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CHAPTER 5

The Question of Credit Policy

THE preceding chapters have discussed impacts upon real estate finance that have resulted from the substantive law of real property, the development and execution of public land policies, the growth of governmental restrictions on land use, the vicissitudes of mortgage lending operations, and the supervision of financial institutions. Nowhere, up to the depression of the 1930's, do we find much that could be called an official policy for the financing of real estate or any effort on the part of state or federal governments to use the power to expand or restrict credit as a means for consciously guiding real estate activity.

Throughout the whole period of national expansion, the role of the federal government in respect to real estate was that of encouraging the settlement of the public domain and promoting a wide dispersion of land ownership. Aside from the distribution of land to settlers and land grants to land companies and canal and railroad companies, it provided few direct aids and offered no interference to the functioning of the real estate market or to the efforts of the states to deal with that market in their own ways. Moreover, beyond the continuous demands for greater privileges for homesteaders, there appears to have been neither pressure for federal intervention nor any broadly held opinion that the provision of special real estate credit facilities was within the federal jurisdiction.

During the same period, the role of the states was mainly concerned with policing fraud, adjudicating disputes in private transactions, chartering and supervising private lending institutions, and intervening more directly only when depressions forced them to extend special relief for debtors. Even the "agrarian revolt" of the last quarter of the nineteenth century brought forth no specific plans for a real estate credit system, but rather concentrated its

effort on such matters as railroad rates and general monetary reforms.[1]

Credit as an Instrument of Governmental Intervention

After the failure of the early land bank experiments, the possibilities of the use of credit facilities and credit policy as a means for strengthening and advancing a land policy were only gradually recognized. Effective realization, in fact, did not commence until about the time of World War I, and the full bloom was not reached until after the close of World War II.

Renewed interest in credit measures resulted from the growing dissatisfaction with the conservatism of state law in face of changing credit requirements and the apparent inability of the states to cope with the effects of the over-exploitation of land resources. Impatience for reform brought pressure for action by the federal government. And the federal government, considered at the time to be restricted from direct action except in its own diminishing domain, or in situations involving interstate commerce, found that credit could be an instrument for accomplishing many objectives. It could be used to foster a dispersion of land ownership; to maintain small ownerships, both rural and urban; to favor one type or method of land improvement over another, or certain classes of borrowers as opposed to others; and to bring about reforms in land utilization, farming methods, and urban building and planning.

The remainder of this study will be largely concerned with the method by which these objectives were pursued. What is important to note here is that the more direct concern with real estate credit as an instrument of public policy brought with it a number of new considerations. Obviously, more was involved than mere influence on the supply of funds for mortgage lending, although this, of course, remained of crucial importance. First, the more or less negative and impersonal type of regulation characteristic of state law had to be supplemented or supplanted by a more dynamic sort of intervention that concerned itself less with restraint and protection than with needs, incentives, and positive guidance. Second, where the continuing conservatism of state law imposed obstacles

[1] See, for instance, Ray Allen Billington, *Western Expansion* (New York, 1949) Chapter 36.

to the new objectives, some means of circumvention had to be provided—a requirement that clearly pointed to action by the federal government. Finally, if credit was to become the instrument for the positive guidance of real estate activity and land use, special attention had to be given to the terms of credit—the rate of interest, the loan-to-value ratio, and the period of repayment—as the means by which a credit policy might be effectuated and made of the greatest possible benefit to those for whom it was devised.

Background of Regulation of Credit Terms

The regulation of the terms under which credit was issued as a means of effecting moral, social, or economic objectives is, of course, not entirely a new thing. Like most other currently used means of control, it reaches far back into history.

The interest rate, in particular, has been subjected to a long and varied scrutiny by government. Throughout the Middle Ages interest carried the opprobrious label of usury and was banned as immoral. Economic compulsion, however, finally overcame the interdiction. Adam Smith relates the progress toward respectability from the statute of Henry VIII of 1545, which had the effect of legalizing interest not in excess of 10 percent, to the renewed ban under Edward VI, the restoration of legal interest with a 10 percent maximum rate in the time of Elizabeth, and the gradual reduction in the recognized rate to 5 percent under Anne. He concludes: "All these statutory regulations seem to have been made with great propriety. They seem to have followed and not to have gone before the market rate of interest, or the rate at which people of good credit usually borrowed." [2]

Thus the offense of usury came to be not that of charging interest, but of charging excessive interest as defined by a statutory limit set in relation to, but not less than, a recognized rate broadly obtainable in the market. Regulation was no longer based on moral grounds but was aimed solely to protect the weak and uninformed borrower from the exactions of an unscrupulous lender. The reasonableness even of this type of regulation was denied by Jeremy Bentham.[3] The Bentham doctrine gradually made headway in

[2] Adam Smith, *The Wealth of Nations* (Modern Library ed., New York, 1947) Book I, p. 89.

