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CHAPTER 4

Governmental Regulation of Institutions Financing Real Estate

THE state has concerned itself with financial institutions for two reasons: to assure adequate credit facilities and to safeguard invested savings. These separate interests, however, are often contradictory, one aim being dynamic and, to a degree, speculative, while the other is conservatory. From the one side government stimulates while from the other it restrains; and out of the shifting balance between these two ends the determination of a credit policy is attempted.

Since this is a study of the relation of government to real estate finance, we are interested only in the influence of government on institutions financing real estate, and only to the extent that government influences the real estate financial policies of these institutions. Yet nearly all financial institutions are engaged to some extent in mortgage lending, specialization in real estate finance being a minor feature of the financial system and of comparatively recent importance. The coverage of the chapter must, therefore, be broad.

Growth of Private Credit Institutions

A nation committed to a policy of widespread diffusion of real property ownership might be expected early to have devised credit institutions especially suited to meet the long-term credit requirements of such an objective. Actually, however, federal land policy during the years of expansion was unaccompanied by a land credit policy.[1] The extensive needs for credit to finance land settlement and improvement were supplied by individual lenders and by state and private banks. These early institutions operated without coordination, and with relatively little supervision, and were more

[1] Except to the extent that time payments were permitted on the purchase of public lands prior to 1820.

often attuned to the speculative potentials of the land movement than to the requirements of credit for productive purposes.

As early as the seventeenth century, efforts were made in Massachusetts and in other New England colonies to organize private banks to make loans on the security of real estate and personal collateral; in the early years of the eighteenth century these efforts began to bear fruit.[2] In 1732 in Connecticut, and in 1740 in Massachusetts, land banks were established that issued notes on the security of real estate mortgages, but these institutions were short-lived.[3] In spite of this setback, many colonies did establish loan offices or public land banks that issued notes on the security of farm mortgages; and numerous private land bank schemes were devised, some of which were put into actual operation.[4] Inept or unscrupulous management resulted in widespread failures, bringing the whole theory of land bank finance into bad odor, a popular disfavor which benefited Hamilton in his successful effort to defeat the formation of a state land bank in New York in 1784.[5]

Nevertheless, the idea was not abandoned. The early part of the nineteenth century saw the development in the southern states of property banks, which were mainly associations of borrowers subscribing mortgages on land for capital stock and making loans from funds obtained by the sale of bonds secured by mortgages and guaranteed by the states.[6] Between 1840 and 1850 a regular farm mortgage banking business developed in the Middle West.[7] In both cases, however, the tendency to finance on the basis of anticipated land values brought widespread failures.

Mortgage lending was not limited to these specialized institutions. Individual lenders remained the principal source of credit; and, in spite of Hamilton's admonitions on the incompatibility of mortgage paper with the requirements of commercial banking,

2 Andrew McFarland Davis, *Provincial Banks: Land and Silver,* Publication of the Colonial Society of Massachusetts (Boston, 1900) Vol. 3, pp. 2-40; *Currency and Banking in the Province of Massachusetts Bay* (New York, 1901) Part 2; and Davis R. Dewey, *Financial History of the United States* (New York, 1931) p. 24.

3 *Ibid.,* pp. 25-26; Earl S. Sparks, *History and Theory of Agricultural Credit in the United States* (New York, 1932) pp. 53-54. The brief and stormy histories of these institutions are given in A. M. Davis, *op. cit.,* and in his *A Connecticut Land Bank of the Eighteenth Century* (Cambridge, 1898).

4 E. S. Sparks, *op. cit.,* pp. 77-78.

5 Nathan Schachner, *Alexander Hamilton* (New York, 1946) pp. 181-82.

6 E. S. Sparks, *op. cit.,* pp. 6-7 and 83.

7 *Ibid.,* p. 177.

state-chartered commercial banks, from the beginning of the Republic, were heavily involved in loans on both farm and town property.[8] Even the Second Bank of the United States, particularly through its southern and western branches, became an important holder of mortgage paper and, as events turned out, of foreclosed property.[9]

In spite of restrictions and repeated disasters, state banks continued to be important sources of mortgage credit. In their fusion of mortgage and commercial lending, little differentiation between the principles of short-term and long-term credit was made either by the banks or by the laws under which they were regulated. The mortgage was treated as an intermediate-term loan (of three to five years) rather than a true long-term loan, as was dictated by the characteristics of real estate investment.

