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CHAPTER 7

Mortgage Market Techniques and Characteristics

THE techniques, characteristics, and institutional arrangements that have distinguished the postwar mortgage market from other sectors of the capital market are described and appraised in this chapter. Emphasis is placed on innovations in mortgage market techniques and arrangements and modifications of older ones that have been particularly characteristic of postwar years. As in the preceding chapter, a large part of what follows is based on information obtained in interviews with executives of financial institutions.

Changes in mortgage markets, it will be recalled, are a part of fundamental changes in postwar financial and economic conditions. The increasing institutionalization of saving and investment—a trend initiated decades earlier—has resulted in new techniques for efficiently channeling funds into mortgage markets and, in some instances, for assuring the continuous investment of funds for months (and sometimes years) ahead. Federal monetary and fiscal policies and the consequent alternate periods of capital market ease and tightness have also contributed to the development of those techniques to support the flow of funds into mortgage markets. The continuing trend towards a nationwide mortgage market, accelerated by federally underwritten mortgage programs, has led to increasing secondary market transactions and to a unique relationship between primary and secondary market activities. The growth of the construction industry and the increasing importance of the large-scale builder have created new needs for large-scale short-term financing. Meeting those needs by financial institutions has led to a closer relationship between interim, construction, and permanent mortgage financing. Finally, the accelerated rate of real estate turnover at increasingly high prices in the postwar period has brought about a renewal of activity in junior mortgages—the "purchase-money" variety rather than the newly originated variety.

Time Lags in Mortgage Lending

A basic and inherent characteristic of mortgage and construction markets is the time lag between a firm decision to invest in mortgages and in their acquisition. Lags are generally greater and timing much more uncertain than in other segments of the capital market.[1] They are longest and most

[1] One indication of this was given in Chapter 4 where the lagging movement of mortgage interest rates was shown. The problems of investment planning faced by mortgage lenders because of the uncertainty of time lags were discussed in Chapter 6.

uncertain in financing new construction, but transactions in existing real estate are also subject to significant delays between firm commitment and closing. Financing of both new and existing properties under VA and FHA mortgage guarantee and insurance takes longer to complete (paper work necessary to meet federal requirements) than comparable financing through conventional mortgages. Because of the uncertain time lags encountered in acquiring uncompleted mortgages through advance commitments, some nationwide lenders unable to judge their cash flows accurately have found it more satisfactory to acquire completed mortgages in secondary markets for immediate delivery.

As the share of postwar mortgage flows accounted for by new construction activity, federally-aided financing, and advance commitments has grown, the time lags between decisions to invest and actual flows of mortgage funds have lengthened. This means that a large share of current mortgage flows at any time stems from investment decisions made several months earlier. The flow of funds into the mortgage market, therefore, may be large and rising at a time when new commitments and funds available for financing proposed construction and real estate transactions are scarce. Conversely, new commitments may be plentiful while the flow of funds into the market is reduced. Which situation arises depends on the capital market environment. This basic characteristic of postwar mortgage finance has important implications alike for general monetary policy, for specific financial policy of institutional investors, and for accurate appraisal of mortgage statistics. The consequences of time lags add a further problem to the prevailing complexities of market analysis.

Relationship between Construction, Interim, and Permanent Mortgage Financing

Short-term as well as long-term credits are an integral part of mortgage market operations. The role of each type of credit and the relationships between them, unique in this sector of the capital market, is one of the more interesting aspects of mortgage market organization and technique.

Short-term credits in real estate finance are extended for two general purposes, to provide funds for the construction process and to meet the interim financing needs of mortgage loan originators.[2] Funds for construction financing are supplied chiefly by commercial banks and savings and loan associations. The banks make principally temporary loans pending completion and sale of the property. The associations make their

[2] Other purposes and types of interim financing, generally called warehousing, are discussed in detail in a later section on interim financing techniques.

loans as a basis for acquiring permanent mortgages.[3] Loans for interim real estate financing are made to mortgage lenders almost exclusively by commercial banks.

Before the rapid postwar growth of large scale residential developers and mortgage companies, construction and interim financing were fairly simple, uncomplicated operations. Construction was undertaken largely on contract for home owners and the financing was arranged either directly by the owner or by the builder for the owner. There was no doubt about the identity of the ultimate owner or mortgagee. Financing of both construction and sale of the property was generally handled by one lender in one transaction with one instrument.

After the war, the increasing importance of large-scale housing developments calling for large amounts of construction funds, and the concurrent growth of mortgage companies, often requiring continuing lines of commercial bank credit to finance mortgages carried for ultimate investors, brought important changes. The processes of construction, interim, and permanent mortgage financing, and relationships between them gave a new facet to the mortgage market. Construction financing became a specialized, separate lending operation with techniques of its own, heavily dependent upon short-term lenders. Its flow to builders is closely related to the availability of permanent mortgage financing and often to interim financing.

It is the unique characteristic of the process that before short-term funds can be obtained for construction, long-term permanent mortgage financing must usually be arranged for the ultimate sale of the completed construction. This is almost invariably true in residential construction for sale. Producers of residential property for sale, therefore, unlike producers of other durable goods, are concerned directly with arrangements for the permanent mortgage financing of their completed properties. If such financing is assured, it smoothes the way not only for obtaining construction funds but also for selling completed houses. Thus, prospective buyers of newly completed houses often find that financing has already been arranged for them. In the secondhand house market where the seller is not the producer this is less often true, although it is not uncommon for prearranged favorable financing terms to be offered as an inducement to buyers.

Despite the interdependent relationship between construction and permanent financing, the suppliers of each type of credit operate in financial

[3] In an important proportion of cases, however, as shown in Chapter 6, construction financing by savings and loan associations has not led to permanent loans.

markets with different characteristics. The disparity can lead to lack of short-term construction financing even when permanent take-out commitments have been negotiated. Such a situation usually occurs during periods of heavy demands for short-term commercial bank credit. During the spring of 1956, for example, when business loans were high and rising and bank reserves low, commercial banks were turning down construction loans, not because permanent financing was not available, but because of inadequate funds. During such periods, customer relations become a paramount factor, and builders having long-established banking relationships are the first to be served.

Because of the basic variations that developed in the nature and purposes of interim financing ("warehousing") in the latter part of the first postwar decade, and because of the widespread attention given to it, a later section is devoted to the subject. At this point it is pertinent only to indicate the general relationship of interim financing to construction and permanent financing. The relationship is, in fact, quite simple.

Interim financing serves generally to bridge the gap from the time construction is completed and the property sold, and the construction loan has to be repaid, to the time when the permanent mortgage papers are completed and ready for delivery to the ultimate investor. As indicated, interim financing has become more integrated into the mortgage financing process with the increasingly important role played by mortgage companies in the postwar decade as originators of mortgages for ultimate long-term investors. These companies rely heavily on short-term commercial bank credit to finance their operations, especially the holding of inventories for the interval described (see Chapter 8). Interim financing has become more important, also, as the needs of large-scale permanent mortgage investors have changed, and mortgage commitment techniques have acquired new aspects. Mortgage commitments were discussed in Chapter 6 in connection with the policies and problems of life insurance companies and mutual savings banks. The basic importance of the mortgage commitment process, however, from the standpoint of market technique and operation makes its discussion in somewhat more detail here both instructive and essential.

Mortgage Commitment Techniques

The mortgage commitment represents, in effect, a promise to provide mortgage credit in the future under specified terms and conditions. In principle it is not unlike any other financial commitment given by a lender to a prospective borrower. In actual practice, commitments have become

an integral part of most mortgage transactions and one of the distinguishing characteristics of mortgage market operations. The only other segment of the capital market in which commitments play a significant role is that characterized by direct placement of corporate securities. In the markets for government obligations and for a part of the market for corporate securities (particularly that of railroad and public utility issues), characterized in the main by open market offerings and competitive bidding rather than direct negotiation, commitments have no part in market transactions.

One interesting difference between commitments in the corporate securities market and in the mortgage market is worth noting. In the former market, negotiations involve two parties—the financial institution and the corporate borrower. In the latter, where commitments to finance the permanent mortgage on new construction are under negotiation, three parties are involved—the financial institution, the builder, and the ultimate mortgage borrower, upon whose acceptance by the financial institution depends the ultimate disbursement of funds. Commitments to supply mortgage funds to finance purchase of existing properties also often involve three parties—the financial institution, the seller, and the purchaser.

Postwar innovations in mortgage commitment techniques, it will be recalled, have been developed in response to the needs of large-scale investors and to changes in capital market conditions. Two such innovations stand out, both used in connection with the financing of new residential construction. The "forward commitment," in which arrangements are made as far in advance as two years for investment of funds in mortgages to be created, was discussed in connection with lending policies and problems of financial institutions (Chapter 6). This commitment variation was developed by—and so far has been limited largely to—a few large life insurance companies that have found it well suited to the fundamental nature of their business and their long-range investment needs. The likelihood is that the forward commitment will continue in limited use by investors able to guage future income flows accurately and finding it expedient to acquire mortgages on a regular basis through a well-established permanent investing organization.

The second postwar innovation of an altogether different sort is the so-called standby commitment. It reflects both the indispensability to the construction process of an arrangement for permanent financing, and the ingenuity of the mortgage industry in adapting to market conditions at times when the supply of long-term mortgage funds becomes severely limited. As the name suggests, a standby commitment is one given by an

institutional investor to a mortgage originator or a builder in which the investor pledges to purchase mortgages at a price below the prevailing market price and below the price expected to prevail when the construction is completed and the mortgage is ready for delivery. The investor, therefore, does not expect to be called upon to fulfill this type of commitment, which he gives principally in consideration of the nonrefundable fee received. The builder or mortgage originator is willing to pay the fee because the standby makes possible arrangements for construction financing upon which commencing the building operation depends.

The standby commitment is usually given for a period of from six to twelve months at a fee that varies directly with the mortgage price. The more the standby commitment underquotes the prevailing market price, the lower the fee charged. Thus, in the spring of 1956, commitments to purchase FHA or VA mortgages at 90 per cent of par were obtainable at a cost of ½ of 1 per cent, while at 93 per cent of par commitments carried a fee of 1 per cent. Mortgage prices associated with fees vary with changes in the current market price for completed mortgages.

The origin of the standby commitment is not completely clear, but at least one claim for its invention has been made by a large New York mortgage brokerage house. It is said that the first standby was given in the summer of 1950 when permanent take-out commitments were difficult to arrange in the booming construction market of that year.[4] However, it was not until the periods of extreme mortgage tightness in 1952–1953 and 1955–1956 that the standby device came into wide use with variations depending upon the institutional investor involved. Large commercial banks, one important source of standbys, have made them often in conjunction with short-term credits extended for construction or interim financing. Thus, a bank may make a construction loan backed by its own standby commitment to purchase the completed mortgage, and accompanied by an agreement to provide interim financing (warehousing) for a short period. This is a convenient arrangement for the mortgage originator, who has a given length of time to locate a more favorable market for the completed permanent mortgage. For each of these separate services (construction financing, standby commitment, interim financing), the bank earns separate fees as well as interest.

To a lesser extent than commercial banks, long-term institutional investors also provide standby commitments. Their reason is not only to earn the fees, but also the hope of obtaining mortgages for their portfolios at

[4] Pringle–Hurd and Company, Inc., *Mortgage Market News and Comment*, September 20, 1954, p. 8.

bargain prices. Savings and loan associations, savings banks, and life insurance companies each sometimes combine standby commitments with options to purchase the mortgages under the commitment at more realistic market prices (i.e., prices higher than stipulated in the commitments) when ready for delivery. If their operations permit and the mortgages are satisfactory, these institutions have thus created an additional source of mortgages for their portfolios.

Without doubt, the standby commitment technique has proved advantageous to each of the participants, when, as anticipated, markets ease at the end of the standby period and completed mortgages are sold to permanent investors. The builder has been enabled to proceed with construction, the mortgage originator has maintained or increased his volume of business, and the institutional investor has earned a profitable fee for a promise to lend in case of need. If, however, the mortgage market tightens further during the standby period and mortgage prices decline, the standby price may become the market price, with the result that the institutional investor is pledged to unintended mortgage acquisition and the builder has paid substantially higher financing costs than he intended. While the standby committer prepared for such an eventuality may not be unhappy to have acquired mortgages at very favorable prices, the unprepared institution may be embarrassed by a lack of ready funds to honor such commitments. Many small savings and loan associations found themselves in a difficult situation in late 1955, for example, when they were unexpectedly called upon to honor standbys at a time when the Federal Home Loan Bank Board had restricted borrowings from the Federal Home Loan Banks. Some of them resorted to commercial bank credit to meet their commitments. Some large commercial banks, on the other hand, that had acquired mortgages unexpectedly when the market price fell below the standby price, were able to absorb these mortgages and sell them later at more favorable prices.

