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MORTGAGE LENDERS AND THE HOUSING SUPPLY*

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Inadequate housing is a major contributor to the social crisis facing the United States today. The economy has failed to produce the new housing needed by a growing population, and has been unable to provide housing at prices within the means of many Americans. Both government reports and private studies indicate[1] that the burden of these failures falls most heavily on the poor, whose continuing frustration and alienation are nurtured in substandard dwellings in squalid neighborhoods.[2]

Investment decisions of mortgage lenders have a significant impact on the production and distribution of housing.[3] Builders are characteristically small and under-financed, and must depend on construction loans and take-out financing to produce and market new

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1 *See, e.g.*, PRESIDENT'S COMM. ON URBAN HOUSING, A DECENT HOME (1968) [hereinafter cited as A DECENT HOME]; Welfeld, *A New Framework for Federal Housing Aids*, 69 COLUM. L. REV. 1355 (1969).

2 *See generally* NATIONAL ADVISORY COMM'N ON CIVIL DISORDERS, REPORT 467-82 (1968).

3 *Cf.* N.Y. Times, March 6, 1970, at 79, col. 1. Other variables of course affect the supply of housing. Increases in cost of materials and labor may cause developers to postpone or abandon contemplated construction, or to price the final product beyond the reach of many Americans; government monetary policy can raise interest rates to levels that discourage all but the most determined home purchaser. Yet financial institutions play a crucial role in determining the availability of housing. *See* notes 4-6 and accompanying text *infra*.

homes.[4] Individual home purchasers normally lack the substantial funds needed to purchase without credit and invariably rely on mortgage loans as a means of spreading housing costs over time.[5]

This study focuses on traditional mortgage lenders—savings banks and savings and loan associations—which are major sources of funds for both builders and home purchasers.[6] On the basis of interviews with officials of such institutions,[7] we have sought to describe two

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4 The dependence of the small-scale builder on mortgage financing is described in Lefcoe & Dobson, *Savings Associations as Land Developers*, 75 YALE L.J. 1271 (1966).

A simplified description of the financing of a typical construction project may be useful. To pay his subcontractors and materialmen, the builder secures a short term construction loan, designed to be liquidated when construction is completed. Since the builder is generally no more able to pay off the construction loan when the project is completed than when it was begun, however, the construction lender may require the builder to obtain a take-out commitment from another lender. "Take-out" financing is simply a long term mortgage secured by the newly constructed buildings, the proceeds of which are used to repay the construction loan. For present purposes, a consideration of the role of the interim lender is unnecessary. *See generally* G. LEFCOE, LAND FINANCE LAW 595-608 (1969). The process is somewhat different in construction of single family homes. *See* Storke & Spears, *Subdivision Financing*, 28 ROCKY MT. L. REV. 549, 555 (1956).

An alternative to the above system, which relies heavily on outside construction funds, is the developing practice of internal financing of construction by large, diversified corporations. *See, e.g.*, Wall St. J., Jan. 2, 1970, at 1, col. 6.

5 *See* L. RODWIN, HOUSING AND ECONOMIC PROGRESS 26-29 (1961). Because of this reliance on mortgage funds, a rise in interest rates or a decrease in available loan funds will deter home purchases.

6 HOUSING AND URBAN DEVELOPMENT TRENDS, May/June 1969, at 23. *See also* A. DIAMOND, MORTGAGE LOAN GROSS FLOWS 23, 31 (1968); *cf.* SENATE COMM. ON BANKING & CURRENCY, 86th CONG., 2d SESS., A STUDY OF MORTGAGE CREDIT 203-06 (Comm. Print 1960).

7 For a listing of institutions interviewed, see APPENDICES A & B *infra*. The New Haven interviews were conducted between March and June, 1969. Those in Los Angeles were conducted between June and August, 1968.

No interviews were conducted with officials of pension or retirement funds in either New Haven or Los Angeles. These sources contributed \$8.4 billion, or roughly 2% of national mortgage funds in 1967. A DECENT HOME 246. The New Haven interviews did include one brokerage firm, Lomas & Nettleton, which had placed approximately \$12 million in mortgages in the New Haven area for insurance companies, and one life insurance company, Connecticut General Life, which had a \$13 million residential mortgage portfolio in New Haven County.

The interviews ranged in length from one-half hour to more than two hours; interviewers were requested to submit complete written reports. The questions and interview notes are on file at the offices of the *Cornell Law Review*.

The data was compiled from interviews because we wished to obtain a close-up view of the operations of individual institutions. We were able to obtain information about operating practices that could not have been discovered by a review of official reports, balance sheets, and statements of condition which are submitted to the regulatory agencies.

The methodology and conclusions of our study should be compared with those of D. HESTER, STOCK AND MUTUAL ASSOCIATIONS IN THE SAVINGS AND LOAN INDUSTRY: A STUDY OF THE ECONOMIC IMPLICATIONS OF CONVERSION (1967). While the report is not entirely adequate (*id.* at 11), or free from puzzling discrepancies (*id.* at 26), it is the most sophistitypical markets exhibiting differing investment preferences. The markets examined are New Haven[8] and Los Angeles;[9] of the two, Los Angeles has experienced a more rapid and steady expansion of the housing supply.[10] Predominant mortgage lenders in each city differ markedly in age,[11] in form of organization,[12] and in size.[13] The study

cated yet conducted. The findings and conclusions presented here do not conflict with those of Professor Hester.

8 *See* APPENDIX A *infra.*

9 *See* APPENDIX B *infra.* Factual statements obtained in interviews with savings institutions will hereinafter be supported by reference to the identification initials assigned to various institutions in the appendices.

10 Although statistics for individual states are not available, the spirited pace of housing construction in California is reflected by the unusually high annual average vacancy rates of units available for rental or sale in the western region. *See* U.S. BUREAU OF THE CENSUS, DEP'T OF COMMERCE, CURRENT HOUSING REPORTS, HOUSING VACANCIES, ser. H-111, No. 51, at 20-21 (1968). This vacancy rate is particularly striking in view of the rapid increase in the population of the western region. From 1960 to 1970, the population of the region rose at a rate of 24.1% while that of the northeast rose only at a rate of 9.8%. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 1971, at 13 (1971).

In absolute terms, data for 1969 indicates that California remains the most active market for new housing construction. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, CONSTRUCTION REPORTS, HOUSING AUTHORIZED BY BUILDING PERMITS AND PUBLIC CONTRACTS 1969, ser. C-40, No. 13, at 20 (1970).

As a result of considerable overbuilding, real estate agents in Los Angeles at one point were offering homes for rent with no required security deposit and six months free rent, simply to get signatures on leases and occupancy of houses. GWSL.

11 The New Haven savings banks operate under charters granted immediately after the Civil War. *But see* CONN. GEN. STAT. REV. § 36-117 (1958) (general state law to prevail over inconsistent charter provision). Concerning savings and loan associations chartered in Connecticut, a state official commented that, except for the Connecticut Savings and Loan in Hartford, owned entirely by Blacks and chartered in 1968,

> we haven't had any applications for new savings and loans for years . . . . I guess the last charter granted was to Naugatuck in 1922. The main reason why S&Ls aren't more popular is that Connecticut is a big savings bank state. We've got 69 of them, founded around the Civil War—they're old and wealthy.

Interview with Reinhard J. Bardeck, Deputy Banking Comm'r, Conn. Banking Dep't, Jan. 27, 1969. Federally-chartered savings and loan associations date from the Depression when the chartering of such institutions was first authorized by federal statute. 12 U.S.C. § 1464(a) (1970). Many of the Los Angeles institutions are much younger, dating from 1945 and the post-War boom.

12 Both California and Connecticut charter savings and loan associations. CAL. CONST. art. 12, § 5; CONN. GEN. STAT. REV. § 36-173(2) (Supp. 1969). In Connecticut, the state-chartered savings and loan associations are mutual or depositor owned. *Id.* §§ 36-175, -178 (1958). This form of organization exists in all states and predominates among savings and loan associations nationally. HOUSE SUBCOMM. ON DOMESTIC FINANCE, COMM. ON BANKING AND CURRENCY, 88TH CONG., 2D SESS., COMPARATIVE REGULATIONS OF FINANCIAL INSTITUTIONS 109 (Comm. Print 1963) [hereinafter cited as COMPARATIVE REGULATIONS]. The vast majority of these state-chartered institutions are insured by the Federal Savings and Loan Insurance Corporation (FSLIC). *Id.* at 101. FSLIC regulation provides a degree of uniformity in institutional operations and policies. 12 C.F.R. §§ 563, 565-66 (1971).

An overwhelming majority of state-chartered savings and loan associations in Los also reveals major variations in the procedures of mortgage lenders in the two cities. The impact of these variations on housing demonstrates the desirability of fundamental change in the internal structure, size, and lending policy of some savings institutions.[14]

Angeles are organized as stock companies under CAL. FIN. CODE §§ 5068-69 (West 1958). This form of organization is permitted in 18 states, but its development has been concentrated in a few jurisdictions, principally California, Ohio, and Texas. COMPARATIVE REGULATIONS 101, 109. Federally-insured associations in this category are regulated by FSLIC in the same manner as state-chartered mutuals. Connecticut does not permit this form of banking. In Los Angeles, a few state-chartered mutual associations, which were founded before stock associations were permitted, continue to function. *See In re* Pacific Coast Bldg.-Loan Ass'n, 15 Cal. 2d 134, 99 P.2d 251 (1940).