Even in national banks, mortgage and commercial credit were blended in somewhat the same way as in state institutions. Although the original Act [10] was designed to keep national banks out of the mortgage lending field, there is strong evidence that in practice the prohibition was elastic.[11] In 1913, the Federal Reserve Act permitted national banks to make loans on farm property for five years and up to 50 percent of appraisal value (provided such loans did not, in the aggregate, exceed 25 percent of the bank's capital and surplus or one-third of its time deposits).[12] In 1916, the first direct authorization to make nonfarm loans was granted, but the contract term was limited to one year and the maximum loan-to-value ratio was set at 50 percent. A further liberalization in 1927 extended the allowable term of nonfarm mortgage loans to five years and permitted the aggregate of such loans to reach 50 percent of a bank's time deposits.[13]

[8] *Ibid.*, pp. 57-58 and 177. Also, George E. Barnett, *State Banking in the United States Since the Passage of the National Bank Act,* Johns Hopkins Studies in Historical and Political Science, Vol. 20, Nos. 2-3 (Baltimore, 1902) p. 50.

[9] E. S. Sparks, *op. cit.*, p. 270.

[10] 13 Stat. 99 (1864); 12 U.S.C. 8.

[11] Homer Hoyt, *A Hundred Years of Land Values in Chicago* (Chicago, 1933) p. 445.

[12] 38 Stat. 251 (1915); 12 U.S.C. 221.

[13] 39 Stat. 360 (1916); 12 U.S.C. 641. Amendments to the Banking Act enacted in 1935 (49 Stat. 684) are part of the effort to increase funds for mortgage lending in the midst of the depression. They permitted national banks to make ten-year loans up to 60 percent of value, provided at least 40 percent of the loan was amortized during the period. National banks at this time were also permitted to make mortgage loans insured by the Federal Housing Administration.

These measures, in combination with the generally more liberal provisions governing the operations of state banks, made mortgage lending an integral part of the commercial banking structure. This combination of function had, of course, the advantage of providing real estate with sources of credit not otherwise available. Nevertheless, it had the danger of tying realty finance to the highly variable conditions of commercial credit, thus affecting the former with the same volatility as the latter, and of placing real estate loans and commercial loans into direct competition for the same funds, a situation likely on the whole to be unfavorable to realty.

From the middle of the nineteenth century, life insurance companies became important sources of mortgage funds. Not being subject to sudden demands for liquidity as were commercial banks, life insurance companies could treat the real estate loan as a long-term, slowly liquidating investment. Furthermore, because their investments were usually less limited geographically than those of banks, they could to a greater degree make funds available in under-capitalized areas and avoid the risk of being tied to the fortunes of a single area.

These were important advantages, but they were not sufficient to bring about a complete solution of the credit requirements of real estate. In fact, at no time for which records are available have the insurance companies as a group held much more than 18 percent of the total real estate mortgage debt,[14] although in 1929 insurance companies had approximately 40 percent of their admitted assets in mortgage loans.[15]

Mutual savings banks and cooperative banks date from an earlier period, but their growth was more limited and was confined mainly to the Middle Atlantic and New England regions. While about 28 percent of savings bank investments were real estate loans in 1948, as compared with approximately 7 percent for commercial banks and about 17 percent for insurance companies,[16] their principal

[14] *Survey of Current Business,* September 1946, Table 9, p. 17.

[15] Mortgage investments of life insurance companies are from annual estimates of the Home Loan Bank Board. At the end of 1948, the proportion of mortgage loans to assets was 19.4 percent, after having dropped to as low a ratio as 14.5 percent in 1945. In spite of the much lower ratio of mortgages to total assets, the dollar volume of mortgages held had actually increased since 1929 to a record level of $10.8 billion at the end of 1948. It may be noted that if the 1929 ratio prevailed today insurance companies would hold about half the total mortgage debt.

[16] Figures for mutual savings banks and commercial banks are from the *86th*

interest, both because of the law and of managerial policy, was the encouragement and protection of thrift rather than the financing of real estate.