The effects of the standby commitment technique on market processes, as on individual participants, are also mixed. One favorable effect is felt during periods of temporary credit stringency in the capital market when standbys may serve the useful function of moderating declines in the availability of mortgage funds and, hence, in the volume of residential construction. Moreover, the standby technique permits the creation of a pool of completed mortgages ready for immediate delivery, an advantage to some types of institutional investors unable or unwilling to commit themselves months in advance to acquire mortgages.

An unfavorable effect lies in the destabilizing potential of the standby

commitment to the mortgage market. Use of this technique makes possible an expansion in construction activity to a level that may not be sustainable, and a volume of mortgages that cannot be readily absorbed by long-term investors. Such a situation can readily result from pressure of builders for construction financing and from misjudgment on the part of standby committers of the time span of the credit stringency. There is evidence that, during part of 1955 and 1956, a volume of residential construction was undertaken larger than financial intermediaries could comfortably finance through the capital market, considering the strong demands for credit from business, consumers, and governments. Mortgage offerings exceeded takings, prices were depressed, and increasing use was made of short-term commercial bank credit to finance temporarily the excess volume of mortgages.

Interim Financing Developments

The use of short-term commercial bank credit by mortgage originators to finance their interim needs between the payment of loan proceeds to borrowers and the delivery of completed mortgages to ultimate investors has long been an integral part of the real estate financing process. Increased demands for this type of credit during the postwar decade are traceable to the standardization of mortgage contracts, resulting from the introduction of federal mortgage insurance and guarantee, and the lowering of legal barriers to out-of-state mortgage investments. The increased ability and willingness of institutional investors, with large aggregations of savings, to purchase mortgages on a nationwide basis has been accompanied by the rapid establishment and growth of mortgage companies originating and servicing loans for such mortgagees. These companies, characterized by limited capital in comparison with the volume of their operations, depend heavily on commercial bank credit.[5] Moreover, changing needs of institutional investors and periodic stringency in the market for long-term financing have further increased the use of commercial bank credits and led to numerous variations in techniques and arrangements, collectively called "mortgage warehousing."

VARIATIONS IN TECHNIQUE

Some of the arrangements for interim mortgage financing apply to mortgages already in existence, others to mortgages not yet made. Some variations concern mortgages on uncompleted houses, others, mortgages on existing properties. Some have two parties at interest, and others three

[5] See Chapter 8.

or more. Some arrangements include the pledge of specific mortgages as collateral, others general credit lines, and still others the purchase of mortgages under specified repurchase agreements. Some call for the use of bank credit for very short periods, others for considerably longer periods. Some are backed by commitments of permanent investors, others not. Most transactions deal with federally underwritten mortgages, but some with conventional mortgages. Some borrowers are builders, others mortgage originators, and still others mortgage investors. In all of these variations, the division of rights, interests, and obligations of the parties to the transaction are finely drawn and often legally complex. The one characteristic and purpose that is common to virtually all warehousing transactions is the use of commercial bank credit for an interim period pending the availability of long-term funds or the fulfillment of prearranged conditions.

The use of the term "warehousing" to describe fundamentally different types of interim financing transactions designed to achieve different purposes has led to considerable confusion and misunderstanding. Equally confusing have been the numerous terms that have sprung up in the trade to describe essentially the same kinds of transactions. It is difficult to distinguish favorite terms for identical transactions from bona fide terms to describe variations in technique. Among the more commonly used terms encountered in market interviews are the following: "committed" or "closed-end" warehousing; "uncommitted" or "open-end" warehousing; "warehouse with a standby"; "institutional" or "repurchase" warehousing; "clearing" loans, "inventory" loans, and "ordinary collateral" loans. The list could undoubtedly be lengthened. Among all the technical variations of interim financing, four types could be distinguished, each having meaningful characteristics with respect to participants, rights and obligations, fees and charges, risk, and purpose of borrowing. They are: (1) committed short-term loans; (2) committed long-term loans; (3) uncommitted loans (possibly including those under standby); and (4) institutional committed loans, or repurchase agreements.[6]

[6] The classification suggested here differs somewhat from those in the sources below, but the differences are readily detectable and should not be confusing. The only published classifications found were in *Mortgage Credit and FHA Multifamily Housing*, Report No. 2 of the Subcommittee on Housing of the Committee on Banking and Currency, House of Representatives, January 31, 1956, pp. 8–13; and in data reported by the Board of Governors of the Federal Reserve System in tables on "Credit Extended to Real Estate Mortgage Lenders by Weekly Reporting Member Banks in Leading Cities," published in various issues of the *Bulletin*, for example, September 1956, p. 1,347. The two classifications differ chiefly in that the former does not distinguish between loans secured and unsecured by mortgages, and the latter does not distinguish between loans backed or not backed by take-out commitments. Further, in *Mortgage Credit* the description of

The first and still most common type of interim financing, basic to mortgage company operations for years, involves the use of short-term commercial bank credits for periods of from 60 to 180 days. These credits are secured by permanent mortgages awaiting final processing and legal documentation, or by temporary loans on construction awaiting completion —both backed by firm take-out commitments of institutional investors. In many long-standing relationships between mortgage companies and commercial banks, a revolving line of credit is provided rather than individual credits for each transaction. When the documents are completed by the mortgage company and delivered to the permanent investor, the company uses the proceeds received to discharge its obligation to the bank. This type of loan is considered by most commercial bankers as an ordinary collateral loan made to finance a customer's sold inventory. The volume of such loans has multiplied in the postwar decade, as mortgage company operations have expanded.

The development of the long-term forward commitment by institutional investors gave rise to the need for longer-term financing of mortgage correspondents by commercial banks—a second form of warehousing. In the newer arrangement—as in the older one—loans are secured by mortgages and by firm take-out commitments of ultimate investors. On the surface, the only difference between the short-term and long-term interim financing techniques is the loan maturity. There is, however, a fundamental difference in purpose and in the obligations and rights of participants. In the short-term type the bank is performing a typical financing service for a borrower short of funds pending technical readying of an inventory of goods that will be taken and paid for immediately by the purchaser that ordered it. In the longer-term type, the inventory of loans is ready for delivery but the investor is not ready to accept it according to his planned investment schedule. In this instance, warehousing seems an apt term for a credit operation that supports storage of completed mortgages in a convenient reservoir for later tapping by an ultimate investor as funds become available. Some commercial banks regard this type of arrangement as a credit to finance a deferred purchase.

Another distinct characteristic of the second type of interim financing is

"uncommitted-line warehousing" encompasses standby commitments discussed separately here. The Federal Reserve classification, finally, does not include all the basic market variations discussed here, primarily because of problems of data collection.

The classification distinguishes between committed and uncommitted warehousing, but does not use the latter as synonymous with standby commitments. Discussions with participants in the market seemed to justify that separation, although a few institutional investors were found to regard the standby commitment as a form of uncommitted warehousing, and some used both together.

the usually unconditional commitment of the ultimate investor to purchase mortgages. Before the warehousing transaction is negotiated, the completed mortgages are subject to inspection by the investor and must have approval with respect to legal documentation, property specifications, and mortgagor qualifications. The investor agrees to purchase the mortgages at the appointed date, whether or not they go into default or delinquency during the warehousing period. In some instances, the agreement even requires the investor to take out of warehouse mortgages that have been in default for at least 90 days. During the warehousing period, amortization payments on pledged mortgages are remitted to the interim lender. The mortgages are generally recorded in the name of the ultimate investor, who may also hold the mortgages in his possession. If so, the interim lender holds a trust receipt. Technical arrangements vary in numerous ways.[7]

A third type of warehousing is similar to the first in purpose and duration except that it is not backed by a firm take-out commitment of an institutional investor. These uncommitted or open-end loans (distinguished from committed or closed-end loans of the second type) are often made to the larger, more heavily capitalized mortgage originators in a position to extend mortgage credit without prior commitments from an ultimate investor. These originators rely on their knowledge of the mortgage market and contacts within it to sell completed loans for immediate delivery. Often, in making uncommitted warehousing loans, the commercial bank also gives a standby commitment to the mortgage company or builder—a transaction known in the trade as a "warehouse with a standby." Through it, the originator unable to find a permanent investor at the end of the warehousing period may, as a last resort, fall back on the bank's standby commitment to buy the mortgage. Some observers have regarded the uncommitted warehousing loan as synonymous with the standby commitment.[8] Sufficient evidence (uncommitted warehousing loans made by commercial banks without standbys or backed by standby commitments of other lenders) was found in this study, however, to justify regarding the two techniques as separate and distinct, albeit closely related.

Commercial bank interim financing loans backed by standby commitments of other financial institutions are regarded as more risky than loans backed by regular take-out commitments. Most commercial banks regard

[7] I am grateful to William F. Keesler and King Upton, vice presidents of the First National Bank of Boston, and to Raymond T. O'Keefe, vice president of the Chase Manhattan Bank of New York, for providing much of the technical information underlying the discussion of the second type of interim financing.

[8] See Report No. 2 of the Subcommittee on Housing of the House Committee on Banking and Currency, pp. 8–10.

standbys as not so firm as regular commitments. Usually the regular take-out lender is interested in acquiring the loan, but the main purpose of the standby lender is often to earn a fee for a promise to lend. When unexpected market declines have occurred, standby committers have often been caught short. At best, they have requested delays in delivery of closed loans, and at worst, have tried to back out of the commitment through technical loopholes. Many commercial bankers have, therefore, classified interim loans backed by standbys in the same category as uncommitted short-term loans.

An officer of a large commercial bank, active in interim mortgage financing, has indicated the following criteria as in general use by commercial banks for granting uncommitted lines of credit to mortgage originators:

1. Ability of mortgage company to sell mortgages under adverse market circumstances
2. Diversification of borrower's sales outlets and reputation as servicer of mortgages
3. Ratio of borrower's unsold mortgages to total capital; to its service account, excluding FNMA account; and to anticipated annual sales
4. Quality of unsold loans, possible market for them, and how well they meet usual requirements of borrower's previous investors
5. Lender's appraisal of the availability of long-term funds for mortgage investment[9]

A fourth—and last in the present classification—variation in interim mortgage financing is the "repurchase" or "institutional warehousing" arrangement. The transaction is between a commercial bank and a permanent mortgage investor; the bank extends regular short-term credits secured by mortgage loans or purchases the mortgage loans under a repurchase agreement. This arrangement, which first appeared early in 1955, received wide publicity, partly because of the large size of single transactions, and partly because of implications for public policy.

Because of the large sums usually involved in such loans, many banks ordinarily participate in one transaction under the management of the bank negotiating the loan.[10] This type of loan has been used by

[9] King Upton (vice president, First National Bank of Boston), unpublished address, "Interim Financing of Closed Loans and Long-term Forward Commitments," at meeting of the Mortgage Bankers Association of America, February 23, 1956.

[10] In the warehousing transaction between Prudential Life Insurance Company and Irving Trust Company in 1955—perhaps the largest of that type—a loan under repurchase agreement of some $350 million was arranged in which 150 banks participated. In the arrangement between Institutional Securities Corporation, acting for several New York mutual savings banks, and Chase Manhattan Bank a loan for $250 million was negotiated divided among several commercial banks. Apparently less than 10 per cent of the large reservoir of funds was actually used by the borrowers.

institutional investors to serve one of two purposes: relief for an overcommitted position, or establishment of a reservoir of mortgage funds. In the first instance, an institution overly zealous in committing itself to acquire mortgages during a period of easy money may be left with insufficient funds to continue both a current mortgage investment program and to acquire mortgages committed for during an earlier period. Rather than sell government securities—perhaps in an unfavorable market—or reduce heavily its current mortgage investment program, the financial institution may prefer a warehousing arrangement. In the second, an institution temporarily lacking funds to acquire a feasible and desirable number of mortgages in a current period seeks to establish credit for that purpose until its own situation is eased. The longer-term aspects of this type of financing as well as the major purpose of establishing a pool of mortgages make it similar to interim financing under long-term forward commitments, discussed earlier.

