JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

6. Real Estate Finance/Mortgage Banking/Mortgage Guaranty Insurance

q. "Commercial Banks and Real Estate Credit", no date

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Commercial Banks and Real Estate Credit

I. Despite a national policy of encouraging wide spread ownership of real estate, commercial banking until recently regarded real estate credit as incompatable with the self-liquidating commercial paper preference of bank transactions.

A. Early in the 17th century the New England colonies tried to organize private banks to make loans on real estate security, but it was not until 1732 in Connecticut and in 1740 in Massachusetts that land banks were established that issued notes to savers, notes secured by real estate mortgages from borrowers.

B. Hamilton thought mortgage lending incompapable with commercial banking. The first bank of the United States did not make real estate loans. However, state-chartered commercial banks were big investors in loans on both farm and town property, and as things generally worked out, big owners of foreclosed property. Even the second bank of the United States in the South and the West indulged in mortgage paper with much the same result as the state banks.

C. However, in fact, our land policy, during all the years of our frontier expansion had no support from a land credit policy except that prior to 1820 time payments were permitted on the purchase of public land.

D. Numerous private land banks or public land banks were devised to lend money on farm mortgages, but most had brief and stormy histories and were the victims of inept or fraudulent management. The whole idea of land banks fell into popular disfavor, and Alexander Hamilton himself successfully opposed the formation of a state land bank in New York state.

E. In the south there appeared the property bank which were associations of borrowers who subscribed to capital stock in proportion to the mortgage they wished to make. The money was raised by the sale of property bank bonds secured by these mortgages and guaranteed by the states. By 1845 there was an extensive farm mortgage banking business in the midwest. However, failure was widespread because of a tendency to base loan ratios on anticipated land values. It seems since the beginning mortgage lending has continually tripped over the practices of property appraising.

F. The first national banking act in 1864 was designed to keep national banks out of mortgage lending. However, national bankers tended to fuse commercial banking and mortgage lending in much the same way as the state banks so that the prohibition was very elastic.

Most legislative prohibitions in this era were elastic. For example the private mortgage guaranty business got its start about 1885 when the New York lending statutes were reworded to clearly prohibit this kind of guaranty. As the guaranty industry flourished out of wedlock with the law, the legislature in its wisdom decided to recognize this illegitimate institution by changing the law in 1895 to permit the guaranty of interest payments only. The law was again changed in 1912 to permit the guaranty of principal, a practice which had long been common in the industry.

G. With the Federal Reserve Act in 1913, national banks were given explicit permission to make loans on farm property for five years and no more than 50% of appraised value. Loans were not to exceed in the aggregate 25% of the bank's net worth or one-third of its time deposits. In 1916 non-farm loans were authorized but for one year terms and a loan to value ratio of 50%. In 1927 the allowable term for non-farm loans was extended to five years and the aggregate of such loans was permitted to reach 50% of a bank's time deposits. This gave the banks an opportunity to get into mortgage finance with both feet in time for the depression.

H. In 1935, as part of the effort to increase funds for mortgage lending, national banks were permitted to make ten year loans up to 60% of value provided 40% was amortized during the period. They were also given permission to make any loan insured by FHA.

II. Since 1960, banks have aggressively developed the one-bank holding company which has become a new breed of commercial banking intermediary--the creature we generally refer to as commercial banking. Its old single entity form has been converted to a family of organizations which permit banking officers to match loan attributes for types of real estate credit to the attributes of savings capital sources with far more flexibility than a cooperative savings and loan.

II. Since 1960 banks have become oriented to marketing money as a full service institution. Despite liberalization of bank regualtions relative to insured mortgages, the market was limited to FHA, VA, or private guaranty loans - primarily small residential while much of the action and profit had shifted to income property mortgages. The competition of banks with the savings and loans thus became a competition between bank holding companies operations rather than just a single entity bank. A holding company is really a new breed of banking intermediary and we should think of it as all part of the creature we call commercial banking.

A. The competitive sub-system advantages of a holding company bank include:

1. Multiple devices to attract and hold savings capital including captive outlets for mortgage notes.
2. Multiple opportunities to capture lending situations
3. Multiple devices for spreading fixed costs of staff over large volumes
4. Flexibility in matching liquidity characteristics of mortgages to need for liquidity or non-liquidity of savings.

B. The liquidity system offered by the federal reserve bank system and the federal deposit insurance corporation is obviously superior to that of the savings and loans unless reserves are inadequate to cover maturity dates on certificates of deposit as occurred in 1966 when government bond rates soared above maximum permitted CD rates. August of 1968 was little short of bank prices when banks had far less in free reserves than would have been required to meet maturity dates in certificate of deposit. With that possible exception the liquidity problem of the bank need no further discussion.

C. The safety system of the bank is a very complex subject which begins with the federal comptroller of the currency, state banking commissioners and the FDIC. The holding company actually contributes to the safety factor by permitting the bank to shift high yield more marginal loans out of the bank to other entities. Thus the bankers can retain their interest in self liquidating commercial paper while advertising full service banking.