Federally-chartered savings and loan associations in both New Haven and Los Angeles are mutual associations. 12 U.S.C. § 1464 (1970); 12 C.F.R. § 544.1(a) (1971). In 1963 approximately 30% of all savings and loan associations were under federal charter. COMPARATIVE REGULATIONS 101. These institutions are regulated by the Federal Home Loan Bank Board (12 U.S.C. § 1464(i) (1970)), and are subject to the same regulation by FSLIC as state-chartered savings and loan associations.

Connecticut, but not California, charters mutual savings banks that are controlled by independent boards of directors. CONN. GEN. STAT. REV. §§ 36-117 to -134 (1958). Mutual savings banks exist in 18 states, predominantly in the northeast, where, as in Connecticut, most charters were issued before the growth of savings and loan associations and the acceptance of savings deposits by commercial banks. Note 11 *supra*. *See* G. MUNN, ENCYCLOPEDIA OF BANKING AND FINANCE 665 (6th ed. 1962). The statutes governing these institutions vary from state to state in a number of ways, *e.g.*, in types of loans, terms of loans, maximum interest rates, geographic area of operation, and allowable personal loans. Virtually all mutual savings banks, except those in Massachusetts, have their deposits insured by the Federal Deposit Insurance Corporation (COMPARATIVE REGULATIONS 68), and this again provides a degree of national regulation over their operations and policies. 12 C.F.R. §§ 329, 335 (1971).

Federally-chartered commercial banks are organized as stock companies (12 U.S.C. § 22 (1970)), as are the state-chartered commercial banks in Connecticut, known as state bank and trust companies (CONN. GEN. STAT. REV. § 36-53(2) (1958)). No commercial banks were interviewed in Los Angeles and they play a comparatively passive role in the mortgage market in New Haven. *See* note 14 *infra*.

The New Haven interviews included nearly every traditional mortgage lender in that city, as well as institutions in neighboring cities that operated branches in the New Haven area. The Los Angeles interviews necessarily included only some of the savings and loan associations in that city.

13 Four of the seven largest savings and loan associations in the country, with assets ranging from $700 to $2,732 million, as of the end of 1967 were located in Los Angeles. SAVINGS & LOAN NEWS, Feb. 1968, at 14. Although smaller than the Los Angeles Savings and Loan Associations, all the institutions interviewed in New Haven were not of insignificant size. Certain institutions boasted moderately large assets: CSB ($244.1 million); FFSLNH ($177.2 million); NHSB ($269.7 million); and PST $545.6 million). These contrast sharply, however, with the much smaller institutions dispersed among them: DSB ($32.2 million); HNB ($13.0 million); NHSL ($21.7 million); ONB ($6.2 million); and SFSLNH ($28.3 million). *See* APPENDICES A & B *infra*.

14 New Haven (population 138,000) and Los Angeles (population 2,814,000) obviously differ greatly in size. BUREAU OF THE CENSUS, U.S. DEP'T OF COMMERCE, STATISTICAL ABSTRACT OF THE UNITED STATES: 1971, at 22 (1971). The contrasting behavior we observed might be attributable to the size of the community in which the institution functions, not to its

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Mortgage Lending in New Haven and Los Angeles

A. *Housing Construction*

To have a direct impact on the production of housing, a mortgage lender must either deal with private developers[15] or, as is authorized in both New Haven and Los Angeles,[16] engage in development itself.

organizational form or size. While community size cannot be ruled out with mathematical certainty, there is evidence indicating that it is not a significant variable. If community size were an influential factor, one would expect that differences in the operations of similarly sized institutions in the same community, regardless of organizational form, would be minor when compared with inter-city differences. We found, however, that the large stock associations in Los Angeles were uniformly aggressive, while at least one of the large mutual savings institutions (CFSL) was quite conservative. Moreover, when one compares the financial statements of California state-chartered stock associations with those of state-chartered mutual savings banks of similar size, the mutual institutions appear more risk-averting when rated according to such indices of risk as percentage of real estate owned, percentage of loans made to facilitate the sale of property, and construction loan originations. *See* G. Lefcoe, *supra* note 4, at 339-40.

No valid intra-city comparisons are possible for the New Haven institutions, because no savings and loan associations or other major residential mortgage lenders organized with capital stock are authorized in that community. To be sure, our interviews included the commercial banks in New Haven, which are stock corporations, but the lending policies of these institutions cannot be compared with those of the mutual savings banks and savings and loan associations in that city. Commercial banks operate under entirely different statutory authorizations than do residential mortgage lenders; they concentrate on short term commercial lending and do not perceive the major thrust of their operations as making residential mortgage loans.

Of course, some institutions in Los Angeles have grown to a size which no New Haven institution could realistically hope to attain. To the extent that institutional size affects behavior, community size will be a factor in that it places limits on the growth of the institutions located within it.

Finally, patterns of community development and expansion of the housing supply have been closely associated with the boom of stock associations in Los Angeles. Cause and effect in this relationship have been extremely difficult to separate. Even Professor Hester's meticulous study was unable to control all the variables in the different markets, or communities, in which the institutions operate. *See generally* D. Hester, *supra* note 7, at 5-6.

The association of expansion of the housing supply with the prevalence of stock associations, taken with the data hereinafter presented (notes 14-70 and accompanying text *infra*), argues for the chartering of stock associations in areas like New Haven, where they are not now authorized.

15 Financial institutions such as those considered here will typically deal with the private developer, often a builder from the community. Public developers can often avoid the intermediary costs which a financial institution must impose. However, public agencies occasionally turn to banks and savings associations for mortgage funds. Thus, many New Haven institutions participated in a consortium which provided funds for the Church Street South urban renewal project in that city. NSB, NHSB, UNHTC, and FNHNB.

16 *See* 12 U.S.C. § 1464 (1970) (federal savings and loans); Cal. Fin. Code § 6705 (West

Either alternative entails more risk than the ordinary mortgage loan made to finance an individual borrower's purchase of an existing dwelling unit.

Loans to finance construction are more risky because, although the mortgage may cover the land on which construction is proposed,[17] the buildings that will furnish most of the security have not been built and often not been rented or sold.[18] The lender thus runs the risk that the demand for housing in a particular area will suddenly decline, reducing the value of his security;[19] that the housing when constructed will be of inferior quality;[20] and that the developer and construction funds will disappear before construction is completed.[21]

Equity investment in new construction is also subject to the vicissitudes of local, regional, and national economies. In addition, the lender-builder must absorb in full whatever losses are incurred since he has given up the protection, however imperfect, that a mortgage would provide. This element of risk is offset at least in part by the absence of any risk that the borrower will abscond with the loan pro-

1958) (California state-chartered institutions); CONN. GEN. STAT. REV. §§ 36-130, -178(n), (o) (1958) (Connecticut savings and loan associations and savings banks).

17 Lenders frequently require that the construction borrower own "free and clear" the land on which he intends to build. This provides a measure of safety beyond the projected value of the housing to be constructed.

18 Without a substantial amount of his proposed building leased before he starts construction, the builder must depend on short-term construction financing—loans at relatively high rates of interest—to carry him through the building phase. The lending practice once was to provide long-term, lower-rate loans if up to 80 per cent of the proposed building were under lease . . . .

N.Y. Times, March 7, 1971, § 8 (Real Estate), at 8, col. 6.

19 For this reason, elaborate economic projections of growth and employment are made by lenders contemplating engaging in large scale development lending. GWSL.

20 Inferior quality will normally be a major concern of the lender, since it will affect the value of the security in event of foreclosure. In addition, home purchasers injured by defects in homes built with construction loans have been held to have a cause of action against the lender on a negligence theory. Connor v. Great W. Sav. & Loan Ass'n, 69 Cal. 2d 850, 447 P.2d 609, 73 Cal. Rptr. 369 (1968) (en banc). *But see* CAL. CIV. CODE § 3434 (West 1970), limiting *Connor* to cases where the lender acted "outside the scope of activities of a lender of money."

21 "The completed building is a better risk than a builder's dream and that's why rates are lower and mortgages are larger." N.Y. Times, March 10, 1971, at 60, col. 4.

As a means of minimizing the chance of outright fraud, construction lenders regularly make periodic disbursements of funds as construction progresses and require completion certificates, vouchers (GWSL), on-site inspections (ESL), or certificates of occupancy (NHSB) as a prerequisite to each successive disbursement. One institution (ESL) utilized a confidential private service which evaluated the credit of construction borrowers.

A Connecticut statute expressly requires that construction loans made by Connecticut savings and loan associations be geared to the process of construction and not proceed at any faster rate. CONN. GEN. STAT. REV. § 36-178(h)(6) (1958). For a similar provision for Connecticut savings banks, see *id.* § 36-99(11)(d).

ceeds and by the theoretically unlimited yield which the investment may furnish.

