituted a trifling 0.17 per cent of aggregate mortgage holdings as late as 1948. The sharp increase in insured loan holdings from \$394 thousand to \$1,254 thousand during the ensuing 2 years reflects an unusually large volume of new lending on the part of three local banks. One of these three banks had never made any FHA-insured loans before, and insured holdings of the other two increased tenfold during this brief interval. This sudden interest in the FHA program perhaps reflects a desire on the part of a few banks to minimize overall risks of lending during inflationary periods by seeking the protection of FHA loan insurance.

It is interesting to note that insured lending by cooperative banks has been concentrated in two quite dissimilar situations. The more recent case was mentioned above and the earlier occurred during the middle and late 1930s. After the depression had inflicted severe losses upon local mortgage lenders, many institutions were reluctant to re-enter the mortgage market for several years. Savings banks, for example, largely withdrew from active mortgage lending, preferring to place savings inflows and other funds in government bonds rather than in "risky" mortgage channels. Cooperative banks and particularly federals were far more anxious to enlarge mortgage holdings during the prewar recovery. At this time, insurance against loss appealed to certain of these lenders as the inherent risks in mortgage lending were still fresh in their minds. By 1940, 18 cooperative banks in the Boston vicinity had made some insured loans on local properties, but their combined

volume represented only 0.4 per cent of aggregate mortgage holdings.

Following this half-hearted interest, however, cooperative banks withdrew almost completely from insured lending, and existing balances fell steadily to 1948.

As indicated in the preceding chapter, federals and cooperative banks were genuinely interested in lending on new construction during the prewar recovery. Savings banks, on the other hand, were less anxious to finance and supervise such activity, and ordinarily preferred to concentrate on older properties. This sharp difference in lending policy is reflected in data presented in Table V.

TABLE V. TYPE OF INSTITUTION ORIGINATING FHA-INSURED HOME MORTGAGES IN BOSTON METROPOLITAN DISTRICT, 1940

<u>Type of Institution</u>	<u>Per Cent Distribution of Amount of Loan</u>		
	<u>New Homes</u>	<u>Existing Homes</u>	<u>All Homes</u>
National banks	14.4	9.7	12.7
State banks	3.3	10.2	5.7
Savings and loan associations	52.9	4.4	35.7
Mortgage companies	3.6	.4	2.5
Insurance companies	11.4	5.4	9.3
Savings banks	14.4	68.6	33.6
All others	-	1.3	.5
Total	100.0	100.0	100.0

Source: Federal Housing Administration, Division of Research and Statistics.

FHA an Aid in New Construction

While most local mortgage lenders have chosen to refrain altogether from insured lending, some have expressed a genuine interest in the FHA program. Although most insured loans made locally involve older properties, the interest among certain lenders revolves primarily about new construction, where the FHA provides valuable assistance in planning and supervising site developments. This assistance is particularly appreciated when the proposed construction involves special risk factors with which the lending institution is either unfamiliar or unwilling to assume without FHA protection. For example, FHA insurance is frequently sought whenever local lenders finance

speculative builders in communities located outside their ordinary lending area. The lender may be unaware of peculiar risk characteristics involved in such operations and is virtually prevented from making continuing investigations during the production period.¹

Along a somewhat different vein, local mortgage lenders have financed prefabricated housing projects to a considerable extent under the guidance and protection of the FHA. While they may be sympathetic to the notion of prefabrication, most lenders are frankly skeptical of the long-run durability and acceptability of such housing under existing technology. Rather than deny builders and prospective home owners the opportunity to deal with such housing, several lenders have willingly financed their erection provided loan insurance is forthcoming. It should be mentioned that the local FHA underwriters have generally been most cooperative with prefabricated home dealers, so long as the manufacturer and erection crews are of reputable quality.

When the promoter of a new housing development submits his site plans to the FHA for processing and approval, the financing institution is safeguarded against an unsound investment. Before preliminary approval is granted, the proposed development must pass a series of rigid qualifying standards. The underwriting staff examines each individual home in regard to its structural soundness, livability, placement on the lot, adaptability to the terrain, etc. Furthermore, the home must blend in harmony with the neighborhood into which it is placed, with reference not only to architectural or aesthetic qualities but also to the general market value of surrounding properties. The FHA seeks to plan well-balanced site developments,

¹The Cape Cod area is a case in point. See pp. 385-386 below.

so that the individual properties concerned will continue to represent acceptable security for mortgage purposes for many years hence.

After the planning stage is completed and preliminary approval granted, the FHA makes a series of thorough inspections during the ensuing construction period. Some lenders regard such examinations as sufficient in themselves, and rely largely upon FHA judgment as a satisfactory criterion of acceptability in passing on loan applications. Others, however, feel morally obligated, both on behalf of their own depositors as well as the FHA itself, to maintain the same close check on all construction activity which they are financing. Even though the FHA substantially insures them against loss, these lenders regard it their responsibility to minimize mortgage delinquency and foreclosure at every possible juncture. Furthermore, in the event of default and acquisition by the FHA, mortgagees are reimbursed for foreclosure costs only so far as subsequent revenues from disposition of the property warrant.

The FHA plan is particularly attractive in new construction activity when firm commitments are issued by the insuring office. Under this arrangement, the builder may qualify as a bona fide mortgagor in case the property is not sold upon its completion. Where the alternative conditional commitment is issued, the FHA agrees to insure the mortgagee against loss only after an acceptable buyer is found. Although the former arrangement is preferred by the mortgagee, the FHA has granted firm commitments only where marketability appears practically assured. In the Cape Cod region, for example, the local office agreed to issue such commitments only so long as demand for new housing was especially active.

In spite of these decided advantages, some local mortgage lenders genuinely interested in insured lending have encountered difficulty in using FHA facilities in securing loans on new properties. In the first place, many speculative builders are reluctant to operate under the guidance and control

of the FHA. This attitude is in direct contrast to that in other sections of the country where FHA approval of a builder's operations is regarded as a treasured seal of approval.¹ In this area, however, many builders prefer not to have their site plans scrutinized and modified by an outside federal agency. Furthermore, they do not appreciate the possible duplication in compliance inspections when both lender and FHA take an active interest in the new construction. Undoubtedly if FHA approval were more highly regarded in this vicinity, the possibility of uneconomic "jerry building" might be effectively minimized, and even selling prices more moderately set in certain cases.² Under present conditions certain lending institutions may be induced to finance speculative builders but lack the staff necessary to maintain a proper check on construction progress, let alone critically analyze the initial site plan. Before the FHA approves a proposed site development, the promoter or builder must submit detailed plot plans, surveyor's maps, etc., whereas some lenders are apparently ready to act upon the perusal of a simple house plan. Certain FHA provisions, such as requiring a minimum lot frontage exceeding local building code specifications, may perhaps seem superfluous and an unnecessary addition to total costs of construction. On the other hand, the FHA seeks to protect the long-run interests of owner, lender, and community at large, and accordingly regards these standards as an essential phase of their underwriting operations.

In the event the builder refuses to submit to FHA construction rules and supervision, he generally encounters little difficulty in securing conventional financing. Provided his reputation as a businessman and builder

¹It should be mentioned that an FHA official referred to a local builder who "really learned how to be successful" while operating under the guidance of the FHA during the prewar years. In recent times, however, while he continues to apply these valuable aids, he no longer feels the need for dealing with FHA, as liberal financing can readily be secured without it.

²See "Capital Surplus Area" below.

is satisfactory, he has been able to bypass the few lenders favoring FHA and deal with other institutions. If certain features of the proposed development, such as builder reputation, construction design or technique, price class, etc., appear to entail undesirable risk elements, the thrift institution may refer the builder to specialized construction lenders for short-term credit.¹ After construction is satisfactorily completed, however, most institutions are once again anxious to secure the permanent financing, even offering a 1 per cent finder's fee for it in many cases. Hence, even though the new property may incorporate certain undesirable risk elements apparent at the time of construction, mortgage lenders are still willing to accept it as security for a liberal long-term mortgage. Certainly such risk is minimized if the home buyer meets the necessary credit standards. The fact remains, however, that rejection of a proposed construction project by the FHA or by conventional lenders themselves on the basis of unsound security does not imply an abandonment of the project. Indeed, it may be carried out in the same minute detail regardless of such rejection.

Even if neither lender nor builder is opposed to the idea of FHA insurance, conventional financing may still be dictated, on grounds that the home buyer would refuse an insured loan anyway. This latter supposition does not imply any a priori mortgagor antipathy toward loan insurance. It merely implies that he may be able to secure a permanent loan at rates below the prevailing FHA maximum, either through a conventional or a VA-guaranteed home loan.² In the past this eventuality has been a little concern, as lenders who were interested in the FHA program primarily during the construction period would readily drop the FHA commitment as soon as a buyer acceptable for either conventional or VA financing was found. This activity has

¹See "Construction Loans", Chapter 12, for a discussion of these lenders.

²See "Reasons for Low Level of FHA Operations in the Boston Area," below.

been effectively reduced by a recent FHA ruling whereby the builder is required to deposit \$45 per unit as an initial application fee, \$25 of which is refunded only if the permanent mortgagor retains loan insurance. While a \$25 loss is not damaging in itself, the builder may not be enthusiastic about FHA operations when this contingent loss is added to the other detail involved in dealing with the agency. In order to maintain builder interest in the FHA, at least one local savings bank offers the former a 1 per cent finder's fee if the permanent uninsured loan is retained with the same bank. This particular institution offers the home buyer a choice of FHA, VA, or conventional financing, provided he meets the corresponding eligibility requirements. A typical percentage breakdown among these 3 types has been 35-50-15 in new site developments.¹

Local lenders interested in the FHA program have found the Cape Cod area singularly attractive for making long-term insured mortgages. The Cape is located far enough away from the Boston vicinity so that loan insurance has an especial appeal for some lenders who prefer conventional financing locally.² Builders in that area apparently regard the FHA insured loan program as valuable if not essential in maintaining a continuing volume of construction activity. Furthermore, the prevailing interest rate on conventional loans of 5 per cent renders the insured loan an attractive proposition for the home buyer as well, as the gross rate maximum on the latter is $4 \frac{3}{4}$ per cent.

VA Home Loan Program in the Boston Area

In contrast to the FHA home loan program, the loan guaranty program of the Veterans Administration has been widely received in the Boston area. Whereas Massachusetts ranks 35th among the 48 states in terms of insured

¹The reasons for this relatively high proportion of insured loans are given immediately below and on pp. 380-381.

²For reasons given above, p. 381.

lending, it is sixth in writing VA-guaranteed loans. Through November 1951, nearly 114 thousand home loans had been approved for insurance, with a principal amount of \$793 million and a guaranteed portion of \$367 million.¹

With the sole exception of life insurance companies, the dollar volume of VA-guaranteed loan holdings have exceeded that of FHA-insured loans among all major lending institutions in the area. Although the VA program has not been analyzed in detail in this study, its influence on the local mortgage market is most significant and hence merits brief reference here. According to sample findings of the Bureau of Labor Statistics, the VA-guaranteed loan has been used in slightly more than one-half of all new home purchases in the Metropolitan Boston Area in recent years. Some mortgage officers indicate that "patriotism" has prompted them to engage in this low-profit business, but competition among rival lenders has certainly been at least equally important in forcing its almost universal acceptance.

The VA program has enjoyed wide appeal among local savings banks and savings and loan associations. The Federal Reserve has found such loans to constitute nearly one-third of aggregate mortgage holdings of these institutions in the local four-county area.² An unknown proportion of guaranteed loans held by savings banks represents mortgages purchased in the secondary market, but the extent of this activity is somewhat less than in the case of FHA-insured loans. All but one small savings bank held VA-guaranteed loans on local properties in 1951, comprising in the aggregate 22.0 per cent of total mortgage holdings. Local federals and cooperative banks, many of which charge 5 per cent on conventional loans, have generally approved most 4 per cent VA loan requests without hesitation. In 1951 guaranteed loans represented 28.8 and 30.6 per cent of aggregate mortgage holdings of local federals and cooperative banks, respectively. Only three of the smallest cooperative banks in the Boston area have failed to write any

¹Finance, VA, November 1951, p. 68.

²See Table IV.

VA loans, largely because of the substandard 4 per cent return. It is very likely, however, that the non-participation of these institutions reflects an overall indifference toward mortgage lending, for cooperative-form mortgages continue to dominate their respective portfolios.

Commercial banks have resembled savings banks in their policy toward holding insured and guaranteed loans. That is, among all Massachusetts commercial banks, VA-guaranteed loans represented 28 per cent and FHA-insured loans 6.1 per cent of aggregate home mortgage holdings on in-state properties in 1950. In terms of aggregate mortgage holdings, however, the corresponding ratios were 21.2 and 19.3 per cent, respectively, one year later.¹ This sharp contrast between the ratios on local as opposed to total mortgage holdings reflects the disproportionate interest in higher yielding FHA-insured loans among local banks when dealing in the secondary mortgage market. At the same time commercial banks, just as savings banks, are generally disinterested in making insured loans on local properties.² As a result of secondary market operations, guaranteed and insured loan holdings of local banks as a share of aggregate holdings differed but slightly from the corresponding ratios for all banks in the nation.³

Insurance companies have traditionally been less bound by law and custom to confine most mortgage operations to a restricted area, and have hence been more conscious of net yields on alternative investments throughout the nation. A local insurance company executive indicates that this firm's mortgage portfolio is dominated by conventional loans made in progressive communities,

¹The former ratios apply to 1-to 4-family loans held by all FDIC-insured banks in Massachusetts. Operating Banks, op. cit. p. 8; the latter, to aggregate residential mortgage holdings of local (four-county) banks as reported by the Federal Reserve.

²Local FHA officials indicate that three of the largest commercial banks in Boston proper occasionally finance speculative site developments under FHA guidance but refer the permanent financing to savings banks, where a finder's fee is paid and, incidentally, the insurance provision is generally dropped.

³The latter being 30.2 and 27.2 per cent for VA and FHA loans, respectively, in mid-1950. FDIC, op. cit., p. 8.

where a minimum gross yield of 5 per cent is realized. The somewhat more favorable yield on FHA-insured relative to VA-guaranteed loans accounts in part for the more prominent role played by the former among mortgage portfolios of local companies. The availability of FHA insurance on large income-property loans, such as under Section 608, also contributes to the lesser relative importance of VA home loans among local companies. Among the six life insurance companies in Suffolk County, VA loans represented 14.9 per cent of aggregate residential mortgage portfolios in 1951.¹

The VA home loan program has been a primary force underlying the demand for new housing in the postwar period. By underwriting liberal credit extension, it has provided veterans an opportunity to purchase new and existing homes with little or no equity savings. Indeed, if mortgage lenders were to relax down payment requirements from 20-40 per cent to 0-10 per cent, the resultant impact upon the demand for home purchase would ordinarily be substantial. Similarly, a liberalization of other provisions of the home mortgage contract might be expected to exert a direct influence on the housing market concerned. As in any reasonably free market, a marked increase in demand for a product might provoke an immediate price advance. In addition, new and existing producers would be induced to step up output and expand plant capacity, especially if the demand increase appeared permanent. If, however, the economy were already operating in a virtually full employment situation, the outward shift in demand would be largely expended in price adjustments. This latter condition has been characteristic throughout much of the postwar period, despite the record levels of new home production attained. The continued upward pressure upon housing prices and new construction at least during the early postwar years was due in no small part to

¹Table XII. Among all companies in the country VA loans in 1949 accounted for 10.5 per cent of the total nonfarm mortgage debt held, but only 2.5 per cent of the debt on Massachusetts properties taken alone. Life Insurance Factbook, 1951, p. 72.

the liberal VA home loan program. The returning veteran was most interested in purchasing a house adequate to meet his pressing needs and was perhaps less concerned with price itself than with the equity down payment and monthly carrying charges required to service the mortgage.

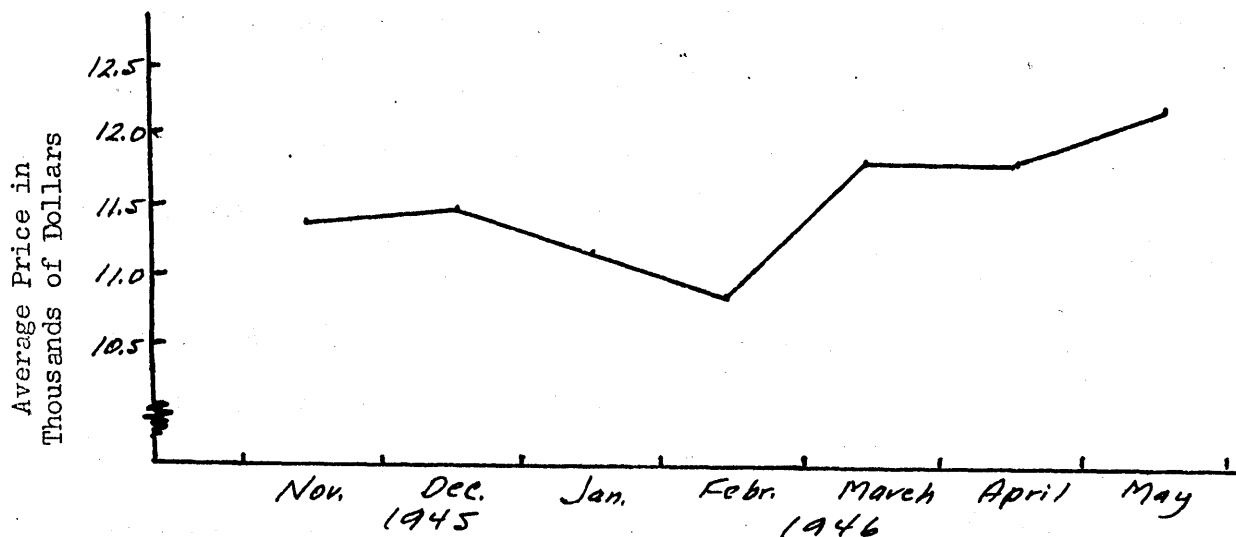
In a buyer's market more liberal credit facilities might induce potential home purchasers to acquire more adequate housing accommodations without any increase whatever in total monthly debt service. In a seller's market, however, when choice is restricted and sales terms virtually set by the seller, more liberal credit availability is likely to be absorbed in substantial price advances. In late December 1945, the Servicemen's Readjustment Act was amended so as to increase the maximum guarantee from \$2,000 to \$4,000. This relaxation in effect reduced the equity down payment required for home purchase, as the lender would presumably feel justified in making a larger loan for a given property purchase. Partly because of this liberalization, the average amount on partially guaranteed loans made in 1946 increased by 31 per cent over the previous year. That the guaranty program heavily influenced this movement is evidenced by the considerably smaller dollar advance in new loans not involving the VA provisions. Between 1945 and 1946 average loan amounts on both FHA-insured loans and on all non-guaranteed mortgages increased only 10 per cent.¹

Data are not available to formulate a similar set of relationships for the local housing market, but it is possible to compare average prices paid for new and existing homes in late 1945 and early 1946. In order to consider communities where the veteran was quite likely to seek his own home, five cities of brisk construction activity were selected. All home purchases are recorded with the local county registry of deeds, and the purchase price is roughly indicated by the stamps required in recording the title transfer.

¹E. M. Fisher, Urban Real Estate Markets, and Their Financing Needs, op. cit., Chapter IV.

All of these recordings are quoted in the weekly Banker and Tradesman, generally entailing a lag of 3-4 weeks between the point of sale and its subsequent reporting. As indicated in Chart I, the liberalization in the VA home loan program in December 1945, did not prompt an immediate increase in average purchase price. Nevertheless, beginning in March a decidedly higher level is in evidence and, if due allowance is made for the lag in reporting home purchases, the above amendment may have exerted a direct upward influence on prices. Obviously it is impossible to isolate the precise effect of this amendment, but it has undoubtedly contributed to the persistent rising trend in current home prices during the early postwar years.

CHART I. AVERAGE PRICE PAID FOR HOMES PURCHASED IN FIVE COMMUNITIES*
IN LATE 1945 AND EARLY 1946



Source: Computed from data reported by Banker and Tradesman.

* Includes homes with purchase price of \$20,000 or less within the following communities: Arlington, Belmont, Lexington, Newton, and Winchester.

Reasons for Low Level of FHA Operations in the Boston Area

The preceding sections have indicated the striking difference in the relative utilization of the FHA and VA home loan programs in the local area. Before summarizing the reasons underlying this curious local development,

the characteristic reluctance of savings and loan associations to the FHA plan throughout the nation will be briefly considered. As shown in Table II, these associations hold nearly a third of the aggregate 1- to 4-family mortgage debt, but less than a tenth of the insured home mortgage debt.