Whether or not institutional warehousing arrangements provide for repurchase within a specified time or for repayment of a regular mortgage collateral loan has little real economic significance. It is generally a matter of legal technicality or convenience. Because of legal limitations on the amount a bank may lend to one customer, large transactions usually are made in the form of repurchase arrangements. For example, in the transaction between Chase Manhattan Bank and Institutional Securities Corporation (footnote 10) the bank agreed to make a straight collateral loan for $50 million and to purchase under repurchase agreement $200 million of mortgages. On the borrower side, a large insurance company, for example, may not care to have its financial statement show heavy bank borrowings and hence may prefer the repurchase form of agreement. Thus, the transaction between Prudential Insurance Company and Irving Trust Company (footnote 10) was entirely under repurchase arrangement, but it is unlikely that the mortgages were ever physically removed to the bank's vaults.

While the distinction between a loan and a repurchase arrangement may have little economic meaning, there is an important statistical distinction in the classification of commercial bank loans. Mortgage loans acquired by a bank under repurchase agreement are properly classified as real estate loans in reports of condition. Mortgages taken as collateral for a loan, however, must be classified as commercial loans. Undoubtedly, the large increase in the volume of warehousing transactions under repurchase agreement in 1955 resulted in a reported increase in the volume of commercial bank real estate credit loans outstanding.

Each of the four types of interim financing discussed above is an individually negotiated transaction between lender and borrower.[11] Each is, therefore, subject to variations in interest rate charges and other fees which are difficult to determine.

There is less semblance of an organized market for interim financing than for other areas of mortgage finance, and thus there is little standardization of terms. For loans in which there is little risk to commercial banks (types 1, 2, and 4), the interest rate seems generally to be 0.5 per cent above the prime loan rate with no additional loan fees or charges. Through most of 1955 the best interim loans were made at 3½ per cent. In early 1956, the rate had risen to 4 per cent and, as the prime loan rate advanced, continued upward to 4¾ per cent by the autumn of 1956. On institutional loans that are managed by one bank for a syndicate, the managing bank usually receives a small fee for its services.[12] On smaller warehousing loans to mortgage companies, even though backed by firm take-out commitments, the interest rate may run slightly higher than on large warehousing loans to institutions.[13]

Many commercial banks will not make an uncommitted warehousing loan without making a standby commitment as well. In such cases the interest charge on the loan may be no higher than on a committed loan, but for the standby commitment a fee of from ½ of 1 per cent to 1 per cent, in addition to the interest, may be charged, the fee depending on the standby price. Total charges on such loans, which generally run for less than one year, are thus considerably higher than on committed warehousing loans. Some banks provide uncommitted interim financing without a standby, often as special accommodation to favored customers carrying large balances with them, and at the interest rate on committed loans. Other banks will provide such financing, however, only at interest charges of from ½ to ¾ of 1 per cent above the rate on firmly committed loans, the rate depending on the mortgage company and the standby committer, if any.

[11] A possible fifth type not discussed here is the loan not secured, or secured by collateral other than mortgages. Such a loan is ordinarily backed by a firm take-out commitment by an institutional investor and is otherwise backed by the credit status of a strong mortgage originator. In any event, as shown in Table 20, the amount of such loans has accounted only for a very small part of interim credit extended to real estate mortgage lenders.

[12] In the arrangement between Chase Manhattan Bank and Institutional Securities Corporation, the interest rate was 3½ per cent on the first $50 million plus a service fee of 1/16 of 1 per cent to Chase Manhattan on the additional $200 million for managing the arrangements with other participating banks (based on "Banks Set to Use Mortgage Funds," *The New York Times*, October 7, 1955).

[13] Report No. 2 of the House Subcommittee on Housing, p. 10, note.

From the standpoint of market participants, the advantages of the various types of warehousing arrangements are clear and seem to outweigh possible disadvantages to them. The interim lender earns a good rate of return for a loan secured generally by federally underwritten mortgages and backed often by a firm take-out commitment of a large institutional investor. The mortgage originator increases or maintains his volume of business and shares in the spread (when there is one) between the interest rate on mortgages held and interim financing charges. The institutional investor is able to compensate for an overcommitted position or have a reservoir of mortgages established for immediate investment of funds as they are received from new savings, life insurance premiums, and mortgage repayments. There may also be an additional fee earned for outstanding commitments during the interim financing period. Disadvantages may arise for the commercial bank if it has to extend a loan or acquire mortgages unwillingly when a commitment has proved less firm than expected. The mortgage originator or investor may also be at a disadvantage if mortgages are acquired at less favorable prices than expected, taking account of warehouse fees and charges.

From the standpoint of broader effects on market processes, warehousing arrangements may be either salutary or detrimental depending on the type of transaction and on market conditions. There is little question that the regular short-term interim financing loan, an integral part of the real estate financing process for years, serves a useful purpose in bridging the gap between loan closing and ultimate sale or delivery of the mortgage to a permanent investor. The question is whether the distinctive postwar innovations discussed above have constituted an appropriate use of bank credit. In this connection, the discussion on standby commitments in the preceding section is appropriate, since both techniques were developed largely to provide a flow or reservoir of mortgage credit during periods of capital stringency.

In brief, the advantages of the new warehousing techniques are that they may permit mortgage originators to operate with flexibility and may enable institutional investors to plan and carry out long-range mortgage investment programs. Used to excess, however, or during periods of extended capital market tightness, warehousing may tend to stimulate investment in construction and real estate beyond available flows of savings, with consequent later destabilizing effects on real estate markets. Warehousing not backed by firm take-out commitments, moreover, may lead to an excess of mortgages over funds available from permanent investors, with a consequent depressing result on market prices. Finally, to the extent that

warehousing is an essential part of long-term forward commitment arrangements, it may contribute to market excesses. Such imbalance may result from miscalculations of investing institutions about future availability of capital funds. Their unwise attempts to build, on those miscalculations, too large mortgage inventories would add to already large mortgage flows in one period and reduce available mortgage funds in a future period.[14]

DATA ON INTERIM FINANCING

Only recently has information become available on the volume and types of interim financing credit extended by commercial banks to mortgage lenders. These data, shown in Tables 20 and 21, confirm two earlier impressions: that mortgage companies are the dominant user of such credits; and that most interim financing is carried out through direct loans secured by mortgages rather than through purchase of mortgages under resale agreement. Data are not available, however, for a classification in the detail given in the preceding section.

The volume of interim financing credit outstanding more than doubled between the summers of 1954 and 1955, following a 50 per cent increase in the four preceding years (Table 20). This sharp expansion resulted in significant changes in the characteristics of interim financing credits. Commercial bank credit extended to insurance companies increased most markedly—from less than 2 per cent of the total outstanding in August 1954 to nearly 18 per cent a year later. Most of the increase occurred in purchases of mortgages under resale agreement (type 4 discussed above), which advanced from 9 to 24 per cent of the total. At the same time interim credits extended to mortgage companies, though doubling, declined as a proportion of the total from 89 to 73 per cent, and loans secured by mortgages dropped from 85 to 70 per cent.

The shifts in the types of warehousing credits outstanding largely grew out of the single transaction of $350 million between the Prudential Insurance Company and the Irving Trust Company syndicate. As the Prudential repurchased their warehoused mortgages during 1956, interim credits to insurance companies declined sharply from the 1955 level of about 18 per cent to only 9 per cent of the total outstanding in August 1956. Total credits under repurchase agreement also declined but not so sharply. The volume of such credit arrangements with mortgage companies remained

[14] Some further discussion of market effects of warehousing may be found in Report No. 2 of the Subcommittee on Housing, pp. 11–13. A private investor's point of view is expressed by R. B. Patrick (financial vice president, Bankers Life Insurance Company), "There's Enough Money in Sight for Mortgage Loan Needs," *The Mortgage Banker,* May 1956, pp. 25–26.

unchanged, while it increased significantly for other types of borrowers. All types of interim financing credits extended to other types of borrowers, in fact, increased during 1956, while those to mortgage and insurance companies showed little change. The proportion of the "other" group rose to the highest on record. Borrowers in that group included savings and loan associations, mutual savings banks, builders, and other organizations. Use of interim bank credits by the financial institutions in the group may have reflected their need for such credits to finance mortgage purchases under earlier commitments, including standbys, when the net flow of long-term savings was slowing down.

Tables 20 and 21 also indicate the association of particular types of borrowers with particular types of warehousing credit arrangements. Mortgage companies typically borrow from commercial banks on the security of mortgages, although their unsecured borrowing also increased proportionately. Insurance companies typically use the repurchase arrangement, although to only a small extent before 1955, when the Prudential loan was closed. Other types of borrowers make use of all arrangements, of which the repurchase type of transaction increased most sharply since 1954.

The distribution of the unused portion of commercial bank commitments to purchase mortgage loans from mortgage companies, insurance companies, and other borrowers—or make loans to them—is quite similar to the distribution of warehousing credits outstanding among these borrowers. Included in these unused commitments, which declined from $1.3 to $1.1 billion between the summers of 1955 and 1956, are standbys. There is no way of determining what proportion they constitute of the total unused bank commitments. Some students have interpreted these data as consisting entirely of standby commitments, but that cannot be correct because the figures cover unused warehousing credits (including regular bank lines of credit) as well. It cannot be correct even if standbys are regarded as the same thing as "uncommitted warehousing," because the category includes all types of unused warehousing credits.

The relative importance of interim credits in total real estate finance varies with conditions in the financial markets. That importance is difficult to measure because suitable data are lacking. The most meaningful comparison probably is between the gross volume of interim financing and the gross volume of mortgage lending for home building and purchase. Estimates may serve to indicate approximate orders of importance. During 1955, for example, the average amount of the various types of warehousing credits outstanding was about $1.5 billion. The maturities of those credits

TABLE 20

Outstanding Interim Financing Credits Extended by Commercial Banks to Mortgage Lenders, by Type of Borrower and Type of Loan, Selected Periods, 1950–1956
(millions of dollars)

	1956				*1955*		*1954*	*1950*
	Nov. 14 (1)	Aug. 8 (2)	May 16 (3)	Feb. 15 (4)	Nov. 16 (5)	Aug. 10 (6)	Aug. 11 (7)	June 30 (8)
Total loans to mortgage lenders	1,525	1,465	1,354	1,425	1,623	1,408	608	404
Type of borrower								
Mortgage companies	1,182	1,137	1,051	1,148	1,182	1,025	541	—
Insurance companies	114	121	127	130	287	250	11	—
Other borrowers	229	208	175	145	152	131	55	—
Type of loan								
Secured by mortgages	1,092	1,051	968	1,066	1,110	982	516	—
Purchased under resale agreement	303	276	276	266	404	338	55	—
Unsecured or secured by other than mortgages	130	137	110	93	107	88	37	—
Type of borrower and loan								
Mortgage companies	1,182	1,137	1,051	1,148	1,182	1,025	541	—
Secured by mortgages	1,012	974	899	1,001	1,035	911	487	—
Purchased under resale agreement	113	103	107	107	109	90	44	—
Unsecured or secured by other than mortgages	57	60	45	40	38	24	10	—
Insurance companies	114	121	127	130	287	250	11	—
Secured by mortgages	7	9	10	11	20	11	2	—
Purchased under resale agreement	102	104	113	116	265	235	7	—
Unsecured or secured by other than mortgages	5	8	4	3	2	4	2	—

(*continued on facing page*)

TABLE 20 (*continued*)

	1956				*1955*		*1954*	*1950*
	Nov. 14 (1)	Aug. 8 (2)	May 16 (3)	Feb. 15 (4)	Nov. 16 (5)	Aug. 10 (6)	Aug. 11 (7)	June 30 (8)
Other borrowers	229	208	175	145	152	131	55	—
Secured by mortgages	73	68	59	54	54	59	26	—
Purchased under resale agreement	88	70	56	42	30	12	4	—
Unsecured or secured by other than mortgages	68	70	60	49	68	60	25	—
Unused portion of firm commitments[a]	794	1,064	1,131	1,131	1,225	1,295	—	—
Mortgage companies	536	791	851	837	889	894	—	—
Insurance companies	97	110	106	118	151	183	—	—
Other borrowers	162	163	173	176	185	219	—	—

Source by Column: (1 to 7) Based on surveys of weekly reporting member banks, by the Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin*, various issues, e.g., December 1956, p. 1,300. With respect to coverage the Board has stated: "Most of the loans and commitments to real estate lenders are financed at the large banks included in the weekly reporting series; banks in this series held about two-thirds of total loans of all member banks."