The first of our present-day institutions to be established for the specific purpose of meeting real estate credit needs were the savings (or building) and loan associations. From a modest, semi-philanthropic start in 1831, these associations have grown in importance until, at the end of 1948, they held 31 percent of the total residential mortgage debt on one- to four-family nonfarm houses and close to one-fifth of the total nonfarm mortgage debt.[17] During their growth, savings and loan associations have been transformed from a very simple form of cooperative society in which nearly every shareholder was a borrower to institutions in which saving need not be associated with borrowing. The word "building" has generally been displaced in their title by the word "savings," and the institutions themselves have come more and more to resemble mutual savings institutions, although their investments have continued to be predominantly in home mortgages. During the latter part of the last century, many building and loan associations operated on a national basis, both as to sources of funds and distribution of loans. The spectacular failure of the "nationals," however, led to closer supervision and greater geographical limitation of activity.[18] Today, they are characteristically local institutions depending mainly on local capital and lending within a restricted area.

To this group of institutions may be added the mortgage bond houses and mortgage guarantee companies, organized under state incorporation laws and to a minor degree subject to state regulation. They flourished mainly during the first quarter of this century, first as farm mortgage investment media and later as means of financing urban income property of all types. Their bond and certificate issues were secured either by a pool of mortgages, or, in the case of large

Annual Report of the Comptroller of the Currency 1948; for insurance companies from the annual survey of the Home Loan Bank Board. By contrast with the current situation, many savings banks during the 1920's and 1930's held 50 to 60 percent of their investments in the form of real estate loans.

17 Seymour Dexter, *A Treatise on Cooperative Savings and Loan Associations* (New York, 1889) p. 43; *History of Building and Loan in the United States,* Morton Bodfish, ed. (U. S. Building and Loan League, Chicago, 1931) pp. 57-58. Estimates of savings and loan business are based on Federal Home Loan Bank and Department of Commerce figures.

18 M. Bodfish, *op. cit.,* Chapter 7.

urban properties, by a mortgage on a single development. During the boom years of the 1920's, the bond houses competed with the more strictly supervised financial institutions, but failures led to a decline in their importance as a source of farm credit and to their disappearance as a factor in the urban mortgage market.

Up to 1916 in the farm, and to 1932 in the urban, market the institutions described above (aside from individuals and various classes of trusts, pension funds, and nonfinancial institutions, such as universities and foundations) composed the sources of mortgage funds.[19] With the exception of the national banks, for which mortgage lending was a minor and relatively recent function, all of the institutions operated under state charter. With the exception of the building (or savings) and loan associations and the mortgage bond houses, none of the institutions providing real estate credit was established primarily for that purpose, nor have real estate loans often, or for long, received their principal attention. The incidental and optional character of most institutional mortgage lending is worthy of note because of its influence on the availability of mortgage funds and on subsequent efforts by government to increase the amount of mortgage lending.

Influence of the State on Institutional Policy

All of the institutions mentioned above are subject to some form of regulation, either by state or federal government, or both. The regulation exists by virtue of the power to charter financial institutions, the provisions of institutional charters, the general laws regulating institutional investment, and the authority granted to the supervisory agencies of government. Each type of regulation gives government important means for influencing credit policies.

Because all such regulation is a matter of state jurisdiction, excepting that of the national banks and the more recent federal institutions, there is little national uniformity. Moreover, within both federal and state spheres of influence, there is great variety among the laws affecting different types of institutions.

19 Mention should also be made of such specialized institutions as the Investors Syndicate (Minneapolis) and Allied Building Credits (St. Paul). These institutions operate under state charter and their activity, which is national in scope, has been concerned with mortgage lending, property improvement loans, and business credits in fields of construction and materials distribution.

The result is that we have, instead of a single mortgage credit system, or a single governmental policy affecting institutional activity, a number of systems and policies. The governmental influence, while pervasive, is not uniform; and its effect on the flow of credit is mixed. Indeed, its effect on the availability of mortgage credit has often not been its most direct concern. The primary and most evident aim of governmental supervision has been to safeguard the funds placed in institutional hands. Like the regulations affecting the construction of buildings, the regulation of investment activity is the product of successive disasters, and often, either in whole or in part, has not appeared until long after the creation of the institutions themselves.[20]

CHARTERING POWER

A primary impact of the state upon the financial system comes from its power to charter financial institutions. This power, of course, is fundamental to the creation of large pools of credit and to the manner and method through which credit is made available for realty needs. Underchartering may result in an insufficiency of credit; overchartering may bring the reverse. However, there is little evidence that, prior to the 1930's, the chartering power was used with any positive intent of directly influencing the flow of credit unless it was on the theory that the greater the number of banks, the better the credit facilities. Speaking of commercial banks, Robert F. Leonard says, "For many years the belief was widely shared that any group of men with a certain, and generally rather limited, amount of capital had an almost undeniable right to establish a bank, and over a long period charters were freely granted." [21] The consequence has often been to raise the supply of loan funds when the supply was already ample, to induce speculative development and finance, to increase the instability of the realty market, and to complicate the difficulty of an ultimate readjustment.