[3] *Defence of Usury*, first printed in 1787.

England when the interest rate came to be recognized as being dependent solely upon considerations of risk and the supply of and need for capital. Demand for legal restraint upon the interest rate lessened, until in 1850 the English statutory rate was repealed on all loans except those on real estate and, in 1854, regulation of the mortgage rate ceased.[4]

In the United States, *laissez faire* has never been applied to interest rates with the full logic of the English example. It is true, of course, that by the time of the first colonization of this continent the legitimacy of interest had been firmly established; and, in any event, the needs of credit were so great that a moral proscription could not have been effective. Nevertheless, because the demand for credit so often exceeded the supply, an unrestrained operation of the money market, such as came to be the situation in England, was not considered feasible here.

The principle accepted by Adam Smith—that of the legalization of an assumed going rate of interest—rather than the Bentham principle of absolute freedom has been characteristic of American law. Nearly every state has some restrictive legislation affecting interest rates.[5] The problem in applying this type of regulation is to assure that the going rate is in fact one that is widely acceptable in the market. The danger always exists that legislators will act on the premise that the interest rate can be what government says it should be and that, consequently, the legal rate may be set at a point actually lower than the market will accept. Furthermore, owing to changes in the market, a once acceptable rate may lose its comparability with the going rate even where an original identity may have existed.[6]

Here we find further evidence of the conflict in governmental objective that is characteristic of our system of real estate finance. The development of mortgage law, with its special concern to protect the borrower in time of stress, undoubtedly has added to the risk of lending and has had a tendency to raise the interest rate to compensate for the additional risk. At the same time the legal

[4] An Act to Repeal the Laws Relating to Usury and to the Enrolment of Annuities, 17th and 18th Victoria, c. 90, August 10, 1854.

[5] Francis W. Ryan, *Usury and Usury Laws* (Boston, 1924).

[6] The history of the fixed 4 percent interest rate on loans made under the Servicemen's Readjustment Act of 1944 (see Chapter 7) provides a vivid example of these tendencies.

freezing of the rate at a level unattractive to investors either lessens the availability of loan funds, or leads to the invention of devices that have the effect of increasing the loan yield, or does both.

Thus we find that, even before the depressed 1930's, many farm states were in the midst of a credit famine. In some of them, available capital was much below what was needed, as investment was diverted to presumably more profitable, or less uncertain, fields. For urban property, the difficulties were no less real than for farm property. In spite of efforts to restrain rates, the actual costs of borrowing on mortgage security, including commissions, bonuses, discounts, renewal fees, and similar devices, put the actual mortgage loan rate far above the nominal legal rate.[7]

The states, therefore, found it almost impossible to combine low interest rates, high protection for borrowers, and ample loan funds. As the years passed, the tolerance born of prosperity also passed; and the onsetting depression aroused demands for an equation of these mutually hostile elements.

Along with the interest rate, borrowers found other difficulties in making satisfactory loan arrangements. Owing mainly to restrictions on institutional lending, which again reflected the state's estimate of the hazardous nature of the transaction, loan-to-value ratios were generally low, with the result that the purchase might be deferred until sufficient equity had been accumulated, or costly second, and even third, mortgage financing might be resorted to. Here the effort to protect those who placed their funds with lending institutions ran directly counter to the policy of promoting small ownerships. Again, state legislatures made little headway in resolving the dilemma; and, again, resort was finally had to the federal government to reconcile incompatibles.

Perhaps even more serious was the problem of repayment. Although the repayment of principal, unlike the payment of interest, has never been considered outright immoral, there have, as we have observed, been occasions when it has been postponed or modified by governmental intervention. These repeated breachings of the

[7] See Albert Farwell Bemis, "The Economics of Shelter," *The Evolving House* (Cambridge, Mass., 1934) Vol. 2, pp. 367-76. Bemis points out the wide variations in rates among the states as well as their high general level of mortgage interest rates during the 1920's. Some estimates placed the effective interest rate on second mortgage loans as high as 18 percent, while the rate on most such loans appears to have been in the range of 8 to 15 percent.

mortgage contract may have had some influence in establishing the incongruous practice of making mortgage loans—which are essentially of a long-term character—on a short-term basis, in the hope of getting payment before a new catastrophe and a new moratorium intervened.

