St. John's Law Review

Volume 12
Number 1 *Volume 12, November 1937, Number 1*

Article 3

May 2014

Mortgage Banks: A Study in Real Estate Finance

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Recommended Citation
Finkelstein, Maurice and Clarke, John J. (1937) "Mortgage Banks: A Study in Real Estate Finance," *St. John's Law Review*: Vol. 12 : No. 1 , Article 3.
Available at: https://scholarship.law.stjohns.edu/lawreview/vol12/iss1/3

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MORTGAGE BANKS

A Study in Real Estate Finance

In the beginning of our history, when America was in the main a land of farms, forests and fishermen, it was said by a wise man that a penny saved is a penny earned. It took a century and a half for this truth to become imbedded in the conscience of the millions who subsequently came to these shores and no sooner had it become a daily precept and a fundamental truth in the lives of most of us, when at last we discovered that in many instances it was no longer the whole truth and that the ancient adage must be rewritten to meet a new order of things. Savings long accumulated through difficult forbearance and painstaking surrender of present joys have disappeared into thin air and have shattered pillars of reliance into blasted hopes.

Two years of experience in salvaging real estate investments have taught the tragic lesson that at least in this field the hope of realization is at best a long deferred one to the investor.[1] Legal procedure developed in another age when problems were simpler and economic forces let loose by conditions undreamed of, have combined to render almost futile any effort to convert frozen security into liquid assets. One naturally looks about for the causes of things—but the frank avowal must be made that to some degree what has happened was inevitable. This avowal, however, must not be taken to mean, and cannot be conceded to justify the conclusion that all that went before must necessarily recur with the same degree of destructive and painful consequence. Much can be avoided by careful planning. Much can be done by the educative process and the slow infiltration of the

[1] This is particularly true in jurisdictions which have adopted mortgage moratoria, under which various devices are utilized to postpone the payment of mortgage debts. In New York State, for instance, the certificate holders in mortgages under the jurisdiction of the Mortgage Commission between May 15, 1935 and September 1, 1937, having an average principal amount for the period of $450,000,000, received payments of principal of $32,233,377.68, of which more than $7,000,000 may fairly be said to be the result of special circumstances. The payment on principal of these mortgages has been, therefore, between 5% and 6%. Effective moratoria exist in nine states.

truths of finance in the minds of the investors. More can be done by careful and scientific governmental husbandry of the resources of the great body of the American saving public.

Almost forty per centum of the national wealth consists of land values.[2] To an enormous extent the people's savings have financed investments in real property.[3] The funds have been derived in the main from investments made by financial institutions, like banks and insurance companies, who draw their assets from the people generally, and, to a large extent, more directly from investors who have bought mortgages, mortgage bonds, or certificates.[4] The devices are simple ones. A mortgage company will lend money to an owner and take as security his bond secured by a mortgage on real property. It will then either sell its own bonds to the public, secured by the mortgage which will be placed in the hands of a trustee for the bondholders, or it will sell part interests in the mortgage, generally called certificates, which are sometimes guaranteed and sometimes unguaranteed by the vendor. In this way many billions of dollars of mortgage bonds and certificates have been sold throughout the United States. In 1933 guaranteed certifi-

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[2] DOANE, MEASUREMENT OF AMERICAN WEALTH (1933) estimates that in 1932 land worth 112.4 billions of dollars constituted 30% of the national wealth; buildings on that land worth 37 billions of dollars constituted 9.9% more.

[3] The private mortgage debt for the year 1932 in the United States has been estimated at 58.4 billions of dollars. DOANE, *op. cit. supra.*

[4] A writer in the Quarterly Journal of Economics, in November, 1930, page 104, estimated that in 1929 urban real estate mortgages in the United States were distributed as follows (in millions of dollars):

Commercial banks	5,195
Mutual savings banks	5,125
Life insurance companies	4,831
Building and loan associations	7,787
Mortgage bonds	4,168.9
Total	27,106.9

The United States Department of Commerce indicates that in 1934 mortgage debts were distributed as follows:

Farm mortgages	7.8 billions of dollars, 10.4% of national debt.
Non-farm home mortgages	17.7 billions of dollars, 23.7% of national debt.
Other urban mortgages	12.7 billions of dollars, 17% of national debt.

cates alone in New York State were slightly less than one billion dollars.[5] Almost another billion dollars of uncertificated whole mortgages, also guaranteed, were likewise distributed to the public through these means.[6] Mortgage bonds to the extent of billions of dollars were distributed by bond houses and real estate mortgage concerns.

During the year 1933 nearly all of these bonds and certificates were in default.[7] The history of this default is now a familiar one, and the efforts of the State of New York, as well as all other states, to deal with the situation, to salvage, to reorganize and to liquidate are now part of a well known record.

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[5] According to the report of George W. Alger, Moreland Act Commissioner appointed by Governor Lehman, in 1934 guaranties of mortgage certificates by companies under the jurisdiction of the Insurance Department totalled on December 31, 1933, $837,819,598.43.

The report of the Joint Legislative Committee on banks, investment trusts and mortgages (LEG. DOC. 1935, No. 57) states that Prudence Company, Inc. guaranteed $51,000,000 in mortgage certificates. This company was organized under the Banking Law and its guaranties are not included within Commissioner Alger's computations.

