Whose? Mr. Daiger

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# MEMORANDUM ON PROPOSED REGULATION OF REAL-ESTATE LOANS

(With Particular Reference to Lack of Adaquate Safeguards in Section 207 of H. R. 7617 as Reported to Senate)

July 12, 1935

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## THE NATURE OF THE PROBLEM

The real-estate loan provisions of the proposed Banking Act of 1935, both as enacted by the House of Representatives and as reported by the Senate Committee on Banking and Currency, may reasonably be said to look toward enlarging and encouraging mortgage investments on the part of member banks of the Federal Reserve System.

For reasons that will be related presently, this would seem to be a logical, proper, and timely development in the successive changes that have been made over a number of years in the laws governing real-estate loans by banks. An examination of the specific amendments now pending, however, and a consideration of these amendments in the light of the knowledge gained by all types of mortgage-lending institutions from their experience during the depression years, suggests that the following question may fairly and prudently be raised:

Do the pending amendments look toward an improvement in mortgage practice--toward standards or safeguards commensurate

with the larger volume of mortgage lending by banks that the amendments are calculated to bring about?

The enlargement of the mortgage-lending privilege contemplated in both sets of the pending amendments is of a twofold character: (1) the total volume of real-estate loans that a national bank may make would be increased, and (2) the total amount that it may loan on a given mortgage in relation to the appraised value of the property would be increased. In the first respect, the provisions of the measure enacted by the House and that reported to the Senate are alike. In the second respect, there is a difference between the House and the Senate provisions, but either would constitute an enlargement over the provisions of the existing law.

Besides making a larger proportion of bank funds available for mortgage lending, both in the aggregate and in respect of the individual transaction, the House and the Senate measures each contain provisions that would make real-estate mortgages eligible as collateral for advances by the Federal Reserve banks.

Here, too, there is some difference between the House and the Senate provisions, but the effect of either would be to give to real-estate mortgages, in common with other types of long-term assets held by member banks, an important status that they do not now possess. Such assets were formerly eligible for borrowing at the Reserve banks, though only under a temporary statute (expired March 3, 1935) and only "in exceptional and

exigent circumstances." The borrowing privilege is made permanent law in both forms of the pending amendment, and the restriction of such borrowing through an emergency is done away with.

Considered together, then, the three sets of provisions enumerated above constitute the basis of a wider participation by banks in mortgage lending, with the assurance that sound assets thus acquired will not be denied access to the Reserve banks should occasion arise for borrowing against them.

## II

## IMPORTANCE OF THE ENLARGED LENDING POWERS

There is a variety of reasons why this broadening and strengthening of the base of mortgage lending under the Federal Reserve Act may be regarded as desirable and justifiable.

In the first place, the member banks of the Federal Reserve System hold, in addition to their commercial deposits, some ten billion dollars of the savings accounts of the people in their communities. Where mutual savings banks are relatively numerous, as in the New York and New England areas, a large part of the people's savings is held by these institutions; but the extent to which the member banks are used elsewhere as the principal savings depositories in their communities is indicated by the fact that in the country as a whole, exclusive of New York City, nearly half of all member-bank deposits other than inter-bank deposits are savings deposits. These are funds

that should properly be invested largely for long-term purposes in the same manner as the funds of mutual savings banks, trust companies, building and loan associations, and insurance companies; and among such long-term purposes sound investments in real-estate mortgages have always held a place of great importance to the economic life of the country.

In the second place, the present low level of real-estate values and the progress of recovery in trade and employment combine both to create a demand for mortgage funds and to make mortgage investments more than ordinarily attractive to institutional lenders. At the same time there has been evidenced, for six consecutive months now, a sustained increase of more than 100 per cent over the corresponding period of last year in the volume of residential construction in the country at large, and a consequent increase in the demand from this source for mortgage funds. Statutory measures that would lessen the existing restrictions on banks in the making of mortgage loans should therefore have an important influence in easing the mortgage market and in furthering recovery and employment in the long-dormant construction industry.

For another thing, the banks have at the present time a huge volume of idle funds that can in part at least be made more largely available for mortgage lending. Furthermore, the banks are the largest and most widespread group of lending agencies that have such a huge surplus of funds. A greater use of these funds in the field of mortgage investment would directly benefit the communities served by the banks, would further relax the pressure for Federal appropriations for mortgage lending, and would

enable the banks to acquire sound earning-assets to meet the interest requirements on their savings deposits. The need of finding a remunerative and secure outlet for savings deposits is for many banks a serious problem, the practical solution of which, to begin with, would seem to lie in the growing demand now being manifested for construction loans and mortgage loans.