Hoyt, for instance, notes the influence of loose chartering of banks as a factor in realty speculation and collapse in Chicago. The

[20] Savings and loan associations, for instance, were an invention of the 1830's, yet the first law requiring the examination of such institutions was passed in 1875, and such laws did not become general until the 1890's. M. Bodfish, *op. cit.,* Chapter 9.

[21] Robert F. Leonard, "Supervision of the Commercial Banking System" in *Banking Studies,* by members of the staff of the Federal Reserve System (Washington, 1941) p. 198.

easy real estate credit extended by newly chartered banks, such as the State Bank of Illinois in 1835, and the swarm of new banks that appeared following the passage of the State Banking Act of 1851, were in both cases followed by a drying up of credit with the failure of overextended institutions.[22] A similar parallelism of chartering, speculative credit, and collapse can be found generally in the "wild cat" banking era of the 1830's and in subsequent occasions of boom and disaster.

In the savings and loan area, the expansion of the twenties was accompanied by an increase in the number of associations from around 8,600 in 1920 to nearly 13,000 in 1927.[23] In spite of the chartering of federal savings and loan associations since 1933, the number of all operating associations at the end of 1948 was only 6,000.[24] In some of the states the percentage fluctuation was much wider than the national total. The number of savings and loan associations in New Jersey, for instance, increased from 939 in 1920 to 1,565 in 1930 but dropped back to 501 by the end of 1948.[25] While this is an extreme case of liberal chartering and painful readjustment through liquidation or reorganization, it shows how the stability of realty credit facilities has been affected by chartering policy.

It is only recently that the chartering power appears to have been used with credit requirements clearly in view. "The convenience and needs of the community to be served" are now important considerations in chartering national banks and federal savings and loan associations, and state authorities have adopted the same attitude. Current policy has been stated as follows: "Out of the harsh experiences of the banking troubles leading up to the bank holiday of 1933 . . . has come the realization that charters should be granted much less freely. . . . As a result of the cooperation of the various Federal and State agencies, it can be said that it is the general aim of all to grant charters only where there is demonstrable need for the bank and reasonable assurance of its success." [26]

On the whole, this statement reflects a restrictive policy result-

[22] H. Hoyt, *op. cit.,* pp. 27, 59-60, and 445.

[23] M. Bodfish, *op. cit.,* p. 131.

[24] Home Loan Bank Board, *Trends in the Savings and Loan Field,* April 1948, p. 7.

[25] *Annual Reports* of the Commissioner of Banking and Insurance of New Jersey. Figure for 1948 is from the Home Loan Bank Board, *Trends in the Savings and Loan Field,* April 1948.

[26] R. F. Leonard, *op. cit.,* p. 198.

ing from the conclusion that past chartering had been in excess of need. That the chartering power may be used to stimulate the creating of new facilities where the credit supply is considered inadequate is evident in the chartering of national farm loan associations and federal savings and loan associations.[27]

Regulation of the Real Estate Investment Portfolio

Although details of institutional regulation as regards different types of institutions vary between state and federal governments and also among state governments, there is nevertheless an underlying similarity in the concepts and methods used. The pattern of investment is established generally by law rather than through examination and supervision, and it falls into the following elements:

(1) *Determination of the character of the investment: creditor versus owner interest.* The preponderant influence of the law has been to favor institutional investments in real estate loans rather than in equities. Prior to World War I, all types of financial institutions were prohibited from owning property except that necessary for the conduct of their business or that taken through foreclosure. Disposition of the latter was required to be made within a few years after acquisition. For the bulk of institutional operations, therefore, real estate finance has meant mortgage loans.