[6] Commissioner Alger states that as of December 31, 1933, mortgages guaranteed by companies under the jurisdiction of the Insurance Department totalled $972,311,706.46. The report of the Joint Legislative Committee, see note 5, *supra,* states that Prudence Company, Inc. guaranteed whole mortgages in the amount of $56,000,000.

In all, the total guaranties outstanding on December 31, 1933, were $1,887,472,875.14, which did not include mortgages on which the guarantying company's agency had been terminated but the guaranty not released. The guaranteed mortgages affected by a termination of agency between December 31, 1932 and June 30, 1934 aggregated $979,689,404.03, and between December 31, 1932 and December 31, 1933, $903,730,701.54. On this last date the total outstanding guaranties were $2,791,203,576.68.

[7] As respects the mortgages guaranteed by companies under the jurisdiction of the Insurance Department, Commissioner Alger in his report (Appendices II, III and IV) gives the status of defaults as follows:

Outstanding Guaranties

	No. of Mtges.	Principal Amount
Whole Mortgages	121.063	$972,311,706.46
Specific Series	8,535	664,375,244.90
Group Series	11.428	173,444,353.53
Total	141,026	$1,810,131,304.89

Defaults

	No. of Mtges.	Prin. Amt.	Amt. of Defaults
Whole Mortgages	41,515	$451,828,836.96	$30,293,261.60
Specific Series	4,885	494,784,380.47	25,524,290.06
Group Series	6,562	142,200,987.65	11,129,977.34
Total	52,962	$1,088,814,205.08	$66,947,529.00

We look back at the events that led up to these defaults in the light of our experience in dealing with them and we discover certain basic truths. In the first place, there was practically no governmental regulation of the business. Any one with small capital, and a mind to do so, could go into the business of lending money secured by mortgages on real property and distribute the burden among investors.[8] Secondly, appraisals of real property were made in a manner that suggests, in many cases, reckless disregard of the relations between the income producing possibilities of real property and the other elements that go to make up concepts of market value.[9] Thirdly, the mortgages were nearly all short term mortgages, from three to five years. There was never any expectation that these mortgages would be paid off. On the contrary, it was fairly certain that the owner would not be in a position to pay off the principal amount on the due date. It was expected that he would either negotiate for a renewal of the loan for a further period of three to five years or perhaps borrow money from some

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[8] The present law permits the formation of corporations under the Stock Corporation Law for the purpose of "loaning money in this state on bonds, notes or other evidences of indebtedness, secured by deeds of trust or mortgages on real property or personal property situated in, upon or appurtenant thereto, and/or purchasing of or otherwise acquiring existing bonds, notes or other evidences of indebtedness, deeds of trust or mortgages of or upon such properties, or any interest therein, and the holding of the same, or the endorsing, selling, assigning, transferring or disposing of the same to another corporation." (GEN. CORP. LAW § 18, as amended by N. Y. Laws of 1935, c. 905.)

[9] Commissioner Alger, *op. cit. supra* note 5, at 96–101, cites many instances of improper appraisal practices. For instance, he states: "I found many cases where an appraiser, being informed of the amount of the loan applied for, apparently reached his appraisal figure by taking one and one-half times this amount." And further: "In a market where competition among lenders was severe, the company which would make the largest loan got the business. The appraisers were in many cases under constant pressure from their superior officers urging them not to be too conservative in their appraisals. I believe that the whole system of company appraisals, in fact the present system generally, requires safeguards not yet provided by law and which must be furnished if this business is to go on under any form of adequate public regulation."

Recommendation No. 14, at page 164 of his report, contains this important proposal:

> "No mortgage to be guaranteed either as to principal or interest which exceeds 2/3 of the appraised value of the real estate, or in respect of which the net annual income (after taxes) of the property for the calendar year preceding the sale has amounted to less than 1½ times the interest charge of the mortgage or where the annual interest charge exceeds one-half of one per cent of the then capital and surplus of the company."

other institution. As long as competition for loans was very keen and the money was easy this hope could be indulged in with some degree of safety, but no provision was made for the contingency which occurred when the money market collapsed and loans were not available. The investor, on the other hand, who bought a bond or a participation in a mortgage was led to believe that at the end of three years, or five years, as the case may be, his money would be readily available to him. With the advent of the depression and the drying up of sources for loans, this assurance necessarily failed to materialize. Finally, without any fraud or corruption, and with the best of intentions, no institution can lend hundreds of millions of dollars without making numerous mistakes. As a result, many investors found that their security was of doubtful value. So occurred the seeming paradox that two investors, who bought participations in mortgages from the same company, and felt the same faith in the lending institution, discovered to the chagrin of at least one of them that one investor bought a fairly good security and the other a very bad one.

These lessons, which have now become clear to all, were not a secret to informed men of finance. Among the lists of bondholders and certificate holders which are available, we find a peculiar and conspicuous absence of the names of wealthy investors and men of affairs. In the main, the bondholders and certificate holders are small tradesmen, who have accumulated savings over a long period of time, financial institutions investing trust funds, and philanthropic societies. There is a notable lack of bankers and men of affairs among the hundreds of thousands of certificate holders and bondholders whose savings went into the financing of these real estate holdings.