III. Now let us examine the savings system and mortgage transaction system of the holding company bank:

A. The multiple methods for attracting and holding savings capital available for mortgages would include:

1. Jazzed up savings plan such as "golden passbook" which may exempt the saver from service charges on his checking account or provide merchandise prizes, etc. (a whole industry has been created to produce merchandise which fits within FDIC value limitations on give-aways, etc.)

2. Certificates of deposit of various sizes, maturity dates and yields to match.

3. Convertible bonds issued by the bank holding company
4. Trust department investment fund pools

5. Correspondent bank investment participation pool
6. Real estate investment trust shares (a phenomenon to be examined next week)
7. Mortgage banking subsidiary warehousing by means of collateral trust shares
8. Pension fund pool controlled by corporate services department and trust department

B. A bank holding company has an infinite number of opportunities to locate and to sell mortgage money. It often uses mortgages to capture and hold bank business of all types and at the same time banking customers are inclined to seek mortgage money from the banker first.

1. For example, the major corporate account may transfer a new executive into town and he will need a new house. The bank graciously offers to make a loan, perhaps helping him to carry his old house at the same time and thus establishing a relationship which generates a compensating balance in his checking account, a logical introduction to the trust department for estate planning, as well as a relationship which strengthens the corporate banking tie to the bank.
2. During periods of tight money the bank was always willing to make a mortgage loan on reasonable terms to a regualr customer of the bank, a service which is not forgotten when the supply of money is more competitive.
3. The contractor looking for a construction loan reveals a project which may need permanent financing, as will a steel fabricator, or building materials supply house who finance their inventories with bank notes.
4. Small town rural banks may lack capacity for large farm loans or new projects in their areas but earn a commission by participating with their corresponding bank in the bit city. The same correspondent bank may be a market for mortgage loans made in the big city by the queen-bee bank.
5. During the 1960's as interest rates went up and down mortgage banking business which warehouse mortgages with bank money often were caught in sharply falling prices for their mortgages. As a result of technical insolvency and difficulty with bank loan, many of these mortgage banking organizations were acquired intact by the banks holding company. This operation could make good use of existing bank computers departments to service loans and the banks acauired marketing staffs and expertise in the selling of mortgage money, not to mention a company name which was generally established in the regent. First Wisconsin acquired a number of wellknown operations including the Hiller Agency which represented the Metropolitan Insurance Company. Thus the bank holding company became a servicing agent for many fo the major life insurance companies.
6. Bank trust departments have recently come alive in marketing investment services for the living as well as for estates of the deceased, including investment in real estate mortgages and equities. Thus these departments are both a source of loan opportunities and a market for investment grade mortgages.

C. Banks have always made a specialty of construction loans - the kind of short term self liquidating paper, assuming there is a permanent commitment. A bank can now offer to find investors in the trust department who would like to put up equity money as a limited partner, secure a commitment for a long term loan from its mortgage banking subsidiary, find high risk seed money in its small business investment corporation, lease furnishings from its general leasing subsidiary, and provide construction money in truly one stop service.

1. It is revealing that at the First Wisconsin the same man is Vice President of the Mortgage department in the bank, of its mortgage banking subsidiary, of its real estate investment trust and the holding company. The fixed cost of his staff and servicing department are thus shared by multiple agencies within the holding company network.
2. It is useful to note that the bank itself retains liquid mortgages such as construction loans or government insured mortgages with secondary markets. The more speculative loans are held by the real estate investment trusts which is offset by non-demand equity shares. Long term investment quality loans are held by the trust department while a great variety of loans are merchandised to insurance companies or pension fund accounts. The holding company can finance the mortgage banking operation by issuing long term debentures, convertible bonds, and common stock.
3. Potential conflicts of interest within and between the bank holding company family have become a significant problem which we will touch on next week.

D. The significant point of all this is that it is generally not appropriate to think of a commercial bank in its single entity form. Banking has spawned the family of organizations which permit it to match the loan to the attributes of the capital source with far more flexibility than a cooperative savings and loan. Thus it is not surprising that the savings and loans seek authority to convert to mutual bank charter, or conceivably like mutual insurance companies, convert to stock form of organization.

More on → COMMERCIAL BANKS AND REAL ESTATE CREDIT

I. National policy encouraging widespread ownership of real estate historically in conflict with commercial banking preference for self-liquidating commercial paper and higher yields on short term consumer financing.

   A. Early land banks in New England colonies issued notes to savers secured by real estate mortgages from borrowers.

   B. First bank of US did not make real estate loans. State banks did. Second bank of US made real estate loans in south and west. Lost heavily and refused to continue real estate credit and was thus terminated by President Jackson.

   C. National government terminated time payment programs for purchase of federal land in 1820.

   D. Continuous history of land bank failures discredited this approach and Alexander Hamilton successfully opposed formation of a state owned land bank for New York.