(8) Based on a special supplement to the June 30, 1950 commercial bank call report, and represents loans of all insured commercial banks shown in Report No. 33 of the Federal Deposit Insurance Corporation, "Assets and Liabilities of all Operating Insured Commercial and Mutual Savings Banks," June 30, 1950, p. 5.

[a] Commitments to purchase mortgage loans from, or make loans to, mortgage lenders.

TABLE 21

Percentage Distribution of Outstanding Interim Financing Credits Extended by Commercial Banks to Mortgage Lenders, by Type of Borrower and Type of Loan, Selected Periods, 1954–1956

	1956				*1955*		*1954*
	Nov. 14 (1)	Aug. 8 (2)	May 16 (3)	Feb. 15 (4)	Nov. 16 (5)	Aug. 10 (6)	Aug. 11 (7)
Total loans to mortgage lenders	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Type of borrower							
Mortgage companies	77.5	77.3	77.7	80.6	72.8	72.8	89.0
Insurance companies	7.5	8.2	9.4	9.1	17.7	17.8	1.8
Other borrowers	15.0	14.5	12.9	10.3	9.5	9.4	9.2
Type of loan							
Secured by mortgages	71.6	71.6	71.7	74.8	68.4	69.7	84.9
Purchased under resale agreement	19.9	19.1	20.5	18.7	24.9	24.0	9.0
Unsecured or secured by other than mortgages	8.5	9.3	7.8	6.5	6.6	6.3	6.1
Type of borrower and loan							
Mortgage companies	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Secured by mortgages	85.6	85.5	85.5	87.2	87.6	88.9	90.0
Purchased under resale agreement	9.6	9.3	10.2	9.3	9.2	8.8	8.1
Unsecured or secured by other than mortgages	4.8	5.2	4.3	3.5	3.2	2.3	1.8
Insurance companies	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Secured by mortgages	6.1	7.4	7.9	8.5	7.0	4.4	18.2
Purchased under resale agreement	89.5	86.0	89.0	89.2	92.3	94.0	63.6
Unsecured or secured by other than mortgages	4.4	6.6	3.1	2.3	0.7	1.6	18.2
Other borrowers	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Secured by mortgages	31.9	33.5	33.7	37.2	35.5	45.0	47.3
Purchased under resale agreement	38.4	33.5	32.0	29.0	19.7	9.2	7.3
Unsecured or secured by other than mortgages	29.7	33.0	34.3	33.8	44.7	45.8	45.5
Unused portions of firm commitments.[a]	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Mortgage companies	67.5	74.1	75.2	74.0	72.6	69.0	—
Insurance companies	12.2	10.3	9.4	10.4	12.3	14.1	—
Other borrowers	20.4	15.5	15.3	15.6	15.1	16.9	—

SOURCE: Table 20.

[a] Commitments to purchase mortgage loans from or make loans to, mortgage lenders.

probably varied within a wide range of from two months to two years, the largest portion for six months or less. Assuming an average annual turnover ratio of 2.0, therefore, total interim financing extended during 1955 would have been on the order of $3 billion.

Total mortgage credit extended for the purchase of new and existing houses in 1955, according to estimates of the Board of Governors of the

Federal Reserve System, amounted to $23.5 billion, some $10.2 billion for new houses and the remainder for old houses.[15] Relating our estimate of $3 billion for gross interim financing to the estimate of $23.5 billion for mortgage loans made for new and existing house purchases suggests a quantitative importance of about one-seventh for interim lending in total home real estate finance. On the other hand, if, as observations in the market suggest, warehousing is associated chiefly with financing of new house building and purchase, the order of importance is increased to well over one-fourth.

The significance of interim mortgage financing in 1955 becomes even greater when comparison is made between the volume of new warehousing and of FHA and VA financing, since conventional mortgage loans are seldom warehoused. In 1955, the total volume of federally underwritten mortgage lending was $10.3 billion, $5.9 billion of it for new house purchases. If the whole volume of warehousing is assumed to be used for FHA and VA financing of new houses, warehousing accounted for approximately one-half of that volume in 1955. This is probably too high a ratio, for not all warehousing was used to finance VA or FHA mortgages on new housing; but it is some indication of the importance of that technique in the federally underwritten mortgage market. Compared to the total of all FHA and VA financing, warehousing accounted for about 30 per cent—still an impressive proportion. Finally, one may consider that the $1.2 billion of unused warehousing commitments outstanding during 1955 was supporting at least that amount of new construction credit.

While the quantitative significance of interim financing cannot be measured exactly, it is clear that such commercial bank credit had become of signal importance in mortgage markets by the end of the postwar decade. In 1956, the relative significance of warehousing remained about the same as that just described for 1955. To mortgage companies, in particular, interim financing from commercial banks was an essential factor in their rapid postwar growth (see Chapter 8).

Primary and Secondary Mortgage Market Characteristics and Relationships

The complexities of special institutional arrangements and techniques associated with marketing mortgages have clouded somewhat the distinction between primary and secondary mortgage markets. The lack of clarity particularly impedes attempts to separate these markets quantitatively in terms of volume, nature of transactions, prices, and costs.

[15] *Federal Reserve Bulletin,* May 1957, p. 369.

What does seem clear is that distinctions made in the mortgage market—as evidenced by general terminology and common understanding of participants—and in the scant statistics that exist are based on somewhat different interpretations of the terms "primary" and "secondary" than those generally given by economists or by participants in other sectors of the capital market.

CONCEPTS AND DEFINITIONS

While there are undoubtedly several different acceptable definitions of a primary capital market, a widely accepted one is a market in which debt or equity instruments are created in transactions between borrowers or sellers and initial lenders or buyers. A secondary market, in contrast, is one in which previously created securities are traded between investors, with or without the aid of intermediaries. The economic function of a primary capital market is to bring together seekers of funds and investors at mutually acceptable prices or interest rates. A secondary market provides a means for holders of securities in need of funds or for other purposes to dispose of holdings before maturity and for buyers to acquire financial instruments. Many investors consider the original acceptability of investments in terms of their marketability. Even though committed to long-term loans or investments, investors may find that unforeseen events or changing programs and policies often make it expedient to obtain funds through secondary markets.

In terms of that definition and of other characteristics of the mortgage market discussed below, a secondary market for mortgages scarcely existed before the advent of federal mortgage insurance in 1934 and guarantee in 1944. Before that the mortgage market consisted in the main of thousands of local primary markets in which individual borrowers obtained new loans or renewals directly from lenders on the security of individual properties. Each loan was tailored to the specific needs and requirements of borrowers and lenders. With little or no uniformity or standardization in loan contracts, shifting ownership of mortgages among investors was quite limited and expensive. It was based necessarily upon detailed examination and appraisal of property, neighborhood, borrower, and loan terms, and confined to places where the underlying property was located and local investors familiar with economic conditions.

A major exception to this pattern of market activity is that of the real estate bond market of the 1920's. In the apartment house and commercial property real estate boom of that period, investment in real estate securities became quite fashionable and widespread. To permit and encourage the participation of many individual investors in one or more mortgages, those

debt instruments were broken down into real estate bonds of readily marketable face amounts, usually $1,000. The bonds, many with the collateral signature of a so-called mortgage guarantee company, were widely traded in over-the-counter markets, predominantly in New York and Chicago. Investors paid too little attention to the underlying properties or the borrowers, partly because of the so-called guarantee of the bonds and partly because of their marketability. The subsequent collapse of real estate values together with the questionable financial practices of many real estate bond houses and "guarantors" resulted in widespread losses by real estate bond-holders. The real estate bond disappeared as a widespread financial instrument.[16] The acceptability and marketability of mortgage loans among investors, therefore, was at a low ebb in the 1930's.

Introduction of federal mortgage insurance through the Federal Housing Administration in 1934 and of guarantee through the Veterans Administration in 1944 imparted to the mortgage instrument a degree of acceptability, uniformity of quality, and standardization of terms unknown before. The need of the investor for close scrutiny of property and borrower was lessened by the federal government's acceptance of contingent liability for fulfillment of the mortgage contract. Federally underwritten mortgages became broadly shiftable among investors, geographic barriers were sharply reduced, and a national secondary mortgage market began to take form.

Considerable changes also took place in basic techniques in primary mortgage markets associated with financing of new houses. The changes accompanied those taking place in the house building industry generally. Postwar changes in production and marketing of houses—especially the large-scale type of operation—and their effects on mortgage markets have been discussed in several connections. Separate and distinct transactions between each individual mortgagor and lender, typical of prewar mortgage markets, were being replaced by mass mortgage transactions between builders and lenders on behalf of numerous unknown ultimate mortgagors.

[16] Statistics on real estate mortgage bonds may be found in Raymond W. Goldsmith, *A Study of Saving*, Princeton, 1955, Vol. I, Tables R-41 through R-43, pp. 635–637. Among the many references on the general subject of real estate bonds the following are examples: Securities and Exchange Commission, *Report on the Study and Investigation of the Work, Activities, Personnel, and Functions of Protective and Reorganization Committee*, Part III, June 3, 1936; Louis S. Posner, "The Lesson of Guaranteed Mortgage Certificates," *Harvard Business Review*, September 1948, pp. 560–571; Ernest A. Johnson, "Long-term Real Estate Securities," *Journal of Land and Public Utility Economics*, February 1936, pp. 44–47 (includes figures on issues from *Commercial and Financial Chronicle*); *Commercial and Financial Chronicle*, 128 (1929), pp. 316–317; 138 (1934), p. 211; 140 (1935), p. 22; Genevieve Koester, "Chicago Real Estate Bonds, 1919–1938: Corporate History," *Journal of Land Economics*, 1939, pp. 49–58.

These observations are not to suggest that widespread trading exists in all types of mortgages on all types of properties or that the primary mortgage market is characterized essentially by mass transactions. On the contrary, there is still only limited secondary trading in conventional mortgages, which account for the largest share of all those originated or outstanding. In the primary mortgage market, furthermore, individual negotiations between borrowers and lenders are predominant for conventional mortgages on all types of properties, residential and nonresidential. Federally underwritten mortgages on existing houses are also usually arranged individually. Mortgage markets by their nature are basically local, and mortgage contracts still vary widely according to the individual needs of borrowers, characteristics of underlying properties, and requirements of lenders.

Introduction and ultimate broad acceptance of FHA mortgage insurance and VA mortgage guarantee largely eliminated earlier investor problems of acquiring mortgages outside local areas. Instead, new problems of market organization and mortgage acquisition for nonlocal investors arose, as previously described. As large-scale institutional investors established branch offices or worked through institutions located in other cities and states (such as real estate and mortgage companies or commercial banks) market processes and techniques of mortgage origination and ultimate investment, already discussed, became more distinctly separate than ever before. It is from that clear separation of processes that the distinction between primary and secondary marketing of mortgages has emerged. Upon understanding of the special trade meaning of the terms "origination" and "purchase" in the mortgage market hinges our understanding of the meaning of primary and secondary mortgage markets, of relationships between them, and of such statistics that exist on those market transactions.

A mortgage origination is considered in the market as a transaction in which a mortgage loan is made and closed in the name of the originator, whether or not the action is taken for another investor and regardless of the ultimate source of funds. An acquisition or purchase, then, is a transaction in which a mortgage is acquired from an originator, whether or not the mortgage was originated under a prior agreement for such purchase. In this framework, three types of transactions may be identified which would be classified by mortgage market participants as belonging to the secondary mortgage market:

1. Transactions in which mortgages are purchased by investors from originators on the basis of prior allocations of funds or firm commitments

2. Transactions in which mortgages are purchased by investors from originators without prior allocations or commitments, but with the clear intent in origination to sell rather than to hold the completed mortgage

3. Transactions between permanent investors in seasoned mortgages acquired originally by the seller as long-term investments

Of the three types of transactions considered from the standpoint of the economic concept and functions of primary and secondary markets, only the third type might properly be classified as a true secondary market transaction. The first type seems clearly to belong in the primary market classification as a special technique of mortgage acquisition which reflects the organization of mortgage markets and operations of out-of-state mortgage investors.