In 1935 the Legislature of the State of New York, in dealing with this problem, enacted a statute creating an administrative agency and conferring upon it the power to study the situation with a view to recommending a permanent state policy.[10] Almost from the beginning of its studies

[10] MTGE. COMM. ACT of 1935, § 4, subd. 21 reads:

"The commission may in its discretion initiate and carry on such studies, investigations and researches as will assist it in recommending

the Commission's attention was attracted to the tremendous difference between the course of real estate investments in the United States and the course that they took in other countries. Apparently, in no other large country did there exist such a complete collapse of the real estate mortgage investments as occurred here.[11] Elsewhere investors in mortgage securities continued to receive their interest throughout the depression, and no defaults of any consequence were noted or were experienced by the public, and this in spite of the fact that the depression was at least as severe in other countries as here.

It is, of course, difficult to theorize about causes. Account must be taken of conditions in foreign countries which differ in many respects from those that obtain here in the field of real estate. The nations of Europe are old. Mortgages are not as common there as they are here. Moreover, there people live for generations in the same houses and develop considerable personal attachment to their property. Here we have a mobile population which moves from place to place within one city and from city to city and state to state. The desire and the interest in preserving equities in such temporary dwellings are infinitely less forceful than those which obtain in the case of an ancestral home. Again, the construction of new buildings has gone on at a much faster tempo here than elsewhere. New ideas for apartments, office buildings, and other structures have been developed and put into execution here with great rapidity. Experiments which we have tried have been left untouched in other lands. These considerations cannot be overlooked in considering the causes which led to the collapse of mortgage investments here.

These differences in circumstances, important though

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the enactment of appropriate legislation designed to increase public confidence in real estate and mortgage investments, lessen the burden of taxation now resting on real property, and provide proper supervision, regulation and control of the issuance, guaranty, sale and distribution of mortgage investments."

[11] The default in external Chilean land bank bonds took place because of the devaluation of Chilean currency. The bank received payment from its debtors in Chilean money, and had promised to pay in American dollars. Since the ratio between Chilean pesos and American dollars had changed to the detriment of the former, it was impossible to pay the external bonds at par.

they are, will hardly suffice fully to explain the fine record that mortgage investments have made in foreign countries. Recognition must be given to the system of governmental regulations that existed abroad and to the fact that there the task of distributing mortgage investments was intrusted almost entirely to mortgage banks. When we contemplate the essential differences between the methods of operation of a foreign mortgage bank and an American mortgage company, it would seem *a priori* that the foreign institutions were sounder, less subject to the ravages of economic cycles, more resilient to the needs of the small investor, and more adequate as a power with which to direct the course of the development of land values generally.

One important distinction between mortgage banks abroad and our mortgage companies is the custom there of making loans only on long term mortgages which are carefully amortized during the life of the loan.[12] We have point-

[12] The Crédit Foncier may make real estate mortgage loans of two kinds: (1) those which are self-amortizing in from 10 to 75 years, known as long term loans; (2) those which may or may not be self-amortizing and which never exceed 10 years in length, known as short term loans. In France, the loans most frequently granted in recent years are twenty-year loans (which must be self-amortizing) for amounts ranging between 10,000 and 50,000 francs. The balance sheet for the year 1934 of the Crédit Foncier shows that at the end of the year the company had outstanding loans exceeding six billion francs at long term and about four hundred thirty million francs at short term.

Similar provisions are to be found in the statutes of other mortgage banks.

See: ENG. AGRIC. CREDIT ACT of 1928, 18 & 19 Geo. V, c. 43, Charter of Mortgage Bank of Uruguay, art. 43, and GERMAN MTGE. BANK ACT of 1899, art. 20, as representative of these provisions. In some countries, however, there has been a departure from this policy.

Dr. H. H. v. d. Berg of Amsterdam, Netherlands, says of mortgage loans in his country:

> "A cette époque (a l'origine) on a sourtout consenti des prêts, remboursable par annuités, dans l'idêe que ce système était favorable à l'agriculture. Il est apparu de plus en plus que les propriétaires de biens ruraux n'appréciaient pas ce genre de prêts et beaucoup d'entre aux, après avoir payé un certain nombre d'annuités, demandaient un changement dans le mode de remboursement. En conséquence les banques hypothécaires n'ont actuellement prèsque plus de prêts remboursables par annuités.
>
> "Les prêts sont faits pour une durée de 5 ou 10 ans, remboursables soit intégralement à la fin de la période convenue, soit par des versements annuels de 2% du capital prêté."

Notice sur le crédit foncier aux Pays Bas, 1934.

ed out that here mortgages were made usually from periods running three to five years with no intention in the world that the mortgagor should pay off the loan in the limited period. On the other hand, the Credit Foncier, or any other leading foreign mortgage bank, would rarely make a loan for only three years. The loan would average twenty, or sometimes even thirty years. Substantial amounts would be paid each year in reduction of the principal. By the time the loan matured ordinarily nothing would be left of the mortgage. It would be paid off in full and if a balance remained unpaid it would be so small that it could be easily dealt with. A mortgage of that kind is a self-liquidating obligation. If it were prudently made in the first instance in a sum not out of line with the earning capacities of the property (as the charters of all successful mortgage banks require), both the interest and the amortization can be derived from the income and all that the mortgagee is required to do to safeguard his investment is to keep a watchful eye against waste. Such a mortgage constitutes adequate security for any bond that might be sold against it and barring totally unforeseen accidents which might occur, the rise and fall of market prices within the memory of ordinary experiences will not seriously affect the value of that mortgage even if it be at some time slightly impaired.