No lender could reasonably be expected to charge the same interest rate for construction mortgages as for other loans in his portfolio. For the reasons just indicated, construction loans are less effectively secured than individual purchase loans, and builders are generally in no position to relieve the lender's fears by providing fully adequate security. The lender will therefore normally demand higher interest rates for construction loans. Since construction loans turn over in months, not years, and often require on-site inspections and periodic disbursements by the lender, one might expect an institution to charge somewhat higher rates to cover higher administrative costs as well. Thus a differential between interest rates for construction loans and those for individual home purchase loans appears essential before a lender can obtain an acceptable return. Los Angeles lenders employing such a rate differential viewed construction loans as an important means of increasing their overall earnings as well.[22]

Interest rates charged by the New Haven lenders, however, exhibited no such differential; only rarely did New Haven lenders make construction loans at rates higher than those for individual home purchase financing.[23] Apparently unwilling to assume the underwriting function, the New Haven institutions originated loans characterized by an overall uniformity of interest rates. This uniformity of rates may indicate that the New Haven institutions have taken steps to

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22 Of course, the higher rates that a lender can command for construction funds do not ensure that such loans will be more profitable in the long run than individual purchase loans. That portion of the higher return which represents self-insurance against increased risk theoretically should not be regarded as net profit but should be held in reserve against future losses. Nevertheless, in Los Angeles the prevalent assumption was that the higher rate of return would more than cover the higher risk. One official, commenting on the home improvement loans made by his association, stated: "They entail a high risk, being unsecured, and we have to be there knocking at the door to collect our money. Collection costs are expensive. But we make a much higher rate of return." CFSL.

For economic studies of the relationship between risk and rate of return, see W. FELLNER, PROBABILITY AND PROFIT (1965); Arditti, *Risk and the Required Return on Equity*, 22 J. FIN. 19 (1967). For one attempt at quantification of the relationship, see Fisher & Hall, Risk and Corporate Rates of Return, Dec. 27, 1967 (unpublished), *reprinted in Hearings on the Present Status of Competition in the Pharmaceutical Industry Before the Senate Subcomm. on Monopoly of the Select Comm. on Small Business*, 90th Cong., 2d Sess., pt. 5, at 2120 (1968). Our study makes no attempt at such precise quantification.

23 DSB, FFSLNH, FNHNB, NHSB, NHSL, and SNBNH made no differentiation between construction and individual purchase loans in fixing interest rates. PST (the largest institution interviewed in New Haven) charged 1/4 of 1% more for construction loans used to build structures which were not to be occupied by owners, but otherwise made no distinction.

eliminate certain elements of risk, with the result that the construction loans they do make are no more risky than loans made to finance the purchase of existing properties. Thus many New Haven institutions refuse to lend to builders with whom they have not previously dealt.[24] In addition, the lender may decide not to gamble on the demand for new housing and may instead finance primarily the construction of custom-built homes, that is, those which, prior to construction, have committed purchasers.[25] Whether cause or effect, the absence of any variation in rates has been coupled with a restriction of construction lending to extremely "safe" borrowers and uses. The erection of financing barriers to the entry of new builders and the reluctance to finance larger, more speculative projects have placed severe limitations on housing production in New Haven.

New Haven institutions were even more chary of the opportunity to engage in equity investment. Despite the advantages of such investment as a hedge against inflation and rising interest rates paid depositors,[26] only one of the institutions interviewed reported any involvement in real estate equity investment.[27] This absence of institutional participation in housing development further restricts new construction.

In contrast, the Los Angeles mortgage lenders whom we interviewed adjusted their interest rates in conformity with the abstract description of market behavior previously set forth.[28] They uniformly charged more—sometimes as much as six or eight percent more—for construction loans than for individual purchase loans[29] and were far more active in housing construction lending than the New Haven

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24 FFSLNH, FNHNB, and NHSB.

25 CTC, NHSB, and PST. A federal institution in neighboring New London, Connecticut reported that it made construction loans

> to individuals, workers, who have gotten together a couple of thousand dollars and want to get financing to build their own homes. We give heavy consideration to this kind of "sweat equity." We've had very good luck with this kind of loan, particularly because the man has put so much of himself into the security. The rates are about the same as for other loans.

Interview with William T. Douton, Jr., Vice President, New London Federal Savings & Loan, Nov. 24, 1968.

26 Wall St. J., July 15, 1969, at 1, col. 6.

27 PST reported owning land worth about $125,000 in Bridgeport, Connecticut which it had acquired as sponsor for a private renewal project. Bridgeport reportedly has not established a public urban renewal agency.

28 *See* notes 17-22 and accompanying text *supra*.

29 BSL, ESL, FSL, LSL, SMSL, and USL. CoFSL, however, stated that returns from its construction loans were about the same as, or slightly less than, yields on its purchase loans.

institutions.[30] The amount of housing construction they financed was significant.[31]

Unlike the New Haven institutions, Los Angeles state-chartered savings and loan associations expressed a willingness to experiment with real estate equity investment.[32] One such institution was completing its first small project of about twenty-five homes and intended to invest as much of its assets as authorized by law in similar projects.[33]

B. *Individual Home Mortgages*

The largest proportion of the assets of all of the institutions interviewed was invested in home purchase loans. In the foreseeable future, traditional mortgage lenders will continue to view home purchase financing as the mainstay of their operations. Moreover, because mortgage financing is essential to the individual home purchaser, mortgage lenders will continue to be the primary screening agents in the distribution of owner occupied dwellings. The criteria used by loan officers in choosing among loan applicants is a critical threshold that members of lower income or minority groups—the marginal loan applicants[34]—must surmount in order to attain home ownership and the advantages that go with it.[35]

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30 FSL (25% of portfolio in early 1960's); GWSL (35% at one time; 10-15% in 1968); LSL (25% of portfolio); CFSL (as high as 60%; 20% in 1968).

31 We have done a great deal of tract financing here at Cal Fed; at times we have been financing as many as 7,000 or 8,000 homes in new developments, homes in construction on 4,000 acres of land. We have had as much as 60% of our portfolio in construction loans. . . . We make what we call community development loans—loans on a tract of land for homes, stores, and various community facilities.

CFSL.

32 *See* note 14 *supra.*

33 "If sales continue to progress this nicely," the president of this institution reported, "we stand to make a profit of $4 million on each of the big tracts already purchased for possible development over the next four years. That could represent quite an addition to our net profits." Interview with Elwood A. Teague, President, United Financial Corp., July 25, 1968.

34 The group to which we refer excludes the very poor whom the private market is incapable of adequately serving. There is no way for private owners to make a profit by housing the poor in decent standard housing except through some form of aid or by demanding excessive payments from the poor. This fact must be faced." NATIONAL COMM'N ON URBAN PROBLEMS, BUILDING THE AMERICAN CITY 93 (1968). We are concerned with those on the margin of the private market. *Cf.* Contract Buyers League v. F & F Inv. Co., 300 F. Supp. 210 (N.D. Ill. 1969).

35 It is quite possible that the unwillingness of established mortgage lenders to make what are perceived as more risky loans has forced large numbers of middle income and minority group citizens to defer purchasing homes and to lose the various financial benefits and psychological rewards which home ownership provides. In addition, individnals who wish to purchase homes notwithstanding the refusal of institutional lenders to provide mortgage funds may be forced to pay excessive rates to unscrupulous lenders operating

The basic process of loan origination and the standards for evaluating individual loan applications are similar in both New Haven and Los Angeles.[36] While an occasional institution in Los Angeles actively seeks borrowers by offering finder's fees to brokers and other correspondents,[37] in most cases borrowers approach the lender directly, walking into a convenient institution or returning to one with which they have had prior dealings. The applicant is referred to a loan officer who conducts an initial interview, during which he obtains the location and description of the property on which the mortgage is sought. The applicant is given a form that seeks information about his outstanding debts, his credit history, and his income.[38] He returns to the institution several days later with the completed form. In the intervening period the property is appraised and the applicant's credit checked with references he has given or with the local credit bureau.[39] If the

beyond the pale of ethics and on the borders of legality. *See* Contract Buyers League v. F & F Inv. Co., 300 F. Supp. 210 (N.D. Ill. 1969).

Among the tax advantages available to homeowners are deductions for interest paid on the mortgage (26 U.S.C. § 163 (1970)), and for state and local taxes paid on the property (*id.* § 164).

For a discussion of the exclusionary impact of FHA and VA lending policies, and of the inflated costs of ghetto home ownership, see G. STERNLIEB, THE TENEMENT LANDLORD 149-51, 186-89 (1966).

36 Our study did not focus on the process of construction loan origination except insofar as we dealt with possible barriers to potential constructiou borrowers. *See* note 24 and accompanying text *supra*.

37 BHFSL. ESL solicited borrowers through extensive personal contacts.

38 A general rule applied by many institutions is that the value of the property should not exceed 2.5 times the annual income of the borrower. An alternative standard is that monthly mortgage payments should not exceed a borrower's weekly income. Some institutions refine their calculations by computing net weekly income after payment of other fixed obligations.