In prosperous times, and in rapidly growing parts of the country, the incongruity of making a short-term loan for a purpose that required a long term for repayment was not always apparent. Renewals were usually possible, frequently without curtailment at the end of the customary three- to five-year loan period; and, in some instances, an increase in property values actually served to reduce the apparent proportion of loan to value. Depressions, however, brought disaster when they coincided with due dates; and the spectacular waves of foreclosures attending each major economic decline were eloquent testimony that the short-term mortgage loan was dangerous for lender as well as borrower.

Clearly, some other way was needed to protect the lender from the hazards of the mortgage business. At the same time, a method was needed that would allow the borrower to repay his loan by small payments spread over a longer period of years. The experience of some savings and loan associations, mutual savings banks, and insurance companies with amortized loans indicated their greater safety. It was also obvious that the longer the period over which amortization could be extended, the lower would be the individual payment, and the greater the number of persons who could meet it. Thus, a general acceptance of the principle of repayment by regular amortization would provide an important means for advancing the dispersion of land ownership. The states, however, appeared to be unlikely to take positive steps in this direction.

Intervention by the Federal Government

With supervision of financial institutions stiffened as a result of the disasters of the early 1930's, the states were handicapped by the rigidity of their own policies which made credit tightest just at the time some relaxation was required. The federal government was drawn into this situation on the wave of popular unrest that demanded new principles to replace old precedents. Many of these new ideas were greatly at variance with those under which the

federal government first entered the field of real estate credit.[8] The responsibility that the federal government assumed was twofold. It not only undertook—as a depression remedy—to assure easier credit generally as well as to make special provision for farm and home financing, but, with steadily increasing clarity and emphasis, it also asserted its obligation to provide "adequate" farms and "decent" homes for those lacking them.

To accomplish these objectives, manipulation rather than mere regulation of credit terms was required; and the interest rate, the loan-to-value ratio, and the method of repayment were all of a piece in providing an instrument for such positive action. The courses open to the federal government in making effective use of this instrument were several:

(1) It could charter mortgage lending institutions, using federal funds when necessary to encourage their establishment and to assure their adherence to federal policy.
(2) It could create institutions wholly financed and controlled by government, and thereby set lending terms in accordance with its estimate of credit needs.
(3) It could, by assuming a major part of the lender's risk, encourage private institutions to lend at a submarket interest rate, with lower down payments and longer repayment periods.
(4) It could subsidize interest rates by making partial payments from public funds.
(5) It could actually reduce interest to a negative quantity, by granting subsidies to certain classes of borrowers.
(6) It could, through various fiscal devices, depress the market rate of interest.

In a relatively few years all of these methods have been used, and the scope of each method, once established, has generally been widened far beyond initial limitations. By and large, the methods followed for cheapening credit have paralleled the methods selected for expanding the availability of credit. Before discussing these matters more fully, however, it is important to note how the interventionary attitude shifts from conventional and orthodox theories of credit operations to almost reverse practices.

The first step, whether in an agricultural or urban environ-

[8] This was the instituting of the Federal Land Bank System in 1916. See the next chapter.

ment, is to establish, or encourage the establishment of, new institutions, or to encourage the wider use of existing facilities in areas or circumstances where a greater availability of credit is desired. The primary purpose is to augment and direct the flow of funds. Interest rates, while lower than those produced by a scarcity situation, are still recognizable as customary rates for borrowers of good credit standing. In the selection of borrowers the ordinary criteria prevail. The borrower must be an acceptable credit risk, and, generally speaking, the best risks get the best terms.

The second step proceeds, through direct use of federal capital, or of guarantees to private institutions, to create lower interest rates and more liberal provision for repayment than would be offered even to borrowers of the best credit rating for the types of loans involved. An element of subsidy may enter the picture to the extent that contingent liabilities may result in claims on the government and certain costs of administration are carried by appropriations rather than by the operation itself. Borrowers are still selected on the basis of presumed ability to pay, but the possible range of differentiation in terms has been so reduced that all selected borrowers receive about the same treatment irrespective of differences in their resources and capacity.

The third step, by a more drastic use of the methods employed in the second, and with greater evidence of present or deferred subsidy, offers terms far beyond those obtainable in the private financial market. At this stage borrowers are selected because of their need for help and their inability to meet the terms otherwise available; and the better class of credit risks may be excluded from use of the special facilities.