Of course, lending money for a twenty-year period freezes one's assets for a long time since the lender has the money in the building and cannot take it out. This is, of course, inevitable. The idea that you can freeze up assets and have them liquid at the same time is a contradiction not only in terms but in fact. And the effort to create the appearance of liquidity by making mortgages short term on paper but long term in fact is undoubtedly one of the primary producing causes of the ultimate mortgage collapse in this country. On the other hand, it is not necessary that the individual in-

vestor should be without remedy against this frozen condition of his investment. When the mortgage is once distributed to the public in the form of bonds, and where there is a large investing public and a limited supply of mortgages, the creation of a public market for these bonds will add some degree of liquidity to the investment. Bond issues of mortgage banks are generally listed on the exchanges.[13] They are sold daily and bids are made for them on several exchanges at the same time. It is interesting to note that the fluctuations in the price of the debentures of these mortgage banks has been rather slight and times of depression have not created havoc with their prices, nor have times of prosperity sent them flying to the sky. They have been, in the main, sound, prudent, safe, and non-fluctuating securities.[14]

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[13] Mortgage bank debentures are listed on the exchanges of: France, Egypt, Colombia, Argentina, Chile, Germany, Netherlands and many other countries.

[14] During the years 1926 to 1930 fluctuations in mortgage bank debentures in the following countries were:

	1926	1927	1928	1929	1930
Argentina	700 / 460	523 / 464	504 / 492	486 / 482	463 / 420
Brazil	510 / 326	542 / 315	530 / 428	465 / 390	470 / 424
Chile	98.5 / 94.75	97.25 / 93	99.75 / 95.75	99.75 / 83.5	99 / 76
Colombia		99.5 / 95.75	98 / 90	93 / 70	78 / 71
Denmark	2835 / 1800	1965 / 1790	2055 / 100	2040 / 1945	2175 / 1985
Egypt	76 / 71½	86.25 / 72.375	82.5 / 78	84.5 / 82	86 / 83.5
Finland	101 / 98.75	102 / 99.75	102.5 / 99.5	102 / 97.75	101.75 / 93.375
France	250 / 215	305 / 240	369 / 300	384 / 320	425 / 385
Germany	101.5 / 94	103.625 / 97.5	101.25 / 98	99 / 92	98.5 / 81
Netherlands	100.25 / 100	100.5 / 100	100.625 / 100	101.5 / 101.0625	100.75 / 100.0625

But the long term mortgage is not the only characteristic of the mortgage bank in which it differs from our mortgage companies. It seems never to have occurred to anyone before it was tried here, that the public investment in general mortgages should be augmented by the sale of participations in an individual mortgage, which are then either guaranteed or not, as the case may be. When a particular mortgage is divided among a group of people the investors in that particular mortgage will, of course, derive only such advantages as the mortgage itself produces. Another investor, buying a part interest in another mortgage, may fare better or worse. Neither has a choice in practice in determining which mortgage he shall buy a part interest in. Usually the advice of the money lending institution is accepted. This inequality among the security holders of real estate investments has been one of the major difficulties of our unregulated system. One comes across many peculiar cases where, for example, a father has established two trust funds —one for his daughter and one for his son—and the one trust fund is valueless and the other is perfectly all right, merely because he has put certificates of one mortgage into one trust

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CREDIT FONCIER

MORTGAGE BONDS			Quotations							
Issued	Rate	Par	1928	1929	1930	1931	1932	1933	1934	1935
1903	3's	500	369/300	385/320	425/385	463/400	425/363	360	364	334
1913	3½'s	500	375/300	394/331	440/387	497/400	426/370	362	360.50	351
1929	5's	1000		1005/1002	1031/997	1040/1000	1028/960	890	960	858
1930	4½'s	1000			997/983	1020/980	967/883	791	842	785
COMMUNAL										
1927	7's		540/475	598/513	597/562	621/575	599/537	521	527	505
1930	4's				980/955	1000/926	959/845	765	795	747
1931–2	4's					986/965	978/885	810	844	789

fund and certificates of another in the other trust fund. It is difficult to explain this to the investor, who repeatedly complains: "I bought these certificates at the same time, from the same company, through the same person, and paid for them with the same kind of money. Why is this better than that?" Mortgage banks never experienced such difficulty because the debentures issued by a mortgage bank are not part interests in any one mortgage, but are the general obligations of the mortgage bank and all of the mortgages held by the bank stand behind all of the obligations of the bank. When an investor buys a bond of a mortgage bank he knows that the whole portfolio of the bank's investments stand behind his bond, and that if mistakes have been made in a few cases they will not seriously impair his security. There will still be the rest of the assets in the bank to fall back on if need be.

This, of course, presents a very different picture from that which was produced by the mortgage guaranty companies, who distributed billions of dollars of part interests in individual mortgages to hundreds of thousands of unwary investors.