This recital of factors that point the practical purposes to be served by a larger volume of mortgage lending by banks might be carried farther, but enough has been related to show that the pending amendments are on solid ground insofar as they would (a) authorize national banks to increase their total real-estate loans relatively to either their time and savings deposits or their capital and surplus, and (b) authorize the Reserve banks to make advances to member banks against such loans, thus precluding a repetition of the experiences in which banks generally found their mortgage portfolios frozen during a period of abnormal withdrawals.

## III

## COMPARISON OF HOUSE AND SENATE PROPOSALS

It is where the amendments have to do with mortgage loans individually rather than in the aggregate that opportunity is to be found for strengthening the amendments in the interest of sound lending. That the restrictions in the existing law were insufficient to prevent many unsound practices and abuses and large losses is now too well known to require

comment. That there is real need of improvement in mortgage-lending policy and practice is not only generally recognized, but widely urged on the part of bankers themselves. Yet neither the measure enacted by the House nor the alternative proposals reported to the Senate fully meet the need and the opportunity for Congress to establish, in the Banking Act of 1935, better standards of mortgage lending and adequate safeguards for the mortgage investments to be acquired henceforth by member banks.

As a practical matter, it is exceedingly difficult to prescribe by statute regulations that would be practicable and sufficient at all times, in all places, and under all conditions of the real-estate and mortgage markets, to govern banks in the making of loans on (a) improved farm land, (b) improved business property, and (c) improved residential property. Recognizing this fact, the House measure limits such loans to 60 per cent of the appraised value of the real estate and then authorizes the Federal Reserve Board to prescribe from time to time regulations governing loans within that limit and requiring banks to conform to sound practices in making real-estate loans. The limitation of loans to 60 per cent of appraised value of the real estate and the authority of the Board to prescribe other regulations and to require sound practices are made applicable, however, only to national banks.

The corresponding provision as reported to the Senate retains the time limit of five years and the loan limit of 50 per cent of appraised value of the real estate provided in the existing law, but creates

an exception authorizing loans up to ten years in amounts not exceeding 60 per cent of appraised value of the real estate if installment payments are required that would reduce the loan to at least one-half its face amount in ten years. These several restrictions are likewise made applicable only to national banks, and no authority is given to the Federal Reserve Board to prescribe additional regulations or to require sound practices.

The Senate proposals also retain the provision of the existing law with regard to the geographical limits within which a national bank may make real-estate loans, together with the existing requirement that such loans shall be made or acquired only in their entirety. The House measure leaves both these matters to regulation by the Federal Reserve Board.

Both sets of amendments exempt renewals or extensions of loans heretofore made, and loans insured under the provisions of Title II of the National Housing Act, from the limitation to 60 per cent of appraised value of the real estate; and the latter class of loans is similarly exempt from the time limits of five and ten years, respectively, provided in the Senate proposals. Loans insured under the provisions of Title II of the National Housing Act are not exempt, however, from the geographical limitations retained in the Senate proposals. The House measure would leave this matter subject to the regulatory authority given to the Federal Reserve Board.

As far as establishing new safeguards for mortgage lending is concerned, therefore, it will be seen that the two sets of amendments have nothing in common. The House measure looks toward such safeguards and vests the responsibility for prescribing them in the Federal Reserve Board; the bill reported to the Senate would leave the existing law unchanged with the single exception of the new provision relating to loans amortized by one-half or more within ten years--a requirement that experience would indicate to be beyond the ability of most mortgage borrowers to meet, and hence of very limited practical application.

## IV

## ELEMENTS OF A PRACTICAL SOLUTION

A wholly workable solution of the legislative and banking problems which this situation presents--a solution, moreover, that would meet the interests of both the public and the banks and conform to the objectives of Congress as evidenced in various existing laws and in the two sets of pending amendments here discussed--would seem to be afforded if modifications having the following purposes in view were made in the proposals now before the Senate and then included in the measure as finally enacted by the Senate and the House:

1. To retain the limitations of five years and 50 per cent of appraised value of the real estate, and to establish an exception authorizing ten years and 60 per cent of appraised value

of the real estate in the case of amortized loans, but to provide that the latter class of loans are to be amortized at a rate that would retire them in full in twenty years.