Opposition of Savings and Loan Interests. From the outset, savings and loan interests looked upon the FHA as a dangerous threat to their very existence as dominant mortgage lenders, fearing that large commercial banks and life insurance companies would be attracted into the nationwide market with added vigor. Mortgage insurance would appeal to institutional investors with vast stores of idle funds, but such was hardly characteristic of the depression-ridden associations during the mid-1930s. The latter were not at all anxious for large outside investors to enter their traditional lending areas by writing insured mortgages at interest rates substantially below existing levels. Rejecting federal mortgage insurance as most unsatisfactory, savings and loan associations regarded an accelerated inflow of share capital as the only sound means of stimulating a recovery in new home construction. Accordingly, their own interests were best served through promoting the various federal measures centered in the Home Loan Bank, such as share insurance, HOLC activities, chartering of federals, etc.¹

Savings and loan associations have traditionally made mortgages on a local basis, and have been little concerned with the marketability of the paper, at least until the postwar period. Especially when they are able to tap the central reserve facilities of the Home Loan Bank System, the typical association can generally meet most liquidity requirements with conventional amortized portfolios. For other institutions, however, which either write mortgages for resale to others or else require marketability

¹ These programs are all described in Part IV.

in their own portfolios, loan insurance is of inestimable importance.¹

At any rate, savings and loan associations have regarded the FHA program as an unnecessary and unsound competitor of their own time-tested methods of mortgage finance. Instead of working hand in hand, savings and loan interests have frequently been prompted to make such statements as: "We have had no trouble meeting FHA competition. . . ."² As stated earlier, some local associations made a limited number of insured loans during the early years of the program when mortgage risk and loss were still paramount in the minds of their investment committees.

Administrative Detail. A variety of additional reasons may be advanced to account for the disinterest of local thrift institutions in insured lending. The most common reason given by interviewed lenders concerns the costly and time-consuming detail required in dealing with the FHA. They point to the typical bureaucratic bungling and unnecessary red tape associated with all applications for loan insurance. The FHA requires detailed plot and house plans and other items which are admittedly desirable but do entail additional effort on the part of all parties concerned. Furthermore, a typical application may require at least a 30-day delay before a final decision is handed down as to its acceptability. Rules and regulations, as well as the numerous forms involved, change frequently and many lenders prefer not to keep up with it. This latter factor suggests the desirability of a lender's either offering no FHA-insured loans whatever or else engaging in the activity on an extensive scale. Indeed, the few interviewed lenders who do continue to write insured mortgages prefer a steady volume of such business so that mortgage personnel may keep abreast of current procedures.

¹ In the following chapter, the participation of these various lender types in the secondary market will be reviewed.

² Statement of Morton Bodfish, TNEC Hearings, Part II, p. 5099.

Several of the visited bank executives refuse to make insured loans because of a decided antipathy toward any extension of federal influence into hitherto private fields. Their attitude is equally adamant toward other permanent federal efforts in home finance, such as the chartering of federal savings and loan associations as well as the spreading of share and deposit insurance. The Home Loan Bank System and the VA home loan program represent notable exceptions to this characteristic attitude. An officer of the local Home Loan Bank attributes its successful reception to a policy of maximum cooperation but minimum interference with the mortgage operations of member institutions. Some reasons for the success of the bureaucratic VA program will be discussed shortly.¹

Undoubtedly the local FHA officials are partly at fault for the lack of interest in insured lending in the local market. Nearly every lender visited referred to the decidedly uncooperative attitude which pervaded the local underwriting office when the program was launched. In contrast to the Home Loan Bank leaders, these FHA officials were "nothing but a bunch of unsuccessful architects and brokers." Many lenders were moderately interested in the idea of loan insurance in the late 1930s and accordingly submitted several applications to the newly-created agency. In nearly every case, however, their respective requests were rejected, either because the desired loan amount was too high or else because the multitudinous forms were not completed in every detail. Some local bank executives even went to Washington on various occasions in order to improve this situation, but to little avail. Frequently new personnel were sent to the Boston office, but the same uncooperative attitude allegedly persisted well into the early postwar period. As a consequence, many lenders were unimpressed with the FHA program from the outset, and have never bothered to utilize its provisions again. One mortgage officer regards the whole scheme as unnecessary

¹Pp. 395-397.

duplication of effort already performed by properly managed lending institutions, and accordingly does not feel justified in paying an insurance premium to support it.

There is undoubtedly some justification for these claims that personalities have retarded the development of local insured lending. Even some local FHA personnel now admit that the crusading officials in the prewar period were quite uncompromising in coping with the equally determined Boston mortgage bankers. The present staff appears to be well aware of this serious problem, and seeks a means of convincing more lending institutions of the virtues of insured lending. They have frequently called on various lenders in order to promote a more genuine feeling of cooperation in promoting their common goals in the mortgage market. They have also sought to answer charges of unnecessary red tape by offering to assist bank personnel at any time in completing the necessary forms and other procedures. This new attitude has induced some lenders to submit a few mortgage applications for loan insurance, but a vast majority continue to utilize the FHA provisions only in distant lending if at all.

A local FHA official believes that savings banks were disinterested in the loan insurance program during the prewar period because of a possible threat to their continuing dominance in the local mortgage market. These institutions were realizing a steady flow of income from long-standing mortgages on 2- to 4-family properties. Such loans were written on a 3-year demand basis, and represented a highly desirable investment so long as the rented portions were continually occupied. Indeed, many banks preferred to reap such interest returns for an indefinite term and even discouraged substantial principal repayment by convincing the mortgagor of the "superiority" of a larger savings account. The FHA threatened to upset this easy investment program by promoting the increasingly popular direct-reduction type mortgage. This new plan would appeal to tenants who were

now afforded an opportunity to purchase their own homes through making monthly rent-like payments, thereby jeopardizing the soundness of existing mortgages on multi-family flats. Furthermore, existing mortgagors perhaps also learned of the advantages of direct-reduction loans, and sought a rewriting of their own unamortized mortgages. This latter would involve additional costs of loan servicing and other modifications, changes which most savings banks were reluctant to make at that time.

FHA Foregone in Favor of VA. Perhaps a primary though infrequently mentioned factor accounting for the low level of insured lending in the Boston area concerns the widespread acceptance of the VA home loan program. The extreme contrast in the relative utilization of these federal programs is aptly manifest by the confusion in evidence as to the points of difference between them. All parties interviewed appeared to be well versed on the guaranty features of the VA scheme, but at least one bank officer had always believed the FHA plan was similarly organized and was unaware of the mutuality of the insurance fund.¹ Many lenders who are opposed in principle to the interventionary efforts of the FHA regard the veterans guaranty program as providing an expedient solution to the critical housing shortage. The former program has set forth lofty, long-run goals in connection with its loan insurance feature, whereas the latter seeks merely to alleviate an emergency situation.

Since the VA program is of a temporary nature with strong "patriotic" overtones, some lenders feel justified in supporting its operations without contradicting their standing objection to the spread of federal influence into this area. If, on the other hand, the VA program had not been established at all, it is conceivable that local mortgagees would have displayed a more sympathetic attitude toward insured lending. They might have found loan insurance decidedly advantageous in fortifying themselves against loss on

¹Several thought the maximum interest rate on insured loans was still 5 per cent, and many thought this gross rate was minimum as well.

on mortgages written in inflationary periods. By utilizing the VA program, mortgage lenders acquire portfolios which not only are partially protected against loss but also reflect a certain degree of marketability, both being advantages which might otherwise accrue to insured mortgage portfolios. Furthermore, VA approval has been practically automatic in most cases while the FHA has tended to be relatively conservative in its appraisal standards.¹ It might be argued, however, that a more widespread application of the latter policy might have effected a reduction in overall risk inherent in many local mortgage portfolios. A sudden economic reversal would undoubtedly inflict severe losses on those institutions whose mortgage portfolios consist largely of unseasoned, conventional, 80 per cent loans based on highly inflated valuations.

In performing its elaborate risk analysis, the FHA requires detailed information about the various factors affecting the degree of risk inherent in the mortgage under consideration. As stated in Chapter 8, these risk factors are arranged and rated in four categories: borrower, property, location, and mortgage pattern. If the resultant rating fails to meet up to minimum standards, the application is either rejected altogether or approved contingent upon the improvement in some of the inferior risk elements.

The Veterans Administration, on the other hand, delegates most risk rating operations to the lending institution, and duplicates a minimum of such effort. In contrast to the FHA which insures mortgagees up to the full amount of the home loan, the VA guaranty is limited to a certain portion of the loan balance. Since its proportionate liability remains unchanged throughout the loan term, the lending institution must bear the primary risk

¹See p. 402.

in making guaranteed loans and hence must exercise care in selecting acceptable applicants. Furthermore, guaranteed loans generally involve longer terms and larger debt-value ratios than conventional mortgage loans, thereby suggesting a somewhat greater degree of total risk in the former.¹ In practice, a loan application is referred to the VA for partial guarantee only after conditional approval has been granted by the lending institution.

Thereafter the VA certifies as to the eligibility of the veteran and makes an appraisal of the property so as to protect him from paying an unwarranted price. This latter function, comprising the primary risk rating operation of the VA, has been liberally interpreted by the local office and has rarely resulted in a refusal to issue the requested guaranty.² As soon as these details are completed, a procedure which has apparently involved a minimum of delay in the local area, the mortgagee has little occasion to deal with the VA again unless the veteran either becomes delinquent in his payments or else requests an amendment to the mortgage. Hence, it is perhaps not surprising that most local lenders regard the simplicity associated with VA lending as preferable to the complicated rules and regulations surrounding FHA lending. Indeed, in the latter case, the lending institution must maintain a continuing correspondence with the insuring agency, through collecting monthly mortgage insurance premiums from the mortgagor and subsequently remitting the proceeds on an annual basis to the FHA Mutual Fund. Summarizing, lending under the FHA, as compared with the VA, loan program not only demands

¹In the event of subsequent default, the VA may choose either to take over the property itself and repay the mortgagee in full for the loan balance and foreclosure costs; or else merely pay off the guaranteed portion to the latter and take no further part in the disposition of the foreclosed property. It is against this latter eventuality that the lender assumes a certain degree of risk in guaranteed lending. The extent of the subsequent loss, however, is seldom substantial, especially since the maximum guaranty was raised to \$7,500 or 60 per cent of loan amount in 1950.

²One speculative builder, however, indicates that the VA would approve his low-cost homes for loan guaranty only if he agreed to remove certain extras ordinarily found only in more expensive homes, such as electric disposal units, large refrigerators, automatic dishwashers, etc.

a greater amount of time and administrative detail in securing initial approval, but it also entails continuing effort throughout the entire loan term.

The interest yield on VA-guaranteed loans is considerably below that realized on most conventional loans made by thrift institutions throughout the country. This allegedly "substandard" yield, as well as the $4\frac{1}{2}$ per cent maximum net return on insured loans, has been repeatedly attacked by housing interests in other sections of the country as inequitable and injurious to the whole industry.¹ Thus far at least, these rate maxima have not been increased, and there appears little likelihood that they will be in the near future. In the Boston market, however, the 4 per cent rate on VA loans has seldom, if ever, impeded their general acceptance among local thrift institutions. Cooperative banks and federal savings and loan associations, many of which write nearly all conventional loans on a 5 per cent basis, regard VA home loans as a safe investment offering a higher yield than government bonds. In addition, the typical veteran is perhaps more aware of alternative rates of interest than most home buyers in the past. He is frequently reminded of the 4 per cent mortgage credit to which he is entitled, and keeps this fact in mind whenever financing a home purchase. This awareness is especially true when a new home is acquired, for most promoters of housing developments advertise the liberal credit available to eligible veterans. As a result, all local thrift institutions are virtually forced to offer 4 per cent VA-guaranteed loans in order to maintain their respective positions in the mortgage market. If one bank refused to make 4 per cent loans to qualified veterans, such business would be lost to rival institutions and the former would be hard pressed to attract a sufficient volume of

¹ See, for example, "Mortgage Crisis," Magazine of Building, August 1951, pp. 121-124.

conventional mortgage applications to keep its funds fully employed.¹

Local institutions which write choice mortgages at a 4 per cent rate frequently offer veterans the choice of either VA or conventional loan plans, provided the respective eligibility standards are met. If the veteran is really afforded either plan, he may choose the latter, preferring to save his GI entitlement for a later date when it would offer more decided advantages. As indicated earlier, however, most lenders are obliged by statute or lending policy to be more conservative in regard to maximum loan terms and debt-value ratios in making conventional mortgages. Furthermore, they may insist on a more conservative ratio between monthly debt service and expected incomes before approving a conventional 4 per cent loan request. Imposing a more rigid risk rating on such loans appears most likely in areas of relative capital surplus where interest rates on VA-guaranteed loans are not below the prevailing rate structure. In other areas, where yields on conventional mortgages are at least 1 percentage point higher, lenders are perhaps reluctant to write guaranteed loans except where the veteran applicant makes an especially good showing. This factor perhaps explains in part the relatively higher loss experience on guaranteed loans in the Boston area. Indeed, through November 1951, claims had been paid on 910 guaranteed home loans initially closed in the Boston regional office, representing the highest number among all 68 offices in the nation. In relative terms, however, the Boston area has not fared so badly, for these claims accounted for but 0.8 per cent of all home loans closed, ranking eleventh among the 68 VA regions.²

¹One cooperative banker indicates that the wider profit margin on 5 per cent conventional loans has made it possible to offer "less profitable" 4 per cent VA loans without limit.

²In terms of total number of loans closed, the Boston office ranked sixth.

Capital Surplus Area. Throughout the nation, the FHA home loan program has perhaps exerted some downward influence on mortgage interest rates. Even today, the prevailing rate on prime home mortgages in most regions is 5 per cent or higher, while the maximum rate on insured loans is $4\frac{1}{2}$ per cent plus the mortgage insurance premium. Hence, the nominal yield on insured loans is substantially below that on conventional mortgages, unless due allowance is made for the difference in risk borne by the lender.¹ In the Boston area, on the other hand, the FHA program has not operated as a price leader in the same fashion. Especially in the postwar period, the relative surplus of mortgage credit has resulted in a mortgage price structure which appears at least as liberal as that generally associated with insured lending. In other areas where demands for mortgage credit are inadequately met by existing mortgage-lenders, the availability of loan insurance has provided an incentive for other institutions, notably outside insurance companies, to enter such markets. In the Boston area, however, existing thrift institutions have not only supplied local mortgage demanders with ample credit but have also sought additional mortgage investment in other areas.² The characteristic abundance of long-term mortgage funds has undoubtedly influenced the success of the insured loan program in the local area.

This condition technically existed during the prewar period as well, but at that time many thrift institutions were far more anxious to accumulate government bond portfolios than to engage in new mortgage investment. Savings banks were singularly reluctant to adopt the direct-reduction mortgage contract and continued to write most new loans on the old-fashioned straight-term

¹Whether or not this differential in risk warrants such a spread in gross yield obviously depends upon the many variables influencing mortgage risk. Many lending interests apparently regard this spread as too great, and accordingly propose an upward revision in FHA maximum rates as the most natural solution. See p. 398 above.

²See the succeeding chapter on the secondary market.

basis, if at all. Indeed, even where most risks of loss in mortgage lending could be shifted on to the FHA, they preferred to invest in low-yielding government securities.

Large life insurance companies and commercial banks, taking an immediate interest in insured lending across the nation perhaps failed to enter the local area for two primary reasons. In the first place, the recovery in new home construction was somewhat retarded in the local area relative to newer, rapidly expanding regions. Since insurance companies at least are primarily interested in making insured loans on new properties, either on isolated lots or in large site developments, mortgage investment opportunities in the local area were relatively unattractive. Secondly, these institutions have striven to place their mortgage credit in areas where existing credit facilities are inadequate to meet current demands. Hence they have been relatively inactive in local mortgage activity, except in cases where large income-property transactions are concerned.¹

During the postwar period, the capital surplus characteristics of the local mortgage market have become increasingly pronounced. At the end of the war, savings banks sought to rebuild their badly depleted mortgage portfolios after nearly 15 years of inactivity. The potential mortgage investment arising from liquidation of government portfolios as well as new savings inflows assumed tremendous proportions. It is true that the local postwar housing boom, while less intense than that in other areas, has perhaps surpassed the expectations of even the more optimistic observers. Nevertheless, "unbalanced supply-demand" relationships have compelled mortgage lenders to make substantial concessions, both of a price and non-price character, in order to share in the ensuing mortgage business.²

¹Although data are not available for all insurance companies, it appears as if Section 608 loans still dominate insured holdings on local properties.

²See Chapter 12 above.

In view of this competitive struggle for new loans, the availability of FHA loan insurance has hardly been required as a further inducement for mortgage investment. Indeed, there is reason to believe that local lending institutions have written conventional mortgages on a more liberal basis than if FHA insurance were utilized more widely. It is true that FHA regulations generally provide unusually favorable treatment for buyers of lower-cost housing, especially in regard to allowable term and debt-value maximums. Up to the present emergency at least, certain 90 per cent, 25-year loans were eligible for FHA insurance while most local thrift institutions in conventional lending have been restricted to making 80 per cent, 20-year loans. In practice, however, such liberal insured loans have been seldom made,¹ and the local underwriting staff has tended to be relatively conservative in approving requests for loan insurance, particularly with respect to maximum loan amount.

Both local underwriting officials and interviewed lenders who have occasionally submitted applications for loan insurance indicate that the FHA estimate of appraised value is "often at least 10 per cent below current market price." FHA officials defend their conservative approach as being consistent with the long-run economic soundness of the entire mutual insurance fund. Only if loan amounts bear a reasonable ratio to true "worth," not merely a transitory inflated figure can the FHA hope to function as a self-sufficient agency over the business cycle. While this conservatism is undoubtedly manifest in regard to old and new properties alike, local officials have referred to several site developments where an FHA commitment was denied because the requested loan amount, as indicated by the proposed selling price of the homes, was out of line with the long-run "value" of the underlying security. Rejection by the FHA, however, does not imply a revision in such development plans, as the builder or promoter is generally

¹See data on average purchase prices, p. 404.

able to secure financing through conventional methods with little difficulty. Competition for new mortgages loans, especially on new properties, has made FHA approval or rejection of limited consequence in this area.¹

There is little evidence available on the respective contract provisions contained in local insured and conventional loans. The Bureau of Labor Statistics, however, has compiled some data in connection with its sample surveys of local home building activity, the results of which tend to bear out the hypothesis advanced above. Only in regard to repayment periods do insured loans appear to be more liberal than corresponding conventional mortgages, while in terms of loan-value ratios or interest rates the opposite tendency prevails. As indicated in Table XII of Chapter 12, the average repayment period on insured loans was 20.3 years in late 1950, compared with 18.1 years on conventional mortgages.² At the same time, average loan-value ratios on the alternate mortgage types were 55.1 and 58.6 per cent, respectively. Average interest rates on insured and conventional loans were 4.1 and 4.2 per cent, respectively, the former being reported as net of the mortgage insurance premium.³ These latter two mortgage price components will be briefly considered in order.

The rather surprising difference in loan-value ratios may perhaps reflect an unreliably small sample, as only 230 insured loans were included in the survey. On the other hand, a similar survey conducted one year earlier found an even greater variation in average ratios, namely, 48.3 and 57.6 per cent among insured and conventional mortgages, respectively.⁴ It is quite likely, however, that the unusually conservative loan-value ratios

¹For further reference to the FHA's role in site developments, see pp. 380-386 above.

²See footnote, p. 406.

³VA-guaranteed loans were more liberal on all counts, as average loan-value ratios were 82.8 per cent; repayment terms, 24.9 years; and interest rates, 4.0 per cent.

⁴Unpublished data of Bureau of Labor Statistics. The average ratio on VA loans was 88.1 per cent.

on insured loans are due in part to the relatively high average purchase price on the properties concerned. As indicated earlier, despite the favorable treatment afforded insured loans on low-cost homes, lenders have rarely utilized the FHA program for such purposes. Indeed, the average purchase price on new homes using FHA financing was significantly higher in both ELS surveys than where either conventional or VA methods were employed. In the 1950 survey, for example, these average prices were \$18.2, \$13.7, and \$11.7 thousand, respectively. Inasmuch as mortgage lenders generally insist on larger down payments when more expensive properties are purchased, the relatively higher loan-value ratios on insured loans are perhaps to be expected. Moreover, under credit regulations existing at that time for either FHA or conventional financing, a new home buyer was required to make a minimum down payment of nearly 40 per cent on an \$18 thousand property. At any rate, even though the wide variation in home price class precludes a valid comparison of contract provisions under alternate financing plans, it seems clear that the FHA has neither promoted to any significant extent low-cost housing nor been instrumental in liberalizing loan-value ratios in the Boston area.