The matter of the appraisal of real property is also differently regulated in countries where mortgage banks prevail than it has been here. We need not recite examples of fraudulent appraisals made in the offices of guaranty companies in the past, but merely refer to the haphazard nature of these appraisals and to the difficulty of determining what constitutes an adequate appraisal.[15] Again this is one of those problems the solution of which is extremely difficult. The difficulty arises from the fact that the value of any real property, that is, its market value, is a function of the economic level in which a particular community finds itself. Market value, by definition, equals the amount of money that an article will bring when offered for sale in the market. It presupposes the existence of the market more or less active. It assumes that there is a buyer ready, willing and able to buy almost everything that is offered for sale. Of course, in times of deep depression the market itself disappears. There are no buyers. Even as a depression recedes the extent to which

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[15] See note 9, *supra*.

the market develops depends upon the extent of the recovery. Moreover, different types of real property are affected differently by the nature of the recovery. If the working man becomes prosperous, that is, if employment returns and real wages rise, one type of real property becomes saleable. On the other hand, middle class prosperity, which may exist without the rise of real wages, affects the value of a wholly different type of structure.

These difficulties present problems for experts to determine. The valuation of real property must be fixed at some point if financing through mortgages is to continue and this valuation must take into account the cycles of economic prosperity and depression, so far as they are predictable by the human mind, and the ultimate value of the real property must be expressed in terms of its income producing probabilities. Obviously, not every man who has been a broker and arranged the sale of real estate, or who has bought and sold an estate himself, or has built a house, or has bought a lot, is qualified to make these judgments. Appraisals, if they are to be relied upon at all must be made by a professional class of men trained in the consideration of the elements of value. Such a professional class can only be created by regulatory measures enacted by the Legislature putting educational requirements behind the license to act as an appraiser and forbidding mortgage banks to lend money except upon the basis of an appraisal made by a duly licensed appraiser. In some countries these appraisers are civil servants. Elsewhere they are chartered like accountants or lawyers.[16] Here every one who pays the fee for getting a broker's license and desires to do so may call himself an appraiser and render opinions which may be relied on under the law by financial institutions, as to the value of real property. Small wonder we have found that in many cases the appraisals which the companies relied on were far in excess of any sensible no-

[16] The report of the Joint Legislative Committee to investigate the guaranteed mortgage situation (LEG. DOC. No. 79, 1936) states: "In California appraisers are licensed by the state, and may be removed by a state officer. A similar system should be adopted here." In England, every person who acts as an appraiser must take out an annual license. If he fails to do so he may be fined and cannot recover for his services. APPRAISERS LICENSES ACT of 1806, 46 Geo. III, c. 43.

tion of the value of the property. More often the appraiser governed himself by what he knew to be the amount of the application for the loan. If the borrower wished $100,000, then the appraiser found no difficulty in estimating the value of the property at $140,000. In this way, the law was satisfied, the loan was made, the bonds or certificates sold, and the foundation laid for the troubles which were thereafter experienced.

Coincident, therefore, with the adoption of any program for the creation of mortgage banks must follow an enactment of a well considered regulatory measure which will prescribe educational and experience qualifications for the profession of appraisers and which will forbid banks and other institutions to lend money on real property except on the basis of an appraisal duly made by a duly licensed appraiser.

The money which mortgage banks use to lend to the mortgagors comes from the public sale of the debentures of the bank. These debentures, as already indicated, are the firm obligation of the mortgage bank and behind them stand all the assets of the institution. Because mortgage banks are conservatively operated, these debentures are high grade investments. They are listed on the exchanges and they sell very close to par with but small fluctuations.[17] The advantage of liquidity and safety renders the investments and the securities of the mortgage bank available for the portfolios of those who wish to put aside their savings to provide for future needs. The interest rates which mortgage banks are compelled to pay on these debentures are, therefore, comparatively low.[18] More frequently the interest rates of mort-

[17] See note 14, *supra*.

[18] The interest rates paid by the Credit Foncier on its debenture issues from 1879 to 1934 are shown below. The comparatively high rates paid from 1917 onward would seem to be the results of an internal condition peculiar to France and these interest rates would not be translated to this country. The size of the issue in millions of francs is also noted. A feature of the French bank's debentures is that they are callable for repayment by means of drawing lots. Each call includes the number of debentures necessary to effect an amortization so that the debentures outstanding never exceed the capital remaining due on the mortgage loans. It is also noteworthy that the issues of 1917 and 1921, which were issued at comparatively higher interest rates than the preceding issues, had been entirely retired by 1931 after an issue of two billion francs at a lower rate permitted a refunding operation. The interest rate on mortgage loans by the bank (upon which data is available) shows that mortgage loans by the bank in 1921 produced 8¼%; in 1922, 7.6%; in 1924, 8%; in 1925, 8%;