39 In New Haven, it appears that if the applicant's credit record, as furnished by credit bureau sources, contains evidence of a single irregularity it may preclude the granting of mortgage funds. There were exceptions, however. NHSB reported that poor credit history could be overcome if a good credit record had been maintained for two years or more. DSB stated that the extent to which the applicant's credit record would be investigated depended upon the amount of the requested loan; a low downpayment would require a full credit report, while a borrower with a poor credit record would be approved if he could make a 50% downpayment.

The importance of credit reports in deciding upon mortgage applications immediately calls to mind the various studies which have criticized, not only the potential for invasion of privacy which such reports entail, but also the danger of inaccuracy inherent in that the subject of the report is not informed of its contents and has no opportunity to challenge it. *See generally* S. WHEELER, ON RECORD: FILES AND DOSSIERS IN AMERICAN LIFE (1969); Karst, *"The Files": Legal Controls over the Accuracy and Accessibility of Stored Personal Data*, 31 LAW & CONTEMP. PROB. 342 (1966); Note, *Protecting the Subjects of Credit Reports*, 80 YALE L.J. 1035 (1971). There is no indication in the interviews that any of the institutions which we interviewed informed applicants whom they rejected on the basis of unfavorable credit reports of the reason for their rejection. Nor is there any property is appraised at sufficient value,[40] loan terms are discussed when the applicant returns. The mortgage may then be agreed upon without further delay.

Although this basic procedure is the same in both cities, the criteria considered important by lenders in New Haven and Los Angeles in evaluating loan applicants diverge.

1. *New Haven*

The New Haven institutions gave explicit consideration to three factors that were not mentioned in the Los Angeles interviews—the applicant's depositor status, the stability of his marriage, and his moral character. Early in the initial conversation preceding discussion of loan terms or security, an overwhelming majority of the loan officers in New Haven asked the prospective borrower whether he maintained a savings account in the institution from which he was seeking a mortgage loan.[41] The question was apparently motivated by a desire to determine whether the applicant had any prior relationship with the lender, rather than to ensure that there was personal security for the loan.[42] While the presence of savings deposits did not guarantee that

indication that the institutions permitted mortgage applicants to rebut or explain unfavorable credit reports. In general, very little sensitivity to this issue was observed.

40 The loan-to-value ratio (LTV) is a critical factor in every loan package. *See* Von Furstenberg, *Default Risk on FHA-Insured Home Mortgages as a Function of the Terms of Financing: A Quantitative Analysis*, 24 J. FIN. 459 (1969). Von Furstenberg found that at high LTV levels small increases in the ratio had a very large impact on the default rate. An increase in LTV from 90% to 91% increased the default rate by 16%; an increase in LTV from 96% to 97% increased the default rate by 50%.

UNHTC indicated that interest rates charged to its borrowers varied with initial LTV, with lower rates being charged those borrowers who provided a larger initial equity. SNBNH reported that it would impose a lower LTV ceiling if the building offered as security were located in what the bank considered a bad neighborhood. *See* comments of DSB, *supra* note 39.

Maximum LTV is set by law. *See, e.g.*, CAL. FIN. CODE §§ 7152-53 (West 1958) (70% and 80%); CONN. GEN. STAT. REV. §§ 36-99(8) to -99(10) (1958) (50%, 75%, and 90%); 12 C.F.R. § 545.6-1(a) (1971) (75%, subject to exceptions). Some New Haven institutions follow a policy of remaining cautiously below the statutorily permitted levels. NSB, HNB.

41 DSB, FFSLNH, NHSB, FNHNB, and SNBNH reported that they would favor depositors in periods in which tight money made rationing necessary. PST stated that if a loan applicant were marginal, he would be given "the benefit of the doubt" if he were a depositor. UNHTC imposed a strict requirement that all its borrowers be depositors, while NHSL evidently preferred depositors even in the absence of a tight money market. HNB stated that since it could not satisfy the demands of even its depositors for mortgage money, an applicant could only obtain a mortgage if he were an exceptionally large, long term depositor. CSB reported that it had favored depositors only during the tight money crisis of 1966. NSB was the only New Haven institution interviewed which did not impose a depositor requirement of any kind.

42 Significantly, the institutions did not ask about the amount of the deposit, nor did

the institution would grant the mortgage, large numbers of potential borrowers were no doubt eliminated by the requirement that they be depositors.

When many mortgage lenders in an area impose this requirement, as they do in New Haven,[43] borrowers may be limited to a single institution in their search for mortgage funds. The mandatory tie-in between savings services and mortgage credit thus has clear anticompetitive effects.[44] In addition, the individual whose savings have gone into other, perhaps more lucrative, investments would have less opportunity to negotiate a mortgage. The requirement that borrowers also be depositors, without more foresight and public knowledge than presently exist, would not seem to benefit the lending institution by encouraging individuals to open savings accounts in a particular institution.[45]

According to statistical studies, marital difficulties do not account for a large portion of mortgage delinquencies and defaults.[46] Never-

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they inquire about savings deposits held in other institutions. This policy may appear to be reminiscent of the requirement imposed by commercial banks that businesses which negotiate bills with a particular bank maintain their checking accounts with that bank; if anything goes wrong with the paper, the bank can simply debit the business's account. However, such protection would seem unnecessary in the case of a mortgage, a secured loan.

43 The requirement might make sound economic sense if depositors felt entitled to receive loans at the place where they have deposited their savings, and would be angered enough to shift their deposits if their loan applications were rejected. Exploring the economic consequences of this practice would require a rather precise comparison of the possible losses attributable to piqued depositors with the potential gains from granting loans to optimal borrowers, a comparison which the institutions involved do not seem to have made.

44 *See* note 41 *supra.*

45 This connection between the extension of mortgage credit and the servicing of borrowers' savings accounts is an arrangement which, if applied on a larger scale, might constitute an antitrust violation. *Cf.* Fortner v. United States Steel Corp., 394 U.S. 495 (1969); Note, *Consumers and Antitrust Treble Damages*, 79 YALE L.J. 254 (1969). It should not matter that the tied product, in this case a savings service, was "purchased" before the tying product, mortgage credit, if the arrangement is otherwise objectionable.

46 L. KENDALL, ANATOMY OF THE RESIDENTIAL MORTGAGE 46 (1964), lists the following reasons for delinquency and the corresponding proportions of delinquencies for which they were found to account:

(*1*) improper regard for obligations (33%);
(*2*) loss of income (27%);
(*3*) excessive obligations (18%);
(*4*) death or illness (12%);
(*5*) marital difficulties (5%);
(*6*) other (5%).

A Veterans' Administration study, based on explanations given by both lenders and borrowers in 2,900 cases, revealed the following breakdown:

(*1*) curtailment of income (39%);

theless, several New Haven institutions candidly reported an interest in the steadiness and well-being of the applicant's marriage.[47] One loan officer apparently encouraged open discussion of marital strife,[48] while another visited applicants in their homes.[49] Despite the difficulty of forecasting separation or divorce over the twenty- or thirty-year period of a mortgage agreement, marital peace was considered by one lender to be "an almost determinative factor."[50] This concern for marital stability seems to be derived from an overemphasis on avoiding foreclosure, which overlooks the fact that the cost of that contingency can be effectively covered by adequate security.

A number of New Haven institutions mentioned an assortment of considerations that, like marital instability, offer ample opportunity for the exercise of subjective judgment and sheer guesswork. One loan officer stressed "financial character," making it clear that in determining financial character he placed more weight on personal characteristics than on the individual's financial record reflected in credit bureau figures.[51] Another institution was looking for borrowers who were "morally decent to the best of the bank's knowledge."[52] A third simply stated that one of the initial decisions to be made about a loan applicant is "whether he is the type of person you want coming in the door in the first place."[53] These considerations seem geared to maintaining a clubby atmosphere marked by warm relationships between the lender and its customers. Obviously such an emphasis can easily lead to homogeneity among borrowers and the exclusion of outsiders and minorities from the mortgage system.[54]

Although relying heavily on subjective responses to the personal characteristics of the loan applicant and other irrelevant criteria, the

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(*2*) improper regard for obligations (26%);

(*3*) death or illness (16%);

(*4*) marital difficulties (9%);

(*5*) excessive obligations (7%);

(*6*) other (3%).

C. ABRAMS, THE CITY IS THE FRONTIER 262 (1965).

47 FFSLNH, FNHNB, and NHSL.

48 NHSL.

49 FNHNB.

50 FFSLNH.

51 FNHNB.

52 SNBNH.

53 HNB.

54 Many interviewees in New Haven, while commenting on the persistence of racial discrimination in real estate marketing and sales, denied that racial discrimination was present in their lending policies. NSB, PST, NHSL, FFSLNH, and FNHNB. Such protestations do not eliminate the possibility that the subjective criteria employed by those institutions can readily veil discrimination.