In regard to the third major price component, average interest rates appear to be significantly higher on insured than on conventional mortgages, at least when the mortgage insurance premium is included in the former. Certainly this inclusion is a necessary one, for only by considering the actual borrowing rate on either type of loan can comparability be attained. Indeed, an average rate differential of 0.4 per cent¹ has a profound influence on total debt service, especially when repayment extends over 20 years.² Although the FHA does not specify the interest rate to be charged on insured

¹i.e., the difference between 4.2 per cent on a conventional and 4.1 + 0.5 per cent on insured loans.

²See Chapter 2 for the influence of varying interest rates on monthly debt service.

loans, most lenders apparently charge the maximum of $4\frac{1}{2} + \frac{1}{2}$ per cent, especially when existing properties are mortgaged. Where new construction is concerned, however, some of the larger savings banks have cut the "net" rate on insured loans to 4 per cent, to be on a par with the contract rate on conventional loans.¹ As analyzed in Part V, many local mortgage lenders, notably large Boston savings banks, have reduced interest rates on choice loans to 4 per cent in order to expand and maintain portfolios at the desired level. Some have also granted 80 per cent, 20-year mortgages on the same basis, though most appear to adjust interest rates in accordance with other contract provisions. At any rate, competition among dominant lending institutions has resulted in a mortgage price structure which appears fully as liberal, if not more liberal, than that generally associated with insured loans.

Even if a lender were moderately interested in insured lending and set the net rate at a par with conventional loans at 4 per cent, a negligible volume would be recorded unless the home buyer would stand to gain from the FHA loan. In other words, unless the buyer were offered a larger loan or longer term under the FHA plan, he would undoubtedly choose a conventional mortgage and thereby avoid paying the 0.5 per cent mortgage insurance premium. A lender located outside the immediate area has promoted FHA-insured loans at the above maximum rate by offering a 20-year term, as opposed to a 16-year limit on conventional loans at $4\frac{1}{2}$ per cent. Among the large Boston savings banks, however, such a policy would be of limited utility, for com-

¹ In a letter from the Washington FHA office, Mr. Allan Thornton, director of Research and Statistics, reveals that fewer than 3 per cent of all FHA-insured loans are made at less than the above maximum rate, and that the bulk of the latter occurs in the Northeast. The local FHA officials report that one mortgagee had written an insured loan at $3\frac{3}{4}$ per cent net, although this concerned rental housing. (Section 608)

petition has virtually compelled the offering of a 4 per cent, 20-year loan plan to most deserving applicants. Of course, if the requested loan amount appears unusually high, such a liberal conventional mortgage would not be forthcoming, but neither would FHA approval be granted under such circumstances.¹ Rather than write new insured loans, some Boston banks have allegedly expanded conventional portfolios through refinancing insured loans held by other lenders by offering a 4 per cent rate.

The question may be raised as to why those institutions which make conventional loans at 4 per cent do not set net rates on insured loans at an even lower level. If FHA loan insurance effectively relieves the mortgagee of most lending risk, he may feel justified in reducing the compensation required to cover the residual risk which is not shifted. If, however, overall risk is considered to be greater on insured than on conventional 4 per cent loans, the lending institution may feel justified in charging at least $4\frac{1}{2}$ per cent gross on the former. Interviewed mortgage officers indicate an indifference between choice conventional mortgages at 4 per cent and insured loans at 4 per cent net, believing the savings in risk to be largely offset by the extra administrative detail involved.²

The Interest Rate Paradox. It may seem paradoxical that despite the inherent capital-surplus characteristics of the local market, many lenders refrain from making insured mortgages on grounds that the current rate maximum of

¹ These references to the existence of effective competitive elements in the Boston mortgage market do not imply the existence of perfect competition. Among the imperfect elements, as indicated earlier, the buyer of a new home rarely has a free choice in regard to mortgagee selection, and ordinarily must accept the loan offering of the bank financing the operative builder, or else seek a different property.

² If such lenders actually believed FHA loans at $3\frac{1}{2}$ per cent net were equivalent or even preferable to conventional loans at 4 per cent, a heavy inflow of new insured loans might seriously impair the flow of undistributed earnings into surplus. Especially with dividend rates of $2\frac{1}{2}$ or 3 per cent, most of the margin would be absorbed by operating expenses. Of course, this is precisely what would be expected, as only limited loss reserves would be required if insured loans predominated. Under this academic possibility, the lending institution would revise its surplus policy, and its overall investment structure would not be unlike that of the early 1940s when government bonds dominated the portfolios of local savings banks.

$4\frac{1}{2}$ per cent provides an unjustifiably low net yield. As stated earlier, many local thrift institutions have continued to attract a steady volume of new loans at 5 per cent, involving new as well as existing construction.¹ In addition to their intense antipathy toward federal intervention in general, these lenders ordinarily feel it altogether unnecessary to sacrifice up to $\frac{3}{4}$ of 1 per cent in gross yield merely to secure FHA insurance protection. Most mortgage officers questioned on this matter believe that their conventional mortgages are so carefully selected that the necessary risk compensation is really a "minor item" anyway. Others apparently are not fully aware of the degree to which most risks of mortgage loss can be shifted to the FHA through adopting loan insurance. At the same time, home purchasers are convinced as to the virtues of keeping their mortgage dealings "within the local community," as well as the negligible savings in mortgage costs between a $4\frac{3}{4}$ per cent insured and a 5 per cent conventional loan.²

It should be mentioned, however, that the non-participation of these lenders in the FHA program may not be as inconsistent with the capital-surplus hypothesis as might appear at first glance. It is entirely possible that many such 5 per cent mortgages would be unacceptable to the FHA even if loan insurance were sought. Indeed, as indicated earlier, allowable loan-value maximums tend to be relatively high among loans written by local federals and cooperative banks on a conventional basis. Furthermore, these institutions willingly write liberal mortgages in communities where other lenders and the FHA are reluctant to operate under any conditions. In

¹The rather substantial volume of new construction lending by institutions charging $4\frac{1}{2}$ - 5 per cent is reflected in data on average interest rates referred to above.

²Lenders seldom mention the very real likelihood of the mortgagors' receiving participation dividends from the mutual insurance fund as a decided advantage of the FHA plan. Indeed, as stated earlier, several interviewed lenders appear to be totally unaware of the mutuality of the Fund.

summary, despite the fact that such non-participating lenders regard necessary risk compensation as a "minor item," there is reason to believe that a significant risk differential accounts in part for the continuing spread between interest rates on certain conventional loans and the FHA maximum rate.¹

Local FHA Loss Experience. The fact that the FHA tends to be relatively conservative in approving loan requests does not necessarily imply that only choice loans are included in local insured portfolios. On the contrary, there is some evidence to indicate that insured loans on local properties have entailed significantly higher risk than corresponding loans in other parts of the country. Through 1950, titles to 173 Massachusetts home properties had been transferred to the FHA pursuant to default on loans insured under Section 203. Stated differently in relative terms, title acquisition had resulted from 1.40 per cent of all Section 203 loans written during the 16-year period. This relatively unfavorable mortgage experience was second only to New Hampshire, while the national average acquisition rate was a slight 0.32 per cent.²

Since Massachusetts has also been a state in which VA mortgage loss has been relatively heavy, one might conclude that local mortgage lending involves an abnormally high degree of risk. As explained earlier, however, the heavy loss experience on VA loans may be due in part to a tendency on the part of local lenders to refer relatively high-risk loans to the VA for

¹The various economic factors influencing interest rate differentials are more fully analyzed in Chapter 12. While permissible loan-value maximums are lower, the FHA tends to favor longer loan terms than most cooperative banks. Unless certain aspects of the transaction point to the contrary, 20-year loans are generally quite acceptable to the FHA, whereas cooperative banks had previously concentrated on "long-term" share-accumulation mortgages with average terms of 12-14 years, and have only gradually offered longer terms on new direct-reduction loans. As indicated earlier, however, most lenders interviewed regard 20 years as a reasonable loan term, especially on new construction.

²Annual Report, HHFA, 1950, p. 246. The corresponding ratios for Section 603 cases were 1.01 and 1.60 per cent for Massachusetts and U.S., respectively. It should be mentioned that these ratios refer to acquisitions by the FHA only, and not total foreclosures. Data are not available on the cases where the mortgagee himself chose to retain title to the property.

guaranty. In a similar vein, the striking difference in acquisition ratios among insured portfolios is perhaps a manifestation of the relative utilization of the FHA loan program locally and elsewhere. In most sections of the country, FHA insurance is sought on the most desirable home loans, especially in connection with new housing developments. Most life insurance companies, commercial banks, and savings banks regard loan insurance as an essential ingredient for long-distant mortgage lending.¹ In the Boston area, however, local lenders can readily meet all mortgage demands without resort to capital importing, with the result that the most desirable loans are generally written without the inclusion of FHA insurance. Even though some lenders prefer to finance operative builders under the guidance and supervision of the FHA, the permanent mortgage is frequently written on a conventional or VA-guaranty basis anyway.² As stated above, some lenders are willing to lend on prefabricated homes only where loan insurance or guaranty is included, while others are reluctant to deal in such properties under any circumstances. Even when existing properties are concerned, local lenders frankly admit that they refer mortgage requests to the FHA only if certain undesirable risk elements are involved. They prefer to avoid the administrative detail entailed in making an FHA application if the request meets all standards for conventional loans. Indeed, many interviewed lenders feel that they are "justified" in imposing the extra $\frac{1}{2}$ of 1 per cent FHA insurance premium on the borrower only when absolutely necessary. Furthermore, if a property is still mortgaged at the time when FHA

¹See the succeeding chapter.

²Unless the lender is able to retain the FHA insurance on a portion of the loans, by means mentioned above. The ability to dictate mortgage terms, of course, depends upon the extent to which the buyer is attached to the institution financing construction.

loan insurance is sought, approval cannot be granted unless the existing holder has refused to rewrite the mortgage with contract provisions as favorable as those contained in the proposed FHA loan.

In view of these circumstances, it is not surprising that insured lending has entailed a relatively high degree of risk on the local level. In contrast to the situation across the country, existing properties have figured more prominently in local insured lending than has new construction. Other things being equal, relatively newer properties are regarded as choice risk elements for mortgage security purposes by most lenders interviewed. Furthermore, in the case of existing properties, the FHA does not attract a random sample of all mortgage recordings and, despite its rigid risk rating technique, a relatively lower grade of loans are perhaps to be expected. Undoubtedly existing portfolios of local mortgage lenders contain many conventional mortgages with risk elements at least as undesirable as those inherent in insured loans. In a well-rounded portfolio, however, the existence of corresponding prime loans counterbalances the influence of such less desirable loans, and makes possible a moderately favorable risk rating for the entire portfolio.

PART VII. CHAPTER 14. SECONDARY MORTGAGE MARKET

The stimulation and encouragement of a truly effective secondary mortgage market has always been a vital adjunct of the FHA loan insurance program. Framers of the program foresaw the development of such a system as indispensable in attaining a satisfactory degree of flexibility and stability in home mortgage lending across the country. The need for a secondary market has undoubtedly been recognized for decades, but agitation toward its realization has stepped up considerably since FHA-insured loans have become widely accepted and respected.

NEED FOR SECONDARY MARKET

The importance of a secondary mortgage market is readily understood if one considers the unequal stages of economic development characterizing the various regions of the country. Numerous economic indicators presage a continuing growth in the South, Southwest, and Far West at a more rapid pace than in the relatively mature regions, notably the Northeast. The general westward movement of population represents a permanent shift away from eastern congested centers, with the Boston area witnessing a negligible growth during the past three decades.¹ Population movements have followed rather closely trends in industrial location, as important industrial centers are developing in newer areas that had been predominantly agricultural. In view of these and other factors, it is not surprising that per capita as well as total income payments are rising much less rapidly in the relatively mature Northeast than in other areas.² Furthermore, these economic variables tend to have a direct bearing on the regional distribution of

¹See Chapter 3.

²Ibid.

urban residential construction. Where growth is more rapid, incomes and population pressures stimulate a continuing demand for new construction and for home mortgage credit. If this demand appears permanent and reasonably stable, lending institutions may find mortgage investment in such areas highly attractive, for both mortgagor and underlying property display desirable risk elements.

Whereas the demand for home construction and financing has mounted rapidly in newer sections, principal sources of mortgage credit are concentrated in established urban centers. Comparison of the geographical distribution of savings with that of construction provides a rough index of relative supply and demand conditions existing in the various mortgage markets concerned. In Table I, aggregate time and savings deposits in commercial and mutual savings banks are compared with total construction for the various Federal Reserve Districts in 1948. Unfortunately comparable data on share capital among savings and loan associations are not available for this geographical distribution, nor is there any breakdown as to residential and other construction. Nevertheless, these data serve to indicate the sharp contrast in construction-savings ratios among Federal Reserve Districts, especially between the Northeast and Southwest. In the Dallas district, there was \$1.20 in construction contract awards for every dollar of savings, while the corresponding ratio in the three northeastern Districts was but \$0.09. These data do not include the San Francisco District, a region of intense construction and general economic activity. Although only 7 per cent of the total population are housed in the state, California has consistently built 15 - 20 per cent of all new residential units in the United States during recent years. Over a sixth of all FHA-insured loans made on single-family units have concerned California properties, involving

TABLE I. RATIO OF CONSTRUCTION^x TO SAVINGS^{*} IN FEDERAL RESERVE DISTRICTS,
1948
(Billions of Dollars)

<u>Districts</u>	<u>Savings</u>	<u>Construction</u>	<u>Ratio</u>
Boston, New York, Philadelphia	\$ 25.1	\$ 2.25	\$0.09
Richmond, Atlanta	2.8	1.80	.64
Cleveland, Chicago, St. Louis	9.9	2.75	.28
Minneapolis	1.1	.29	.27
Kansas City	.7	.38	.56
Dallas	.6	.89	1.20
Total	\$ 40.1	\$ 8.17	\$0.20

Source: Federal Reserve Bulletin and National Association of Mutual Savings Banks, presented in a privately circulated brochure by the Worcester County Institution for Savings, completed in September 1948.

x Construction - F. W. Dodge data on construction contracts awarded in 37 states east of Rockies for 12 months through March 1948.

* Time deposits of member banks as of late March, and savings deposits of mutual savings banks as of January 1, 1948.

over 400 thousand individual loans with an aggregate principal value of \$2 $\frac{1}{4}$ billion.¹

As a result of this geographic unbalance between demand and supply, certain areas are blessed with an abundance of home mortgage credit while others suffer from a chronic shortage. The development of an effective secondary market offers an economic and sound method of alleviating this situation. By providing a means whereby credit may flow freely throughout the economy, a secondary market facility would effect a more equitable distribution of mortgage funds and thereby afford all communities an opportunity for expansion and development. Home buyers in capital-importing areas would enjoy the benefits of more liberal credit availability, while institutional investors in exporting areas would acquire sounder, better diversified mortgage portfolios. Before these objectives could be realized, however, several fundamental barriers would have to be eliminated or largely overcome.

¹Speech by W. A. Marcus before Convention of Mortgage Bankers Association of America, San Francisco, September 4, 1951, reprinted in Commercial and Financial Chronicle, September 20, 1951, pp. 1070-71.

Concerted efforts have already been directed toward this end, but much remains to be done. These barriers, conveniently classified into technological and statutory impediments, will now be summarized in order.

TECHNOLOGICAL IMPEDIMENTS

The key to the development of a secondary market lies in the creation of a standardized and readily salable mortgage instrument. Although the characteristics of the institutions operating in the market are of vital importance, the character of the paper itself is even more crucial. Stated differently, if the security is such that it commands universal acceptance, the institutional problem will largely take care of itself.

Among the various instruments used in financial exchange, the traditional mortgage contract is perhaps least satisfactory, at least as far as marketability is concerned. As indicated earlier, poor marketability is perhaps both a cause and a consequence of the localization characteristic of conventional mortgage lending. Since mortgage lenders in general have not adopted a uniform set of quality standards for selecting individual loans, a conglomerate of uncoordinated, isolated mortgage markets has been an inevitable development. Mortgage terms have been set in accordance with local lending practices, reflecting no necessary relation to those currently offered in other areas. Appraisal standards and risk analysis techniques have been so diverse that lenders traditionally insist on a first hand knowledge of the loan security before making an investment.¹

¹On the other hand, mortgage banking on the Continent has long been well organized and concentrated in a limited number of specialized institutions. Consequently, a high degree of qualitative control over this type of credit has developed, and yields on mortgage bonds have continuously corresponded closely with that on long-term government paper. This situation contrasts sharply with that existing in this country, at least until recent years, where a great many, non-specialized institutions are engaged in mortgage lending, with the result that "standards of qualitative control might easily deteriorate." M. Palyi, Principles of Mortgage Banking Regulation in Europe, University of Chicago Press, Chicago, 1934, pp. 11-12.

Mortgage investment policies of life insurance companies have long represented a notable exception to the extreme localization so characteristic of conventional mortgage lending. Their mortgage portfolios are built up and serviced primarily by company personnel in branch offices and loan correspondents who operate as intermediaries between borrower and distant lender over the loan term. Although occasional loans are bought outright from independent agents or brokers, most conventional loans are made directly through affiliated personnel who maintain a continuing relationship with the company. Such operations, while greatly facilitating a more equitable distribution of funds for home finance, hardly evidence an effective secondary market, however, as mortgage paper is seldom freely traded among various mortgage investors. In other words, insurance companies have typically invested long-term funds for optimum profitability regardless of property location, but they are reluctant to purchase conventional mortgages without being familiar with the details of the individual case.

The fact that insurance companies have succeeded in making distant mortgages on a conventional basis at all is an achievement in itself. Perhaps an extension and elaboration of the techniques employed by these companies in evaluating and approving mortgage loan requests may provide a key for the development of a conventional secondary mortgage market. While the risk rating procedure prescribed for loan correspondents in considering eligible mortgage applications is admittedly crude and somewhat arbitrary, it at least provides a widely recognized yardstick understandable to all parties concerned. This method contrasts sharply with the risk analysis employed by all but the most progressive local mortgage

lenders. Rarely have local mortgagees placed much weight or confidence in the numerical risk rating methods as promoted by the American Bankers Association in making conventional loans.¹ Perhaps existing methods, based on the informed judgment of experienced specialists, are adequate in evaluating mortgage risk so long as a lending institution is satisfied in confining mortgage operations to the immediate community. Only if it seeks either to place surplus funds in outside markets or else to interest outside investors in its own mortgage paper might the institution become vitally concerned about systematic risk analysis.

Under existing "technology," expense constitutes a primary stumbling block to the development of a standardized mortgage instrument on a conventional basis. If all loans were to be drawn up according to a risk rating schedule accepted and respected by private mortgage investors in general, the cost per loan would be almost prohibitive. Before universal acceptability were attained, all investors concerned would have to agree on the precise items to be covered in the risk analysis, as well as the weighting system used in arriving at a final rating. In order to make such a procedure applicable to lenders throughout the nation, due allowance would have to be made for factors peculiar to certain areas. At any rate, the resultant risk analysis network, provided agreement has been reached, might entail such an elaborate procedure that the services of added mortgage specialists would be required by the institutions concerned. Furthermore, even though the method of risk rating were most satisfactory, mortgage investors would be reluctant to place unlimited confidence in the judgment of the mortgage originating institution. In other words, even if Banker B

¹ These recommendations are similar to those prescribed in the FHA Underwriters Manual, and may be found in Home Mortgage Lending, American Bankers Association, 1938. Both volumes reflect the substantial contribution of Professor E. M. Fisher in their formulation.

in Dallas were using the same criteria in evaluating a given loan application as all other lenders in the country, Banker A in Boston might hesitate to invest his depositors' funds in such an investment without additional assurance as to its soundness. A credit rating agency, analogous to Dun and Bradstreet in commercial credits, would temper such skepticism to a considerable degree, provided the agency were widely recognized and properly set up to perform the task required. Perhaps even the creation of private credit agency would not allay all doubts, however, and the inclusion of some form of guarantee or insurance might be needed. This latter scheme was adopted and widely respected in some areas during the 1920s, when title guaranty companies found a flourishing business in selling guaranteed mortgages. As indicated earlier,¹ the subsequent depression experience of these as well as other mortgage bond companies was most unsatisfactory, and the development of a private secondary market was promptly checked, for the time being at least.

Remedial Action

The FHA loan insurance program, coupled with the FNMA, incorporates certain features designed to remove or effectively counterbalance these impediments. Indeed, a primary purpose of the FHA in analyzing, rating, and insuring mortgage loans has been the establishment of quality standards to widen the mortgage market. When a mortgage originating institution submits a loan request to the FHA for insurance, the resultant risk analysis is performed in accordance with prescribed standardized criteria. This risk rating, as described in Chapter 8, incorporates all the primary variables influencing mortgage risk and follows a relatively objective weighting system universally applied by all underwriting offices.² In addition to the

¹Chapter 8.