gage bank securities are very close to those paid by the government itself and, in the case of some governments, the debentures of the mortgage banks sell at a lower rate of interest than that of their own governments.[19] In this country it was almost conventional for a mortgage loan to carry an interest rate of 6% and for the certificate or bond to carry an interest rate of 5½%. This was true even though the best securities and the highest grade bonds were only carrying interest at 3% or 3½%. Obviously, there is something wrong here when gilt-edge securities can bring only 3½% and senior mortgage securities can bring 5½%. Nevertheless, the investor was given the impression that these senior mortgage loans were unique investments in which the high interest rate was paid in spite of maximum safety. It is illogical, in a period of declining interest rates, that securities which are really safe should carry an interest rate so high as 5½%. At the present time it is perfectly possible, presumably, to market mortgage bank debentures under a system of mort-

in 1926, 8%; in 1928, 8.2%; in 1929, 7.15%; in 1931, 6.25%; in 1932, 6.5%; in 1933, 7.5%; in 1934, 8.05%. By law there is established a differential of 6/10 of 1% between interest received on mortgage loans and interest paid on mortgage debentures. The apparent excess of differential is accounted for by taxes and other out-of-pocket expenses to which the transactions are subject under French law.

Debentures		Size of Issue (Millions of francs)
1879	3%	900
1883	3%	900
1885	2.6%	500
1895	2.8%	250
1903	3%	300
1909	3%	350
1913	3½%	500
1913	4%	150
1917	5½%	300
1921	6½%	300
1926	7%	500
1929	5%	300
1930	4½%	2000
1932	4½%	200
1933	5%	500
1934	5½%	200

[19] Limited information on this subject shows that in 1928, in Germany, the comparative prices of mortgage bank and government bonds were as follows:

Mortgages	90.22
Mortgages (Public banks)	89.19
Government	88.32

DR. G. PLUM, DAS HYPOTHEKENBANKJAHR (1928).

gage banks properly authorized with all necessary safeguards at rates considerably less than 5½%. It has been variously estimated that these mortgage bank debentures could be sold anywhere from 3% to 4½%, depending on the quantity and the extent of the issue. Mortgage lending itself should not go into the rut of a fixed rate of interest regardless of what the money market is commanding at a particular time. The idea that a mortgagor must pay 6% interest on mortgage money regardless of what the conditions are in the field of finance is without foundation in logic, and it is unsound from an economic point of view. There are times when loans on mortgages must be made at higher rates of interest and there are other times when they may be made at lower rates of interest. Mortgage banks scientifically organized must study the situation and they are entitled to receive fair compensation for the service they thus render, to wit, the distribution of the bonds to the investing public and the investment of the proceeds in satisfactory mortgage loans. This compensation ought never to exceed a differential of 1%, at the most, between the amount received from the mortgagor and the amount paid to the security holder. Our estimates show that with such a differential of 1% a very adequate and satisfactory profit can be earned by the entrepreneurs of the mortgage bank.[20]

Money borrowing institutions did not suffer in the depression because the principal amount of their loans were called. Even in bad times there were places (and the last resort was always the Government), where loans could be obtained by financial institutions to meet pressing obligations

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[20] A differential of one per cent between income received on mortgage loans and interest paid on mortgage debentures will be expended: one-half of one per cent on cost of operation, one-half of one per cent on profit and reserves. The full disbursement of one-half of one per cent to stockholders would show a return to stockholders (assuming capacity holdings of mortgages and capacity issuance of debentures and allowing a three per cent investment income for liquid surplus) as follows:

Ratio of Debentures to Capital				
10 to 1	15 to 1	20 to 1	25 to 1	30 to 1
Return to Stockholders				
9½%	12%	14½%	17%	19½%

to return the principal amount due to their investors. What created the serious problem for the money borrowing institutions was the obligation to pay a fixed rate of interest higher than they could earn. This sort of fixed obligation renders difficult of achievement whatever chance which the institution may have of working out even a temporary embarrassment. When an institution must pay 5½% and can only collect 3%, obviously a condition exists which cannot be made the basis of sound governmental aid. Such at least was the attitude of financial experts during the last depression.

The most spectacular illustration of this attitude is the difference between the experiences of our mutual savings banks and those of our mortgage companies. The mutual savings banks, in the main, weathered the storm quite happily, and they did so in spite of the fact that all of their deposits were constantly on call. Here and there a savings bank found itself in a position where its depositors demanded their money. The neighboring institutions supplied it with money and the depositor was satisfied until confidence was restored again. What saved them was the fact that through the operation of the law they were able to reduce their interest requirements from 4% to 3½% to 3% to 2½%, and finally, to 2%, so that at no time was it necessary for any of these mutual savings banks to operate on a basis where its expenses exceeded its income. The securities they held were industrial bonds and real estate mortgages, but they were able to reduce their obligations and thus to continue to live. Mortgage companies, on the other hand, were unable to reduce their obligations and when interest payments became due and the money was not forthcoming with which to pay them, it was pointless for them to borrow because they would only put in good money to pull out bad. The longer they stayed in business the greater the deficit and the more money they needed, and so the mortgage companies had to collapse while the mutual savings bank continued to exist without too much difficulty. This lesson is one which must not be ignored and which, taken to heart, leads inevitably to the conclusion that mortgage banks, if they are to succeed and to remain permanently whole, must be in a posi-

tion to permit the interest rate which it pays on the debentures to fluctuate with the income produced by the collateral which it holds. In the long run, investors are better served by an institution which can continue to pay even 1%, or ½ of 1%, on the investment than by an institution which obligates itself through all seasons, in all sorts of financial weather, to pay 5½% and then collapses in the attempt to fulfill its obligation.