The first important break in this legal tradition came in New York in 1922, when insurance companies were permitted to make direct investments in housing property. Through 1948, twenty-five states and the District of Columbia had made it possible by special statute for their domestic insurance companies to make investments in residential property; companies domiciled in seven additional states have the same power under more general statutes. Beginning about 1945, the movement to permit equity investment was broadened so as to permit investment in other types of income-producing realty. Because of the absence of specific prohibition, such investment was already possible in five states; five others (including the District of Columbia) did not apply their prohibitions to the investments of companies domiciled in other states. The years 1945-47 saw a majority of the states dropping or modifying their old restrictions, and by the middle of 1948, thirty-four states and the District

[27] See Chapter 6.

of Columbia had in one way or another made investment in a wide range of residential, commercial, and industrial real estate possible for both domestic and out-of-state insurance companies.[28]

Generally, the grant of authority in this new field has been broad, with relatively few limitations on the investor. A few states have confined realty investment to cases where long-term leases to business establishments were involved; in some, residential investment is limited to housing built by the investor; but the most common limitations merely define the maximum amount of a single investment, or the aggregate of investments, or the ratio of realty investments to total assets. As might be expected, there are wide variations among the statutes in these details. Moreover, where realty investment is given some special privilege in connection with urban redevelopment, such as limitation of taxes, the right to benefit from the power of eminent domain, or a subsidy to reduce land cost, there are often restrictions on rentals, net income, or freedom of tenant selection.[29]

Starting in the main from the social purpose viewpoint (the first New York law was closely linked with the housing shortage following World War I), the application of the ownership-investment principle has been broadened to that of a general outlet for funds. In this respect, the trend is contrary to what we commonly find, particularly in the federal sphere. It constitutes the one major relaxation in favor of a freer flow of investment along lines dictated by management rather than by government. The movement, however, is yet too new to have resulted in any large amount of institutional investment or any strong influence on the real estate market.[30] It has been, for the most part, limited to life insurance companies, although Massachusetts, New Jersey, and New York allow mutual savings banks to invest in housing either in redevelopment projects or otherwise. A few other states also permit savings and loan associa-

28 Summary based on a digest of state insurance laws published January 1, 1948, by the Division of Law, Office of the Administrator, Housing and Home Finance Agency, and supplements thereto.

29 See, for instance, New York General Laws, c. 892 (1941), c. 892 (1942), c. 234 (1943); Massachusetts Laws, c. 654 (1945).

30 As of June 30, 1949, the total amount of investment by life insurance companies in the ownership of rental housing was reported by the Institute of Life Insurance to be $275 million, with $185 million additional in projects still under construction. Life insurance investment in commercial and industrial rental property at the same date came to $453 million.

tions to have real estate investments of the same types; several states permit these associations to build houses, either for their shareholders or for sale.[31]

There has, however, been little activity under these last-mentioned authorizations. Thus, notwithstanding the opening of new avenues, the mortgage loan remains the predominant type of realty investment for institutional funds. The reason for this no doubt lies in the supposed margin of safety created by the overage of value in relation to the loan and in the covenant binding the borrower for any deficiency. The recent interest in ownership investment has been influenced by increasing doubts about the protection for the institution inherent in a lender-borrower relationship, by a surplus of funds seeking investment, and by the relatively low prevailing mortgage interest rate.

(2) *Restrictions on the type of property on which real estate investments may be made.* As in ownership investment, the kinds of property in which an institution may invest on a mortgage basis are frequently specified by law or regulation. Savings and loan associations are quite generally limited to loans on one- to four-family houses or very small apartment buildings; farm loans are frequently prohibited and loans on commercial and industrial realty are almost always prohibited or narrowly limited. The authority to lend even on residential property designed for more than four families is usually much restricted, commonly by limiting the maximum size of loans in which the bulk of the assets might be invested. These restrictions, of course, reflect an attempt through legislation to preserve the original purpose for which this class of institutions was created. It may be noted that in recent legislation, and proposals for legislation, the tendency is to increase the classifications in which mortgage loans may be made.

In contrast to the close limitations placed upon savings and loan associations, life insurance companies may usually lend upon the security of real estate without restriction as to type of property. Banks, similarly, have very broad discretion in selection, although in both instances loans on unimproved property are sometimes prohibited or restricted.

31 Summary based on a digest of state insurance laws published January 1, 1948, by the Division of Law, Office of the Administrator, Housing and Home Finance Agency, and supplements thereto.

(3) *Restriction on the location of the property.* State banks and savings and loan associations are commonly restricted as to the geographical area in which mortgage loans may be made.[32] The area may be coextensive with the state in which the institution is chartered or it may be limited by the area within a specified radius (often fifty miles) from the location of the institution. Rarely may these classes of institutions lend on property located in states other than the one in which they are domiciled.

The reason for these limitations is threefold. First, it is assumed that loans may be placed more safely in areas with which management may be personally familiar. Second, it is considered desirable to retain local funds to meet local needs. Third, it is often advantageous to retain local markets for local funds. The objection raised in 1934 by the savings and loan associations to the creation of national mortgage associations, which might operate without restriction as to area, is evidence of the dislike of external competition.