²It will be recalled that all eligible insured loans are classified into three quality groups.

assurance that risk elements are properly evaluated, lenders are protected against most risks of loss through the inclusion of loan insurance. In other words, overall risk of default is not only initially minimized through scientific risk analysis, but in the event of default the mortgagee is insured against all loss except for part or all of the attendant costs of foreclosure.

Among the immediate objectives in offering mortgage insurance, framers of the FHA program hoped that a wide range of institutions would become actively interested in mortgage lending. Furthermore, as stated earlier, they firmly believed that the universal acceptance of insured loans, coupled with federal encouragement of national mortgage associations, would set the stage for an effective secondary mortgage facility on a private basis. It was soon apparent, however, that private capital was not interested in establishing any such associations, so the federal government was obliged to take the lead in creating two agencies within the RFC, the RFC Mortgage Company and the FNMA.¹

The FHA-insured loan, and later on the VA-guaranteed loan as well, has largely overcome many of the technological impediments generally associated with conventional mortgage lending. Holders of such loans reap the benefits of a widely recognized trade mark, for the product must meet certain quality standards and, if it fails to do so, there is virtually a "money-back guarantee." Banker A in Boston is less reluctant to purchase a mortgage written by Banker B in Dallas if the loan is underwritten in full or in part thereof by the FHA or VA. Not only does the federal agency concerned offer to indemnify the mortgagee against loss of principal, but the expanding private secondary market also gives promise of providing a ready

¹The former was terminated in 1947 and the latter was transferred to the HHFA in 1950.

resale for the paper if immediate liquidity is sought before maturity. Indeed, since the relatively uniform risk characteristics of insured loans have enjoyed widespread recognition, a limited private secondary market has emerged without federal encouragement. Many institutions have actually preferred to purchase mortgages from other lenders rather than originate them directly.¹ The development of an effective private secondary market, however, has depended and still depends upon the relaxation or elimination of various legal barriers.

STATUTORY IMPEDIMENTS

In this section the primary legal barriers retarding the free inter-regional flow of mortgage credit will be reviewed. The first of these, already touched on in Part IV, relates to the dissimilarity among the states in regard to foreclosure and title laws. Although a lending institution may be effectively insured against principal loss in a particular mortgage investment, it must still stand to bear part or all of the costs associated with a contingent foreclosure.² Moreover, even if the institution is fully reimbursed for foreclosure expense, a lengthy redemption period may be required before the mortgage may be foreclosed. As indicated earlier, this redemption period has ranged up to 2 years in the case of Alabama, with laws varying among the states as to whether or not the FHA may acquire the title during the interim. In any case, however, mortgagee loss is minimized, for the debentures issued by the FHA are effective as of the date when foreclosure proceedings are instituted, not when completed.³

¹ See below.

² It will be remembered that FHA issues certificates of claim which are to cover foreclosure costs only if the subsequent property sale by the FHA warrants; the VA pays a cash settlement to the lender to cover what it regards as a reasonable sum for foreclosure.

³ As stated above, VA claims are payable in cash.

Another legal barrier concerns the various qualification requirements which must be met before service contracts and foreclosure proceedings may be enforced. Once again state laws vary widely. Some require no qualification standards so long as the permanent mortgagee does not deal directly with the mortgagor, while others may require detailed application forms as well as various entrance fees, franchise and property taxes, etc.¹

The above barriers all relate to restrictions imposed upon mortgage investors within the state into which mortgage funds are to be imported. Even more restrictive have been the various statutory limitations placed upon those lending institutions which seek to export mortgage funds. Such regulations generally favor investment within the individual state of incorporation, with the result that institutional investors are virtually precluded from placing funds on the basis of maximizing net yields alone.² As indicated in Chapter 5, all state-chartered thrift institutions in Massachusetts, except life insurance companies, are largely confined to mortgage lending within the Commonwealth or adjacent states. National banks may invest anywhere in the country without regard to state lines, while federals may operate within 50 miles of their main office as well as in any region permissible for cooperative banks. Federals are given greater leeway when the mortgage loans are insured or guaranteed, as FHA loans may be made anywhere within a 100-mile radius of the main office, and VA loans may be made without geographic restriction. With special permission, insured loans may be made beyond the above limit, within the 15 per cent of assets category, and authorization to further liberalize this clause is

¹Special Report by Worcester County Institution for Savings, op. cit., pp. 36-38.

²Some implications of these geographic restrictions are discussed in W. C. Ballaine, "New England Mutual Savings Bank Laws and Interstate Barriers to the Flow of Capital," American Economic Review, March 1945, pp. 155-9.

now pending approval.¹

Cooperative banks are permitted to operate in the secondary market only in a most indirect manner. While they are not prevented from trading in mortgage paper, these state-chartered institutions are able to hold mortgages only where the pledged properties are located within their ordinary lending area. If they are members of the Home Loan Bank, cooperative banks, just as all federals, may indirectly provide mortgage credit for distant lenders through holding time deposits in the District Bank. Thus if a member bank is unable to keep its share capital optimally employed in local mortgages, it may choose to deposit a substantial amount in the Home Loan Bank, which in turn may advance credit to other member banks seeking added funds to make more loans. This procedure obviously is a poor substitute for outright purchases in the secondary market, one primary reason being the significant differential in net yields on time deposits as opposed to mortgage loans. Moreover, effecting a free inter-regional flow of mortgage funds via the Home Loan Bank System is hardly more favorable for the borrowing than for the depositing member institution.²

Traditional restrictions on lending areas of local savings banks have constituted a major stumbling block to the development of a secondary market. Soon after the introduction and widespread adoption of FHA-insured loans, some of the more progressive savings bankers foresaw the very real possibility that investment in such standardized instruments would solve many of their pressing investment problems. Even during the prewar period, at least one executive began pressing for permissive legislation to invest in insured loans beyond conventional lending areas. His recommendations were largely disregarded both by state legislative interests as well as by

¹Interview with R. P. Harold, President of Worcester Federal Savings. The 15 per cent category is described in Chapter 5.

²See "Summary and Prospects" below.

other members of the local savings bank fraternity. Most opposition centered about the notion that the savings of local depositors should be used to promote home ownership in the Commonwealth alone, and should not be exported into distant areas.¹ Most official objection took the form of lacking confidence in the overall soundness of insured loans. For example, the Massachusetts Commissioner of Banks in 1942 rejected the idea of an immediate removal of geographical limitations as follows:

. . . . The time may come when such an investment has sufficiently seasoned and the administrative policies and machinery surrounding it have become sufficiently stabilized to justify some such relaxation of the usual safeguards; but it does not seem to have arrived as yet.²

In the postwar period agitation for such a relaxation was renewed with added vigor, as most savings banks possessed vast sums of savings capital well-suited for mortgage investment. Savings continued to flow into these institutions during the prewar and war years, while mortgage portfolios dwindled steadily. By the end of the war, mortgage-assets ratios had reached historic low levels and new lending operations had been largely taken over by rival savings and loan interest.

The methods pursued by local savings banks in expanding mortgage portfolios have already been spelled out in some detail.³ In addition to making liberal mortgages on a conventional basis, they have participated to a considerable extent in the VA home loan program. For reasons advanced in Chapter 13, the FHA program failed to make a much better showing among local savings banks during the postwar than during the prewar years. Nevertheless, even though the insurance feature was regarded as superfluous in

¹The same reasoning in the past had once prohibited any investment in private securities of any corporation organized outside the Commonwealth.

²Annual Report, Massachusetts Commissioner of Banks, 1942.

³Chapter 12.

making local mortgage loans, the more progressive leaders have become increasingly aware of its importance in long-distant lending. Indeed, it soon became clear to most large savings bankers that the limited demand for mortgage credit locally was sorely inadequate to absorb the abundance of capital available for such investment. The case for relaxing geographic barriers on insured and guaranteed loans was implemented by the circulation of special report prepared by the Worcester County Institution for Savings.¹ Shortly thereafter a team of leading savings bank executives made an inspection tour of areas of concentrated home building operations in the Southwest and West. As a result of these visits, local lenders became familiar with the general economic characteristics of the regions as well as the probable soundness of the properties as loan collateral. Moreover, they became acquainted with leading mortgage servicers operating in these markets, and learned of the various procedures involved in purchasing and handling loans on distant properties.

As soon as these local bank executives became well aware of the virtues of extensive operations in a nationwide secondary market, a united block presented a proposal to the state legislature. Although the subsequent authorization was less extensive than that proposed by some, their efforts bore fruit in enabling legislation effective mid-year 1949.² As a result, Massachusetts savings banks are now permitted to invest up to 10 per cent of their deposits in either FHA-insured or VA-guaranteed loans regardless of property location, provided the total holdings of each type do not exceed 50 per cent of aggregate holdings on in-state properties.

SECONDARY MARKET PURCHASES OF LOCAL INSTITUTIONS

Inasmuch as most secondary market activity among local thrift institu-

¹"FHA Insured Mortgages for the Savings Banks of Massachusetts," completed September 24, 1948.

²Acts of 1949, Chapter 374, approved June 2, 1949.

tions has revolved about out-of-state purchases by savings banks, much of the following material refers primarily to these operations.¹ Secondary market operations of life insurance companies and national banks have not been carefully investigated in this study both because of a lack of relevant data as well as the relative insignificance of these institutions in the local permanent mortgage market. Among the other thrift institutions, cooperative banks are forbidden by statute from distant lending and local federals have not felt obliged to participate in such operations on a large scale. Indeed, the latter associations have kept share capital fully employed in meeting local mortgage demands, and have frequently sought substantial advances from the Home Loan Bank to supplement this capital.² A large federal outside the immediate Boston area, however, is completing arrangements for purchasing VA loans from reputable FSLIC-insured associations in the South and Southeast.

Since mid-1949 when authorization was initially granted, several local savings banks have been singularly active in the nationwide mortgage market. As of October 31, 1951, all but three of the institutions with total mortgage portfolios of \$15 million or more held some out-of-state insured or guaranteed mortgages. The largest bank in the area held a much larger investment in out-of-state FHA-insured loans than the combined in-state insured holdings of all 56 banks. For the 14 banks which have engaged

¹Savings banks have also dominated insured loan purchases on local properties. During the 3 years for which these data are available (1942, 1947, 1950), the number and dollar amounts were distributed among major lender types as follows:

	<u>Number</u>	<u>Amount in Thousands</u>
National Banks	117	\$ 534
State Bank	70	350
Mortgage Company	3	12
Insurance Company	187	1,196
Savings and Loan Associations	128	624
Savings Bank	389	2,007
Federal Agency	8	48
Others	1	5
Total	<u>903</u>	<u>\$ 4,776</u>

Source: Federal Housing Authority, Division of Research and Statistics.

²Some have also sold mortgages at various times for liquidity purposes. See p. 442.

in such secondary market operations, combined holdings of out-of-state insured and guaranteed loans had reached \$96.8 million by October 1951, representing 22.2 per cent of their respective aggregate mortgage holdings. At the same time, these holdings accounted for 13.1 per cent of the total mortgage debt held by all 56 banks.¹ In the case of three banks, out-of-state mortgages account for over one-fourth of their respective total portfolios with the ratio being as high as one-third in one instance.²

Out-of-state mortgage loans are acquired in a variety of ways. Although this is not the place to describe these procedures in detail, a few principal methods will be mentioned. Perhaps most such loans are acquired through a brokerage house or some other intermediary, agencies which may or may not engage in servicing functions. Several large organizations have their headquarters in New York City, frequently handling the financing phase of a site development all the way from construction to placing the permanent mortgage. Construction financing is generally supplied by short-term lenders, notably national banks, provided the operations are performed under FHA guidance and frequently provided a commitment for the permanent financing has already been secured.³ Many of the largest national banks in the country have found this business highly attractive. Frequently involving "warehousing operations," a line of credit is issued to a reputable mortgage originating company for use in financing the development for a 6-month period. The yield on these loans is favorable and with FHA backing

¹Only 7 banks held insured loans both on local and distant properties. These data are compiled from special reports submitted by all savings banks to the Massachusetts Savings Banks Association.

²Savings banks are now seeking authorization to raise the maximum holdings of out-of-state FHA and VA loans to 20 per cent of deposits for each type.

³Indeed, FHA loan insurance is an essential feature of any proposed mortgage transaction in capital-short areas, in direct contrast to the situation prevailing in the local money market center.

the risk involved is minimized. Even if the mortgage company fails to contact a suitable permanent mortgagee and the construction lender is compelled to retain the mortgage, relief may still be sought from FNMA if desired.¹

While some savings banks deal exclusively with specialized brokers, others acquire most distant mortgages through a local cooperative buying group organized for this purpose. This latter group operates as a broker itself and deals directly with the builder or promoter concerned with the particular housing development. Certain members of this group make periodic visits of regions in which they are interested, investigating not only the areas in which developments are concentrated but also the quality of the servicing agent retained by them. Inasmuch as the servicer alone maintains a continuing direct contact with the mortgagor, utmost care and scrutiny must be exercised in making this selection. The buying group receives applications for advance commitments in large blocks and, in turn, refers them to member banks for selection and acceptance. As indicated above, local banks are concerned solely with the permanent financing and generally will issue a commitment only if adequate construction credit has already been arranged.² Individual member banks receive detailed information surrounding each mortgage application, including such items as borrower credit rating, house construction, neighborhood location, FHA rating, etc.

If a given insured mortgage application is acceptable to a member bank, the commitment is forwarded to the builder representative and the servicer agrees to perform his specified functions at a fee of $\frac{1}{2}$ of 1 per cent of the unpaid loan balance. The price which the local institution is required to

¹Warehouse operations are described by J. J. Scully of the Chase National Bank in the Boston Sunday Herald, Real Estate Section, June 1, 1952.

²As stated earlier, each type of financing institution, short-term and long-term, frequently requires a commitment on the part of the other before granting final approval to a particular home mortgage application.

pay for the mortgage depends upon current competitive conditions prevailing in the market. Inasmuch as contract interest rate maximums on such loans are fixed by the VA and FHA, adjustments in net yields are accomplished through a variable market price on the paper itself. Since most out-of-state mortgages have been acquired pursuant to commitments issued prior to Spring 1951, purchase prices have generally been above par. Paying premiums did not in itself deter most banks from making such purchases, however, as net yields were still quite favorable, especially when acquired through disposing of government bonds which were also selling at a premium.¹ It was during these times that local lenders were anxious to purchase sound mortgages from the FNMA, as selling prices on its holdings were generally quite favorable.²

Since the bond market break in early 1951, however, most insured and guaranteed loans have been selling at discounts of 1 - 3 points. The discount may even be more substantial if the property is not in a choice location or if the mortgage company is encountering special problems in securing adequate financing. The continuing existence of substantial discounts does not necessarily spell severe operating losses on the part of the servicer, however, for he is generally reimbursed in full by the builder who, in turn, makes a corresponding adjustment in home selling prices. Furthermore, the servicing agent does not ordinarily depend upon broker commissions as a primary source of income but is far

¹Some interviewed lenders, however, refer to other members of the mortgage fraternity who are opposed in principle to buying mortgages either at a premium or at a discount; the former because they refuse to pay more than what the paper is "worth", and the latter because they fear the paper is substandard.

²See below for a discussion of FNMA operations.

more concerned with retaining the servicing option.¹ Since insured loans are now selling at a discount, mortgage lending institutions are able to realize net yields in excess of those indicated on the contract itself. At the present time, market selling prices are such that net yields after servicing are approximately 3.75 per cent on either FHA or VA home loans if carried to maturity.² Some bankers have estimated that the additional servicing required on such loans at their own office entails an extra 0.15 per cent of the loan balance, roughly equivalent to a third of that for conventional portfolio loans held by a moderate-sized institution.³

Although lending institutions take every possible precaution in selecting suitable servicing agents, a certain degree of risk remains in the event the latter are unable to fulfill their stated obligations. It is possible, though perhaps not likely, that the payment of $\frac{1}{2}$ of 1 per cent of outstanding loan balances is adequate to provide profitable operations only so long as a sizeable volume of loans are serviced each month. If new lending were to be drastically curtailed, outstanding balances on existing mortgages would decline rapidly, and revenues drop off sharply. If the servicer were forced to discontinue operations, the lending institution holding the permanent mortgage would perhaps choose one of these alternatives: search for a new servicer, attempt to sell the paper, or else continue servicing the loan from its home office. Even though the mortgages concerned are either insured or guaranteed, administrative problems would be doubly serious if servicer bankruptcy were accompanied by

¹One of the lenders interviewed spoke of a servicer who charged a 1-2 point premium for all loans but agreed to perform all servicing for an unusually low $\frac{1}{8}$ of 1 per cent fee. This lender shuns away from such schemes, believing the agent to be after short-run gains but unable to effectively service the loans throughout the term for such a small fee.

²It will be recalled that nominal gross yields are $4\frac{1}{4}$ and 4 per cent, respectively, on these two mortgage types. FHA debentures continue to offer a nominal $2\frac{1}{2}$ per cent yield, a factor which allegedly reduces the desirability of insured loans in face of a general tightening of bond rates. Although debentures are marketable and fully guaranteed by the government, a mortgagee seeking immediate liquidity from a foreclosed loan would absorb a capital loss in their sale. In contrast, settlement of VA claims
(Footnote continued)

waves of mortgage delinquency and foreclosure throughout the region.¹

In order to effectively hedge against this latter eventuality, at least one local savings bank refuses to invest in mortgages beyond the New England area. The mortgage officer of one such bank indicates that all secondary market transactions are handled through a large broker-servicer located in Portland, Maine. In the event this agent is forced into bankruptcy, the mortgagee is in a position to continue servicing himself with a minimum of confusion and effort, as all properties are located within a one day's driving distance from the home office.²

All but one savings bank out of the Big Five have participated rather extensively in the secondary mortgage market. The executive officer of the remaining institution expresses an interest in the secondary market and believes current out-of-state lending regulations are most desirable. His institution has also shown a real interest in the FHA program, as its insured holdings on local properties exceed that of any other lender in the area. Perhaps in part because of distant lending activities of others, however, this Boston bank has been able to approach its legal mortgage-deposits limit through making loans on local properties alone. Only if

¹Indeed, widespread foreclosures would be hazardous even where the servicing agent were reasonably competent, for the latter may be unable to exercise the same discretion in handling such matters as would a local mortgagee.

²Many life insurance companies were compelled to set up their own servicing systems after encountering difficulty with the correspondent system during the early depression years. The latter were unable to fulfill their initial servicing contracts, owing in large part to methods of receiving compensation therefor. Rather than charge a percentage fee periodically throughout the loan term, they were paid a fee only at the time of loan origination. Saulnier, Urban Mortgage Lending By Life Insurance Companies, op. cit., pp. 31-32.

are always paid in cash.

³These estimates were made by the president of a progressive \$25 million savings bank.

demand slackens considerably will this bank seek any out-of-state loans whatever, particularly so long as relative yields on local and distant mortgages remain unchanged.

An important factor which has induced the above and other institutions to refrain from distant lending altogether and has also limited such activity of participating banks concerns the $\frac{1}{2}$ of 1 per cent state excise tax. As stated earlier, average deposits are the basis for this tax, but investments in Massachusetts securities or real estate loans, federal securities, and certain other outlets constitute allowable deductions. Since non-taxable assets exceeded average deposits among most local savings banks in mid-1949, a certain amount of out-of-state mortgage investment was possible without incurring tax liability. After a certain point has been reached, however, any added investment in such loans subjects the bank to substantial cuts in net yields after tax. Under present conditions, the net yield might be trimmed to as low as $3\frac{1}{4}$ per cent, little above the government bond rate and equivalent to that on choice eligible corporate securities.¹ Accordingly, many banks have made purchases in the secondary market only up to the point where any added loans would entail this tax liability. Hence, the prospects for continuing purchases are not very promising under existing circumstances, as most lenders consider a net yield of $3\frac{1}{4}$ per cent as inadequate to warrant added mortgage investment. Quite understandably, savings bank interests regard this discriminatory levy as detrimental to the best interests of their depositors, for it has effectively precluded an optimum mortgage investment program. To remedy this situation, a substitute measure has been proposed whereby tax liability is a function of dividend payments. This latter levy would supposedly produce larger tax revenues for the Commonwealth, but would remove the undesirable

¹Residual administrative costs appear to be roughly the same among these alternate investments.

discriminatory features of the existing structure.¹

Summarizing, local savings banks have realized several distinct advantages from their recent operations in the nationwide secondary market.² In the first place, a greater availability of insured loans has afforded participating institutions an opportunity to increase income without endangering surplus. During the postwar period, a means of increasing revenues was not only desirable, but was virtually essential for the continuing growth of local savings banks. Indeed, costs were mounting steadily and dividend rates were still far below those on savings and loan shares, largely because the latter were invested primarily in high-yielding mortgage loans. Insured mortgages appeared well-suited to qualify under both investment criteria of profitability and safety. Especially as long as the excise tax could be effectively avoided, these low-risk mortgages offered considerably higher net yields than could be obtained on government bond holdings. At the same time, overall risk in this marginal investment would be effectively minimized through gaining the loan insurance protection of the FHA or VA.³

A second major benefit accruing to secondary market purchases concerns further implications of the safety criteria in mortgage investment. The opening of this additional source of investment has undoubtedly lessened the temptation for certain banks to expand mortgage portfolios through accepting undesirable risk elements or engaging in other dangerous practices. The competitive tactics employed by local savings banks in the postwar period have already been outlined, including liberal construction loans

¹Interview with C. L. Goss.