For the second type of transaction, appropriate classification is less clear. The "open" market in which purchases of this type are made at quoted prices, in contrast to the first type in which purchases are made in a "closed" market on the basis of prior arrangements, may be thought of as a secondary market. On the other hand, mortgages so purchased are originated for the express purpose of sale to a permanent investor, and such transactions are not unlike those in the corporate securities market where new issues are underwritten by investment bankers and offered for sale in the open market to final investors. The techniques, timing, and services performed by respective "originators" in the mortgage and corporate securities markets are, to be sure, vastly different, but the ultimate transactions seem parallel in nature. In transactions defined in 1 and 2 above, the mortgage originator may retain ownership of a mortgage for several months after completion under warehousing arrangements before "selling" to a permanent investor. Where the intent to sell is clear from the beginning, however, especially under prior commitment, extended ownership before sale does not necessarily change the basic nature of the transaction from a primary to a secondary one.

The suggestion here is that a basic criterion for distinguishing between "true" and "pseudo-secondary" and "quasi-secondary" market transactions is the intent and purpose of the seller (indicated partly by the nature of his business) in originating the loan in the first instance. By that criterion, the type 1 transaction may be thought of as a pseudo-secondary market transaction; type 2 as a quasi-secondary market transaction; and type 3 as a true secondary market transaction.

Perhaps a more colorful distinction between types of secondary market transactions is that derived from discussion with an officer of a large

mortgage brokerage firm. He described the secondary mortgage market as consisting of two basic types of transactions: "nepotism loans" controlled by the large life insurance companies and savings banks on the basis of prior allocations of funds and commitments (type 1 above); and loans purchased in the "open wholesale market" created by originators without prior allocation (types 2 and 3 above). A few others representing large mortgage firms regarded the basic type of secondary mortgage market transaction as consisting of loans acquired in the open market without prior allocation or commitment. Those intermediary mortgage dealers were thus in agreement that a mortgage purchase or sale without arrangement before origination was a true secondary market transaction. They did not make the distinction suggested in this study between transaction types 2 and 3.

Just as only one type of transaction clearly fits our definition of a true secondary market, so there is only one equivocal primary market type of mortgage loan transaction. It is the loan made directly by a permanent lender to a borrower for his own portfolio. The bulk of savings and loan association mortgage activity, for example, falls into this category. Most life insurance company mortgage investment activity, in contrast, is conducted through other originators. It is this distinction between methods of loan acquisition, suggested earlier, that is used in this study to classify the few data on primary and secondary market activity. In what follows, secondary market activity encompasses all three types distinguished here.

STATISTICS ON SECONDARY MARKET ACTIVITY

While no direct data on the volume and characteristics of true secondary market transfers, as distinct from the pseudo and quasi types, could be found, some implication may be drawn from the data on transfers of FHA-insured mortgages. Other data on secondary market activity presented here are based on information obtained in the *Census of Housing, 1950*, on estimates prepared in this study from annual reports of life insurance companies, and from a special survey of savings and loan associations. None of the data provide an adequate measure of the volume and character of secondary market activity but are of interest as indicators of market organization and techniques of loan acquisition.

Tables 22 and 23 summarize data from the *Census of Housing, 1950* on originations and purchases of mortgages on owner-occupied and rental residential properties. Of the total amount of owner-occupied mortgages outstanding around mid-1950, about one-fifth was acquired by portfolio holders through purchase, compared with one-fourth for rental property

TABLE 22

First Mortgages Originated and Purchased on Owner-Occupied Properties, by Type of Holder, 1950

	All Holders (1)	Commercial Banks (2)	Mutual Savings Banks (3)	Savings and Loan Associations (4)	Life Insurance Companies (5)	Mortgage Companies (6)	FNMA (7)	Individuals (8)	Other (9)
				AMOUNTS (millions of dollars)					
Total	32,691	6,848	3,200	8,797	5,957	421	968	5,475	1,025
Originated	25,994	6,003	2,466	8,375	3,274	323	—	4,743	815
Purchased	6,697	845	734	422	2,683	98	968	732	210
Conventional	18,939	2,826	1,657	6,097	1,980	115	—	5,470	792
Originated	16,875	2,684	1,396	5,826	1,440	93	—	4,740	696
Purchased	2,064	142	261	271	540	22	—	730	96
FHA-insured	6,603	1,986	683	601	2,854	194	152	—	133
Originated	3,933	1,476	341	555	1,367	135	—	—	63
Purchased	2,670	510	342	46	1,487	59	152	—	70
VA-guaranteed	7,149	2,036	859	2,099	1,124	113	816	4	98
Originated	5,186	1,843	728	1,995	467	96	—	3	55
Purchased	1,963	193	131	104	657	17	816	1	43
				PERCENTAGE DISTRIBUTION					
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Originated	79.5	87.7	77.0	95.2	55.0	76.7	0.0	86.6	79.5
Purchased	20.5	12.3	23.0	4.8	45.0	23.3	100.0	13.4	20.5
Conventional	100.0	100.0	100.0	100.0	100.0	100.0	—	100.0	100.0
Originated	89.1	95.0	84.2	95.6	72.7	80.9	—	86.7	87.9
Purchased	10.9	5.0	15.8	4.4	27.3	19.1	—	13.3	12.1
FHA-insured	100.0	100.0	100.0	100.0	100.0	100.0	100.0	—	100.0
Originated	59.6	74.3	49.9	92.3	48.0	69.6	0.0	—	47.4
Purchased	40.4	25.7	50.1	7.7	52.0	30.4	100.0	—	52.6
VA-guaranteed	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Originated	72.5	90.5	84.7	95.0	41.5	85.0	0.0	75.0	56.1
Purchased	27.5	9.5	15.3	5.0	58.5	15.0	100.0	25.0	43.9

SOURCE: Data from *Census of Housing, 1950,* Vol. 4, *Residential Financing,* Part 1, United States, Chapter 2, Table 2, p. 40; Table 4, p. 76; Table 4.a, p. 79; Table 4.b, p. 87, and Table 4.c, p. 89.

mortgages.[17] Wide differences were reported among types of holders and types of mortgages, however. Among owner-occupied mortgages, two-fifths of those insured by FHA and over one-fourth of those guaranteed by VA were acquired by purchase compared with only a little over one-tenth of conventional loans. Of all portfolio holders, life insurance companies acquired the largest proportion of their mortgages, including over one-half

[17] For the sake of brevity, the terms owner-occupied mortgages and rental property mortgages will be used here to denote mortgages secured by owner-occupied houses and by all kinds of rental properties, respectively.

TABLE 23

First Mortgages Originated and Purchased on Rental Properties, by Type of Holder, 1950

	All Holders (1)	Commercial Banks (2)	Mutual Savings Banks (3)	Savings and Loan Associations (4)	Life Insurance Companies (5)	Mortgage Companies (6)	FNMA (7)	Individuals (8)	Other (9)
				AMOUNTS (millions of dollars)					
Total	10,251	1,340	2,592	1,178	2,832	145	70	1,510	583
Originated	7,684	1,191	1,658	1,111	1,992	98	—	1,212	422
Purchased	2,567	149	934	67	840	47	70	298	161
Conventional	7,970	896	2,209	1,016	1,793	95	—	1,510	452
Originated	6,364	836	1,474	964	1,435	73	—	1,212	370
Purchased	1,606	60	735	52	358	22	—	298	82
FHA-insured	1,930	331	338	67	987	45	42	—	119
Originated	1,064	252	143	60	543	20	—	—	46
Purchased	866	79	195	7	444	25	42	—	73
VA-guaranteed	352	113	45	96	53	4	28	—	11
Originated	256	103	41	87	14	4	—	—	5
Purchased	96	10	4	9	39	—	28	—	6
				PERCENTAGE DISTRIBUTION					
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Originated	75.0	89.0	64.0	94.3	70.3	67.6	—	80.3	72.4
Purchased	25.0	11.0	36.0	5.7	29.7	32.4	100.0	19.7	27.6
Conventional	100.0	100.0	100.0	100.0	100.0	100.0	—	100.0	100.0
Originated	79.8	93.3	66.7	94.9	80.0	77.0	—	80.3	81.9
Purchased	20.2	6.7	33.3	5.1	20.0	23.0	—	19.7	18.1
FHA-insured	100.0	100.0	100.0	100.0	100.0	100.0	100.0	—	100.0
Originated	55.1	76.1	42.3	89.6	55.0	44.4	—	—	38.7
Purchased	44.9	23.9	57.7	10.4	45.0	55.6	100.0	—	61.3
VA-guaranteed	100.0	100.0	100.0	100.0	100.0	100.0	100.0	—	100.0
Originated	72.7	91.2	91.1	90.6	26.4	100.0	—	—	45.5
Purchased	27.3	8.8	8.9	9.4	73.6	—	100.0	—	54.5

SOURCE: Same basic source as Table 22; Chapter 5, Table 2, p. 348; Table 4, p. 389; Table 4.a, p. 393; Table 4.b, p. 395; Table 4.c, p. 397.

of their FHA and VA loans, by purchase rather than origination. Savings and loan associations acquired only a very small proportion of all mortgage holdings through purchase. Except for FHA loans, savings banks and commercial banks also acquired a modest amount of their holdings by purchase rather than origination.

Somewhat different figures, but a similar pattern, characterized activity in rental mortgages outstanding as of mid-1950. One difference worth noting in the savings banks data is the much larger proportion of conventional mortgage loans on rental properties than on owner-occupied

properties acquired through purchase—one-third compared with less than one-sixth. While there are no data on the subject, market discussion suggests that this large proportion of rental property mortgage purchases consists chiefly of pseudo and quasi purchases from originators scattered throughout large states where the banks are located or in adjoining states.[18]

The large proportion of mortgages reported as purchased by mortgage companies (Tables 22 and 23)—surprising in view of the basic nature of mortgage company operations—is owing in large part to the activities of Institutional Securities Corporation (ISC), an organization wholly owned by New York State savings banks. The Corporation has been classified as a mortgage company by FHA for purposes of statistical reporting, and apparently also by the Bureau of the Census. ISC purchased a large volume of FHA-insured mortgages for savings banks accounts before 1950, when state statutes were amended to permit savings banks to purchase out-of-state mortgages on their own. Since 1950 purchases by the Corporation have declined sharply, as indicated by FHA data on mortgage company purchases (Table 24) and by personal interviews with ISC officials.

Ordinary mortgage companies on occasion purchase mortgages from individuals and from other originators to meet demands for mortgages. Such purchase activity was not uncommon before 1951, when demands for mortgages by investors were generally larger than the available supply. While no other except FHA data are available, it seems clear that purchases by mortgage companies have been an insignificant part of their activities in recent years.

Comprehensive data for the postwar decade on primary and secondary mortgage market activity are available only for FHA-insured mortgages in the reports on "originations" and "transfers," which the Federal Housing Administration receives directly from mortgage lenders. The institution in whose name the mortgage loan is closed and insured is considered to be the originator even though the loan is to be transferred immediately to a permanent investor. Thus, a loan made by a mortgage company for ultimate sale to a life insurance company is reported as both an origination and sale for the mortgage company and as a purchase for the life insurance company. Clearly, transfer activity as reported by FHA, summarized in Tables 24 and 25, includes pseudo and quasi transfers as well as true transfers. Some inferences about the volume of true secondary market

[18] Laws of some savings bank states permit acquisition of conventional mortgage loans in adjoining states.

TABLE 24

Primary and Secondary Market Activity of Main Types of Finanical Institutions in FHA-Insured Home Mortgages, 1947–1956
(millions of dollars)

	All Lenders			Financial Institutions											
				Commerical Banks			*Mutual Savings Banks*			*Insurance Companies*			*Savings and Loan Associations*		
YEAR	Holdings (1)	Originations (2)	Transfers (3)	Originations (4)	Purchases (5)	Sales (6)	Originations (7)	Purchases (8)	Sales (9)	Originations (10)	Purchases (11)	Sales (12)	Originations (13)	Purchases (14)	Sales (15)
1947	4,146	895	278	276	98	86	21	30	1	185	133	25	98	3	21
1948	5,564	2,087	887	657	157	253	64	90	3	468	487	60	221	3	48
1949	7,438	2,206	1,100	672	86	281	110	145	7	507	569	80	238	4	73
1950	9,228	2,469	1,421	730	230	320	189	268	11	514	757	74	266	17	64
1951	10,647	1,929	1,313	669	194	350	126	351	11	329	666	63	174	8	71
1952	11,786	1,914	988	707	190	272	85	237	30	267	397	54	170	17	40
1953	13,319	2,262	1,375	822	131	324	107	310	8	277	566	69	233	30	51
1954	14,491	1,938	1,340	669	176	325	114	311	4	228	461	48	209	37	43
1955	16,245	3,077	1,345	1,078	244	389	222	325	20	343	574	66	378	36	46
1956	17,838	2,639	1,506	1,029	166	375	238	389	16	220	735	65	251	37	45

SOURCE: Data in Annual Reports of the Federal Housing Administration. Data on total volume of insured home mortgages originated by type of institution for years prior to 1947 are not available. Data for mortgage companies, federal agencies, and all other institutions are not shown separately, but the relative importance of purchases and sales by those institutions is given in Table 25.