2. To authorize the Federal Reserve Board, subject to the limitations prescribed by Congress for real-estate loans by national banks, to prescribe additional regulations governing real-estate loans by member banks, but with the exception that such regulations would apply to State member-banks only insofar as the regulations did not conflict with express provisions of existing State laws.

V

TENDENCY TOWARD PERIODIC AMORTIZATION

The reason for suggesting the first of these proposed modifications has already been indicated. It is to make possible a much wider use of the amortized mortgage in banking practice than would be possible if the proposal now before the Senate is adhered to. The advisability of encouraging and fostering the use of the amortized mortgage, in the interest of both borrower and lender, is now universally recognized; and there is a marked tendency among lending agencies generally to adopt the policy of either requiring amortization of all mortgage loans or to give preference and more liberal terms to mortgages that call for periodic payments.

The three-year or five-year mortgage, hitherto customary even among lenders not bound by a statutory limitation in respect of maturity, has come more and more to be recognized as a legal fiction--a contract usually impossible of performance and one that tends to perpetuate debt instead of providing for its actual payment. Moreover, in practical operation it has subjected borrowers to onerous and unwarranted "renewal" charges, it has caused lending agencies to take imprudent risks, and it has put both borrower and lender under severe pressure in periods of local or general economic stress.

Congress has itself taken cognizance of the essential long-term nature of a real-estate loan and has given the chief impetus and direction to the present general movement toward the adoption of amortization as sound practice. In doing this, it has also indicated the period that it regards as necessary for the amortization of mortgage loans made by private lending agencies.

For example, the maturity limitations authorized for fully amortized loans in the case of Federal Savings and Loan Associations is 20 years. The corresponding limitation in the case of loans insured by the Federal Housing Administration is also 20 years. In the case of loans by the Federal Land Banks it is 40 years.

Among the several groups of mortgage-lending institutions, the building and loan associations constitute the only class with which amortization has hitherto been standard practice. The length of time prescribed for complete amortization of their loans varies, depending on State laws or on local custom in the absence of statutory limitation.

In general, the period of amortization runs from ten to fifteen years, with a recent tendency toward twenty years. The usual limitation on the amount of such a loan is 66 2/3 per cent of appraised value of the real estate. Federal Savings and Loan Associations, however, are authorized to make loans up to 75 per cent of appraised value of the real estate, and the period of amortization authorized by Congress for loans by these associations is from a minimum of five years to a maximum of 20 years, depending on the nature of the loan.

Evidence of the extent to which insurance companies are turning to the long-term amortized mortgage loan has been afforded for some months past by advertisements published by such companies in newspapers in various parts of the country. These advertisements would indicate that insurance-company loans on real estate are available up to 20 years, with provision for partial or complete amortization depending on the length of the loan. It would appear that, even in the absence of statutory provisions that authorize or call for amortization over a period of 20 years, the practice is more or less general among insurance companies of requiring some annual curtailment. The requirements in this respect are for payments that would fully retire the loans in periods ranging variously from 20 years to 50 years.

The practice among mutual savings banks, incorporated savings banks, trust companies, and commercial banks in respect of amortization requirements also varies widely. Many institutions among these groups have no such requirements; many others do have. There is apparently no guiding principle that is accepted among them with regard to amortization,

but in general the tendency seems to be to have mortgage loans more or less regularly curtailed.

The Committee on State Legislation of the American Bankers Association, in its report of February 1, 1935, on "Legislative Trends in Banking," pointed out that the time limitation of five years or ten years on mortgage loans, as provided by law in various States, "is criticised on the ground that it results in straight mortgage loans rather than amortized ones, although experience teaches that the heavier losses occur on straight mortgages." The Committee made no specific recommendation with regard to a time limitation on amortized loans, but cited the period of fifteen years authorized in Pennsylvania as meeting the problem.

The Special Committee of the American Bankers Association on the Proposed Banking Act of 1935, in its report of March 22, 1935, expressed itself as favoring loans up to 60 per cent of appraised value of the property, with a time limit of five years on unamortized loans; but the Committee omitted to make any specific recommendation with regard to a time limit for amortized loans.

The Federal Advisory Council, in its statement of April 10, 1935, suggested that loans up to 60 per cent of appraised value of the real estate be authorized up to 12 years, if provision were made for reduction "by payments of not less than 5 per centum per annum on principal in addition to current interest."