   E. Agricultural farm land banks generally failed in the midwest for lack of good appraisals.

   F. National Banking Act in 1864 intended to prevent real estate credit by banks but prohibition was not well regulated.

   G. Federal Reserve Act of 1913 gave explicit but limited permission to make farm loans for five year terms with 25% of bank's net worth and one-third of time deposits. Liberalized in 1927 to include non-farm property, just in time for the Depression.

   H. In 1935, banks were permitted to make ten year loans up to 60% of value provided 40% was amortized during the period or any loan insured by FHA. By 1970 the ratio was to 75% and any loan insured by an approved guarantor, public or private.

II. Since 1960 banks have moved into mortgage credit by intensive use of the one-bank holding company--the creature we now generally refer to as commercial banking.

   A. The competitive sub-system advantages of a holding company bank include:

      1. Multiple devices to attract and hold savings capital including captive outlets for mortgage notes.
      2. Multiple opportunities to capture lending situations.
      3. Multiple devices for spreading fixed costs of staff over large volumes.
      4. Flexibility in matching liquidity characteristics of mortgages to need for liquidity or non-liquidity of savings.

B. Liquidity system offered by FRB theoretically superior to S & L's if it were not for certificates of deposit and unlimited letter of credit capacities.

C. Holding company may or may not increase safety of bank.

1. Holding company subsidiaries can invest in more marginal loan types presumably permitting bank entity to market full service banking while retaining only best quality and self-liquidating paper.
2. Presumably net worth of holding company will stand by its own troubled bank.
3. Mistakes by holding company subsidiaries can damage bank image and adversely influence deposits.

III. The savings attraction systems and mortgage transaction preference systems of a holding company bank are very complex.

A. Multiple methods to attract savings include:

1. Bank service packages tied to passbook savings.
2. Certificates of deposit.
3. Convertible bonds issued by the bank holding company.
4. Trust department investment fund pools.
5. Correspondent bank investment participation pool.
6. Real estate investment trust shares (a phenomenon to be examined next week).
7. Mortgage banking subsidiary warehousing by means of collateral trust shares.
8. Pension fund pool controlled by corporate services department and trust department.

B. Bank operations generate an infinite number of loan opportunities from inside information, reciprocity, business accounts, correspondent relations, and internally generated markets for loans.

C. The construction loan has always been a bank specialty because it offered high yields and short term liquidity if builder was required to have a permanent take-out commitment.

1. Competition for construction loans with sliding interest rates led to disregard of take-out commitment.
2. Construction loan money makes it possible to capture permanemt loans for other divisions of holding company.
3. Interlocking management of holding company real estate leads to serious conflicts of interest.

D. During the 1960's banks made large loans to mortgage banking companies to warehouse closed loans pending their sale by the mortgage banker. Sharp increases in interest rates in 1966, 1968, and 1971 would devalue the mortgages and wipe out equity of mortgage bankers.

1. Result was acquisition of many mortgage companies by bank holding companies as a "voluntary liquidation"

2. Purchase of sound mortgage bankers has permitted permanent introduction of large eastern banks into competitive territory of midwest and southwest territories (CITICORP through advance mortgage company and Chase-Manhattan via Dovenmeuhle of Chicago).

E. Banks are currently facing the possibility of severe losses as a result of direct and indirect financing of real estate.

1. Defaulted construction loans on big city office buildings, Florida condominiums and recreational land development.
2. Federal reserve bank required large bank consortiums to save REIT's from bankrupcy. REIT's were expected to pay four points over prime which has exhausted equity and led to threat of Chapter 11 defenses against the banks.
3. Law suits by bank holding company bond holders to prevent holding companies from underwriting losses of subsidiaries.

IV. While the mortgage banking company is often controlled by a bank holding company, it depends heavily on non-bank resources, particularly life insurance funds, mutual funds, FNMA-GNMA, collateral trusts for pension funds, and until recently REIT's.

A. Mortgage banking function is a conduit and servicing agent between investor and borrower, generally in separate geographical regions. Thus mortgage banker is called a "correspondent" , an agent with limited powers representing ultimate lender.

B. Profit centers include:

1. Origination fees
2. Servicing fees
3. Warehousing spread between mortgage rate and bank rate
4. Spin-off of insurance and property management
5. Joint ventures

C. Mortgage banker in difficult position because he must generate loan opportunities and sell loans to investors. Selling a mortgage loan requires liberal terms while investors want conservative loans.

1. Bependence on FHA residential and federal secondary markets in which to dump insured loans
2. Development of captive market for loans through control of collateral trusts, REIT's, or insurance company quotas
3. Control of loan origination through joint ventures in land development for industrial parks, subdivisions, etc.

D. Mortgage banking in its present form began with FHA and grew primarily from 1947 to 1962 as life insurance company shifted from 16% of their assets in mortgages to 35% by 1962.

1. Large life insurance companies have tended to withdraw from residential loans or set up their own servicing operation
2. Large life insurance companies, dissatisfied with mortgage bankers in terms of service relative to cost have set up their own loan origination offices
3. Salesmen for origination of loans and economies of scale in loan servicing make mortgage bankers attractive purchases for savings and loan service corporations and bank holding companies