TABLE 25

Purchases and Sales of FHA-Insured Home Mortgages as Per Cent of Total Transfer Activity, by Type of Institution, 1945–1956

Year	*Total Purchases or Sales* (millions)	*Commercial Banks*		*Savings Banks*		*Insurance Companies*		*Savings and Loan Assns.*		*Mortgage Companies*		*Federal Agencies*		*All Other*	
		Purchases	Sales	Purchases	Sales	Purchases	Sales	Purchases	Sales	Purchases	Sales	Purchases	Sales	Purchases	Sales
1945	$478	36	26	10	1	40	5	3	4	4	35	4	22	3	7
1946	266	45	26	8	1	37	8	2	5	4	44	[a]	9	5	8
1947	278	35	31	11	[a]	48	9	1	8	3	43	[a]	1	2	9
1948	887	18	29	10	[a]	55	7	[a]	5	3	52	12	[a]	2	7
1949	1,100	8	26	13	1	52	7	[a]	7	2	51	24	[a]	1	9
1950	1,421	16	23	19	1	53	5	1	5	2	46	6	15	3	6
1951	1,313	15	27	27	1	51	5	1	5	2	51	3	6	2	6
1952	988	19	28	24	3	40	6	2	4	3	52	10	3	2	6
1953	1,375	10	24	23	1	41	5	2	4	2	61	20	2	3	4
1954	1,340	13	24	23	3	34	4	3	3	2	61	21	5	3	4
1955	1,345	18	29	24	1	43	5	3	3	2	57	8	1	2	3
1956	1,506	11	25	26	1	49	4	2	3	1	64	7	1	3	2

SOURCE: Data in Annual Reports of the Federal Housing Administration.

[a] Less than 0.5 of 1 per cent.

activity may be drawn from the tables, which are limited to activity in home mortgages and show face amounts of mortgages.

The total volume of FHA-insured mortgage originations has exceeded transfers by a substantial margin in each postwar year (Table 24). In most years, the ratio of transfers to originations has ranged between one-half and two-thirds, with no steady pattern of growth or decline. Compared with the face amount of home mortgage loan holdings of all lenders, transfers have varied between 8 and 16 per cent, the lower percentages prevailing in more recent years.

Among financial institutions, the pattern of activity is similar to that suggested by 1950 Census data: insurance companies and savings banks having a volume of purchases well in excess of originations; savings and loan associations and commercial banks having a volume of originations far greater than purchases. Sales of FHA-insured home mortgages by savings banks, insurance companies, and savings and loan associations were very small throughout the first postwar decade; indeed, in the case of savings banks and insurance companies markedly smaller than purchases. Commercial banks, on the other hand, showed a substantial volume of sales that in most years was much greater than purchases. As indicated in Table 25, mortgage companies and commercial banks account for the bulk of all sales activity, insurance companies and savings banks for the bulk of all purchases.

In these data on originations, purchases, and sales can we distinguish between true secondary market activity and pseudo- or quasi-secondary market activity? An approximation may be attempted on the basis of our knowledge of the nature of financial institutions' operations in the mortgage market. If we assume that sales by mortgage companies (Table 25) are entirely of the pseudo or quasi type, then the maximum amount of true FHA mortgage sales would, in most postwar years, amount to less than one-half of total reported FHA transfers, and in some years to little more than one-third. A minimum estimate of true mortgage transfer activity might be approximated also by excluding sales by commercial banks, on the assumption that those institutions originate FHA-insured mortgages chiefly for resale to other institutions. Of sales by only the principal types of savings institutions—savings banks, savings and loan associations, and insurance companies—by the Federal National Mortgage Association, and by miscellaneous lenders, the minimum volume of true sales of FHA-insured mortgages would amount to between 12 and 30 per cent of total sales of those mortgages in the postwar years.

This must be considered the minimum range, of course, because some

proportion of commercial bank sales represent seasoned mortgages from portfolios, just as do sales from savings institutions—primarily in the business of holding mortgages. Thus, somewhere between the minimum and maximum figures cited lies an approximation of true secondary market activity in FHA-insured home mortgages. If we arbitrarily assume one-half of commercial bank sales to be of seasoned mortgages, then in 1956, for instance, the volume of true transfers would amount to $352 million, or about 2 per cent of the face amount of mortgages outstanding at the end of 1956. Even at maximum, the proportion of true transfers to outstandings would be less than 5 per cent.

On this basis (eliminating all mortgage company sales and one-half of commercial bank sales), the volume of true secondary market activity in FHA-insured home mortgages may have amounted to between 12 and 13 per cent of primary market activity (originations) in 1955 and 1956. It may have been somewhat more in 1953 and 1954 (averaging around one-sixth), when originations were considerably smaller and transfers almost the same as in the later years. In postwar years before 1953 the ratio of secondary to primary market activity ranged between 13 and 18 per cent, except in 1950 and 1951 when the ratio reached almost one-fourth, because of the large proportion of sales by FNMA under the "one-for-one program."[19]

Without comprehensive data comparing primary and secondary market activity in VA and conventional home mortgages, an idea of the proportion of secondary market activity can be gleaned from general knowledge of market techniques and from a few data on purchases by savings banks (Table 15), and life insurance companies (Table 26). It is clear that VA secondary market activity of all types, quasi and pseudo as well as true transfers, is at least as large a proportion of primary activity as the proportion of secondary activity in FHA home mortgage markets. It seems logical to conclude, therefore, considering the similar nature of the instruments, that true secondary market activity in both VA mortgages and FHA home mortgages is about the same proportion of total market activity.

Nothing is known about the volume of trading in conventional mortgages except that, for obvious reasons, it is considerably smaller than the trading in federally underwritten mortgages. Data from the *Census of Housing, 1950* (Table 22) indicate that the percentage of conventional home mortgages outstanding in mid-1950 acquired by purchase was between one-third and one-fourth of the percentage of federally underwritten mortgages so acquired. A comparable ratio of true secondary

[19] See Chapter 3 for an explanation of this program.

market transfers in conventional mortgages to transfers in federally underwritten mortgages suggests that the former account for about 5 per cent, more or less, of total primary activity in conventional home mortgages. Primary lending on conventional mortgages accounts for the largest part of home mortgage lending—between two-thirds and three-fourths in recent years, on the basis of mortgage recordings. If our estimated percentages are weighted by these proportions, it would appear that true secondary market activity in home mortgages of all types represents somewhere between 7 and 10 per cent of total primary activity, and approximately 2 to 4 per cent of the amount of total home mortgage debt outstanding.

Data on market activity in FHA multifamily mortgages are available in the same detail as for FHA home mortgages. By application of a similar estimating technique, the ratio of true secondary to primary market activity for FHA multifamily mortgages seems to be somewhat higher and more erratic than the ratio for FHA home mortgages. One difference to be taken into account is that the bulk of originations and sales of FHA multifamily mortgages is made by commercial banks, not by mortgage companies. One explanation is that commercial banks make most of the construction loans on FHA multifamily properties. Such loans are insured by the Federal Housing Administration (unlike most one- to four-family construction loans insured by FHA only after the permanent mortgage is closed) and reported in the statistics as originations. When construction is completed and the permanent mortgage taken over by the ultimate investor, the transaction is recorded by FHA as a sale and purchase. In estimating the volume of true secondary market activity in FHA multifamily mortgages, therefore, it is probably appropriate to eliminate all sales by commercial banks as well as by mortgage companies. Conventional mortgages on multifamily properties are traded about as infrequently as conventional mortgages on one- to four-family properties.

Concerning some other aspects of secondary market activities of major types of financial institutions, for an indication of the importance of out-of-state purchases of mortgages by mutual savings banks, see Chapter 6. Data on the significance of mortgage purchases (quasi and pseudo, and true) in the activities of life insurance companies and of savings and loan associations are presented in Tables 26 through 28. Data shown are subject to an unknown amount of error, but the general order of magnitude and the comparisons among types of mortgages are undoubtedly accurate enough to warrant a few broad conclusions.

Total purchases of mortgages by life insurance companies have constituted something over one-third of their total mortgage acquisitions since

TABLE 26

Mortgage Loans Purchased by Life Insurance Companies, 1946–1955

		1- to 4-Family						
Year	*Total* (1)	Total (2)	FHA (3)	VA (4)	Conventional (5)	*Multi-family* (6)	*Commercial* (7)	*Farm* (8)
				AMOUNTS (millions of dollars)				
1946	415	310	88	192	30	39	57	9
1947	808	637	120	426	91	56	91	24
1948	1,022	837	445	227	165	111	59	15
1949	894	670	530	65	75	148	66	10
1950	1,713	1,436	620	716	100	175	80	22
1951	1,900	1,557	547	800	210	187	135	21
1952	1,233	987	366	274	347	120	107	19
1953	1,438	1,208	483	359	366	80	128	22
1954	2,003	1,737	395	1,122	220	92	153	21
1955	n.a.	n.a.	612	1,474	n.a.	n.a.	n.a.	n.a.
				PERCENTAGE DISTRIBUTION OF TOTAL MORTGAGE ACQUISITIONS				
1946	25	40	63	74	8	18	10	5
1947	29	41	59	71	14	22	11	9
1948	30	42	52	62	21	24	10	5
1949	26	37	54	50	11	24	8	3
1950	35	45	51	74	10	30	11	6
1951	37	47	64	62	18	32	13	5
1952	31	42	60	64	26	25	14	5
1953	33	45	65	79	24	23	15	5
1954	37	50	65	81	15	24	14	5
1955	n.a.	n.a.	65		n.a.	n.a.	n.a.	n.a.

SOURCE BY COLUMN:

(1, 2, 6, 7, 8) For years 1946–1953, unpublished data obtained by the Federal Home Loan Bank Board (FHLBB) in annual surveys of mortgage lending activities of life insurance companies. Ratios of loans purchased to total acquisitions indicated by these data were applied to revised figures on acquisitions (FHLBB, *Nonfarm Mortgage Investments of Life Insurance Companies*, 1955, p. 3) to derive adjusted figures for loans purchased. The relationship between purchases and acquisitions shown by the FHLBB data were checked for recent years and found to agree closely with information contained in annual statements of ten leading life insurance companies accounting for about one-half of total life insurance company assets in 1954. The 1954 annual statements were, therefore, used as the basis for deriving data in 1954, since FHLBB discontinued receiving purchase and origination figures after 1953.

(3) Derived from unpublished FHA data on face amount of originations and purchases of life insurance companies (published figures are for all insurance companies). Acquisitions, upon which percentages shown in this table are based, were derived by applying to total FHA mortgage acquisitions, as reported by the Institute of Life Insurance, the ratio of FHA one- to four-family acquisitions to total, as indicated by FHA data.

(4) Calculated by subtracting figures on originations reported by VA from figures on acquisitions reported by the Institute of Life Insurance.

(5) Col. 2 minus sum of Cols. 3 and 4.

n.a. = not available.

1950, compared with an average of a little over one-fourth in preceding postwar years (Table 26). The bulk of these purchases has been of one- to four-family mortgages, mostly insured or guaranteed by the federal government. Throughout the postwar decade purchases accounted for the largest proportion of FHA and VA mortgage acquisitions—a proportion showing, however, erratic fluctuations through the years. The proportion of conventional home mortgage loans obtained through purchase has been fairly modest throughout, and larger in the later than earlier years.

TABLE 27
Primary and Secondary Mortgage Market Activity of Savings and Loan Associations, 1952–1955
(millions of dollars)

	Outstanding (end of year)	Originations	Purchases (during year)	Sales
1952	18,396	6,617	151	201
1953	21,962	7,767	289	161
1954	26,193	8,969	463	279
1955	31,584	11,432	508	399

SOURCE: Based on data for all associations insured by the Federal Savings and Loan Insurance Corporation and shown in FHLBB release, "Mortgage Lending Activity of Savings and Loan Associations," September 1955. Loans originated by insured associations accounted for from 88 to 92 per cent of loans originated by all associations in 1952–1955, and ratios of transfer activity were assumed to be about the same.