The capital structure of mortgage banks is to be established on a sounder basis than was the capital structure of the old mortgage companies. It would seem to be self-evident that those who wish to engage in the business of distributing real estate securities among the public should at least invest a substantial sum of money in the undertaking to assure the financial stability of their companies. The mortgage bank must, therefore, be required to have a minimum capital which some of us have thought should be not less than $5,000,000; others have been satisfied with only $3,000,000. In addition a paid-in surplus should be required of the stockholders of the mortgage bank at least equal to the amount of the capital. Many have thought that a percentage of the profits of the mortgage bank should be set aside as a reserve fund to meet contingencies as they occur. Others have been of the opinion that this is an unnecessary drain on the institution. Whatever may be the ultimate conclusion with regard to these matters, it is, of course, obvious that the larger the permanent financial resources of the bank are the easier it will be to meet contingencies if a general collapse should occur. And again, the requirement that the capital and surplus should be a substantial one will make it difficult for small companies to come into existence with means that are inadequate to meet even temporary reverses.

An important feature of the mortgage bank legislation is the limitation of the total amount of debentures which any mortgage bank may issue to a specified ratio of the capital and surplus of the bank. The bills which were introduced into the Legislature of the State of New York variously fixed this ratio at fifteen or twenty times the capital.[21]

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[21] S. INT. (1936) No. 1080, PR. 1215, 1648, 1810; S. INT. (1937) No. 1104, PR. 1240, 1450, ASS. PR. 3238.

Theoretically, it is not necessary to limit the amount of debentures that a mortgage bank may sell if we assume, as we must, that the mortgage bank will be prudently managed and the investments conservatively made. Then it does not matter how many debentures are sold as long as they do not exceed the mortgages held in the portfolio of the bank. Practically, however, it seems wise to limit the amount of the debentures that a bank may issue to a fixed proportion of its capital. In other countries this ratio has varied enormously. In some countries the amount of the debentures that may be sold is as low as ten times its capital.[22] On the other hand, in one mortgage bank it is as high as fifty times its capital.[23] We believe that at least to begin with, it might prove a wise policy to limit the total debentures that may be sold by a mortgage bank to twenty times its capital, permitting the Legislature to expand this ratio if at some future time it seems advisable and safe to do so.

The best laid plans for the regulation of financial institutions will, of course, be utterly futile unless the institutions are manned by honest and efficient directors. We cannot legislate honesty and efficiency into men. These things are the heritage of individuals and not the gifts of the state. Nevertheless, while we cannot insure, we can frequently advance honesty and efficiency. A watchful eye over the affairs of the mortgage bank must ever be kept by the regulatory body duly empowered and enabled to do so by the

[22] A partial list of these ratios, as contained in Legislative Document No. 63 of 1936, shows that mortgage banks in the following countries maintain a ratio of outstanding debentures to capital at 10 to 1 as follows:

Country	Bank
Brazil	Credit Foncier du Brezil
	Banco hipotecario de Minas Geraes
Colombia	Mortgage Bank of Bogota
Finland	Mun Mortgage Bank
Sweden	Town Mortgage Bank of Kingdom of Sweden

[23] Crédit Foncier de France. It should be noted in this connection, however, that of the eighteen billion francs of loans in the portfolio of this bank in 1934, eleven billion francs were invested in loans to municipalities, to repay which the taxing power of the municipal government was pledged. The safety of the municipal loans may be judged by the fact that only one million francs were in arrears on February 28, 1935, or one franc in each eleven hundred loaned. Of nearly seven billion francs on real estate mortgage loans outstanding at the end of 1934, the arrears on February 28, 1935 totalled one hundred twenty-five million francs, or less than 2%.

state. Frequent reports by the bank to the Superintendent of Banks, frequent examinations by the superintendent of the affairs of the bank, are inevitable and indispensable, both to the creation of confidence in the public in the institution, which is necessary, and to the smooth functioning of its policies.[24] Reports alone, however, filed in the office of the superintendent are not enough. Publicity—pitiless publicity—is vital, and the kind of publicity which the common man can understand and which does not require learning and experience to interpret must be made available. Mortgage banks should be required to publish financial statements at least twice a year, not only in financial papers but in daily newspapers. Data should be available at the superintendent's office where, upon request, any proposed investor can obtain information about the bank. Publicity should be given by the superintendent to the fact that such data is available. This data should be in form prescribed by law so that he who runs may read, and he who reads may understand. Here, as elsewhere, experience teaches that the secret of democracy is best guarded by knowledge of the truth and that secret financial transactions, like secret diplomacy and secret governmental councils, lead to the ultimate disruption of the democratic processes in business as well as in government.

Drafting legislation to put into effect some of the recommendations which we make has been a most difficult task. It is, of course, not difficult to put down in words and phrases the regulations which have been suggested in this paper. The difficulty is in getting unanimity of opinion among the experts about the particular form which these recommendations should take in the statutes. We have been met with a number of propositions which, in some cases, are difficult to deal with.

In the first place, it has been stated by some that there is already too much government regulation in business, and

[24] Section 42 of the Banking Law now requires quarterly reports from every institution under the jurisdiction of the Superintendent of Banks.