Among state-chartered institutions, the life insurance companies alone have generally been permitted to invest beyond state boundaries, and, under certain conditions, beyond national boundaries. Only a small proportion, if any, of the total mortgage investment made by these institutions is restricted to the state of domicile. Otherwise, the common area-limitation is that requiring the company to conduct an insuring business in the states, territories, or countries in which loans are placed. The fact that insurance is sold without geographical limitation makes such widespread activity inevitable. In fact, to prevent insurance funds from being drained from one locality to serve credit demands in another, Texas, as an example, imposes regulations requiring out-of-state companies to maintain local investments in proportion to the insurance written within the state.

Mutual savings banks in northeastern states have generally been allowed to make mortgage loans on properties in adjacent states. In 1949, New York and Massachusetts authorized their mutual savings banks to make or purchase mortgage loans in any part of the United States, if insured by the Federal Housing Administration.[33]

[32] National banks have no area restriction; federally-chartered savings and loan associations and farm lending institutions, however, follow state practice in restricting the area of activity.

[33] New York Banking Law, § 235, subd. 20, as amended by the L. of 1943, c. 629, as amended by the L. of 1949, c. 545; Massachusetts General Laws (Ter. ed. 1932)

The other class of national lenders were the predepression mortgage bond houses and mortgage guarantee companies. These institutions placed loans and sold their securities without regard to state lines. Loosely regulated by law, free from supervision as to their practices, inadequately protected by reserves, and often irresponsibly conducted, they fell victim both to subsequent legal restraint and loss of public confidence. At the present time, federal restrictions on the interstate distribution of securities are so rigid that the real estate bond, as formerly known, rarely qualifies for widely dispersed investment.

Where ownership investment is permitted for insurance companies, there is sometimes a location restriction based on the size of the city or metropolitan area in which the investment is made. Where other institutions are permitted to indulge in ownership, location is restricted to the state of domicile.

(4) *Limitation of the proportion of assets available for realty investment.* The mortgage loans of national banks are limited to an amount equal to their capital and surplus, or 60 percent of time and savings deposits, whichever is greater. The mortgage loans of state commercial banks are frequently subject to similar, though often less restrictive, limitations.

The amount that mutual savings banks and insurance companies may invest in real estate mortgages is generally limited in relation to their total assets, but the allowance (often 60 percent or more) is more generous than in the case of commercial banks. Savings and loan associations are the only institutions that are required—in contrast to being permitted—to lend on mortgage security. With the others, alternative investments may be listed at length and, as a group, are frequently given preference over mortgage loans; with the savings and loan associations, it is the alternative investments that are restricted in relation to total investment.

Where ownership investment is permitted to institutions, an investment-to-asset ratio is again stipulated, which in itself would prevent any degree of dominance of this type of investment. A 10

c. 168, § 54a, as amended by the Act of June 2, 1949. Both of these laws extend the authorization to cover secondary mortgages guaranteed by the Veterans' Administration and made in connection with FHA first mortgages, according to the provisions of § 505a of the Servicemen's Readjustment Act as amended (see Chapter 7).

percent ratio on residential investments and a limitation of 3 to 5 percent on investments in other types of property are common.

(5) *Regulations of the loan pattern.* One of the most common restrictions on institutional lending is the loan-to-value ratio. The limitation is strictest for national banks, where it is held to 50 percent on unamortized loans and 60 percent on loans at least 40 percent amortized within the maximum ten-year term. For state commercial banks the limit is frequently 50 percent or somewhat higher, but in twenty-four states no maximum loan-to-value ratio is prescribed by law. For insurance companies the two-thirds ratio is the norm, although the range is from 40 percent in Texas to a 75 percent ratio (where accompanied by special reserves) allowed for insurance companies domiciled in New Jersey. With savings and loan associations, the usual two-thirds limit is now rising to 75 percent of value to conform to the loan-to-value ratio on home loans permitted to federal savings and loan associations. Eighteen states prescribe no legal ratio for savings and loan associations, although in many cases these are not the same states that give a similar discretion to banks. Frequently, lower ratios are set for loans on unimproved than on improved property, and higher ratios for amortized than for unamortized loans.