While quantitative evidence is lacking, market observation and discussion lead one to conclude that these data on mortgage purchases of life insurance companies reflect chiefly pseudo- and quasi-secondary methods of loan acquisition, and only in minor part true secondary market trading in seasoned mortgages. Thus the data reinforce the general impression that most mortgages on commercial and farm properties in portfolios of life insurance companies are originated directly by them, rather than being acquired indirectly through originators, as home mortgages are. The latter are obtained mainly through mortgage loan correspondents, usually on the basis of prior commitments. Purchases of seasoned mortgages from portfolio holders are only occasional, when available funds exceed earlier expectations and planning. Life insurance companies rarely sell mortgages from their portfolios.

Data on secondary market activities (defined in the broadest sense) of savings and loan associations, made available for the first time in 1955, confirm general knowledge of the insignificance of such activity with respect to their own mortgage operations. These data, shown in Table 27,

are somewhat surprising, however, in that the absolute volume of mortgage purchases by savings and loan associations is quite significant in comparison with the volume purchased by life insurance companies and by savings banks--both considered to be active participants in secondary markets.

Between 1952 and 1955 mortgage purchases and sales by savings and loan associations increased significantly but remained a small part of their total mortgage activity, never exceeding 2 per cent of outstandings or 5 per cent of acquisitions. The total volume of savings and loan mortgage purchases in those years was nevertheless substantial, about one-fourth of that of life insurance company purchases and about one-half of that of savings banks.

Additional evidence on the nature and characteristics of savings and loan secondary market activity was obtained as part of a survey made in this study and noted in Chapter 6. The primary purpose of the survey was to clarify problems associated with gross mortgage lending activity of savings and loan associations. Supplementary questions on mortgage purchases and sales, a little known aspect of savings and loan activity, were included also. Returns from the survey were too small to justify firm conclusions in quantitative form, but not too small to be used as guides to characteristics of purchases and of sales activity—also practically unknown before that. In view of limitations in the data, calculations were made from survey results in the form of percentage distributions, presented in Table 28. The figures should be considered primarily as approximate magnitudes. Some encouragement about the validity of the data, however, may be drawn from a comparison with similar data for all insured associations. For the latter group, mortgage purchases, as reported by the Federal Home Loan Bank Board (Table 27), accounted for 3.7 per cent of mortgage originations in 1953, 5.2 per cent in 1954, and 4.4 per cent in 1955. In the survey made for this study, mortgage purchases in those years represented 3.8, 8.5, and 3.9 per cent, respectively. The difference is significant only for 1954 and the direction of change between years is identical.

Of the 58 savings and loan associations responding to the questionnaire, 33 or nearly three-fifths indicated that they had engaged in some purchasing or selling of mortgages during the three years from 1953 through 1955. Among states, California accounted for both the largest number of associations and largest amount of transfer activity. Of the 11 California associations reporting in the survey, 9 indicated that they had bought or sold mortgages. Most other associations reporting secondary market activity were located in the Midwest and Southwest.

Moitgage purchases of savings and loan associations are made more often than not on the basis of prior commitments. They consist principally of VA loans, and are obtained most frequently from mortgage companies (Table 28). The conclusion seems fair, therefore, that a large part of savings

TABLE 28
Percentage Distribution of Amounts of Mortgage Purchases and Sales by Savings and Loan Associations, 1953–1955

	Purchase			*Sale*		
Type of Purchase or Sale	1953	1954	1955	1953	1954	1955
Total	100	100	100	100	100	100
Prior commitment						
With	52	58	60	3	3	2
Without	48	42	40	97	97	98
Type of mortgage						
VA	73	85	73	63	76	66
FHA	16	8	15	7	3	2
Conventional	11	6	13	30	21	32
Type of purchaser or seller						
Life insurance company	—	—	—	16	17	30
Savings bank	—	—	—	57	57	56
Commercial bank	—	—	3	—	8	10
Savings and loan association	4	12	28	3	11	1
Mortgage company	73	56	56	15	1	2
FNMA	11	24	7	—	6	—
Other[a]	13	7	7	9	—	1

SOURCE: Replies of 58 savings and loan associations in survey made in this study.
[a] Individuals and the Veterans Administration.

and loan purchase activity is of the pseudo- or quasi-secondary type. The only private financial institutions, except mortgage companies, from which a significant proportion of mortgages is purchased are other savings and loan associations. In 1955, especially, such purchases rose sharply, perhaps because of the tight position experienced by some as a result of borrowing restrictions imposed by Federal Home Loan Banks. For those associations, sale of mortgages from portfolio became necessary in order to honor outstanding commitments. Purchases from FNMA were especially important in 1954, when savings and loan associations had more funds available than investment in private mortgage markets could absorb. The data indicate that, on occasion, savings and loan associations have purchased mortgages from private individuals and from the Veterans Administration. The latter purchases consisted chiefly of direct loans made by VA to veterans unable to obtain financing from private lenders.

Mortgage sales made by savings and loan associations, in contrast to

purchases, were almost entirely without prior commitment. While consisting largely of VA loans, they included a significant proportion of conventional mortgages. Such activity is fundamentally of the true secondary market variety. Most sales were made to savings banks and life insurance companies, although most other types of institutions were represented among the purchasers. The reader is reminded (Chapter 6) that the high percentage of sales to savings banks shown in the table reflects in the main the activity of one large California savings and loan association. Perhaps most surprising in the data on sales is the large proportion of conventional mortgages. That they were sold to all types of financial institutions is the only information we have on the characteristics of such mortgages. Undoubtedly both newly originated and seasoned mortgages were included, the latter probably increasing proportionately towards the end of 1955 when some savings and loan associations were pressed for funds.

With respect to secondary mortgage market activities, we may recall that general brokerage business is prohibited for federal savings and loan associations. The law allows them to sell any type of mortgage loan at any time so long as total sales in a calendar year do not exceed 20 per cent of the dollar amount of mortgage loans held at the beginning of the year. Federal associations may purchase any type of mortgage loan originated by them. They may purchase federally insured and guaranteed loans (up to a maximum amount of $35,000) on property located outside of their regular lending area—usually within a radius of fifty miles from an associations' home office.[20]

MARKETING ORGANIZATION, COSTS, AND PRICES

The institutional framework of primary and secondary mortgage markets, defined however broadly or narrowly, overlaps both ways. Some institutions participate more extensively in one market than the other; some perform more specialized functions than others; but most participate in both markets to some degree.[21] Briefly, the structural organization of mortgage markets consists of mortgage originators, construction lenders, interim lenders, brokers, and ultimate investors. Of the functions implied by these terms only mortgage origination and brokerage are performed by specialized organizations—mortgage companies and mortgage brokers—created for those purposes and performing few other functions. Other

[20] For more details on these regulations see *Rules and Regulations of the Federal Savings and Loan System,* as amended, Federal Home Loan Bank Board, Secs. 145.6–5, 145.6–6, and 145.11.

[21] The functions and operating techniques of major market participants were discussed in Chapter 6 and some aspects of market organization have been touched upon above.

major types of market participants perform at least two or more functions in the market.

Savings and loan associations, for example, primarily originate mortgages directly for ultimate investment, but engage in construction lending as well. Commercial banks provide construction and interim financing, originate mortgages for resale to others, and also hold large mortgage portfolios for investment. Savings banks acquire mortgages for ultimate investment by direct origination or acquisition through other originators. They occasionally make construction loans. Life insurance companies are engaged in permanent mortgage lending either through direct origination or indirect acquisition.

All participate to some extent in the buying and selling of mortgages, as indicated in the preceding section. There are no specialized institutions, organized markets, or established exchanges through which trading in mortgages takes place, except the federally organized and sponsored Federal National Mortgage Association (see the next section). Purchases and sales of mortgages in the "open market"[22] are arranged either directly by the participants themselves or through mortgage brokerage houses, which operate also in primary markets. No data on the relative proportions of direct trading and trading through intermediaries are available. Information from interviews suggests that the largest proportion is carried on through direct negotiation, on the basis of general knowledge of the market and contacts in it. While many individuals and small organizations are engaged locally in mortgage brokerage business, only a handful of large-scale brokers, with principal offices in New York, arrange transactions on a national scale.

In the secondary mortgage market, marketing costs are difficult to separate from prices. When funds available for investment exceed the supply of mortgages, lenders may be willing to pay fees or premiums to obtain them. When the reverse situation obtains, fees decline or disappear. The fee is essentially a cost of marketing or a part of the mortgage price. Marketing costs, in the sense of direct charges for mortgage purchase or sale, are incurred only when brokers have arranged a transaction. When transactions are directly negotiated between participants, no marketing costs are involved. In brokerage transactions, marketing costs to clients generally range from $\frac{1}{4}$ to $\frac{1}{2}$ of 1 per cent of the mortgage loan. The smaller the transaction, the higher the percentage rate and cost.

[22] The "open market" concept includes quasi- and true secondary transactions as defined earlier. Pseudo-secondary transactions are excluded because they are based on prior arrangements and may be considered as occurring in a "closed" market.

In primary mortgage market transactions, the basis of marketing costs charged by brokers is the same as in the secondary market. In the primary market, however, several other charges or fees, which vary with market conditions and types of services, are levied directly by lenders against borrowers or builders. A 1 per cent fee is common for the origination of a permanent mortgage, for a construction loan, or for a firm take-out commitment. The charges may all be levied and earned by the one lender involved (for example, a savings and loan association may provide the construction loan, take-out commitment, and permanent mortgage financing in a package transaction). Or they may be charged by several lenders, when each provides a specialized service (for example, a commercial bank may charge the construction loan fee, a mortgage company the mortgage origination fee, and an insurance company the commitment fee). The charges, if considered part of marketing costs, raise the cost of primary mortgage marketing substantially above that of secondary mortgage marketing.

Perhaps the nearest approach to a specialized institution or organized trading place in the private secondary mortgage market is provided by the large-scale mortgage brokerage house (distinct from the mortgage company, the subject of Chapter 8). One outgrowth of the increasing volume of secondary market transactions during the postwar decade is the rapid growth in business of the few national brokerage houses, rather than in any significant increase in their number. Mortgage brokers have arranged transactions for most major types of institutions and between them—savings banks, commercial banks, savings and loan associations, pension funds, and mortgage companies. Insurance companies, however, have seldom made use of brokerage services.

While no statistical evidence is at hand, interviews suggest that the largest part of secondary market transactions arranged by brokers is the quasi rather than true secondary type. One reason is that the over-all volume of true secondary trading transactions is still relatively small. Another is that the development and use of the standby commitment technique in periods of credit stringency has increased the proportion of mortgages originated without firm take-out commitments and offered upon completion for sale in the open market. Mortgage originators having such mortgages available and offering them at standby prices often seek the services of mortgage brokers to find buyers. Mortgage investors, on the other hand, unwilling or unable to commit for mortgages months in advance, may approach brokers to obtain through them mortgages for immediate delivery. The broker maintains his market for mortgages

through trade journal and direct mail advertising of mortgage offerings and investors' specifications.

Lack of data and confusing market terminology make comparison of primary and secondary mortgage market prices extremely difficult. There is no way to compare directly the price of an originated mortgage with its price when sold in the secondary market. Unlike the situation in corporate or government securities markets, information about specific mortgage instruments according to borrower or underlying property is not generally available. Nor is distinction between a new issues market and a secondary market so clear as it is in those others. A definite distinction is made, however, between pricing mortgages available for immediate or for future delivery. Further ambiguity about mortgage prices arises because FHA and VA loans, with fixed interest rates, are originated and also traded in terms of discounts or premiums, while conventional loans, with flexible interest rates, are originated at par on the basis of changing interest rates but are traded, like FHA and VA mortgages, in terms of discounts or premiums from par.

For the purpose of price comparison, pseudo- and quasi-secondary market transactions may be considered equivalent to primary market transactions because they involve newly originated mortgages. Mortgages of comparable quality (judged so by the market on the basis of underlying property and location, mortgage terms, type of borrower) will generally command the same price. This is true whether they are originated directly by the investor; obtained indirectly through an originator on the basis of a prior commitment (pseudo-purchase); or obtained for immediate delivery from an originator without prior commitment (quasi-purchase). The mortgage with prior commitment will, of course, bear the price agreed upon at the time the commitment was made. It may be higher or lower than the market price by the time the mortgage is delivered. Price differentials, which may exist between pseudo- and quasi-type transactions, reflect differences in timing rather than in nature of transactions. True secondary market trading in mortgages, on the other hand, may command a premium over otherwise comparable mortgages because of "seasoning." Evidence on this point is thin, however, because of the limited number of transactions and transactors in that market.