New Haven institutions expended little effort in analyzing the property that would secure the loan, a major objective element in the loan package. Connecticut lenders are required by law to appraise the property offered as security,[55] but few New Haven institutions went beyond a cursory appraisal of the structural soundness and current market value of the building.[56] Precise data on development and property values in the suburban communities in which many loans were placed was not sought.[57] Many loan officers had only a general notion of where the bulk of homes on which their institutions held mortgages were located.[58] Although the increased expenditures involved in a careful analysis of economic trends arguably might not be justified for a small institution, lack of information concerning the potential value of properties accepted as security characterized the large institutions as well as the small.

In effect, New Haven institutions appear to view the mortgage loan as no different from an unsecured loan. Disregarding that foreclosure need not result in financial loss, they tend to deny loans to persons who pose any risk of default, rather than give the loan applicant the benefit of the security. The uniformity of interest rates between construction and purchase loans also prevails within the purchase loan category itself. Borrowers are not permitted to bid up the price of money; rather, the lender controls the rate and rations his funds among a select group by use of such standards as depositor status and subjective judgments as to the probability of default. The New Haven institutions were apparently little influenced by a desire to earn profits or even by a desire to make home ownership more widely available; they were motivated by a genuine aversion to having to "take a house away from someone."[59] As might be expected, the result of this emphasis has been extremely low rates of delinquency, default, and foreclosure, in which the institutions take some pride.[60]

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55 CONN. GEN. STAT. REV. §§ 36-99(4),-178(h)(2) (1958).

56 *E.g.*, "We are interested in the borrower and his qualities more than the security." DSB.

57 Most institutions contended that they had a general grasp of the real estate picture. The interviewers at HNB, NSB, NHSL, PST, SFSLNH, and UNHTC concluded that in most cases this did not mean hard knowledge. In contrast, however, FNHNB and NHSB had specific and pointed information.

58 Only NHSB reported that it was computerizing its loan portfolio to facilitate retrieval of information about its operations.

59 SNBNH.

60 HNB and ONB had no delinquencies and no foreclosures. CSB had five foreclosures in two years. DSB had a foreclosure rate substantially under 1% and a delinquency rate of 2%. FFSLNH had five foreclosures in 1968, slightly below its yearly average. FNHNB had three foreclosures in its portfolio and a delinquency rate of 0.1%. NHSL had

The New Haven institutions have undoubtedly paid a price in earnings for satisfying their desire for smooth sailing. Yet their placidity is socially harmful as well as financially unproductive. Fear of taking a home away from someone may seriously limit an institution's willingness to make home mortgage funds available in cases where any modicum of risk is present, particularly when the loan officer is vested with full discretion in deciding whether or not to grant the mortgage.[61] In an active market a loan officer may normally be encouraged to lend out funds at higher and higher interest rates. In New Haven, however, very much a lender's market at the time of our interviews, loan officers concentrated on finding the safest possible borrower. The loan officer's decision would be reviewed, not if he were too conservative and denied a loan application, but only if he erred on the side of risk and a later delinquency occurred. Low rates of delinquency and foreclosure indicate that loan officers are responsive to the pressures implicit in such a review system, and that only those loan applicants who clearly pose no danger of default will be deemed eligible for mortgage funds.

2. *Los Angeles*

In contrast, Los Angeles mortgage lenders gave consideration to factors which are readily subject to quantification—income, outstanding debts, and the value of the security—and gave no consideration to factors that were of dubious relevance (depositor status), difficult to ascertain (marital stability), or hopelessly vague and subjective (good moral character). Mortgage lending in Los Angeles was bottomed on a view of the mortgage as a security device.[62] As a result, heavy emphasis was placed on the value of the property. Appraisal of the property often preceded any further investigation of the loan applicant.[63] As one

one foreclosure per year. PST had a foreclosure rate of less than 1%. SNBNH had three or four foreclosures per year and a 1% delinquency rate. UNHTC had one delinquency per year.

61 The discretion accorded the loan officer tends to vary with the size of the loan requested and the assets of the lending institution: the more significant the risk in relation to total assets, the more likely that the loan will require the approval of several lending officers. At GWSL, an individual loan officer was authorized to approve loans of up to $25,000; loans of from $25,000 to $50,000 required approval of the loan officer and his supervisor; loans of from $50,000 to $100,000 required three signatures; loans of more than $100,000 required the approval of the entire loan committee. NHSL, a small institution, required that all loans be approved by the loan committee or the board of directors. In most institutions, however, the typical home mortgage could be approved by a loan officer without the need for clearance from his superiors. HNB (up to $50,000); SNBNH (up to $35,000); UNHTC (up to $25,000).

62 "Since we were making secured loans, you could get a loan here if you could walk in and sign your middle name." GWSL.

63 One loan officer described the process as follows:

official explained: "Sure, we ask the borrower to tell us about his salary and outstanding debts, but if he misrepresents to us [and then defaults], he is the loser because we can always foreclose his mortgage."[64]

The Los Angeles institutions sought to measure not only the borrower's ability to meet mortgage payments but the future value of the security as well.[65] Some institutions employed generally available economic studies and reports;[66] one maintained its own research department.[67] When this institution on one occasion was obliged to foreclose a large construction loan, the research staff recommended that the security (numerous tract homes) be held for rental and that resale be deferred until a more favorable time. The recommendation was followed and the institution ultimately made a profit.[68]

Marginal loan applicants in Los Angeles, unlike those in New Haven, were given the benefit of the security in the evaluation of their loan applications. The risk of loss was not equated with the risk of default, but rather with the possibility of a deficiency. Delinquency and default on the part of some borrowers were accepted as normal, if unpleasant, parts of an active mortgage lending program. Thus, many Los Angeles institutions maintained regular staffs to deal with default and foreclosure.[69]

Some institutions demonstrated a substantial degree of toughness rather than an aversion to taking a house away from someone:

> Some people just don't give a darn—you get all kinds of people, and there are bound to be some problem cases. . . . [W]e have no sympathy for the habitual delinquent. If possible, we will foreclose and get him out of our portfolio.[70]

Because the security had been appraised with an eye to its sufficiency

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> First we get a call asking for the prospects for a loan on a certain property. We then send out an appraiser and he makes an external inspection of the property. We make a tentative commitment, based on a certain amount as down payment, for a certain number of years, at a certain interest rate. If the deal goes through, we make a second appraisal, based on an interior inspection, with special attention to bad points. We look at the condition of the building, the kind of plumbing facilities. We estimate the replacement cost, the land value, and so on. Then we also weigh in three sales of similar property. . . . Then we obtain a credit rating on the buyer.

GWSL.

64 CFSL.

65 ESL and GWSL.

66 USL.

67 GWSL.

68 *Id.*

69 GWSL, USL, and UnivSL.

70 CFSL. Another institution pursued a policy of moving rapidly towards foreclosure after delinquency. "Most of our loans are in foreclosure before the sixtieth day of delinquency arrives." GWSL.

in the event of default, foreclosure did not carry with it the overtones of institutional failure as in New Haven. Fear of foreclosure, consequently, did not bias the decision to grant the loan.

The contrast that emerges from the foregoing description of mortgage lending in New Haven and Los Angeles can be summarized as follows: mortgage lenders in New Haven are motivated by an exaggerated concern for safety and a desire to avoid risk. They have refrained from engaging in construction lending or direct equity investment even though higher returns might result and the subsequent expansion of the housing supply would benefit the community. In making home purchase loans they have effectively limited their lending to a single class of low risk borrowers. They pride themselves on their low rates of delinquency, default, and foreclosure, rather than on their impact on housing construction, their fostering of home ownership, or their rate of return.

In almost every respect, Los Angeles institutions exhibit a greater concern for growth and earnings, one that has resulted in sizable institutional development and has promoted substantial expansion of the housing supply. Their decisions in structuring loan portfolios demonstrate a willingness to accept higher risks in exchange for the chance of high returns; Los Angeles lenders do not hesitate to undertake construction lending and are actively exploring direct equity investment. At the same time, borrowers and their security are carefully analyzed so that the lender can make an intelligent estimate of the risk or danger of deficiency. Thus, emphasis has been placed upon the property securing the loan and upon lending at selective rates. Receptivity to the marginal loan applicant has continued even during times of tight money.

The Los Angeles profit-seeking method of operation offers more hope for improving the performance of mortgage lenders as catalysts in the production and distribution of housing. While New Haven institutions are inhibiting housing construction by their unwillingness to make construction loans even at premium rates or to promote development themselves, Los Angeles lenders are embracing profitable opportunities in construction lending and equity investment. While New Haven lenders are rejecting loan applicants based on irrelevant and ill-defined standards which may allow subconscious bias to enter the lending process, and which are applied without any possibility of review, Los Angeles lenders are making loans more widely available by stressing the value of the security and focusing on objective characteristics of the potential borrower.

II

MAKING MORTGAGE LENDERS RESPONSIVE TO THE HOUSING SHORTAGE

This study did not include any control for determining with certainty which of two variables is more important in promoting the profit-seeking behavior exhibited by the Los Angeles institutions—the stock format of organization, which predominates in Los Angeles, or the larger size of many of the Los Angeles institutions.[71] With a few exceptions[72] it appears that both the organization and, perhaps to a lesser degree, the size of the institution are significant.[73]

A. *Form of Organization*

The evidence indicates that an important factor contributing to the safety-maximizing behavior of the New Haven mortgage lenders is their form of organization. The predominant mortgage lenders in Los Angeles are the state-chartered savings and loan associations, which are stock corporations. In New Haven, all savings banks and savings and loan associations are mutual in form.[74] The only stock corporations among New Haven mortgage lenders are the commercial banks and certain life insurance companies.