Also, the term of the loan is often subject to regulation. National banks are limited to mortgage loans of five years or less where unamortized. In many of the states, however, fully or partially amortized loans may run from ten to twenty years and in thirty states no restriction of any kind is imposed on the term of the loan. Insurance companies are not usually restricted as to length of term, and savings and loan associations, when restricted at all, are ordinarily permitted terms up to twenty or twenty-five years, usually with the requirement that loans be regularly and fully amortized. The amount of a single loan is sometimes regulated.[34]

[34] Summary statements in sections (1) to (5) are based upon a study, *Legal Maximum for Loan-Value Ratio and for Term of Real Estate Loans by State Banks Generally and to G.I.'s,* prepared by the legal department of the American Bankers Association, July 5, 1946 and a summary of *State Laws Regulating the Investment of Mortgage Funds,* prepared by the Mortgage Bankers Association, May 25, 1945. The description does not cover mortgage loans made by federally-chartered institutions, or insured by the Federal Housing Administrator, or those guaranteed by the Administrator of Veterans' Affairs, for which see Chapters 6 and 7.

Regulation of Methods of Operation

In connection with the regulatory legislation, supervisory authorities (departments or commissions) are commonly established for the examination and supervision of banks, insurance companies, and savings and loan associations. All types of state banks are supervised by the same state agency; savings and loan associations may be grouped with the banks or treated separately; insurance companies are almost always supervised by a separate agency.

The scope and effectiveness of the examining powers vary from state to state, but the substance is fairly uniform. The Pennsylvania banking law may be taken as an example.[35] This law gives the banking department full power to inquire, during the course of its examinations, into the following:

(1) Property, assets, and reserves held or maintained by the institution,
(2) Loans and collateral deposited,
(3) Methods followed by the institution in the conduct of its affairs,
(4) Investment of its funds,
(5) Interest taken in its affairs by the officers, directors, and employees,
(6) Compliance with the law and its charter,
(7) Any other matter bearing on its condition which the department shall prescribe.

Examinations are made regularly, usually at intervals of one year, but special reports may be demanded whenever in the opinion of the examining authorities they may be called for to protect depositors, shareholders, or policyholders.

Depending upon the wording of the statute and the policy of the administrative officials, supervision may be limited to findings of fact: Is the business being conducted in accordance with the limitations of the law and of the charter of the institution? Are the records in order? Is the institution solvent? Under such a view, action may be taken only when the examination clearly reveals insolvency or a violation of law.

[35] Pennsylvania Banking Code, §§ 401, 403, 501-4. For the summaries of this legislation the author is indebted to Ralph H. Richards, President, Home Loan Bank of Pittsburgh. *Nature and Future of Public Supervision.* Address before the Sixth International Congress of Building Societies (Zurich, September 1938).

But this narrow view of the function of supervision is probably not widely held. On the basis of a decision of a federal court, the state may regulate "its corporate creatures" in almost any matter in which it sees fit. Again, the Pennsylvania law may be cited to show the extensiveness of the power of the supervisory authorities.[36] Under the banking code of that state, the banking department may take possession of the business and property of any institutions under its jurisdiction whenever it is found that the institution has:

(1) Violated its articles of incorporation, any order or writ issued upon application of the department, or any law of the Commonwealth regulating its business;
(2) Fallen into unsafe hands or is in unsound condition to transact its business;
(3) Impaired its capital below the minimum required by law or by its articles of incorporation;
(4) Suspended payment of its obligations and has not for a period of one year, after due demand or notice by its shareholders, paid any matured share or withdrawal;
(5) Refused to submit its records and affairs to, or its officers or directors have refused to be examined concerning its affairs by, the Secretary or examiner;
(6) Requested the department to take possession for the benefit of depositors, other creditors, and shareholders.

In many jurisdictions, supervisors, by regulation or practice, go beyond the requirements of law in prescribing limitations on managerial discretion. Thus in Delaware, where no legislative limit is placed on the loan-to-value ratio, the authorities frown on unamortized loans of more than 60 percent of value. The New Jersey law does not restrict the volume of mortgage loans to a proportion of time deposits or capital, but this is done by the regulations of the banking department.[37]

Supervisory agencies frequently consider it within their authority to criticize or make recommendations in respect to lending plans, appraisal practices, or other matters relating to the operation of the institutions. After the financial collapse of the early 1930's,

[36] Hackler v. Farm and Home Savings and Loan Association (1934). 6 Federal Supplement, 610. Pennsylvania Banking Code, § 504. See R. H. Richards, *op. cit.*

[37] *State Laws Regulating the Investment of Mortgage Funds,* Mortgage Bankers Association, May 25, 1945.

supervisors tended to broaden the scope of their functions, exerting pressure on management in respect to lending policy and the liquidation of foreclosed property, thus making themselves a direct influence on the real estate market.[38] This influence was greatly amplified through the control directly exerted by the supervisory agencies over insolvent or frozen institutions.