Section 44 of the Insurance Law requires annual reports from every corporation or other insurer under the jurisdiction of the Superintendent of Insurance.

that the directors of a bank ought to be given a free hand to carry out the policies as they see fit. After all (it is said), one cannot depend on the Superintendent of Banks to know as much about business as the experts who invest their money in the banking institution. They, above all, know more and understand more than government officials could possibly hope to, and, accordingly, the statute ought to be drafted in order to give the widest discretion to the bank management. This sounds so much like an echo of the *laissez-faire* economics that it is difficult to deal with. Most of us were content with the thought that such economics were decently interred on the 4th of March, 1933, but it seems not to be able to stay within the confines of the sepulchre. Every now and then it shows itself again with a distrust of government regulation and a desire to restore unrestrained liberty of action to bank directors and entrepreneurs generally. The history of the last two decades should have proved that unbridled freedom is infinitely more undesirable than the occasional errors which might have come from regulation. And, of course, regulation should be tempered to meet the need for it. Where there is no need for the regulation, it is, of course, futile and wasteful to have it. The losses sustained by the American public in the field of real estate securities seem to us to justify a strong measure of regulatory supervision in the future.[25]

In the second place, we are asked, if the business of selling real estate securities is to be so carefully guarded by the state as to be entrusted only to mortgage banks under careful supervision of the state government, what about the business of selling other securities? Why should investors in other securities be left to the mercy of high pressure salesmen while investors in real estate securities are carefully protected by state laws? The objection has been urged most strongly in connection with the proposal to limit the

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[25] A typical case is that of American Bond and Mortgage Company, Inc. (Chicago). Its bonded debt, unsecured, amounted to $4,860,000. Defaults in interest began on the 1st of March, 1930. Subsequently it was petitioned in bankruptcy and a 10% dividend was paid in cash and the balance in notes, of which 5% has been paid. In addition to the foregoing, they also underwrote the payment of twenty-one issues of mortgages amounting to $18,799,020, all of which were in default.

sale of real estate securities to mortgage banks. The proponents of the mortgage bank idea have naturally felt that real estate securities should not be permitted to be sold by any other group. Because of the restrictions placed on mortgage banks it was deemed inadvisable to permit non-regulated companies to compete with them. Monopoly for the sale of real estate securities would exist in a sense. This is the situation in countries where mortgage banks are in existence and have prospered.[26] However, we are told that this sounds like class legislation in that it discriminates unfairly in favor of the purchaser of real estate investments. The objection sounds technical in that the words "class legislation" impart a flavor of unconstitutionality. Constitutional lawyers, however, have not generally feared that the classification is an unreasonable one. Nor can it be argued logically that a statute which attempts to do some good should not be enacted simply because it does not do more good. All reforms in the past have been piecemeal and it is perfectly possible that the regulation of real estate securities is a beginning toward the general approach to the regulation of all securities. Whether this be so or not seems to be beside the question, for the problem we have set ourselves to solve is the problem involved in the distribution of real estate securities. Other problems must bide their time and be the subject for solution for those who are particularly qualified to deal with them.

In the third place, we have been urged to consider that mortgage banks and the program under which they are to operate would put a definite brake upon the construction of new buildings and the development of the real estate industry generally. Mortgage money would become more conservative and financing of real estate would require larger contributions of capital by the owners of the venture. There are those who think that this is an objection to the plan. Others think it is an advantage. We do not believe that it is either an objection or an advantage; we are of the opinion that the consequence foretold will not occur. In spite of the conservative approach which mortgage banks will undoubt-

[26] A monopolistic mortgage bank exists in Sweden and did until recently exist in Spain. A *de facto* monopoly exists in France.

edly have, and in spite of the fact that mortgages will be smaller in relation to the cost and value of the property than they have been in the past, it will not be necessary for owners to invest larger sums of capital than they heretofore have. Many will do so, others will take advantage of junior financing, which used to flourish even in the good old days and which will now be able to exist on a more prudent basis. The difficulty in the past has been that junior financing has been totally unscientific and that in many cases there was no real justification for it after the first mortgage had been placed. With more conservative first mortgages there will be an adequate opportunity for junior financing from which legitimate profits can be gained by investors, and which will go far toward paying adequate returns on real property to real property investors.

Finally, we have been told that the whole scheme of authorizing mortgage banks in the United States is unconstitutional, contrary to the traditions of America, a foreign importation, and something with which we ought to have nothing to do. We state this objection not because we hope persuasively to refute it, but because it has been made so often. To refute it is impossible. The late Mr. Justice Holmes told about the knight of old who was accustomed to point to his lady fair and if you did not agree that she was the most beautiful in the world you had to fight.[27] So it is with those who object to reform measures on the ground that they are foreign or out of line with some supposed tradition and frequently that they are unconstitutional. This argument is the refuge of an opponent who will not reason but who reacts emotionally, or perhaps for some ulterior motive, to a proposed suggestion for reform. With such as these it is futile to engage in further polemic. We must simply submit our case to the board of public opinion, where we who still have faith in democracy believe reasoned judgments will ultimately prevail.

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[27] Oliver Wendell Holmes, *Natural Law* (1918) 32 HARV. L. REV. 40.

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