Unlike the garden variety corporation, mutual associations have

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71 *See* notes 11-13 and accompanying text *supra*.

72 Some of the more aggressive institutions in Los Angeles are the giant federal savings and loan associations (CFSL and GFSL) which, as those in New Haven, are mutual associations. *See* note 12 and accompanying text *supra*. One official rejected the view that mutual associations do not attempt to maximize profits. As he put it, mutuals attempt to "maximize profits with risk factored out." CoFSL.

The aggressive activities of CFSL and GFSL may be explained by the pace-setting influences of the stock associations with which they are in competition. There is a constant interchange of ideas and, to a lesser extent, of personnel, between these institutions. Alternatively, it may be that the large size of institutions has overcome the potential for cautiousness inherent in the mutual form of organization.

The smaller Los Angeles stock associations (BSL, UnivSL) may be less venturesome than the giants; however, a comparison of Los Angeles stock associations with California mutual associations of the same size has demonstrated that the former are substantially more venturesome. G. LEFCOE, *supra* note 4, at 339-40; *cf.* Pratt, *Risk Aversion in the Small and in the Large*, 32 ECONOMETRICA 122 (1964).

Certain New Haven institutions (*e.g.*, NHSL) of smaller size and mutual organization exhibited some agressive tendencies. The national banks in New Haven, which are stock corporations, were rather passive participants in the housing mortgage market.

73 Of course, there are other variables which may be important. One factor may be the relative availability of credit in different areas and other regional differences. We have concluded that these variables are not nearly as important as organizational format and size. *See* note 14 *supra*.

74 *See* note 12 *supra*.

no common stock; they are "owned" by their depositors. Their "dividends" do not vary as they might if they reflected earnings or profits, but are fixed over the short run and are essentially equivalent to interest on deposits. Although depositors in these institutions possess voting rights akin to those of corporate shareholders,[75] limitations on the aggregation of such rights[76] and the inability of the depositor to increase his earnings beyond the interest he receives on his deposits have led to apathy on the part of mutual depositors, and proxies are routinely signed over to management or its nominees.[77]

Historically, mutual institutions were regarded as advantageous to the little man.[78] Indeed, when they were founded in the nineteenth century these institutions provided a vital service in making mortgage money and home ownership available to the middle class, a function in which no other financial institutions then performed. The original building and loan associations were often amateur organizations without permanent offices or full time staff. The utilitarian function of the association, its small size and its democratic aspects were attributes which won a number of fervent supporters.

Today, however, savings banks and savings and loan associations

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[75] *See* note 76 *infra*. For example, depositors may be granted the right to obtain a list of other depositors, one prerequisite for at least a rough form of "shareholder democracy." *Compare* Ochs v. Washington Heights Fed. Sav. & Loan Ass'n, 17 N.Y.2d 82, 215 N.E.2d 485, 268 N.Y.S.2d 294 (1966), *with* Daurelle v. Traders Fed. Sav. & Loan Ass'n, 143 W. Va. 674, 104 S.E.2d 320 (1958).

[76]
> 4. *Members*. All holders of the association's savings accounts and all borrowers therefrom are members. In the consideration of all questions requiring action by the members of the association, each holder of a savings account shall be permitted to cast one vote for each $100, or fraction thereof, of the withdrawal value of his account. A borrowing member shall be permitted, as a borrower, to cast one vote, and to cast the number of votes to which he may be entitled as the holder of a savings account. No member, however, shall cast more than 50 votes.

12 C.F.R. § 544.1 (1971) (mandatory charter provision for federal savings and loan associations).

The Connecticut statute provides: "No member of any building or savings and loan association shall be entitled to more than one vote in any meeting of such association." CONN. GEN. STAT. REV. § 36-175 (1958).

[77] A regulatory official commented informally that:

> There is no real difference between a stock association and a mutual—the management in either case is out to milk the association for what they can. The only difference is that the people who control the mutual have no stock to sell on the market or to pass on to their kids, they have to find other ways of retaining control. But it is absolutely impossible to wrest control from those who hold it in a mutual. You know, when someone goes in to open up an account, he doesn't care about his right to vote—he'll sign it right away to whoever is on the proxy form—one man, or the board of directors.

Interview with Alvin Paley, Attorney, California Dep't of Sav. & Loan, July 29, 1968.

[78] *See generally* S. PRICE, BUILDING AND LOAN SOCIETIES: THEIR ORIGIN AND HISTORY (1958); J. SUNDHEIM, THE LAW OF BUILDING AND LOAN ASSOCIATIONS (3d ed. 1933).

have grown from modest beginnings to comparatively large size, owning elegant office buildings and employing substantial full-time staffs; those whose size and overhead have not expanded have, by and large, fallen by the wayside. Along with increasingly large size, the development of institutionalization, and the attendant lessening of significance of the individual depositor, federal deposit insurance may have diminished depositors' incentive to involve themselves in the affairs of "their" institutions. Real control of the mutual tends to reside in its permanent management.[79] The goal of management has been to defend the status quo and avoid risk to whatever extent possible. When "profits" remain after payment of interest on deposits, management tends to divert them to larger salaries and increased benefits,[80] which may sometimes be camouflaged as collateral sources of revenue[81] and various perquisites of office.[82]

The example of the Los Angeles market suggests that conversion of mutual financial institutions into stock corporations would contribute significantly to a lending attitude that would facilitate housing construction and home purchase mortgages. By making management more responsive to shareholder pressure for capital appreciation and dividends, such a change would tend to push institutions into profit-seeking behavior, such as allocating aditional funds to construction lending. As in Los Angeles, institutional growth would become highly important.

There is no evidence that growth of stock associations would lead

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79 *See* note 77 *supra*; *see also* Nicols, *Stock Versus Mutual Savings and Loan Associations: Some Evidence of Differences in Behavior*, 57 AM. ECON. REV. 337 (1967). As one savings and loan director commented, one symptom of this lack of control is a lack of knowledge: "I do not believe that savings and loan depositors or shareholders are nearly as well informed with respect to their directors' qualifications, as established by their activities past and present, as are most corporate stockholders." Langhans, *The Director and the Association*, 1966 SAV. & LOAN ANNALS 112, 113. *But cf.* Jones v. H. F. Ahmanson & Co., 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969) (breach of fiduciary duty by majority shareholders in stock association).

80 *See* CONN. GEN. STAT. REV. § 36-126(a)(1) (1958) (savings bank directors fixing own compensation); Nicols, *supra* note 79, at 341; *see also* Kaufman's Estate, 35 T.C. 663 (1961), *aff'd per curiam*, 300 F.2d 128 (6th Cir. 1962).

81 Control of a major lender can provide substantial indirect income from associated business enterprises such as title insurance, fire insurance, and escrowing. *Cf.* Southern Cal. Title Co. v. Great W. Fin. Corp., 60 Cal. Rptr. 114 (Ct. App. 1967), *vacated sub nom.* Chicago Title Ins. Co. v. Great W. Fin. Corp., 69 Cal. 2d 305, 444 P.2d 481, 70 Cal. Rptr. 849 (1968).

82 Benefits may come indirectly—from the prestige of office, from the plush modern buildings which many mutuals have constructed for themselves, or from expense accounts. Officials at one federal association in Los Angeles candidly admitted, when asked what a mutual seeks to maximize, that it attempts to maximize the security of its employees. This goal was later rephrased as meaning "stability" and "growth." UFSL.

to an undesirable level of risk or instability in the savings or mortgage markets. New Haven type management might admittedly lose the occupational security which it presently enjoys,[83] but this is more likely to lead to competent, innovative management than to irresponsibility. The burden of institutional failure, an extremely unlikely eventuality, would fall on the stockholders of the institutions, whose equity is constantly at risk.[84] Federal insurance through the FSLIC would continue to protect depositors. FSLIC regulation desigued to protect its interest in sound management[85] should combine with shareholder caution to provide ample protection against mismanagement and unnecesary instability.

Changes in the regulatory laws would be required to shift the balance between mutuals and stocks in places like New Haven, where the stock organization has traditionally been limited to commercial banks. It is now impossible to obtain a charter for a stock federal or a Connecticut state-chartered stock savings and loan association. It would thus be desirable to enact legislation—either at the state or federal level—authorizing the chartering of stock associations. Since the opportunities for new associations may be limited by the financial hegemony which mutuals have traditionally enjoyed, such legislation should also authorize the conversion of existing mutual associations into stock form upon the approval of depositors. Competition between mutual associations and stocks might well force the remaining mutuals into a profit-maximizing stance[86] or, as one commentator has predicted, stock associations might in time assume a dominant position.[87]

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83 There is a high rate of management turnover in Los Angeles. ESL, UnivSL, USL, SMSL. A decided inducement to perform is thus created for those involved in running the institutions. USL. No similar turnover was evidenced in New Haven: apparently management in New Haven changes only with the progress of natural life cycles. *Cf.* Nicols, *supra* note 79, at 345, reporting that, between 1950 and 1964, turnover in the management of stock associations was 18.9%, compared with 5.9% in the federal institutions.