²Most of these benefits were discussed in an interview with Mr. C. L. Goss, President, Worcester County Institution for Savings, who has undoubtedly been the primary driving force behind current secondary market authorization.

³See below.

with tying agreements for permanent mortgaging, price cutting, etc. Since 1949, these institutions have had the option of securing distant mortgages with a minimum of administrative effort, if securing additional local business became unusually difficult. Unsound loan requests could be refused on the local level, as the funds could be profitably invested elsewhere. Price-cutting has apparently subsided in recent years and some lenders outside Boston proper have found a more ready demand for $4\frac{1}{2}$ and 5 per cent mortgages than previously. This latter factor reflects in large part a general tightening in bond rates, but it may also result from the opening up of mortgage investment opportunities in other markets.

Even if only high quality conventional loans are selected, a lending institution may achieve an even higher quality mortgage portfolio by increasing its investment in FHA and VA loans. The more funds that a bank invests in the latter, the smaller is the probability of its holding frozen assets in a subsequent depression. If such an economic reversal should occur in the near future, the dangers of holding frozen assets would be especially critical in the case of many local thrift institutions with conventional mortgage portfolios overburdened with unseasoned, high-percentage loans based on the current inflated price level. In order to hedge against this eventuality, a few savings banks have expanded holdings of insured and guaranteed mortgages both on local and distant properties so that their combined volume comprises over one-half of aggregate mortgage holdings.

Thirdly, the quality of mortgage portfolios is materially improved by virtue of the diversification accruing to out-of-state mortgage investment. Although savings banks have long been permitted to invest in securities of other states, mortgage investments until 1949 were restricted to Massachusetts properties alone. Until this barrier was removed, all such investment

was subjected to the many risks inherent to this local economy. Under current regulations, the undesirable effects of this concentration may be minimized, as mortgages may be placed on properties in regions whose economic fortunes hinge on vastly different forces. The effects of prosperity and depression vary widely across the country and the probability of mortgage delinquency and loss is lessened through proper geographic diversification.

Lastly, local savings banks have acquired the art of trading in mortgages on a big scale, and have also strengthened the secondary market in so doing. Mortgage officers have become familiar with the details of this operation and have attained a certain skill in selecting sound mortgage investments without a personal knowledge of either borrower or pledged property. Out-of-state mortgages are generally purchased in large block amounts, and are regarded not wholly unlike certain bond investments. The usefulness, or more correctly the indispensability, of FHA risk rating in making such selection has perhaps served to emphasize the primary risk elements in any mortgage transaction, whether it be distant or local, insured or conventional. Lenders note the care with which the FHA examines not only the construction itself, but also its relation to the neighborhood as well as the continuing ability of the borrower to bear the prescribed debt service. The more progressive lenders have already incorporated a certain degree of systematic risk analysis in conventional mortgage screening but an appreciation of its indispensability in distant insured lending may well induce a more universal adoption of such methods in all lending.

The private secondary market has been materially strengthened through the increasing participation of savings banks and other lending institutions in its operations. Indeed, at certain times in the postwar period, this private network has been so active that FNMA operations were confined

primarily to mortgage sales, with a negligible demand for purchases. If trading in mortgages continues to expand in volume, the point may be reached whereby the secondary market would approach a conventional securities exchange. In such an event, the holder of an eligible mortgage could find a ready and reasonably stable market for the paper whenever additional liquidity were sought. Obviously the current secondary market is far from this advanced stage and even the FNMA stands willing to purchase certain mortgage loans only from the original mortgagee, and only within a restricted period following its origination. Nevertheless, mortgage lending is no longer strictly a local operation, and methods of facilitating a free inter-regional flow of mortgage credit are steadily improving.¹

FNMA EFFORTS IN THE NATIONWIDE SECONDARY MARKET

As indicated earlier, two essential elements in the development of a secondary market have been the creation of a standardized mortgage instrument and an institution designed to facilitate its exchange. The private mortgage interests throughout the country were, among other things, too disorganized and localized to provide these elements without fairly direct federal stimulation. The FHA-insured, and later on VA-guaranteed, mortgage loans have served as the eligible paper, and the FNMA and RFC Mortgage Company have stood ready to support their prices in the open market. Providing this necessary support has required extensive purchases in some periods, but a negligible volume in others.

Nationwide Activity

In the prewar period, the FNMA stimulated an interest in newly-authorized high-percentage, long-term mortgages by purchasing \$246.6 million in Title II loans. During the subsequent war years, credit demands for new home construc-

¹See "Summary and Prospects" below.

tion were sharply curtailed and the volume of mortgage sales far exceeded that of acquisitions. By 1945 sales, repayments, and other credits had reduced the outstanding FNMA portfolio to a \$7.4 million level.¹

During the early postwar years, the FNMA gradually enlarged its holdings of insured mortgages, but the extent of such operations was limited until mid-1948. As stated earlier, the RFC Mortgage Company alone was authorized to trade in VA loans, having made cumulative purchases of \$140.8 million before its liquidation in June 1947. From this date until July 1948, when FNMA authorization was extended to include VA loans, government bond rates tightened somewhat, certain lenders shunned away from making 4 per cent VA loans, and the market for this paper fell sharply.² It was at this time that the inferior trade mark on guaranteed loans, relative to that on Section 203 insured loans, was first brought to the forefront. Undoubtedly the "substandard" interest was the primary cause of this inferior marketability, but also risk characteristics were less uniformly and systematically analyzed in VA loans. Perhaps similar comments would apply to the 4 per cent Section 603 loans under the emergency FHA program. Postwar purchases of Section 603 loans have nearly equalled in volume the cumulative purchases of Section 203 during the entire 12-year period through 1950.³

Following its expanded authorization in mid-1948, the FNMA proceeded to purchase VA-guaranteed as well as FHA-insured loans. Although the former accounted for but 11 per cent of total purchases in the latter half of 1948, this proportion rose sharply to 80 per cent one year later. During this

¹Annual Report, HHFA, 1950, p. 71.

²From May 1947 to January 1948, the average yield on taxable long-term Treasury bonds rose from 2.19 to 2.45 per cent. Business Statistics Supplement to Survey of Current Business, Department of Commerce, July 1951, p. 96.

³The precise values were \$374.6 and \$339.3 million, respectively, Annual Report, HHFA, 1950, p. 77. FHA Section 203 mortgages were still quite marketable in large part because the 4½ per cent maximum rate was in effect until early 1950.

latter period, the FNMA disposed of \$19.8 million of its mortgage holdings, only \$0.4 of which were VA loans. These data serve to indicate the relatively inferior marketability of 4 per cent VA loans even when the government bond rate was falling once again.¹ Nevertheless, now that VA loans once again became more marketable either through the FNMA or the private secondary market, veterans began to experience less difficulty in securing 4 per cent credit and VA applications rose from 330 thousand to 623 thousand between 1948 and 1950. A substantial portion of FNMA purchases of VA loans during these years, however, were acquired directly from mortgage companies whose primary function is to originate and sell mortgages to private investors. The frequency of such acquisitions increased abruptly in late 1949 when certain restrictions were removed. Until October of that year, original mortgage lenders could sell to FNMA no more than 50 per cent of all loans insured or guaranteed since April 1948. The removal of this limitation made it possible for lenders to sell all such loans made, thereby providing an assured market for their paper in the event private buyers could be found only at a discount. As a result, mortgage companies accounted for nearly 40 per cent of VA purchases by the FNMA in late 1949, in contrast to a 14 per cent share one year earlier.²

The virtually guaranteed par market provided by the FNMA, coupled with a generous advance commitment procedure, played a prominent role in the postwar home building boom. The latter procedure made it possible for the mortgage company or other institution receiving the commitment to secure the necessary construction financing with ease, since the commitment assured a market for the permanent mortgage on the completed house.³ While such operations undoubtedly facilitated an expanded volume of new home

¹Yields on government bonds had fallen back to 2.19 per cent by December 1949. Business Statistics, op. cit., p. 96.

²Annual Report, HHFA, 1949, p. 24.

³Through issuing such commitments, the FNMA agreed to purchase specific mortgages at par plus accrued interest at any time within 1 year provided all other requirements are met.

construction and purchase, the federal government had in effect become a primary source of mortgage credit, thereby aggravating inflationary pressures already mounting. Whenever access to the secondary market facility is given to all types of mortgage originators, government credit may virtually relegate credit facilities of conventional thrift institutions to a subordinate role. Investment programs of the latter, frequently termed portfolio lenders, are controlled primarily by the flow of savings and repayments and the demand for various types of investments. Since their operations are tied in with the general capital market, the interest rates which they charge roughly reflect supply and demand conditions existing in that market. The operations of other types of mortgage originators, such as mortgage companies, are controlled neither by these general market forces nor by monetary authorities. To take an extreme case, suppose that no loans whatever are made by portfolio lenders and that a government facility provides unrestrained and indiscriminate purchasing authority. Under these circumstances, the secondary market facility would actually function as a primary lender, with mortgage originators operating as feeders and servicing agents so long as the compensation for such activity proved to be adequate.

Through such a perversion of secondary market functions, interest rates may be permanently maintained at a level at which the private credit market cannot equate supply and demand. If it appears in the public interest to supplement or supplant private credit in certain capital-short areas, a more logical procedure might entail direct government aid in providing credit or in improving existing private credit facilities. Indeed, when indiscriminate use of a government facility is permitted, there is a real danger of unsound mortgage lending. So long as the Association continues to assure a market at par without recourse and without examination of indi-

vidual loans, mortgage originators may exercise less discretion in selecting loans for resale than for permanent portfolio holding. Undoubtedly this danger is minimized when the loans have undergone a screening process based on uniform standards, but the reliability of this hedge is decidedly less certain in the case of VA than FHA loans. In any event, mortgage originators would logically sell off prime loans to private portfolio lenders so long as a premium were offered, and channel the remaining less desirable loans to the facility.¹

The disastrous consequences of an unrestrained government facility in an inflationary economy were clearly demonstrated by early 1950, and remedial measures were promptly instituted. During the first 3 months of 1950 alone, commitment contracts amounting to \$963 million were made, representing FHA and VA mortgages of \$42.3 million and \$920.7 million, respectively. At the end of March 1950, advance commitments aggregating \$1,456 million were outstanding, all but \$485 million of which were fulfilled or otherwise cancelled by the end of the year.² Largely pursuant to these contracts, the dollar volume of the 1950 purchases was 55 per cent greater than those in 1949 and equal to 90 per cent of all purchases from the inception of FNMA in 1938 through 1949.

Inasmuch as the federal government was attempting to combat inflation through fiscal measures, and later on through monetary policy as well, an unrestrained FNMA would tend to nullify these objectives. Hence, the Housing Act of 1950³ provided for the cessation of the advance commitment procedure, after which eligible mortgages could be purchased by FNMA only

¹The writer is indebted to Prof. Leo Grebler, Columbia University, for much of this material on the analysis of the FNMA.

²Annual Report, HHFA, 1950, p. 74.

³April 20, 1950, Effective May 10.

when guaranteed or insured at the time of the contract. Under current regulations, over-the-counter mortgages may not be presented to the Association for purchase earlier than 2 months or later than 12 months after the date of insurance or guaranty. In addition to this restriction, as well as others¹ regarding the price class or construction standards of the property, a lender may not dispose of over one-half of its otherwise eligible insured loans to the FNMA. These regulations effectively reduce the dangerous feeder operations of non-portfolio mortgage companies, who no longer can rely on the government to provide a ready market for their paper. They now must have adequate resources to hold eligible loans at least 2 months, and they must look to the private market for most permanent mortgage credit.²

Through curtailing the quantity of FNMA support for private home financing and through stimulating sales out of its portfolio, the federal government has paved the way for a larger participation of private capital in the secondary market. It was during this period that Massachusetts savings banks and other large institutional investors became active buyers in the expanding secondary market. During 1950 alone, the dollar volume of FNMA sales³ was more than double its total mortgage sales during the 12-year period through 1949. Private investors became interested in VA-guaranteed as well as FHA-insured loans, so that during the later months of 1950 dollar sales of the former actually exceeded the latter. Perhaps this increasing concentration on VA loans was due in part to the relative availability of the two mortgage types, for only one-sixth of VA mortgages purchased by FNMA had been sold by the end of 1950, while the corresponding proportion

¹See "Federal National Mortgage Association," Chapter 8.

²Apparently the 50 per cent rule does not apply to VA loans, at least as of late 1950. Annual Report, HHFA, 1950, p. 72.

³Involving 69,996 mortgages with total unpaid balance of \$469 million.

for insured mortgages was three-fifths.¹

Although average bond yields were rising slowly throughout 1950,² the FNMA found a ready market for both insured and guaranteed mortgages, even commanding a premium of $\frac{1}{2}$ of $2\frac{1}{4}$ per cent. During 1951, however, it has already been mentioned that the market for this paper fell rather abruptly as a result of a substantial tightening in the overall capital market. FNMA had already withdrawn much of its support from the private mortgage market and the Federal Reserve largely abandoned its government bond support program, with the result that interest rates advanced and low-yielding FHA and VA mortgages could be sold only at a discount.³ Some large insurance companies found themselves overburdened with advance commitments to purchase VA or FHA mortgages at or above par, and could fulfill these agreements only through disposing of government portfolios at a discount. Relevant data are not at hand, but from interviews made it appears that, after these commitments were completed, mortgage funds have flowed more freely once again. Indeed, as far as Massachusetts savings banks are concerned, the factor retarding a continuing interest in making purchases of insured or guaranteed mortgages is not the substandard nominal yield, but rather the discriminatory state excise tax on out-of-state mortgage investment.⁴ As would be expected, mortgage sales from FNMA holdings fell to \$111 million

¹ Annual Report, HHFA, 1950, p. 77. These ratios may be somewhat misleading, as it must be remembered that FNMA authority to purchase VA loans was granted only in 1948, while FHA loans had been bought and sold since 1938. Another factor accounting for the increased interest in VA loans concerns the more widespread impression that VA rates would not be raised in the near future; in the past, such speculation undoubtedly deterred many investors from buying 4 per cent VA loans (especially during late 1947 and early 1948).

² The long-term treasury bond rate rose from 2.20 to 2.39 per cent from January to December.

³ Between February and May 1951, average yields on Treasury bonds rose from 2.40 to 2.63 per cent, and yields had reached 2.74 per cent by January 1952.

⁴ Page 430 above.

in 1951 from the 1950 high of \$469 million. VA-guaranteed loans have gradually occupied a major role in such sales operations, comprising three-fourths of the 1951 volume, but less than one-half during 1950. At the same time, however, VA loans also continue to dominate FNMA purchases, accounting for nine-tenths of the \$677 volume million purchased in 1951.¹

Local FNMA Activity

The Boston area has rarely depended upon outside sources, either private or governmental, in order to meet its mortgage credit requirements. On the contrary, it evidences a relative surplus of mortgage funds, and of necessity has exported funds to those areas where opportunities for profitable investment are more abundant. As indicated earlier, portfolio lenders dominate the local mortgage market, and mortgage companies have never flourished to the same extent as in other areas where existing credit facilities are unable to provide the required long-term financing. In mid-1951, the dollar volume of mortgages being serviced for others by lenders or other agents in the local four-county area amounted to only \$92 million, representing 4 per cent of total mortgages held for their own account. Undoubtedly, a large share of these servicing operations arises from loans on isolated single-family and multi-family properties arranged through loan correspondents for outside insurance companies. These agencies frequently operate as real estate agents or brokers, channeling choice loans to affiliate insurance companies while retaining servicing, and referring other mortgage business to local lending institutions on a fee basis.² In contrast to the local area, loans serviced for others among mortgage lenders and agencies in the Dallas Federal Reserve District were equivalent to $1\frac{1}{4}$ times

¹ Housing Statistics, HHFA, January 1952. As of December 31, 1951, approximately two-thirds of the \$2,750 million gross authorization consisted of mortgage holdings, of which 89 per cent were VA-guaranteed loans.

² Mortgage brokers and real estate agents accounted for over 80 per cent of such servicing operations. These agents may service a few mortgages for individual investors who had purchased the instrument from them but are not equipped for proper servicing.

the total dollar amount held on their own account.¹

In view of these supply-demand relationships, it is not surprising that the FNMA has purchased a limited amount of mortgages on local properties. On December 31, 1951, the Association owned no mortgages in the entire Commonwealth, and during the past several years such purchases have been rare.² Obviously the volume of insured mortgage purchases has been practically nil, inasmuch as the FHA program has never flourished in this area. In addition, even though the VA-guaranteed loan has enjoyed a wide acceptance, lending institutions have rarely looked to the FNMA for relief if immediate liquidity were required. A small federal in the local market has frequently sold insured or guaranteed mortgages to other associations in order to maintain a steady volume of new lending or to satisfy pressing withdrawal demands. Another large federal has virtually functioned as a miniature FNMA, by purchasing mortgages from certain loaned-up institutions and selling to others with an excess of idle share capital. Among those "loaned up," a large Boston federal has frequently solved serious liquidity problems, generally arising out of withdrawal demands, by converting VA-guaranteed mortgages into cash. The continuing effectiveness of this hedge, however, depends upon an ample stock of eligible mortgage paper, as well as a ready and reasonably stable market.³

As mentioned in the previous discussion, local savings banks have figured prominently in the development of a private secondary market. Authorization for out-of-state mortgage investment coincided with the

¹"Real Estate Loans of Registrants under Regulation X," Federal Reserve Bulletin, June 1952, p. 627. Across the nation, total loans serviced for others amounted to one-fourth of total portfolio holdings.

²Letter from J. S. Baughman, President of FNMA, February 5, 1952. From the data referred to in footnote on p. 424, the negligible amount of local FNMA purchases are clearly indicated; in 1942 insured loans on 8 Massachusetts properties were thus acquired, but none whatever in either 1947 or 1950 (Sections 203 and 603).

³The association could have perhaps called in the Home Loan Bank for additional advances, but this facility had already been used quite extensively.

launching of the new FNMA policy regarding the sale of its portfolio holdings. Accordingly, as the government proceeded to withdraw from its extensive support program, local savings banks stepped in and purchased nearly \$30 million in FNMA mortgages by mid-1951. During the 2-year interval through June 1951, these purchases aggregated \$200 thousand or more in the case of 9 local banks, and approached \$16 million in one case. Of these aggregate purchases, FHA-insured loans represented 58.4 per cent of the dollar volume and 51.9 per cent of the number of individual mortgages.

(See Table II.) Next to savings banks, which accounted for two-thirds of

TABLE II. PURCHASES OF FHA-INSURED AND VA-GUARANTEED MORTGAGES FROM FNMA BY LENDING INSTITUTIONS* IN THE BOSTON AREA, AUGUST 5, 1949-JUNE 30, 1951

(Dollar Amounts in Thousands)

<u>Type of Institution</u>	<u>Number of Institutions</u>	<u>FHA Loans</u>		<u>VA Loans</u>		<u>Total</u>	
		<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>	<u>Number</u>	<u>Amount</u>
Savings Banks	9	2,315	\$16,544	2,153	\$11,793	4,468	\$28,337
Commercial Bank	1	160	1,269	671	3,901	831	5,170
Life Insurance Co.	2	126	820	1,020	7,565	1,146	8,385
All	12	2,601	\$18,633	3,844	\$23,259	6,445	\$41,892

Source: Data supplied by J. S. Baughman, President of FNMA.

* Includes only those institutions making aggregate purchases of \$200 thousand or more.

all mortgage purchases from FNMA, were two local life insurance companies. Curiously, VA loans accounted for over 90 per cent of total purchases by the larger of these companies, in direct contrast to the corresponding ratios for other institutions. This may reflect a preference for VA loans as a matter of policy, but it may merely result from the acquisition of mortgages on a particular site development in which VA financing was used almost exclusively. Just as in other secondary market trading, the investing institution generally purchases mortgages from the FNMA in large block amounts. The single commercial bank included in Table II has been active both in financing construction operations as well as in purchasing

permanent mortgages on distant properties. In dollar volume, its purchases from FNMA constituted 12.3 per cent of the total and ranked third among all institutions.