Effects of Institutional Regulation

The primary purpose of the legal regulation of financial institutions is to maintain a watch over their solvency in the interests of those whose funds are entrusted to them. Regulation has a profound influence on the flow of funds, but in a positive sense the influence may be greater on their flow into the institutions than it is on their subsequent investment. Governmental supervision, combined with additional protective measures to be discussed later, has contributed much to the confidence of the public in financial institutions, but the influence of supervisory authorities on the flow of funds into the realty market has tended largely to be restrictive rather than stimulative. By increasing the conservatism of lending policies, it has increased the demand for special means for expanding the volume of mortgage credit.

Because the bulk of institutional funds that are available for real estate finance are subject to stringent geographical limitations, real estate finance has retained a strong local flavor.[39] The variety of state laws that regulate the operations of all institutions, except those operating under federal charter, is in itself an impediment to the flow of funds across state lines. Even a federal charter does not completely eliminate local influence since a mortgage is a state instrument and the restrictions and limitations prescribed by the state still apply, whether the loan is made by a local bank on conventional terms, or by the same bank subject to federal mortgage insurance, or by a national bank, or a federal savings and loan association. The tendency is to discourage the entry of out-of-state

[38] This influence can go far, whether by direct intent or not, toward inducing lending institutions to support government credit programs. As one mortgage loan official stated to the author: "We have put our entire portfolio in FHA's because the examiners never question them."

[39] National banks and life insurance companies, not subject to an area restriction on mortgage loans, have done considerable trading in FHA mortgage paper. Both the Federal National Mortgage Association and The RFC Mortgage Company have also contributed to the formation of a national market.

funds where redemption periods, deficiency judgment limitations, and similar restrictions create greater-than-average hazards to the mortgagee. Pressure to circumvent these impediments and to bring credit to areas regarded as undersupplied has provided another impetus for federal intervention.

The local character of real estate finance is in striking contrast to the national scope of operations in other fields of investment and has placed realty financing at a relative disadvantage as regards availability and cost of funds. Broadly speaking, the states have been unresponsive to demands for more credit; only in the recent limited authorizations permitting direct investment in realty have they been moved to provide new investment facilities for real estate; and here the aim has probably been more to provide financial institutions with an additional outlet for funds than specifically to meet the presumed requirements of the real estate market.

Consequently, the pressure for credit expansion to meet express demands has tended to shift from state legislatures to the federal Congress. Demands for credit for farmers, urban homeowners, and owners of urban rental property have created national political issues; and the federal government has been induced to supplement, through a number of financial devices, funds flowing into these several uses from the customary sources and to compensate for the restrictions on the flow of funds resulting from state policies.

One outcome of the federal government's entrance into the realty credit market has been (through insurance of deposits and share accounts) to place state-chartered institutions under the influence and regulation of federal agencies as well as their own supervisory authorities. Conflict in policy often ensues. The attitude of state authorities may be at variance with the expansionist policies of the federal agencies. Thus, in 1946 many lenders reported that state supervisors disapproved of 100 percent loans to veterans. Even in the federal sphere, the conservative attitude of the supervisory authorities has not always been in complete harmony with policies promoted by other agencies.[40]

Another angle of governmental concern with credit institutions

[40] See, for instance, the speech of M. T. Harl, Chairman, Federal Deposit Insurance Corporation at Quebec, October 16, 1946 (FDIC release) and the *83rd Annual Report of the Comptroller of the Currency 1945*, p. 2. Both statements decried thin equities and urged caution in lending at the time when the housing agencies of the government were advocating precisely contrary policies.

and credit policies deserves mention: it is the creation of competitive relationships through the benefits provided, or the limitations imposed, by law. If state commercial banks can deal in mortgage lending, then national banks will seek amendments permitting them to do the same. If federally-chartered institutions may make high percentage loans, then state institutions are likely to insist on the same privilege. One group of institutions may not only seek laws to its own advantage but may also attempt through governmental intervention to prevent competition from other types of institutions. Thus, competition among the several varieties of lenders is, to some degree, replaced by maneuvering for a legal advantage. Once started, this provides a rich soil for the growth of governmental intervention.