In the case of loans up to 60 per cent of appraised value of the real estate, a time limitation that would seem practicable from the standpoint of the ability of the borrower to retire the loan in full by periodic payments would be one predicated on the 20 years provided by Congress for loans made by Federal Savings and Loan Associations and for loans insured by the Federal Housing Administration. Where loans up to this limit are amortized by annual or more frequent periodic payments of interest and principal combined, approximately 35 per cent of the principal is paid in ten years.

The proposed requirement that 50 per cent of the principal be repaid in ten years in the case of mortgage loans by national banks, would involve considerably larger periodic payments--payments at a rate that would retire the entire principal in approximately 15 years rather than 20 years. The alternative method, amortizing by annual or more frequent payments of principal with interest added, would likewise involve, especially in the earlier years of the loan, larger payments than mortgage borrowers can ordinarily meet.

## VI

## DEFECTS MET BY ADMINISTRATIVE REGULATION

The reason for suggesting that the Federal Reserve Board be given authority to prescribe regulations to supplement the statutory provisions governing real-estate loans is that this is the logical and practical means of raising the standards of mortgage lending among member banks of the

Federal Reserve System in the interest of sound banking. Up to this time the principal safeguards that legislation has sought to establish for a mortgage loan have been the time limit of five years and the loan limit of 50 per cent of appraised value of the real estate. Both these have proved illusory in the test of practical experience and both have proved easily susceptible of abuse.

Most stress is usually placed on the loan limit as a factor of safety. Putting that limit, however, at 50 per cent of appraised value of the real estate is scarcely more dependable as a safeguard than putting the time limit at five years. The latter does not make the loan collectible in five years, nor does it assure whatever curtailment the bank may then insist on. Having learned these facts to their cost, more and more institutions have come to insist that real-estate loans must be paid off by some clearly defined program of amortization. In like manner they have come to recognize that the loan limit is not the all-important fact that it was formerly thought to be.

The loan limit is in reality based on a highly variable factor—namely, "the appraised value of the real estate." Two appraisers, each honest according to his lights and each perfect according to his ability, may put substantially different values on the same piece of property. A bank on one corner may offer a loan of a certain amount on a piece of property, a bank on the opposite corner a much higher amount, and each be going to what it regards as the loan limit prescribed by law.

Furthermore, the property that appraises at one figure under one set of conditions, appraises at a higher or lower figure when economic conditions are altered. The Florida boom is the most recent conspicuous example of one extreme; the nation-wide experience of the depression abundantly illustrates the other extreme. In late years the 50 per cent loan has more often than not become the 60 or 80 or 100 per cent loan, sometimes within a matter of months.

Nor is this factor of variability in appraisals the only reason for not placing too great a reliance on the loan limit. A 60 or 70 or 80 per cent loan on a given property may involve much less risk over a period of five years or ten years than a 40 or 50 per cent loan on the same type of property in another neighborhood or another community.

The same divergence in risk is to be found among different types of property, and particularly so among different types of business property. In fact, for a number of types of business property appraised value is an extremely unreliable guide in making a real estate loan. For another thing, the degree of risk would appear to vary according to the size of the loan, even when the ratio of the loan to appraised value may be the same. The larger the loan in dollars, the greater the difficulty of finding a buyer in the event of default, the greater the risk.

A prudent policy, therefore, would seem to suggest that the Federal Reserve Board be given authority to regulate real-estate loans by member banks in the same manner as it is given authority to prescribe the conditions under which advances on such loans may be made by the

Federal Reserve banks. It would appear desirable, that is to say, to surround these loans with adaquate safeguards at the time they are made rather than to give the Board authority only to determine the conditions under which they will be available for borrowing at the Reserve banks after they are made.

While it is true that the Board, no more than Congress, can as a practical matter prescribe real-estate loan regulations in exhaustive detail, it can establish certain minimum standards in appraisal practice and other governing factors that should bring about a greater uniformity and a greater degree of safety in the lending methods of member banks. What is of equal importance, it would be in a position at all times to revise these regulations to meet changing conditions in the real-estate and mortgage markets, to restrain speculative excesses and abuses, and to take account of economic conditions generally that might have a bearing on real-estate values and on mortgage investments.

In conclusion it may be observed that no reason has been suggested why regulation in this manner by the Federal Reserve Board would not be in the public interest.