SUMMARY AND PROSPECTS

In summary, it appears as if the private secondary mortgage market has developed to a considerable extent during the postwar period. This development has been decidedly hastened and strengthened by the entrance of Massachusetts and New York savings banks into this nationwide market. It is to be expected that as private lending institutions come to recognize and respect the relatively uniform security characteristics of insured and guaranteed mortgages, the government facility may occupy a progressively less prominent role in the market. Aside from the specific benefits accruing to the individual lending institutions themselves, extensive purchases of distant mortgages have effectively channeled long-term credit into areas where it is most needed. In the continuous theoretical case, assuming a perfect capital market, lenders would continue to purchase mortgages in the secondary market until at the margin net yields on all portfolio investments were equalized. In a free market, a mass transferral of funds from government bonds into out-of-state insured mortgages would tend to reduce current prices of the former and raise those of the latter, thereby bringing net yields more closely in balance.

In the local capital-surplus area, participating institutions in the secondary market have relied almost entirely upon the retirement and sale of government bond holdings in making distant mortgage purchases, and have not perceptibly modified credit standards in making local conventional loans. On the other hand, it is conceivable that in the absence of the recent savings bank authorization, the pressures of mounting expenses and inadequate

revenues from predominately government bond portfolios would have prompted some institutions to further relax eligibility requirements in order to expand mortgage holdings. While such an eventuality merely reflects a highly competitive situation, it might result in an impairment of the soundness of mortgage portfolios if undesirable risk elements are blandly accepted without due compensation therefor. As pointed out above, the opportunity to invest elsewhere has facilitated a more equitable distribution of long-term funds, benefiting both borrowers in import areas as well as depositors in the exporting thrift institutions.

It is not at all unlikely that the development of an effective secondary market has obviated a further extension of federal intervention into the mortgage field. If large institutional investors from the Northeast had been unwilling to invest vast sums of long-term credit in capital-deficient regions of the country, the government might have felt obliged to make direct loans in order to relieve the situation. This latter procedure was virtually followed between 1948 and 1950 when the FNMA offered to purchase unlimited amounts of insured or guaranteed loans from non-portfolio mortgage companies. Especially where advance commitments were involved, construction financing was easily secured and the mortgage originator was not compelled to seek private investors to take over the permanent mortgage. Since these practices were effectively minimized in 1950, the market for eligible mortgages has fallen significantly but only in accordance with the overall bond market, despite the less active participation of the government facility.

Although the FNMA functions less as primary source of funds now than previously, a new challenge to the private secondary market lies in direct loan program of the VA. Under the Housing Act of 1950, the Veterans Administration was granted authority to make direct loans to veterans in areas where 4 per cent VA mortgages are unobtainable through the usual lending

agencies. In other words, if institutional investors possessing investible long-term funds are unwilling or perhaps unable to satisfy credit requirements of veterans in capital-short areas, the federal government is now authorized to offer direct relief. Although the extent of this direct lending activity has been slight compared with aggregate VA guaranty operations, its mere existence represents a challenge, if not a threat, to private mortgage investment.

Although the secondary mortgage market is increasingly dominated by private institutional investors, the federal government continues to be the key factor in its operations. First of all, FNMA has not withdrawn completely from the market, but has merely curtailed certain highly inflationary aspects of its operations, and continues to make substantial purchases on an over-the-counter basis. Since its purchases are somewhat limited, both as to amount and type of insured loan accepted, the private market for this paper has slipped below par. Nevertheless, the fact that FNMA is still potentially if not actually a supporter of the insured mortgage market has retained the interest of private investors in buying and holding such paper. It seems most unfortunate that private interests have never established a private national mortgage associations to possibly supplant the existing FNMA.¹ This serves as an instance where federal authorities were not only willing to charter private associations but were even offering financial inducements for so doing. Curiously, private interests, abhorring

¹The American Bankers Association and other trade associations have discussed such proposals at various times, but there is little evidence of any concerted efforts toward positive action. In 1951 a special panel of builders, promoters, and lenders recommended that the ownership of FNMA be transferred to approved mortgagees under a plan which would require all to own stock, similar to member bank investment in the Federal Reserve and the analogous Home Loan Bank System. Thence, the new FNMA could sell short- and long-term debentures to the public and not depend upon the Treasury for funds. See "Mortgage Crisis," Magazine of Building, August 1951, p. 123.

the spread of federal intervention, failed to seize this opportunity for strengthening private control over the market and virtually prompted the establishment of FNMA by default.

Even if FNMA were completely abandoned, the government would still be compelled to supply an essential ingredient in secondary trading, namely, the standardized credit instrument. As discussed earlier in this chapter, it appears highly improbable that a free nationwide exchange would evolve about a privately-underwritten mortgage contract for a great many years, if ever. Only if certain basic weaknesses in the conventional mortgage contract were removed or largely overcome would mortgage paper move freely in financial trading. If such were accomplished, however, a private secondary market would perhaps be a natural and inevitable development without any federal prompting.¹

At least three primary changes would be required before a truly effective private secondary market could be attained.² The first of these changes has already been discussed earlier in this chapter, namely, the incorporation of uniform foreclosure and title laws and procedures across the country.³ Closely allied to these barriers to free interstate mortgage investment are the various statutory regulations placed upon lending areas of state-chartered thrift institutions. Partial relaxation of such restrictions among savings banks in Massachusetts and New York represents a notable achievement in this regard. Even among local savings banks, however, continuing interest in out-of-state mortgage investment is contingent upon the removal of the discriminatory excise tax on most forms of non-state invest-

¹ Under these circumstances, government supervision might be required only where public distribution of the mortgage debt is involved, in order to prevent a repetition of the mortgage bond disaster. See Chapter 8.

² These proposals are mentioned by M. L. Colean, "What Makes a Secondary Mortgage Market Tick?" Savings and Loan Annuals, 1948, pp. 152-153.

³ P. 419.

ment.

As a second prerequisite of a more effective secondary market, a uniform method of appraisal and risk rating must be instituted, to be universally accepted and practiced by all lending agencies. Disregarding the possible violation of anti-trust laws, the establishment of such standards would be most costly and time-consuming, as existing methods of risk rating are generally haphazard and applicable only to a restricted lending area. Among the various methods available, perhaps agreement could best be reached by using the FHA appraisal system as a model. Hence, it appears as if a more widespread utilization of FHA-insured lending offers more immediate promise for a more effective secondary market than would an extension of Home Loan Bank facilities.¹ FHA insurance is a necessary trade mark which must be associated with a mortgage instrument before it is freely traded. A similar public acceptance accrues to VA-guaranteed loans as well, but the VA program is of a temporary nature and consequently will gradually wane in significance in future years.² By promoting FHA-insured lending on a much more extensive scale, all mortgage lenders would become familiar with the elaborate risk rating system employed in screening applications. Gradually thereafter it would be hoped that the understanding and recognition of such scientific risk analysis would facilitate the adoption on an uninsured basis of an acceptable standardized mortgage instrument for secondary trading.

The Home Loan Bank, on the other hand, seeks not to interfere directly with lending practices and specific mortgage contracts written, but rather to standardize and coordinate the overall operations of member institutions.

¹For a penetrating analysis of the FHA and FHLB objectives, activities, and rivalry, see D. M. French, "The Contest for a National System of Home Mortgage Finance," The American Political Science Review, February 1941, pp. 53-69.

²Unless, of course, the VA program is extended or otherwise modified so as to cause its significance to continue.

Only after this latter objective were realized to a high degree would any secondary trading of conventional mortgages take place on a nationwide basis. Such a development seems most remote at best, as it is difficult to conceive of a local savings and loan association purchasing mortgage loans written by even reputable lenders on distant properties unless the former were familiar with the details of the case and unless some concrete assurance of its soundness were provided. Perhaps this development is not seriously considered by the Home Loan Bank, except on a most hypothetical level.

As a substitute solution to long distance mortgage lending, the Home Loan Bank System does attempt to promote inter-regional capital flows through making short- and long-term advances to member associations. In order to raise the necessary funds, the Banks accept time deposits and certificates from members with an abundance of idle share capital and also issue debentures for sale.¹ As stated earlier, this method of channeling mortgage credit is inferior to the system whereby FHA, VA, or some other standardized mortgage loans are to be freely traded. Under the former scheme, the member institution enlarging its time deposits maintains a high degree of liquidity but makes a substantial sacrifice in yield relative to mortgage investment. At the same time, the association seeking Bank advances is afforded the opportunity to make additional mortgage loans, but is unable to reduce overall portfolio risk to the same extent as under the alternate system. The member may put up its mortgage holdings as security for advances, but it cannot sell them outright to the Bank. Indeed, mortgage originating institutions would be far more willing to dispose of existing holdings in order to make new loans if these holdings could be sold without recourse. Under existing circumstances, the inclusion of a FHA or VA contract is required before the buying institution is willing to assume the

¹See Chapter 7.

mortgage without recourse.¹

A third requirement of a truly effective secondary market specifies that interest rates be permitted to move freely with interest rates in general. Under the present FHA and VA programs, the establishment of interest rates, loan terms, and other dimensions of mortgage price is directly influenced by social and political as well as economic considerations. This is not the place to analyze the philosophy underlying such activities, but federal attempts at providing unusually liberal credit availability for certain income groups have heavily influenced the type, tenure, and price class of new home construction. Unless the government or private secondary facility seeks to promote certain non-economic objectives, it seems essential that interest rates be free to fluctuate as changing market conditions dictate. If the facility attempts to maintain interest rates at an artificially low level, its mortgage portfolio would expand steadily up to the limit of its authorization and inflationary pressures already mounting would continue unchecked. Such conditions prevailed during much of the postwar period until FNMA purchasing operations were decidedly curtailed in 1950. Since that time, however, net yields on insured mortgages have moved quite closely with general interest rates, although FNMA purchases during 1951 exceeded sales by a 6 to 1 ratio.² If the facility were absolutely free from federal interest rate tampering, the total volume of mortgages held would be relatively unchanged over long periods of time,

¹The Boston Home Loan Bank has recently introduced a service of assisting local members in trading mortgages among themselves. It does not function as a true broker, but merely brings the two parties together on an informal basis.

²Just as the FNMA tends to abet the inflationary spiral during boom periods, so also would it tend to accelerate a possible deflationary movement. During a downswing, the fixed interest returns on FHA and VA loans would appear more favorable and private investors would become active buyers of FNMA holdings. Therefore, the facility would absorb current savings without a corresponding increase in real investment.

as purchases from mortgage lenders in capital-short areas would tend to be counterbalanced by sales to those in surplus markets.

In conclusion, the realization of a truly stable secondary mortgage market is not yet clearly in view, although prospects are not altogether unfavorable. It will certainly be a long time before private individuals will feel free to purchase mortgage loans in the same manner as corporate or government securities. Rather than expect the ultimate in secondary trading, it would be a great achievement if appraisal standards and statutory regulations were sufficiently modified so that institutional investors would freely trade in mortgage paper. The road ahead is long and difficult, but there are indications that the private secondary market, especially when insured mortgages are concerned, will become progressively stronger and more effective.

PART VIII. CHAPTER 15. SUMMARY AND CONCLUSIONS

This study will be concluded with a brief analysis of two timely issues, some background material for which have been presented in the body of this study. Firstly, the soundness of existing mortgage portfolios will be analyzed with reference both to the adequacy of the interest rate structure as well as the relation between surplus reserves and potential mortgage loss. Secondly, the influence of certain federal programs upon the competitive structure of the local mortgage market will be reviewed.

SOUNDNESS OF MORTGAGE PORTFOLIOS .

Among the three types of institutions chosen for detailed study, mortgages have always constituted a primary investment outlet for savings capital. Among local cooperative banks and federal savings and loan associations, real estate loans have consistently comprised over 70 per cent of total resources, with the ratio exceeding 90 per cent in some cases. Even savings banks, whose investment opportunities provide for a far more widely diversified portfolio, have also regarded mortgage loans as their major non-government investment. As indicated earlier in the study, lending operations of all institutions tend to vary directly with local real estate activity, although the extent of these fluctuations is not uniform among the various types. For example, local savings and loan associations found a sharply curtailed demand for new home loans during the depression years, but nevertheless assisted many existing home owners through rewriting old-fashioned mortgage contracts and offered prospective home buyers liberal long-term credit availability. Savings banks, on the other hand, largely because of unsystematic mortgage loss policy, virtually withdrew from the market precisely at a time when risk on new loans was at a minimum. As a

consequence, mortgage-assets ratios among local savings banks had fallen from a 52.2 per cent level in 1927 to 23.5 per cent by 1946. Corresponding ratios among federals and cooperative banks in the latter year were 71.0 and 74.5 per cent, respectively.

Despite an unusually severe depression loss experience, mortgage loans continue to represent a highly profitable investment. Indeed, gross losses on mortgage holdings of all Massachusetts savings banks during the years 1931-1945 amounted to only 1.16 per cent of the average outstanding portfolio of unforeclosed mortgages. After deducting this amount as well as an estimated 0.4 per cent per year for acquisition and servicing expense from the average interest rate of 4.96 per cent, net yields realized on mortgage portfolios during this 15-year period were 3.4 per cent per year. Hence, even when evaluating mortgage experience at a time when delinquencies and foreclosures were at a maximum, net yields were larger than could be obtained in any year except 1933 on government bonds with maturities exceeding 12 years.¹ If the period under consideration were extended back into the earlier prosperity years, mortgage yields were even more favorable, for over the 39-year period, 1907-1945, aggregate losses represented only 0.6 per cent per year of the average volume of mortgages outstanding. Comparable data are not available in regard to mortgage yields among local savings and loan associations, but Professor Lintner estimates that their loss experience corresponded quite closely with that on unamortized, 60 per cent residential mortgages held by Massachusetts savings banks.²

To summarize, not only does the spread between interest rates on mortgages and on other investments such as government bonds include a differential

¹Lintner, op. cit., pp. 305-6.

²Lintner, "Our Tremendous Mortgage Debt," Harvard Business Review, January 1949, p. 104.

risk premium, but this premium appears to have exceeded the actual loss sustained by all major lender groups over the past half-century. The fact that the losses which did develop were not smoothly and effectively handled has been due in large part to the failure of lenders to set aside special loss reserves effectively available for this purpose.¹ Nevertheless, while a proper handling and use of reserves would have effected a more satisfactory method of dealing with mortgage losses as they appeared, an improvement in other phases of mortgage lending policy would undoubtedly have been even more beneficial. Indeed, the fact that such heavy mortgage losses had been sustained in the first place was due in large part to inadequate methods of loan selection and servicing as well as an inferior contract form (i.e., straight-term, non-amortized, etc.).

The postwar expansion in mortgage holdings has surpassed all previous peaks among many local lending institutions, and mortgage-assets ratios have also advanced significantly. Aggregate portfolios of both local savings banks and federals doubled in dollar volume during the first 5 post-war years, while cooperative banks registered a less spectacular 33 per cent advance. Furthermore, new loans written by savings banks over this period were 2.2 times the outstanding balance in 1946. Inasmuch as unseasoned, high percentage loans based on highly inflated valuations dominate mortgage portfolios, some parties have expressed concern over the possible unsoundness of the existing mortgage structure. This concern is not wholly unfounded in view of the fact that much of the recent depression loss experience can be traced directly back to unsound mortgage investment policy during the late 1920s.

Since maximum mortgage yields are necessarily limited by contract interest rates, net yields on existing portfolios will undoubtedly be less

¹Lintner, Mutual Savings Banks, op. cit., Chapter XII.

than in previous years, even assuming a most favorable experience during the downswing of the cycle. Contract rates of interest on new mortgage loans have followed rather closely the overall decline in interest yields over the past two decades. Although average rates tend to be more flexible on new than on aggregate mortgage holdings, the decline among the latter has been equally significant. Between 1927 and 1951, average interest rates on aggregate mortgage holdings of local savings banks fell from 5.99 to 4.27 per cent, and of local cooperative banks from 6.20 to 4.59 per cent.¹ Over this 25-year span, interest rates on mortgage loans have consistently exceeded those on long-term government bonds by $1\frac{1}{2}$ to 2 per cent, although this margin has narrowed recently in the case of institutions making 4 per cent mortgages.² The spread between average dividend rates and mortgage rates has declined steadily since the prewar years, but is significantly above the 1927 level among both savings and cooperative banks.³

Cost Components

As indicated in Part III, interest returns on mortgage loans are expected to adequately cover three primary cost components, namely, dividend returns, administrative costs, and risk compensation.⁴

These components will be briefly summarized with reference to the existing rate structure. As shown in Tables IX and X, dividend rates among both types of institutions fell steadily from the late 1920s well

¹ Tables IX and X, Chapter 11.

² The long-term government rate on taxable bonds was 2.74 per cent in January 1952.

³ Tables IX and X, Chapter 11.

⁴ It should be repeated, however, that earnings on invested surplus have generally provided local institutions with substantial revenues; in the past such revenues plus fines, etc., frequently covered total administrative costs among local cooperative banks. On the other hand, the narrow spread between interest and dividend rates during the late 1920s undoubtedly was inadequate to properly compensate for the heavy risk inherent in the new mortgages being written at that time.

into the postwar period. Since 1949 there has been a slight upward tendency in dividend returns once again, except in the case of cooperative bank serial shares. In recent years savings banks and cooperative banks have paid roughly the same return on ordinary savings accounts, with federals generally offering a slightly higher yield. At the same time, however, aggregate capital costs have been the highest among cooperative banks, for paid-up and serial shares continue to dominate their capital structure on which a premium return of up to a full 1 per cent has ordinarily been paid. Hence, taken as a whole, savings banks have consistently attracted savings capital by offering the smallest relative dividend return among local thrift institutions, with the notable exception of commercial banks which have largely refrained from active mortgage lending on other counts.¹

Little data are available as to the administrative expense involved in procuring and maintaining mortgage portfolios. As indicated earlier in the study, there appear to be some significant economies accruing to large-scale mortgage operations, although unit costs vary widely among local thrift institutions, both as to type as well as size. Among local savings banks making choice new loans at 4 per cent, including primarily the largest Boston institutions, an allowance of 0.5 per cent per year appears to be adequate to cover all acquisition and servicing costs.² Average costs appear to be considerably higher among cooperative banks than among savings banks, in part because of size differentials, but undoubtedly because of other factors as well. Expressed in terms of average operating expense per \$1,000 of assets, the respective cost ratios were \$8.68 for cooperative banks

¹See Chapter 10.

²One progressive banker estimates such costs have risen in recent years but still approximate 0.45 per cent per year on local mortgages, where all servicing is performed by the bank itself. See below for yields on out-of-state investments.

and \$4.92 for savings banks in 1950.¹ A large part of the existing differential in average expense ratios even among cooperative banks and savings banks of similar asset size is due to the far more prominent position of mortgages in the asset structure of the former associations. Indeed, it is very possible that if the two institutions were comparable both with respect to asset size as well as mortgage-assets ratio, the cost differential existing between local savings and cooperative banks would largely disappear.² In addition, some local savings banks continue to hold a substantial volume of large income-property loans as well as unamortized term loans, generally regarded as less expensive to service than small, monthly payment type mortgages. Though comparable data are not available, there is good reason to believe that operating costs among federals are significantly higher than among either type of state-chartered institution. Federals in particular maintain far more extensive advertising budgets than any other type of mortgage lender, although some of the larger savings banks have stepped up such activities in recent years. Most interviewed mortgage officers from local savings and loan associations are quite uncertain about precise servicing costs, but a margin of at least 2 per cent is frequently mentioned as a minimum coverage for both risk and administrative expense.³

Very little can be said with assurance regarding the risk component implicit in the mortgage interest rates currently charged by local lending institutions. Indeed, the extent of subsequent losses on any mortgage portfolio depends upon a great many variables, some internal and some external

¹ Annual Report, Massachusetts Commissioner of Banks.

² Unfortunately there is no simple method of testing this hypothesis, as mortgage-assets ratios among cooperative banks consistently exceed those of savings banks by a significant margin.

³ If the interest rate structure of local cooperative banks and federals were analyzed in detail, one would probably discover that most of this 2 per cent margin should be allocated to loss reserves, as loans made by these associations tend to involve a higher risk assumption than corresponding savings bank loans. (See below.)

to the lending firm. Included among the primary internal variables are the quality of loans in present and prospective portfolios, the adequacy of servicing functions, and the ability to effectively handle mortgage delinquency and default once such a contingency arises. A reasonably complete understanding of past mortgage lending experience provides an invaluable guide for future mortgage policy, but the element of uncertainty can never be eliminated. Indeed, perhaps the most determining of all factors concerns the extent of the economic reversal hypothesized, inasmuch as delinquency and foreclosures tend to be cumulative and most damaging during such periods.