84 The stockholders, in turn, exercise great influence because they are aware of their rights and of the institution's performance as reflected in its financial figures and dividend policies. Moreover, they are not restricted in purchasing adequate stock to obtain working control.

85 12 U.S.C. §§ 1724-30 (1970). *See, e.g., id.* § 1726(c) ("the Corporation shall reject the application of any applicant if it finds that the capital of the applicant is impaired or that its financial policies or management are unsafe") and § 1730(b) (termination of insurance for, *inter alia,* unsafe or unsound business practices). FSLIC regulations governing sound banking operation are found in 12 C.F.R. § 563 (1971). *See* 1967 DUKE L.J. 1233, 1244.

86 As it apparently has in California. *See* CFSL, GFSL.

87 *See* Hester, *Ownership and Behavior in the Savings and Loan Industry,* in CONVERSION OF MUTUAL SAVINGS AND LOAN ASSOCIATIONS TO STOCK FORM: LEGAL AND ECONOMIC ISSUES 30 (K. Scott & D. Hester eds. 1967).

Enactment of a statute permitting the chartering of new stock associations and conversion from mutual to stock is not the only step that might be taken to undercut the dominance of mutual institutions in many parts of the country. Stock associations, when chartered, must be able to compete for savings accounts. Such competition is now greatly hampered by the interest rate restrictions imposed by federal regulation.[88] During the early 1960's Los Angeles institutions offered interest rates consistently above those in other regions; thus they were able to lure new deposits from throughout the country.[89] Rates are now held at a maximum of five percent by federal regulation, a rate which is offered by nearly every institution. Competition for deposits has shifted from the paying of higher interest to the offering of meaningless or hard-to-evaluate frills.[90] No rate competition between stocks and mutuals will be possible until either rates fall below the current ceiling or the ceiling is raised to permit competition.[91]

B. *Size*

Small size can prevent a lending institution from having a significant impact on the housing supply. Financing a major construction project, for example, would require many New Haven institutions to place a substantial portion of their total capital in a single investment.

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88 The Federal Home Loan Bank Board now has the power, after consultation with the Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System, to limit the rate of return on deposits. 12 U.S.C. §§ 1425b(a), 1828(g) (1970).

Rate regulation was formerly a function of FSLIC. On September 24, 1966, FSLIC promulgated 12 C.F.R. § 569.3(a). 31 Fed. Reg. 12,596 (1966). This regulation established a maximum interest rate of 4.75% on regular savings accounts. Section 569.3(c), promulgated simultaneously, permitted institutions in California, Nevada, and Alaska to pay interest rates of up to 5.25%. On December 14, 1966, section 569.3(b) was amended to establish numerous exceptions to the 4.75% limit, permitting institutions to pay up to 5% in various situations. 31 Fed. Reg. 15,729 (1966). On June 3, 1967, section 569.3(c) was amended to limit interest rates in California, Nevada, Alaska, and Hawaii to 5%. 32 Fed. Reg. 8024 (1967). On December 25, 1969, 12 C.F.R. § 569.4-1(a) was promulgated to permit the payment of up to 6% interest on certificate accounts of $10,000 or more deposited for at least two years. 34 Fed. Reg. 20,266 (1966). This marks the highest rate ever allowed.

On August 4, 1970, the regulation of interest rates was transferred from FSLIC to the FHLBB. 35 Fed. Reg. 12,388 (1970). The maximum rate on regular accounts has remained at 5%, with a 6% limitation on the certificate accounts described above. *See* 12 C.F.R. § 526.3(a) (1971).

89 SMSL, USL, BHFSL, and SoFSL.

90 For a discussion of bank giveaway programs, see N.Y. Times, June 30, 1970, at 57, col. 3.

91 For a different criticism of the ceiling on interest rates, see Tobin & Ross, *Living with Inflation*, N.Y. REV. OF BOOKS, May 6, 1971, at 23.

The resulting concentration of risk would be contrary to sound financial management and might violate the regulatory statutes.[92] Moreover, small size can prevent an institution from compiling adequate statistics on which to base predictions of default and delinquency and may thus promote a cautious lending policy. An institution may seek to avoid all "problem loans" by lending only to the safest applicants, thus avoiding the necessity of developing a specialized staff with experience in foreclosure and property management. In short, small size can prevent the lender from treating the mortgage as a secured transaction.[93]

The handicap of inadequate asset size must be overcome if institutions such as those in New Haven are to become more deeply involved in housing construction and less restrictive in their lending decisions. One approach to this problem would be to promote the asset growth of individual institutions, either by loosening interest rate restrictions, thereby permitting more vigorous competition between savings associations and other investment sources, or by promoting consolidation and branching. An alternative approach would be to accept present patterns of institutional size, but to encourage joint action and the pooling of information by smaller institutions.

The ceiling imposed on interest rates paid to depositors[94] not only inhibits home financing competition between savings institutions[95] but is also a barrier to their growth. Imposed as a check against irresponsible rate inflation and as a means of ensuring parity between commercial banks and savings associations, the ceiling has effectively eliminated all meaningful competition between savings associations and other recipients of investment funds. In addition, the interest ceiling is pitifully low in relation to inflation.[96] Either complete abolition of the ceiling

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92 Federal savings and loan associations are compelled by statute to place the vast majority of their funds in mortgages on single family dwellings ranging in value up to $45,000. 12 U.S.C. § 1464(c) (1970). No more than 20% of their assets may be loaned on the security of multi-unit dwellings. *Id.* § 1464(c).

93 A striking example of the impact of asset size can be seen in New London, Connecticut, where the relatively large federal savings and loan association (with assets of $42 million), in 1968 shortened its grace period (during which a delinquent borrower may cure his delinquency) from 30 to 15 days, largely owing to efficiencies resulting from computerization. New London Federal had several attorneys handling foreclosures. Interview with William T. Douton, Jr., *supra* note 25. At precisely the same time, the smaller New London Savings & Loan was carrying delinquent borrowers for as long as five months and had had no foreclosures in two years. Interview with C.W. Sevin, Secretary, First New London Savings & Loan, Inc., Nov. 20, 1968.

94 Note 88 *supra.*

95 *See* notes 88-90 and accompanying text *supra.*

96 The maximum interest payable on regular savings accounts has been fixed at 5% per year. *See* note 88 *supra.* The course of inflation is traced in the following table:

or its increase to a level where mortgage lenders can compete effectively for investment funds is necessary if more of those funds are to be channelled into housing. The desire of lending institutions to pay depositors as little as necessary should be sufficient to stabilize the interest rate paid to depositors. Alternatively, the interest rate ceiling could be raised in stages, with close examination of the impact of successive increases on institutional assets and on housing.

Another remedy for the problem of limited assets would be the adoption of a deliberate policy of promoting institutional expansion by the agencies charged with regulating savings institutions. Consolidation of a failing institution with a stronger one has been a common practice;[97] it should be continued with particular attention to the resulting aggregation of assets. For example, if it appears that the incremental benefits of increased size fall off sharply after a certain size is attained, a regulatory agency might seek to plan consolidations so that the resulting institutions have optimal asset size. In addition, the regulatory agencies might adopt a broader view of what constitutes the public interest, a standard they are usually compelled to respect.[98] In passing upon applications for new branch locations, for example, an agency

CONSUMER PRICE INDEX

Year	All Items
1965	94.5
1966	97.2
1967	100.0
1968	104.2
1969	109.8
1970	116.3
1971 (Sept.)	122.4

COUNCIL OF ECONOMIC ADVISERS, ECONOMIC INDICATORS, OCT. 1971, at 26 (1971).

Although both the rate of inflation and the rate of interest paid on deposits rose during the period before the Presidential wage-price freeze, inflation increased at a faster rate and finally denied savings depositors any genuine income on their savings.

97 ESL was the result of one such merger. A similar consolidation of associations in Bridgeport, Connecticut, in 1953, was noted by an official in the Connecticut Banking Department. Interview with Reinhard J. Bardeck, *supra* note 11.

The process is generally one of compromise. As described by an inside observer: "In a forced merger situation, the Commissioner just gets all the guys together and they hash it out." Interview with Alvin Paley, *supra* note 77.

98 *E.g.*, CONN. GEN. STAT. REV. § 36-173(3) (Supp. 1969):

> The commissioner, before approving such articles of association and issuing a certificate of authority, shall consider: (a) The character and experience of the proposed directors and officers; (b) the adequacy of existing financial facilities in the town; (c) the convenience and necessity to the public of the proposed facility; (d) that conditions in the locality in which the proposed association will transact business afford reasonable promise of successful operation; (e) that the establishment of a new building or savings and loan association will not harm an existing financial institution to a hazardous degree.

might consider not only whether another branch in a given locality would serve the interests of potential depositors,[99] but also whether further expansion of the institution's assets would be in the public interest. Such a consideration would be particularly appropriate in the common situation where more than one institution is seeking approval to branch into a particular locality. By giving more attention to the effects its decisions can have on institutional size, the regulatory agency could do much to promote home and construction lending.