The fourth step eliminates all financial considerations except the need of the borrower for funds. The use of subsidy is outright—either to reduce the effective interest rate or the proportion of the loan amount that must be repaid, or both. The beneficiary may be an individual borrower for farm or home, or the client of a public authority to which the subsidy is granted.

The steps outlined have not always been taken in the order given, nor does the taking of an additional step mean an abandonment of methods previously adopted. Moreover, the stages are not always as clear-cut as described, since frequently there is a blending of methods. At the present time all methods are being used, the

trend being toward greater experimentation with the third and fourth.

All fields of real estate finance, of course, are not directly affected, since the emphasis so far has been on agricultural and housing finance. Yet, during World War II extra-market financing was provided by the government for industrial and commercial property related to the war effort, and, in the postwar period, similar facilities were offered to classes of industrial property connected with the drive for increasing the production of prefabricated houses and of building materials for residential construction.

Emergence of a New Attitude Toward Credit

The shifting of the government's attitude toward credit terms has been accompanied by a profound, if not always clearly expressed, change of attitude toward the nature of capital. In the middle period between medieval prohibitions and the present type of intervention, the accepted theory was that financial capital represented a pool of savings available for productive purposes, that interest represented the inducement necessary to create the savings, and that the rate of interest was the measure of the incentive necessary at any given time not only to the creation of the capital fund but to the direction of its flow toward the various investment opportunities.

The place of government under this theory (if, indeed, it was admitted that government had any direct concern with the financial operation) was the creation of an environment favorable to saving (by the maintenance of a sound currency and the protection of investors in financial institutions) and the protection of weak borrowers against avaricious creditors. By and large, it was assumed that a pool of savings would naturally be created by the existence of opportunities for remunerative investment, that savings would flow without compulsion into productive uses, and that, irrespective of state action, the rate of interest would be determined by the supply of and demand for funds at any moment and the degree of risk in the particular investment.

The new attitude stems from quite a different point of view. It assumes first of all that, in a highly industrialized economy, there need no longer be any special incentive to save. As stated before the

Temporary National Economic Committee by Adolph A. Berle, Jr.: [9] "When the scientific development which began in 1900 began to reach its peak, we suddenly found ourselves in a state of affairs which is frequently described as a surplus economy, by which I mean that the productive mechanism of the country could produce more than the effective demand. At that point there was no particular need to bribe or cajole or reward anyone for not consuming, because if he consumed everything he was able to there was still capacity left over, and at that point the economics have distinctly changed."

As a corollary to this assumption, it was taken that the compelling factor in the investment process was no longer the incentive to the saver, but the need for capital funds, and that the rate of interest was not to be determined by what is necessary to cajole a saver but, as Berle puts it, by what was needed to get a particular job done. It was the purpose and nature of the investment, not the requirements of the investor, that henceforth were to set the terms of the loan. If the job required a low rate of interest, then that was what it should get.[10]

This attitude will be clarified by further quotation from Berle's testimony: [11] "The noncommercial business, like a hospital or low cost housing, or the semi-commercial business, like middle-class housing, cannot pay the same kind of rate of interest which a commercial enterprise pays. . . . Our first concern ought to be to work out a banking system which can quote a rate of interest which will take the business. If that rate happens to be a nominal one for something which isn't going to make any profit, then that is the rate to quote. If it happens to be, let us say, a 1- or 1½- or 2-percent rate for middle-class or lower middle-class housing which is not being built by anybody today, then quote that rate. If it happens to be a commercial enterprise, making the standard commercial rate, then quote that rate."

Although this theory has not been explicitly stated in legislation, it is implicit in federal credit measures since the Farm

[9] U. S. Congress. House. Hearing before the Temporary National Economic Committee (Washington, 1940) 76th Congress, 1st sess., Part 9, Savings and Investment, p. 3814.

[10] *Ibid.*, p. 3822.

[11] *Ibid.*, pp. 3820-21.

Loan Act of 1916.[12] It became fully evident in the repeated efforts, following World War II, to manipulate the interest rate and other terms on insured and guaranteed mortgage loans so as—despite a contrary market trend—to make borrowing easy for veterans and to reduce the cost of buying or renting housing constructed during the period of postwar inflation. In the process, a new realm of conflict and inconsistency has been created. A financial system based upon, and apparently to a large extent still motivated by, one concept of the investment process is overlaid by demands arising from a wholly contradictory point of view.

12 See Donald C. Horton, *Interwar Credit Aids Associated with Farm Ownership and Operation,* Department of Agriculture (Washington, 1945) mimeographed.