Even assuming a subsequent loss experience as severe as that sustained during the years 1931-1945, choice conventional loans written by savings banks at 4 per cent appear to provide a satisfactory net yield. Thus, after deducting 0.5 per cent per year for acquisition and servicing costs and an unusually generous loss allowance of 1.2 per cent per year, net yields on uninsured loans are but slightly below current long-term government yields.¹ As pointed out above, a more valid estimate of potential mortgage loss should be based on previous lending experience over a longer period. Hence, if the 39-year interval, 1907-1945, were taken as a guide for mortgage risk, the net yield on 4 per cent mortgages would be 2.9 per cent, slightly above current government bond yields. Breaking down current rates in a different manner, if the above cost rate of 0.5 per cent per year as well as the current 2.3 per cent dividend rate on savings deposits were deducted from the 4 per cent mortgage contract rate, an estimated 1.2 per cent per year would still be available for reserve allocation.²

¹This comparison overstates the attractiveness of government bonds, for the bank must exert a certain amount of administrative detail in managing these portfolios.

²Inasmuch as dividend rates and administrative costs have drifted upward since 1949, the margin for reserve allocation was even larger in earlier years.

Inasmuch as the mortgage loss experience of local savings and loan associations has not been the subject of an intensive analysis, very little can be said in regard to inherent risk in their respective portfolios. Perhaps the minimum interest rate to be charged by local cooperative banks and federals is somewhat higher than by savings banks on account of all three cost components mentioned above. As reviewed earlier, these smaller institutions have consistently faced a higher relative cost structure, and have generally paid more generous dividend returns on savings capital. With respect to risk implicit in mortgage transactions, several reasons were advanced in Part V to indicate that local savings and loan associations have on the whole been willing to write relatively high-risk mortgages. Whether this risk be manifest in an unusually high loan-value ratio, property location in an unstable or decadent neighborhood, antiquated construction, or inferior borrower credit rating, many local associations have continued to charge a full $\frac{1}{2}$ to 1 per cent premium above the rate realized on prime savings bank mortgages.¹ Certainly one cannot ascribe a minimum rate differential to properly compensate for the added risk inherent in certain loans, but a differential of up to a full 1 per cent may be consistent with a reasonable degree of competition.²

Favorable Risk Factors

Even if a forthcoming depression should prove to be as severe as the last, some factors point to a more favorable mortgage loss experience while others foretell the opposite situation. Only by weighing the relative influence of these opposing factors can any tentative conclusion be reached. The latter factors relate primarily to the unseasoned, high percentage loans which predominate most local mortgage portfolios. Inasmuch as such loans have been based upon a highly inflated price structure, a sudden reversal in economic activity might easily wipe out the accumulated thin equities,

¹ As pointed out in Chapter 12, high-risk loans also tend to entail added servicing costs, as such loans require close check to minimize delinquency and accelerated property depreciation.

² See concluding summary on competitive structure.

thereby resulting in substantial losses to the lending institution. .

Among the favorable factors, the first relates to the increasing significance of small home loans among mortgage portfolios of local savings banks. Losses taken on residential loans made by all Massachusetts banks between 1918 and 1931 were no more than half as large as those incurred on aggregate portfolios. Indeed, all subsequent losses could have been easily covered through reserves accumulated at the rate of 0.48 per cent per year on outstanding balances.¹ Furthermore, even on single-family loans made during the years 1927-1929, subsequent losses amounted to only 0.6 per cent per year of the average life of the original loans.² Inasmuch as loans on 1- to 4-family properties have always dominated mortgage holdings of local savings and loan associations, the increasing prominence of small home loans is less pronounced. On the other hand, loans on single-family dwellings are undoubtedly more common today, especially among associations financing new construction on a large scale.

Another favorable factor concerns the significant role played by insured and guaranteed loans in the mortgage portfolios of local thrift institutions. Although the FHA program has not been well received by local federals and cooperative banks, VA loans have been generously written throughout the postwar period, so that by 1951 insured and guaranteed loans represented nearly a third of aggregate holdings of both lender types. The participation of savings banks in these two federal programs has followed much the same pattern so far as local properties are concerned, for in 1951 in-state FHA and VA loans accounted for 2.3 and 22.0 per cent, respectively, of aggregate holdings. Since mid-1949, however, mortgage portfolios of local savings banks have undergone substantial revision, largely resulting from

¹Lintner, "Our Tremendous Mortgage Debt," *op. cit.*, p. 96. The properties included in aggregate portfolios ranged all the way from single-family home to a fair grounds.

²Lintner, Mutual Savings Banks, *op. cit.*, p. 312.

their authorization to make a limited investment in out-of-state mortgages. By October 1951, nearly \$100 million had been placed in these channels, thereby increasing the proportion of aggregate mortgage holdings represented by insured and guaranteed loans to 37.4 per cent. Largely because of this extensive participation in the FHA and VA programs by savings banks, the dollar volume of conventional mortgage holdings was actually larger in both 1927 and 1936 than in the peak postwar year 1951.

As indicated earlier, FHA and VA loans are not entirely free of risk, although the probability of gross mortgage loss is effectively minimized. FHA-insured loans are covered in full by the insurance feature and, in the event of default, the mortgagee may choose whether to retain title to the property or seek FHA debentures and a certificate of claim. The VA provides only a partial guarantee against loss and reserves the right to determine whether mortgagee or guarantor acquires the property title in the event of foreclosure. On the other hand, the VA guarantee of up to 60 per cent of the loan balance is sufficient to offset most contingent depression losses. In addition to providing safety, federally-secured loans are undoubtedly more marketable than any other type of mortgage contract, thereby injecting a vital element of liquidity into mortgage portfolios. When distant FHA or VA mortgages are purchased in the secondary market, the investing institution engages an outside agent to handle all servicing functions, ordinarily entailing a fee of 0.5 per cent per year of the loan balance. Accordingly, current nominal yields are seldom in excess of 3.75 per cent, but net yields on such investments are still quite attractive.¹ It should be emphasized that these data on FHA and VA loans refer to overall mortgage holdings, and

¹Unless the savings bank is subject to the $\frac{1}{2}$ of 1 per cent state excise tax on its added out-of-state investments. See Chapter 14.

of course indicate nothing about the individual portfolios concerned. Indeed, whereas some local institutions have over one-half of their aggregate holdings protected by either federal agency, others continue to concentrate on conventional loans for the most part.

In addition to their substantial holdings of FHA and VA loans, local lenders have perhaps improved the overall quality of their conventional portfolios through various means.¹ In regard to proper loan selection, many local lenders appear to employ somewhat more thorough and systematic risk rating techniques. Rather than rely upon a conservative debt-value ratio as the primary criterion of soundness, lenders are placing an increasing emphasis upon the credit rating of the borrower and his ability to carry the attendant debt service. Furthermore, the long-term adequacy of the pledged property is considered in the light of the economic characteristics of the surrounding neighborhood and its secular development. As indicated earlier, the risk analysis employed in all uninsured lending is still far from this desired level, but there is definitely a tendency away from the dangerous "curb appraisal" methods of the 1920s.²

Perhaps the increasing concern over proper risk selection and loan servicing is due in large part to the prominence of high-percentage, long-term loans in mortgage portfolios. Indeed, only by careful loan selection and servicing can these otherwise high-risk elements be effectively overcome. At the same time, however, borrowers are less frequently obliged to seek second and third mortgage loans for supplementary financing. Even though aggregate borrowings are roughly the same, mortgagors secure all the necessary credit from one source on a relatively low cost, convenient basis. Lender and borrower alike benefit from making debt repayment on a

¹See Lintner, "Our Tremendous Mortgage Debt," op. cit., pp. 102-106.

²Certainly it is to be hoped that the lessons learned from the past disastrous loss experience may be used to advantage in minimizing mortgage delinquency through proper loan selection and servicing, and in effectively handling defaulted mortgages once they occur.

monthly direct-reduction basis, with principal, interest, and real estate taxes all included together. Although amortization itself is no panacea for mortgage loss, a systematic retirement of the outstanding obligation safeguards the lender from heavy principal loss if a forthcoming depression were to occur but a few years after such loans were written.¹

Furthermore, the likelihood of mortgagor delinquency is perhaps significantly lessened whenever debt service can be conveniently handled on a monthly income basis. Not only as a matter of convenience, but borrower motivation is properly stimulated by virtue of the fact that a progressively larger equity in the property is lost if foreclosure becomes necessary during the repayment period. Indeed, the fact that the recent depression loss experience of cooperative banks was no more favorable than that of residential holdings of savings banks can hardly be regarded as an indictment against amortized loan contracts. On the contrary, the loss experience of cooperative banks would have perhaps been far more disastrous if it were not for regular principal repayment, especially if these institutions tended to make relatively high-risk mortgages in the 1920s just as in the postwar period.²

Loss Reserves

An analysis of the current rate structure is essential in providing an insight into the adequacy of these rates to properly compensate for the various cost elements implicit in new mortgages being written. When considering the overall soundness of existing mortgage portfolios, however, one generally refers to the adequacy of reserve accumulation to cover the

¹See Table II Part IV for a schedule showing the remaining debt balance on a 25-year loan after repayment has proceeded a varying number of years. Professor Lintner observes that, if bank appraisals in 1929 had been 5 per cent below current prices, an 80 per cent, 15-year loan would have had an outstanding balance lower than current market valuation (based on new construction costs) in every depression year. *Ibid.*, p. 104.

²For the relative loss experience, see *Ibid.*, p. 104.

potential losses arising out of these holdings. Since the depression years, the surplus position of local thrift institutions has improved steadily, so that by 1951 these reserves were at an all-time high relative to total resources. Between 1930 and 1951, for example, book surplus as a percentage of total assets increased from 7.76 to 10.55 per cent among all savings banks in Massachusetts, and from 3.34 to 9.12 per cent among cooperative banks. In 1951 surplus reserves in the 15 local federals represented 6.86 per cent of total assets, also presumably at or near an all-time high.

As a result of their favorable surplus position, local thrift institutions could perhaps sustain relative mortgage losses in terms of total assets fully as severe as during the last depression without seriously disrupting normal bank operations. Gross losses on mortgage portfolios of Massachusetts savings banks amounted to \$207.8 million during the last depression, a sum equivalent to 9.0 per cent of total assets and 1.05 times combined book surplus in 1930. Even if the same share of total assets in 1951 were to result in mortgage loss, this latter sum would represent but 0.85 times present surplus.¹ To be more realistic, the adequacy of present surplus should be based upon the relation of total loss on past mortgage portfolios to surplus existing at that time. Once again current prospects are favorable, for even if 16.4 per cent of total mortgage portfolios held in 1951 resulted in total loss, the dollar loss would represent but 0.61 times present surplus.²

Analogous observations may be made regarding potential loss on cooperative bank portfolios. As indicated earlier, cooperative banks fared somewhat better than savings banks in terms of relative loss on aggregate mortgage

¹ When losses on securities are included as well, aggregate loss figures relative to book surplus are correspondingly greater. See Lintner, Mutual Savings Banks, op. cit., p. 266. Also see footnote 1 on p. 465.

² The 16.4 per cent value refers to the ratio between subsequent losses in the years 1931-45 to mortgage portfolios in 1930.

portfolios, largely because of the heavy non-residential holdings of the latter. Among all cooperative banks in the Commonwealth, gross losses during the years 1931-1945 amounted to 0.63 per cent per year of the annual outstanding volume, in the aggregate equivalent to 1.38 times their significantly smaller book surplus of 1931.¹ By 1951, combined surplus of the remaining state-chartered banks had more than tripled, while mortgage portfolios has actually declined somewhat. Hence, if subsequent losses were to amount to 7.14 per cent of existing mortgage holdings, the total sum would constitute but 0.56 times the present book surplus.

Two additional comments should be made relative to the adequacy of existing bank reserves. In the first place, the mere existence of a substantial reserve accumulation does not in itself assure a satisfactory mortgage-loss policy. Indeed, before mortgage delinquency and default can be systematically handled, these retained earnings should be properly recognized and treated as bona fide loss reserves. In order to minimize the characteristic reluctance among local banks to write down book surplus as a matter of principle, the establishment of special mortgage valuations reserves has been proposed.² In the second place, depositors in all local thrift institutions are largely protected against loss through a network of central banks and deposit insurance funds. State-chartered institutions belong to their own respective organizations, whereby

¹It must be remembered that private securities were much more prominent in savings banks' portfolios and actually accounted for nearly two-fifths of total depression losses; hence, it is to be expected that surplus bear a higher ratio to mortgage portfolios among savings banks. It should be mentioned, however, that potential losses arising out of bond portfolios are undoubtedly far less severe today than 20 years ago. In 1930 private securities accounted for 24.4 per cent and government securities 11.1 per cent, respectively, of total assets for all savings banks in the Commonwealth. In 1951, on the other hand, the relative importance of these investments was reversed, with private and government securities constituting 10.8 and 46.8 per cent, respectively, of combined assets. In view of the predominance of low-risk federal securities, the relation between non-mortgage portfolios and existing surplus appears highly favorable.

²See Lintner, *Mutual Savings Banks*, *op. cit.*, Chapter XII.

state authorities may take over and operate insecure affiliated banks and also tap the resources of the limited insurance funds if necessary. Federals, and member state-chartered banks as well, may utilize the central reserve facilities of the Home Loan Bank, and the former have the added share insurance protection of the FSLIC. Undoubtedly a repetition of the debacle of the early 1930s would inflict a severe strain upon these state and federal agencies, but their existence should go far in easing the burden among member institutions, no small part of which revolves about a continued public confidence in the safety of their deposited funds.

In summary, a final judgment as to the adequacy of the existing rate structure and book surplus can be ascertained only at some future date when mortgage delinquency and default perhaps mount once again. Certainly the actual loss experience depends to such a great extent upon the severity of the forthcoming downswing hypothesized that even an informed guess is of limited value. Undoubtedly the fact that savings banks as a whole refrained from active mortgage lending at a time when overall risks were at a minimum and have surged back into dominance during inflationary periods has influenced the potential loss in such portfolios. Savings and loan associations are less guilty of this charge, as lending operations have been a bit more stable over the cycle. It remains to be seen, however, whether or not improved techniques of mortgage selection and servicing, full amortization contracts, and other favorable factors will be sufficient to offset the various opposing factors. On the whole, it seems highly probable that, providing a future depression is no more severe than the last, local savings banks and savings and loan associations are fairly well fortified against loss. Not only are the major cost components well compensated by the existing interest rate structure but book surplus also appears to be in a far healthier position today than 20 years ago.

Inasmuch as current revenues from mortgage loans as well as other investments have enabled local thrift institutions to expand book surplus to unprecedented levels, the present upward drift in dividend returns among the stronger banks appears well justified.¹ Indeed, since they are truly mutual institutions, both savings banks and savings and loan associations are obliged to distribute those earnings which are not required for loss reserves or other specific purposes. Now that their retained earnings are subject to the federal corporate profits tax after reserves approach a certain level, local institutions may be more inclined to either reduce mortgage interest rates or increase dividend rates in the near future.² In view of the overall tightening in interest rates throughout the country, the latter eventuality seems a bit more likely. As indicated earlier, lenders are perhaps more selective in extending liberal credit today than in the early postwar years, but there has been no perceptible advance in average contract rates.

IMPACT OF FEDERAL INTERVENTION UPON THE COMPETITIVE STRUCTURE OF THE LOCAL MARKET

The issue of raising dividend payments or reducing interest rates on some or all mortgage loans once again raises the philosophical question as to what thrift institutions seek to maximize, a question which defies a simple explanation. Both rates are tied in with the general capital funds market in some fashion, but the degree of isolation between these markets varies widely through time as well as among areas at any given time. For instance, the level of dividend rates is roughly related to current yields

¹Cf. the narrowing spread between mortgage interest rates and dividend returns, Tables IX, X, Chapter 11.

²On the other hand, they may prefer to utilize otherwise taxable revenues in enlarging salary or advertising budgets. The former may involve a permanent increase, while advertising may be expanded only until the levy is eliminated or reduced.

on savings bonds, insurance policies, and other public investments, as well as the necessary compensation for parting with cash liquidity. Such a functional relationship is a tenuous one at best, for many systematic thrift programs are of a long-term nature, whether they involve insurance premiums, payroll savings, or savings and loan serial shares, and the individuals concerned are not at liberty to shift from one plan to another without a substantial sacrifice in yield.¹ On most conventional thrift accounts, however, the savings institution may adopt a fairly flexible dividend policy, adjusting current rates to correspond with changing market conditions. Changing mortgage rates, on the other hand, is not so simple when an institution is holding a substantial portfolio of long-term loans. Consequently, many are reluctant to reduce existing rates below a level which appears permanent, lest they risk a substantial loss in long-run income maximization in the event of subsequent rate advances.² Aside from the problem of anticipated rate changes, mortgage lending policies are dependent upon the relative attractiveness of alternate investment outlets, notably government bonds and choice private corporate securities. Once again, however, thrift institutions both because of custom and statutory regulations ascribe a widely varying role to mortgage investment in their respective portfolios.

Savings banks, as indicated earlier, were initially established to provide a depository for community savings, and all investment decisions, pertaining to mortgage lending as well as other forms of investment, have been regarded as subordinate to the accomplishment of this goal. In other

¹e.g., special club accounts promote regular savings but offer no special premium for it; indeed, frequently no dividends whatever are paid on these small accounts on grounds that they are unusually expensive to service.

²Methods of hedging against this eventuality are reviewed in Part V.

words, savings banks are afforded an opportunity to invest in various private and governmental securities as well as out-of-state mortgages whenever local mortgage demands appear relatively less attractive. In a sense, life insurance companies pursue the same objectives, that of maximizing investment income consistent with safety, but in this case the supply cost of investible funds is somewhat more rigid by virtue of long-term premium and adjustment schedules on policies outstanding. Moreover, these companies are perhaps less bound than most thrift institutions to maintain a steady mortgage investment in their local communities, and are afforded considerable latitude in placing funds in various mortgage markets throughout the nation or in any of a great many other investment outlets. Savings and loan associations, at the opposite extreme, regard the promotion of home ownership and community thrift as coordinate objectives, and on a policy level at least are supposed to ascribe equal significance to their realization.¹ Provided competitive conditions permit, insurance companies and savings banks may feel obliged to increase dividend returns as soon as adequate loss reserves have been established. At the same time, savings and loan associations perhaps feel an equal responsibility to lower mortgage rates, thereby effectively reducing overall costs of home purchase and widening opportunities for individual home ownership.

In practice, however, there may be little or no difference in the operations of these various lender types, as the existence of all types in the same market area permits but a relatively narrow range for arbitrary policy-making. Furthermore, one should not gain the impression that raising dividend rates and lowering mortgage interest rates necessarily constitute the accomplishment of contradictory objectives. On the contrary, the realization of these goals may come hand in hand, and the latter is frequently

¹The varying degrees of attachment to mortgage lending as a primary investment outlet have been amply demonstrated by the impact of the upward drift in bond rates, especially since early 1951, upon a continuing interest in VA and FHA mortgages among insurance companies and conventional thrift institutions. See Chapter 14.

a prerequisite for the former. Whenever demand for mortgage credit appears relatively elastic, either to the firm or to the system of firms, individual lenders may find a rate reduction to be an effective means of stimulating a heavier inflow of mortgage applications and hence of augmenting revenues. For example, at the close of the Second World War, local savings banks regarded a significant reduction in current interest rates as essential in reversing the steady downward movement in operating income and dividend returns.¹

Over the past two decades the interest rate structure has declined to what might appear to be a permanently lower plateau. The significant declines in both mortgage rates and dividend returns reflect in large part the overall movements in this structure and are not the result of forces operating within the mortgage sector alone. While one cannot delineate the specific role played by any given institutional factor in influencing this movement, the significance of federal intervention in both local and nationwide mortgage markets should not be overlooked. Perhaps no one would deny the dominant influence exerted by the federal government in establishing and maintaining an easy-money policy well into the postwar period. Similarly, federal activities and agencies have had a profound influence upon specific mortgage contracts written as well as lending practices and policies followed in the Boston market area. This is not the place to appraise the overall desirability of federal intervention into hitherto private sectors, but brief reference should be drawn to its impact upon the competitive structure of the local mortgage market.

Disregarding the philosophical considerations underlying these efforts, it can be shown that federal activities have afforded positive benefits to home buyer and depositor alike, with the lending institution sharing in

¹See below.

the gain of both. Certainly many of these benefits would have arisen as a natural outgrowth of existing conditions, but federal efforts have tended to accelerate their development. Inasmuch as these gains are mutually shared by the three parties concerned, they will be considered jointly in the discussion that follows.