Finally, to the extent that institutional size cannot be sufficiently increased by the above measures, efforts should be made to facilitate joint action and pooling of information by individual institutions. One way to reduce the high concentration of risk that large projects entail is exemplified by the Government National Mortgage Association (GNMA) created by the Housing Act of 1968.[100] GNMA is authorized to issue securities backed by a pool of government insured mortgages bought from traditional lending institutions. GNMA can thus offer investors easily marketed securities and provide lenders with a purchaser for large project mortgages. A small lender would be able to write a relatively large mortgage and then sell it to GNMA. By making repeated sales to GNMA, a smaller institution could develop the expertise needed for large or intricate projects.[101] In turn, GNMA should aim at purchasing those large mortgages (for example, multi-unit dwellings) which many small lenders might be willing to arrange if they could be sold in a secondary mortgage market.

The sale of participations, partial interests in a pool of mortgage loans, by the originating institution to others seeking investment opportunities may be an additional method for spreading the risks of large projects.[102] Participations can permit smaller institutions to join safely

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[99] *See, e.g.*, CAL. FIN. CODE § 6002 (West 1958):

> If the commissioner is satisfied that the operation of the proposed branch is in the interest of such association, that the area where the proposed branch is to be located is not adequately served by one or more existing associations or federal savings and loan associations, that such association's financial program is sound, and that the public convenience and advantage will be promoted by the operation of such branch, he shall issue a license for the proposed branch.

[100] Act of Aug. 1, 1968, Pub. L. No. 90-448, 82 Stat. 526, 12 U.S.C. §§ 1716-23 (1970). GNMA may provide additional security. *Id.* § 1720.

[101] A loan official at NSB said that a bank as small as his could not bother keeping up with government programs other than FHA and GI loans. DSB, NHSL, SFSLNH, and FNHNB mentioned a lack of expertise in dealing with complex paperwork as the reason for their noninvolvement in governmental programs.

[102] CONN. GEN. STAT. REV. § 36-99(16) (1958) (participation authorized for Connecticut savings banks); *id.* § 36-178(z) (participation authorized for Connecticut savings and loan associations); 12 C.F.R. §§ 563.9-1 to -2 (1971) (FSLIG regulations on participations). *Cf.* note 15 *supra*.

in large projects, either by arranging the project and then selling a portion of it to other institutions, or by purchasing a share in a project arranged by another lender. Wider utilization of participations would allow small lenders to specialize in arranging particular types of loans and to balance their portfolios by participation in a variety of larger loans.

Participations may be hampered, however, by present state-by-state variations in foreclosure laws.[103] To the extent that the purchasing institution is not protected by a buy-back provision in the participation agreement, the difficulty and complexity of foreclosure laws may deter it from purchase. Existing foreclosure laws may work well to protect the owners of single-family dwellings from hasty eviction and loss of equity. However, those laws should be modified at least for foreclosures of multi-unit dwellings, where the aim of the foreclosing lender will normally be only to obtain legal title and not to evict present tenants. It would undoubtedly be beneficial if the states were to adopt more expeditious procedures for foreclosing nonowner occupied properties. By increasing the attractiveness of mortgages secured by such properties, a modification of the foreclosure laws would draw more capital into the private housing market.

Small size can also have an unfortunate influence upon a lender's knowledge of potential risk and ability to deal with default. Many New Haven institutions, for example, lacked the volume of transactions necessary to develop reliable statistics and to permit risk-taking in return for the possibility of a higher overall rate of return. Larger institutions can engage in internal studies and make relatively accurate predictions of risk,[104] but smaller institutions cannot.[105] Mechanisms should be established for the compilation of statistical data, its systematic evaluation, and distribution of the information thus obtained. Such action could be undertaken cooperatively by the small institutions involved or by a regulatory agency.[106] A cooperative arrangement could also be established to handle defaults and foreclosures.

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103 *See* Durfee & Dodderidge, *Redemption from Foreclosure Sale—The Uniform Mortgage Act*, 23 MICH. L. REV. 825, 839 (1925). United States v. Stadium Apartments, 425 F.2d 358 (9th Cir. 1970), *cert. denied*, 400 U.S. 926 (1970), holding that FHA foreclosure proceedings are not governed by state redemption statutes, represents a step forward in this area.

104 GWSL and GFSL.

105 Of course, even precise knowledge of the general incidence of risk would not fully protect such institutions, for a single large default might be disastrous.

106 In 1968, the California Department of Savings and Loan began to implement a computerized system designed to evaluate the financial positions of institutions under its jurisdiction. Interview with Frederick M. Rammler, Administrative Ass't to the Comm'r,

CONCLUSION

The remedies suggested are by no means panaceas for the ills of either the mortgage or the housing markets. The former will continue to suffer from the inherent difficulty of lending for long periods at fixed interest rates with no assurance that today's rate will result in a return adequate to pay the interest needed to retain tomorrow's depositors.[107] The latter is plagued by inefficiencies in construction, serious cyclical variations, and continued inflation, all of which make decent housing an unattainable goal for millions of lower income Americans.

Nonetheless, there is ample opportunity for improvement of the present system. By embracing a more venturesome, profit-seeking, and informed investment style, lending institutions such as those in New Haven can achieve the level of responsiveness to both individual and societal needs exhibited by those in Los Angeles.

Cal. Dep't. of Sav. & Loan, July 26, 1968. The system produces a quarterly "Early Warning Report" on each association, consisting of selected data and various key ratios, which are placed in historical perspective by inclusion of similar data for the nine previous quarters. Such information has proved reliable in pointing out institutions having financial difficulty. The reports are limited to internal use. Letter from Daine P. Jones, Chief Examiner, Cal. Dep't of Sav. & Loan to the Author, Nov. 9, 1971, on file at the *Cornell Law Review*. Such a system could provide a model for the more complicated task of developing data to predict economic changes which could affect interest rates, demand for mortgages, and savings withdrawals.

107 A variable interest rate is one method of dealing with this problem. Under a variable rate plan, interest on mortgages would be tied directly either to the rate of interest which the lender paid its depositors, or to some other variable. The lender's role under such a scheme would directly reflect its status as an intermediary between those who wished to save and those seeking to borrow. Some experimentation with a variable rate has been conducted. CoFSL. *Cf.* Lefcoe, *Monetary Correction and Mortgage Lending in Brazil: Observations for the United States*, 21 STAN. L. REV. 106 (1968).

APPENDIX A

INSTITUTIONS INTERVIEWED: NEW HAVEN

Institution	Identification	1967 Assets (millions)	Date of Interview
Connecticut Savings Bank	CSB	244.1	March 28, 1969
Dime Savings Bank of Wallingford	DSB	32.2	April 2, 1969
National Savings Bank of New Haven	NSB	63.5	July 22, 1969
New Haven Savings Bank	NHSB	269.7	March 25, 1969
People's Savings & Trust of Bridgeport	PST	545.6	April 2, 1969
New Haven Savings & Loan Association	NHSL	21.7	April 24, 1969
First Federal Savings & Loan of New Haven	FFSLNH	177.2	March 28, 1969
Second Federal Savings & Loan of New Haven	SFSLNH	28.3	May 2, 1969
City Trust Co. of Bridgeport (Milford Branch)	CTC	269.5	July 15, 1969
Union & New Haven Trust Co.	UNHTC	128.8	March 27, 1969
First New Haven National Bank	FNHNB	253.2	March 25, 1969
Hamden National Bank	HNB	13.0	March 28, 1969
Orange National Bank	ONB	6.2	April 10, 1969
Second National Bank of New Haven	SNBNH	159.2	March 26, 1969

APPENDIX B

Institutions Interviewed: Los Angeles

Institution	Identification	1967 Assets (millions)	Date of Interview
Beverly Hills Federal Savings & Loan	BHFSL	152.4	July 1, 1968
California Federal Savings & Loan	CFSL	1,489.8	July 30, 1968
Coast Federal Savings & Loan	CoFSL	707.3	Aug. 1, 1968
Glendale Federal Savings & Loan	GFSL	813.7	Aug. 20, 1968
Southern Federal Savings & Loan	SoFSL	116.0	June 26, 1968
Union Federal Savings & Loan	UFSL	122.6	July 29, 1968
Wilshire Federal Savings & Loan	WFSL	82.1	June 27, 1968
Belmont Savings & Loan	BSL	138.9	June 19, 1968
Equitable Savings & Loan	ESL	295.5	June 25, 1968
Financial Savings & Loan	FSL	73.7	June 26, 1968
Great Western Savings & Loan	GWSL	835.1	July 23-Aug. 1, 1968
Lincoln Savings & Loan	LSL	482.8	June 28, 1968
State Mutual Savings & Loan	SMSL	334.7	June 24, 1968
United Savings & Loan	USL	270.3	June 27, 1968
University Savings & Loan	UnivSL	9.0	July 30, 1968