Prewar Competitive Structure

A perusal of limited data has confirmed the impression shared by numerous interviewed parties that local savings banks as a whole had long enjoyed a commanding influence over mortgage lending operations, perhaps as late as the onset of the recent major depression. These institutions had been firmly entrenched in their respective communities for over a century in many cases, and prospective mortgagors as well as depositors looked to them as the primary source for such services. Cooperative banks and savings departments of local trust companies grew rapidly during the booming 1920s, but hardly constituted much of a threat to the continuing dominance of savings banks. The latter rarely found it necessary to engage in outright price cutting or extensive advertising campaigns, as the desired mortgage level could be maintained without resort to such tactics. Indeed, once such a level had been established, the bank could maintain the same mortgages within its portfolio for an indefinite period. As pointed out earlier, their unamortized mortgage portfolios were simple to service, provided generous interest yields, and rendered mortgage investment policy a routine matter. Moreover, such loans were reasonably secure, especially when the pledged property provided steady rental income for the mortgagor and was adequately maintained. As a result of these "favorable" factors, the lending institution seldom felt inclined to seek substantial principal repayment until liquidity needs would warrant.

During this period, cooperative banks functioned primarily as small community institutions, facilitating local home purchases through providing long-term credit for existing shareholders. Being of modest means, such

individuals required high-percentage loans, but the absolute dollar amount was relatively low. For the best mutual interests of borrower and lender, repayment was set up on a level monthly payment basis under the traditional share-accumulation plan.¹ Quite naturally, such loans were relatively expensive to service, both because of the type of mortgage contract as well as the small loan amounts concerned. At the same time, cooperative banks were compelled to continually seek new mortgages in order to keep funds fully employed, inasmuch as existing loans were automatically retired in full as soon as the sinking fund reached a certain level. Indeed, a local cooperative bank executive frankly admits that his bank got merely "the drippings" from mortgage business which would otherwise be refused by savings banks.

This easy life among savings banks was abruptly checked following the downswing of the early 1930s. While public confidence in the soundness of these institutions was amply demonstrated by the heavy inflow of panic savings from rival depositories, savings banks were entering a period in which their previous dominance was seriously challenged on several counts. First of all, the creation and adoption of various federal and state deposit and share insurance funds gradually restored public trust in any approved thrift institution. Thereafter the community of savers began to select a depository on the basis of more than safety alone, notably including dividend returns and convenience.² Thus, while the widespread adoption of deposit and share insurance did not in itself impair the position of local savings banks, their competitive advantage of assuring absolute safekeeping was gradually waning in significance.

¹See Chapter 5.

²See Chapter 5.

A far more serious challenge to the dominance of savings banks resulted from the re-chartering of several local cooperative banks into federal savings and loan associations. This authorization, in addition to the creation of FSLIC referred to above, provided member associations a new lease on life whereby they might enter the local savings and mortgage markets with added vigor. A deficiency of share capital posed no particular problem for most federals, as they could readily secure substantial advances from the newly-created Federal Home Loan Bank to make new mortgage loans. Thus, protected by federal share insurance and afforded liberal credit availability from the central bank, local federals were properly equipped to embark on a spectacular expansionary program during the prewar period. Savings banks, on the other hand, were so busily engaged in handling delinquent and defaulted loans that new mortgage applications were entertained only where an exceptionally good showing was made. Being preoccupied with clearing up the unfavorable consequences of earlier unsound lending practices, these institutions were either unaware of or indifferent toward the rapid rise of newly-chartered federals. The latter not only welcomed loan applications but enthusiastically promoted individual home ownership through advertising and publicity campaigns of unprecedented proportions.

A vital key to the success of local federals, and of the more progressive cooperative banks as well, concerned the offering of high-percentage, direct-reduction loan contracts. Whereas savings and loan associations had always recognized the merits of fully amortized loans in their share-accumulation schemes, it took more overt federal intervention before genuine direct-reduction contracts would be universally adopted. Not only were federals required to write new home mortgages on this new monthly payment basis, but the FHA and HOLC also had similar provisions. Whereas FHA-insured loans were made rarely in the Boston area,¹ the HOLC proved to be

¹See Part VI.

most helpful in disposing of frozen mortgage holdings among all types of local thrift institutions. At any rate, federals offered the type of mortgage program which the home buying community preferred, while savings banks persisted in writing loans on a straight-term basis, if at all. Although both factors are significant, it is hardly stretching the point to state that federals achieved dominance in the prewar mortgage market as much through default as through their own aggressive efforts. Moreover, it is noteworthy that federals expanded portfolios without making any substantial concessions in the form of lower interest rates. Advertising and other forms of non-price competition, coupled with a significant liberalization of such quasi-price components as loan-value ratios and loan terms, were used as primary tools in realizing this growth.

Postwar Structure

The competitive struggle for new loans in the postwar period has already been analyzed in some detail,¹ so only brief reference will be made here. Savings banks had finally completed their extended depression foreclosure program and once again sought to rebuild sorely depleted mortgage portfolios. Their re-entrance into the local market was not automatic, however, as federals and other rival lenders had retained many of the solidities established during the prewar era. The inherent surplus capital characteristics of this market became increasingly pronounced and savings banks were virtually compelled to make substantial concessions in order to recoup some of their loss in relative position. Loan contracts which appeared to be fully as liberal as those written by most federals were offered by these banks and interest rates were reduced to 4 per cent in many cases.² Although they were opposed to the principle of honoring brokerage fees, most

¹Chapters 10-12.

²This similarity in contract provisions does not necessarily imply similar risk characteristics. See Chapter 12.

large Boston banks at least have consistently paid a 1 per cent finder's fee for new loans. Furthermore, liberal construction credit was extended to operative builders in order to secure a corner in the permanent financing of new home purchases.

While one cannot describe the local market structure as a perfectly competitive one, it may be safely presumed that the postwar period has witnessed many competitive features perhaps characteristic of a capital surplus area. Although the various trade associations seek to maintain strong ties among affiliated lender groups, the postwar race for mortgage loans has resulted in a certain amount of disaffection to these ends. As stated earlier, federals were frequently scored in the prewar period for refinancing on a direct-reduction basis unamortized mortgages which had been held by savings banks. During the recent competitive scramble, however, many energetic savings bankers engaged in extensive portfolio-raiding through offering a 4 per cent rewriting of choice seasoned loans held by suburban lenders, the latter frequently being savings banks as well as cooperative banks.

As indicated earlier, there is some reason to believe that the typical home buyer is better informed of alternate mortgage plans today than previously. Largely because of the widespread publicity afforded liberal VA-guaranteed loans, local buyers are increasingly sensitive of varying interest rates, down payment requirements, etc. Indeed, the significant role played by the VA home loan program has greatly narrowed the spread in average interest rates among mortgage portfolios of most local lending institutions. The FHA program has produced similar results in many parts of the country, but its influence on the local market is most indirect at best.¹

¹The VA program locally and both VA and FHA programs nationally have also had a direct bearing upon the increasing popularity of relatively low-cost single-family homes. The socio-political implications of this intervention are analyzed in some detail in Colean, The Impact of Government on Urban Real Estate Finance in the United States, op. cit.

Despite these favorable signs, the awareness of specific contract provisions is far from perfect among the home buying community. Lending practices and mortgage terms still display a wide variation within each lender type as well as among the principal types, a variation which cannot be wholly explained on economic grounds. There is reason to believe that cooperative banks and federals tend to accept a relatively high degree of risk in making 5 per cent loans on a conventional basis, while those large savings banks which offer 4 per cent credit strive to be highly selective in placing their funds.¹ As shown in the first section of this Part, a gross rate of 4 per cent on the latter appears to be adequate to cover the major implicit cost elements associated with mortgage lending. Whether or not this rate approximates that equilibrium rate which would exist under a theoretical perfectly competitive situation cannot be judged at this point. In face of rising net yields on government bonds and prime corporate securities, a 4 per cent rate hardly appears unjustifiably high.

It is doubtful, however, whether the $\frac{1}{2}$ - 1 per cent premium charged by suburban savings banks and most savings and loan associations is always the minimum compensation required for the additional risk involved. Extensive advertising, coupled with effective salesmanship, has greatly assisted local federals in maintaining a steady inflow of mortgage applications. Furthermore, the universal adoption of direct-reduction mortgage contracts has undoubtedly led many buyers to be more concerned about monthly payment than other important price elements, notably interest rates and length of repayment term. Cooperative banks continue to enjoy the utmost allegiance of their shareholders in regard to making home mortgages. Some bank officers frankly admit that rival savings banks in the immediate community would offer essentially the same liberal credit at a significantly lower rate.

¹See Chapter 12.

Home buyers are ignorant of alternate sources of credit, and prefer to deal with small community institutions with which they are familiar. Indeed, one savings bank officer reports that occasionally home owners are surprised to learn of the convenient mortgage plans available at savings banks. In large part because of ineffective merchandising efforts among the latter, many mortgagors continue to regard savings and loan associations as the only place where monthly payment mortgages are available.

In a similar vein, the mortgage interest rate structure continues to be significantly lower among the large Boston savings banks than among smaller suburban institutions. As explained in Chapter 12, the former often regard $\frac{1}{2}$ of 1 per cent as the minimum compensation to counter-balance the relative locational advantage enjoyed by banks in suburban residential communities. Thus, even though the five largest banks account for over two-fifths of total mortgage recordings among all savings banks in the Boston area, few genuine monopolistic privileges accrue to this dominance. Rather than operate as a collective unit, these dominant firms have vigorously competed with one another in securing new loans for postwar portfolio expansion. Certainly individual home buyers rarely shop around among city and suburban institutions for the "best deal" in mortgage credit, preferring to accept the offer of nearby banks as most satisfactory. Accordingly, the large Boston banks can keep their savings capital optimally employed only if home buyers in outlying sections are attracted to them in great numbers. It is here that builders and brokers perform an essential service, but the latter at least are frequently extremely sensitive of relative contract provisions offered by rival lending institutions. Through these operations, a certain degree of uniformity in long-term credit availability has been achieved within the center of the local market area, although this tendency becomes less pronounced as one extends outward into suburban districts.

Confirmed supporters of state-chartered thrift institutions have always decried the indiscriminate spread of federal influence into their own sphere of operations. Steeped in traditional New England conservatism, these parties absolutely refuse to deal with any bureaucratic federal administration unless dictated by necessity. It is interesting to note, however, that the nature of their attacks upon the existence and growth of federal savings and loan associations have been modified in recent years. During the late 1930s, most objections to the activities of local federals revolved about specific lending practices, particularly with respect to the aggressive promotional tactics employed and the liberal high-percentage, long-term contracts written. In the postwar period, however, rival institutions have found some merit in certain of these practices and now appear to decry the existence of federals on a more philosophical level. Several interviewed parties have referred to two separate features of the operations of federals that contradict the "very heart of true time-tested mutual banking."

The first of these objections concerns the creation of branch banks in communities not adjacent to the home office of the parent bank. Whereas state-chartered institutions may seek permission to set up branch offices only within the county of incorporation, two federals in Worcester and Pittsfield have established such offices in "distant" Springfield. Whereas the federals involved point to the crying need for more adequate credit facilities in the Springfield area, state banking interests have taken legal action against this extension of federal influence on grounds that conversion should not exempt an association from long-standing regulations, and also that the area concerned is overbanked already. The second objection centers about the liberal borrowing facilities of federals from the Home Loan Bank and other sources. Whereas state-chartered banks are dependent upon the inflow of community savings to provide investible funds, federals

are limited only by their extended line of credit. As a result, the latter have borrowed extensively to meet the credit demands of home buyers in mortgage markets already blessed with an abundance of long-term capital. In a similar vein, savings bank interests in particular have attacked the policy among local federals of permitting dangerously high mortgage-assets ratios without setting up adequate loss reserves.¹ A leading savings bank executive summarizes this position as follows:

. . . . We believe that savings banks are ready to meet all fair competition from soundly operated savings institutions, but some of our competitors appear to be acting on the theory that federal insurance is a substitute for reserves. The public is led to believe that these institutions will pay on demand, yet they invest all but a small per cent of their funds in long-term mortgages and then borrow against their liquidity funds to make more investments in mortgages.²

From an academic point of view, it has perhaps been contrary to the principle of optimum resource allocation in many cases for federals to seek Home Loan Bank advances merely to make additional mortgage loans. State-chartered institutions, especially savings banks, had vast sums of long-term capital ideally suited for sound mortgage investment. Lack of perfect knowledge among the various parties concerned, coupled with a singularly ineffective merchandising program on the part of many savings banks, has resulted in an inordinate proportion of new mortgage business being directed to local federals. The former continued to hold substantial portfolios of low-yielding government bonds unless positive measures were taken toward expanding their mortgage lending activity.

When analyzing the competitive elements in the local market, there is a very real danger of overstating the influence of federal intervention,

¹Cf. surplus positions of various lender types, p. 464 above.

²Address by T. W. Symons at Massachusetts Savings Banks Association Annual Convention, 1951, Reprinted in U. S. Investor, September 29, 1951, pp. 52-54.

for the lessons learned from the recent depression loss experience as well as the natural development of lending practice would have achieved similar results. There is no doubt, however, that the spectacular growth of federals had a very direct bearing upon the difficult competitive struggle that local savings banks faced in re-entering the postwar market. Their quasi-monopolistic position had been lost and the surplus nature of their investible capital became increasingly apparent. This is not to say that savings bank resources performed a subordinate role in financing the unprecedented housing boom in the postwar era, but merely that alternate sources of credit were mounting in significance. Savings bank leaders soon realized that local mortgage demands were insufficient to absorb the vast sums of investible funds without endangering the soundness of the entire mortgage structure. Hence, just as federals had assisted in rendering local mortgage lending increasingly competitive, so also did the FHA and VA provide a mortgage instrument to alleviate any undesirable consequences of this development. As analyzed in Part VII, all savings banks were authorized in 1949 to make a limited investment in insured and guaranteed mortgages regardless of geographic location. By virtue of this authorization, dependent almost entirely upon the uniform quality characteristics of the mortgage contract, savings banks are now afforded an opportunity to attain a degree of liquidity and diversification in their portfolios never before possible. At the same time, secondary market purchases of local savings banks are improving the overall competitive structure of the nationwide mortgage network by facilitating a flow of funds into optimal mortgage investment channels.

The rapid growth of federals has undoubtedly caused all local state-chartered institutions to re-examine their own policies and practices, with an eye toward maintaining their relative positions in the savings and mortgage markets. In the case of cooperative banks, however, the impact of

federal chartering has been even more direct, for the continued existence of the system of state-chartered associations is at stake. The immediate appeal of federal share insurance coupled with liberal borrowing and lending opportunities prompted a large number of local banks to relinquish their state charters during the prewar period.¹ As indicated earlier, conversion was readily accomplished during these years, but since 1938 ardent cooperative bank supporters have been quite successful in blocking further desertions from the state ranks. Indeed, beginning in 1943 conversion was absolutely forbidden by statute as an emergency measure, with the prohibition being successively extended through most of 1950. Under current regulations, an association is technically eligible to convert from state to federal charter, and vice versa, whenever a two-thirds vote of all qualified shareholders is secured. In view of the disinterest among a great many small shareholders in the typical bank, conversion is difficult to accomplish today, even where most active parties favor the move. Hence, only one cooperative bank in the Boston vicinity has acquired a federal charter since the prohibitive clause was removed.

It is entirely possible that the system of cooperative banks has actually strengthened its overall position in the market and that the incentives for conversion are perhaps less pressing today than during the post-depression years. Many of the weaker banks were either forced into liquidation during the depression years or merged with nearby stronger institutions without loss to the individual shareholders. During the postwar years, the surplus position of local cooperative banks has attained a more wholesome ratio to outstanding mortgage portfolios than ever before in their 75-year history. As far as home mortgages are concerned, lending

¹In Part III operating positions of converting banks were compared with those which did not convert. In many cases the former appeared relatively weak, and consistently relied upon borrowed funds more extensively. Others, however, were among the stronger banks and regarded the acquisition of a federal charter as an effective method of facilitating a rapid and sound growth.

opportunities now available to these state-chartered institutions are nearly as liberal as those of federals, with respect both to loan amount and repayment term. Furthermore, local cooperative banks have substantial holdings of VA-guaranteed loans, which provide a certain degree of liquidity as well as invaluable protection against substantial mortgage loss in a subsequent downswing. Finally, most of the larger banks are members of the Home Loan Bank System, and as such may tap these central reserves in the event of emergency liquidity needs. In view of these other elements of strength, most local cooperative banks apparently regard their own small Central Bank and Share Insurance Fund as wholly adequate to meet any contingency.

Perhaps the best interests of borrower and lender alike are promoted through a continued co-existence of state- and federally-chartered savings and loan associations. By preserving such a dual system of banking, each type of association acts as an effective check upon the operations of the other, and the community of savers and borrowers stand to benefit from this wholesome rivalry. Provided conversion from one type charter to the other can be accomplished with a minimum of arbitrary detail and red tape, each group will strive to meet the changing needs of their patrons. Under existing conditions, however, there is the real possibility that the impediments retarding the chartering of more federals reflect a latent desire to preserve the system of cooperative banks regardless of the relative merits of each type. Undoubtedly ardent cooperative bank advocates would regard the loss of several additional strong banks to the group of federals as detrimental to the continuing soundness of the remaining institutions. At the same time, some of the small non-member cooperative banks would perhaps encounter difficulty in securing membership in the Home Loan Bank System

as well as share insurance coverage by the FSLIC.¹ Thus, aside from the possible social or political benefits accruing to their continued existence, the present concerted efforts toward preserving the cooperative bank network in tact has the effect of preserving individual competitors instead of competition. Even though overall bank efficiency may not be in direct proportion to firm size for an indefinite range, the long-run efficacy of a thrift institution with total resources of less than \$300 thousand is open to serious question.²

Emergence of Specialized Mortgage Lenders

Up to the recent depression at least, the functions of the various types of financial institutions were sharply defined with a minimum of overlapping. Since this period, however, a combination of federal interventionary and private efforts have gradually narrowed these gaps, and in many cases the savings and lending activities of local thrift institutions are scarcely distinguishable. Cooperative banks have abandoned their insistence upon systematic thrift, whereby non-compliance necessarily resulted in fines, and have offered ordinary savings shares in increasing volume. Moreover, shareholders may frequently invest in such savings shares without any significant sacrifice in dividend yields. Savings banks, on the other hand, have invested far more heavily in residential loans during the postwar period than previously. They have also written nearly all new mortgage contracts on a long-term, direct-reduction basis, in direct contrast to the situation prevailing in the 1920s. Just as savings banks have drawn nearer to savings and loan associations in regard to making home loans, federals at

¹This opinion was mentioned by executives of local federals and cooperative banks alike; the latter officials, however, tended to favor the gradual abandonment of the State Share Insurance Fund, a view not shared by most cooperative bankers. Local Home Loan Bank officials, on the other hand, did not refer whatever to the possible inability of certain small banks to qualify for membership.

²Especially in areas which are already well supplied with alternate credit sources.

least have extended their lending operations to include a limited volume of large income-property loans, a sphere previously reserved for savings banks and others. It should be remarked, however, that most federals continue to concentrate almost entirely on small residential mortgages, and even the largest associations have shown little interest in non-residential properties.¹

Now that the traditional lines of demarcation separating the various lender types have become less distinct, some interviewed persons express the belief that a single-type institution is an inevitable consequence. Such a view is frequently shared by savings and loan interests, who quite expectedly regard an extension of their own methods of operation as the optimum arrangement. As analyzed in Part VII, ardent supporters of Home Loan Bank activities regard the evolution of a uniform type of lending institution as the natural means of attaining a truly effective secondary market.

Despite the increasing evidence of uniformity in regard to lending practices, the emergence of a system of truly specialized mortgage lending institutions appears highly remote indeed. So long as vast sums of long-term capital are held by such institutional investors as life insurance companies, the mortgage market will be heavily influenced by the operations of these "fair weather" lenders. Constituting an effective competitive fringe, insurance companies, as well as commercial and savings banks to an increasing extent, will continue to enter and withdraw from active participation in various mortgage and securities markets more or less in accordance with relative net yields. Especially with the increasing recognition of the uniform quality characteristics of FHA-insured mortgages, the continuing existence of lender types dependent in varying degrees upon mortgage lending

¹The latter are included in the 15 per cent of assets category referred to in Chapter 5. A large federal outside the Boston vicinity has often purchased home mortgages on a large-scale block basis, frequently involving VA-guaranteed loans on distant properties.

as an investment outlet may provide a most satisfactory arrangement. Indeed, if private interests maintain an active participation in the secondary market and if perchance a private FNMA were established, the nationwide mortgage market would be materially strengthened and stabilized. By trading freely in insured paper, a more equitable distribution of the available long-term credit would result and lending institutions in surplus areas could maintain reasonably well-diversified and profitable mortgage portfolios at all times.

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