Some originators have testified that they have been able to get higher prices from investors—as much as 1 per cent higher—on mortgages held for a year or so after completion than on those sold immediately upon completion. This is attributed to the greater assurance that can be given the investor about the credit worthiness of the mortgagor, the promptness

of his payments, the soundness of the underlying property and its location. Discussion with FNMA officials has also revealed that investors often prefer to purchase somewhat seasoned mortgages from FNMA's portfolio. Mortgages that are too old in the sense that outstanding balances have been reduced to low levels are undesirable because the return is small compared with the cost of servicing—the same for small and large mortgages. But because there is no organized or continuous market for trading in older mortgages, each transaction is subject to individual negotiation, the price being influenced by the relative bargaining position of the participants, among other special considerations. Chief of those determining the level of mortgage prices in the true secondary market are the general financial situation and the prevailing prices in the primary mortgage market.

THE FEDERAL NATIONAL MORTGAGE ASSOCIATION

In the American capital markets the existence of a single federally sponsored and organized secondary market facility is unique. An analysis of the nature and characteristics of primary and secondary mortgage markets, therefore, requires a description and appraisal of the role of the Federal National Mortgage Association (FNMA). An appraisal of the impact on postwar mortgage markets of major statutory and administrative changes in FNMA operations was given in Chapter 3. In this section we are concerned with the developing history and operations of FNMA from its pre-World War II background and early charters to its latest reorganization in November 1954.

Background and Development

During its lifetime beginning in 1938, FNMA has been organized under three separate charters, reflecting changing needs in the mortgage market and changing philosophies about the nature and scope of federal intervention in this market. The original formation of the Association occurred against a background of federal efforts to stimulate housing construction, building materials production, and mortgage investments following the unprecedented decline during the Great Depression. The basic program of federal mortgage insurance was to be supplemented in part by a program to achieve greater liquidity and marketability of institutional mortgage investments, especially FHA-insured mortgages. To this end, federal chartering of private national mortgage associations to buy and sell first mortgages on residential real estate was authorized in 1934 under the supervision of the Federal Housing Administrator.[23]

[23] National Housing Act, Title III, enacted June 27, 1934.

Initially, to obtain charters, mortgage associations were required to have paid-in capital of $5 million in cash or government securities. Supplementary capital to finance operations was to be obtained through issue of notes, bonds, debentures, or other obligations to the general public. Amounts allowed were up to ten times the par value of capital stock but not in excess of the face value of insured mortgages, cash, and government obligations owned by an association. The organizations authorized were thus similar to mortgage banks long popular in Europe.

When no private national mortgage associations were formed under the original act, a series of liberalizing amendments was enacted over a period of about three and one-half years, successively reducing capital stock requirements and increasing borrowing capacity, authorizing direct lending on some types of FHA-insured mortgages, and exempting associations from all federal, state, and local taxes. Still not a single private national mortgage association was organized. Finally, perhaps to demonstrate the feasibility of such associations, the Reconstruction Finance Corporation was asked by the President, under authority granted earlier, to organize and manage a national mortgage association in Washington.

On February 10, 1938, the National Mortgage Association of Washington was chartered by the Federal Housing Administrator with an initial paid-in capital and surplus of $11 million and borrowing capacity limited to twenty times that. Further, the RFC was prepared if necessary to contribute an additional $40 million to the capital of this and other national mortgage associations, if formed. The functions of national mortgage associations were at that time defined as "maintaining an active market for insured mortgages and a steady flow of mortgage money at relatively favorable interest rates, and of providing an avenue of investment for individuals and institutions heretofore unable to benefit directly from the insured mortgage program."[24]

On April 5, 1938, the National Mortgage Association of Washington was named Federal National Mortgage Association, better known subsequently as "Fanny May." While authority for chartering private national mortgage associations still existed, none were formed. The act of July 1, 1948, providing for the reorganization of FNMA under a new charter rescinded authorization for them.

The failure to establish a privately owned secondary mortgage market facility in the 1930's was probably the result of a combination of circumstances. For some time following the enactment of the FHA mortgage

[24] "Opening the Mortgage Association Field," *Insured Mortgage Portfolio*, Federal Housing Administration, p. 3, March 1938.

insurance program, FHA-insured loans were not readily acceptable to mortgage lenders. Their provisions for long-term amortization, relatively high ratios of loan-to-value, and relatively low interest rates were radical departures from mortgage lending practices then in effect. In 1934 and 1935, home mortgage loans of less than $100 million were insured by FHA, less than 5 per cent of the two-year total volume of home mortgage loans made. In 1936 the volume of FHA mortgage insurance increased substantially but, by 1938, when the last federal attempt was made to encourage formation of private national mortgage associations, the rate of expansion had slowed considerably. During the three years 1936–1938, only about one-sixth of home mortgage lending was insured by FHA compared with three-tenths in the postwar decade.

Mortgage bankers and investors were reluctant to invest in the capital stock of untried associations dealing in untried mortgages when real estate and building activities were depressed. Even if FHA mortgages should become widely accepted on the market, the outlook for profitable operation of national mortgage associations seemed doubtful. The prospective net return on invested capital seemed low, judging from likely costs of operation and borrowing. Then, after establishment of a federally owned corporation to buy and sell federally underwritten mortgages, there was little chance that a private mortgage corporation would be organized.[25]

FNMA, during the first phase of its operations from February 1938 to July 1948, was limited to the purchase of FHA-insured mortgages and to a maximum lending capacity of $220 million. Under those limitations and the impact of World War II, the Association's activities were on a fairly modest scale. Total purchases during the decade amounted to $318 million and sales to $166 million. Mortgage repayments and other receipts reduced FNMA's portfolio to only $4 million by the end of 1947. Practically all

[25] Three years before the National Mortgage Association of Washington (later FNMA) was established, the RFC Mortgage Company, on March 14, 1935, under authority granted three months earlier (P.L.1, 74th Congress, Jan. 31, 1935), became a subsidiary of the Reconstruction Finance Corporation "to assist in the reestablishment of a normal mortgage market." Originally, rather than acting as a secondary market facility, the company provided direct loans for new construction or refinancing of income properties, as HOLC was doing in the residential housing area. By 1936, in the absence of national mortgage associations, the RFC Mortgage Company was authorized to purchase from original mortgagees certain kinds of FHA-insured mortgages. Similar authority was given in 1946 to purchase VA-guaranteed mortgages, not yet eligible for purchase by FNMA. As FNMA became more firmly established and real estate markets strengthened, the RFC Mortgage Company, no longer needed, dissolved in June 1949.

During its operation the company had purchased over 63,000 FHA-insured loans ($252 million), 24,000 VA-guaranteed loans ($141 million), and had made direct mortgage loans ($102 million) almost entirely on commercial properties. The company's portfolio was transferred to RFC in mid-1947. With the dissolution of RFC in mid-1954, remaining holdings of $64 million were absorbed by FNMA.

purchases were made during the prewar years when real estate activity and institutional originations of FHA-insured mortgages were increasing. Most sales were made after 1942, when war restrictions sharply limited building activity and the supply of funds to be invested was far greater than mortgages available in the private market.

First Reorganization, July 1, 1948

Increased capitalization ($21 million), lending capacity (40 times capital and earned surplus), and broadened authority to purchase and make commitments to purchase mortgages were given FNMA in its 1948 reorganization. Rapid increase in activity followed. Four later changes increased maximum lending capacity to a high of $3,650 million. Several other statutory and administrative changes over a six-year period alternately expanded and restrained FNMA's activities under its 1948 Charter.[26]

Developments during that period showed clearly that FNMA was not serving as a secondary market facility, as that term is ordinarily understood. Rather, it had become a special support for government sponsored housing and mortgage programs, which were not acceptable in private financial markets. The Association's policy of purchasing FHA and VA mortgages at par, regardless of market price, built up rather steadily its holdings—chiefly mortgages least acceptable to private investors. From July 1, 1948 to November 1, 1954 (the date of its latest reorganization) FNMA purchases of mortgages were $4.3 billion and sales only $1.4 billion. Its holdings increased from $50 million at the beginning of the period to $2.4 billion. Most of FNMA's activity was in VA mortgages.

Second Reorganization, November 1, 1954

After 1948, as FNMA was transformed into a primary source of mortgage funds, support—both private and government—developed for establishment of an organization which would operate as a true secondary mortgage facility and with limited dependence on federal funds. Under the Housing Act of 1954, FNMA was again rechartered and was directed to reorganize its structure into three separate operations providing for: (1) a secondary market for federally underwritten residential mortgages; (2) assistance for financing selected types of mortgages originated under special housing programs; and (3) management and liquidation of mortgages held or acquired by contracts under its previous charter. For each of these operations the Association was separately accountable.

[26] See Chapter 3 for more detail.

New Secondary Market Facility

The 1954 mandate from Congress required FNMA to prevent excessive use of its secondary market facilities, which were to be self supporting. Accordingly, mortgages were purchased over-the-counter only, at market prices not exceeding par. A mortgage price schedule was established. Prices varied according to location and type of property, mortgage terms, and market conditions. A "purchase and marketing fee" was introduced —½ of 1 per cent of the outstanding loan balance of "readily marketable" mortgages, 1 per cent for others. The maximum amount of mortgage per dwelling unit eligible for purchase was increased from $10,000 to $15,000. Restrictive requirements eliminated were: that mortgages be held for a minimum period by originators before sale; that purchases be made only from original mortgagees; and that purchases be limited to no more than one-half of VA mortgage originations by these mortgagees, and to one-fourth of FHA.

New financing provisions were aimed essentially at ultimate substitution of private for federal ownership. Initial capital consisted of $21 million of capital and surplus from the former Association (paid in by the U.S. Treasury) plus accumulated surplus, reserves, and undistributed earnings of $72 million. Preferred stock—total of the above, $93 million—was issued to the Treasury by FNMA.[27] Sellers of mortgages to FNMA were required to subscribe to common stock—not less than 3 per cent of the unpaid principal of mortgages sold. In addition, FNMA could issue (subject to Treasury approval) debentures up to ten times its capital and surplus, but not in excess of mortgage holdings, cash, and government or government-guaranteed securities.

Some objections were raised to the restrictive nature of FNMA's new secondary market facility. But so long as funds for mortgage investment were readily available in private and secondary mortgage markets investors made little use of FNMA's facilities and protesting voices were not loud. As increasing tightness took hold in private credit markets during late 1955 and 1956, however, the policies and operating techniques adopted to prevent excessive use of FNMA's secondary market facilities came under increasing pressure. As a result, liberalizing actions were taken in the late summer and autumn of 1956.

Requirements for subscription to stock by sellers of mortgages to FNMA were reduced twice from the original 3 per cent to 1 per cent of outstanding mortgage balances. The Association adopted a private market technique

[27] This Treasury-owned stock is to be gradually retired from the proceeds of the sale of common stock and debentures, and from retained earnings.

of combating credit stringency—issuing standby commitments for a period of one year. As FNMA raised the offering price on standbys to near its own purchasing price for mortgages, it approached its old policy of supporting primary mortgage markets. By this time, however, FNMA had achieved greater flexibility in determining mortgage prices under the Housing Act of 1956, which authorized establishment of prices "within the range of market prices rather than at the market price."

FNMA's activity under the new secondary market program remained small for several months. Mortgage funds from private investors were ample in late 1954 and early 1955, and requirements of the new program were not yet familiar to the market. As private credit became progressively tighter in late 1955 and 1956, and investors became better acquainted with the new operation, purchases of mortgages by FNMA increased rapidly, as shown in Chart 28. Just as before the 1954 reorganization, the bulk of FNMA purchases under the secondary market program was of VA mortgages.

The sharp increase in mortgage purchases during 1956 was due in part to adoption by FNMA in late January of a "mortgage purchase option plan," allowing sellers to FNMA to repurchase the same mortgages at the same prices within nine months. Adoption of that form of warehousing, already in use in the private market, and, a little later, adoption of the previously noted standby commitment technique indicated the Association's willingness to embrace approved private market techniques to help ease mortgage credit stringency.

To finance its secondary market operations, FNMA had sold, by November 1956, $300 million of short-term obligations to the public. Through June 1956, sales of common stock in connection with its mortgage purchases amounted to a little over $7 million, and net income from operations to $1 million (after federal income tax). Clearly, there was still a long way to go before the $93 million Treasury-owned stock would be retired and the secondary market facility be operated under private ownership.

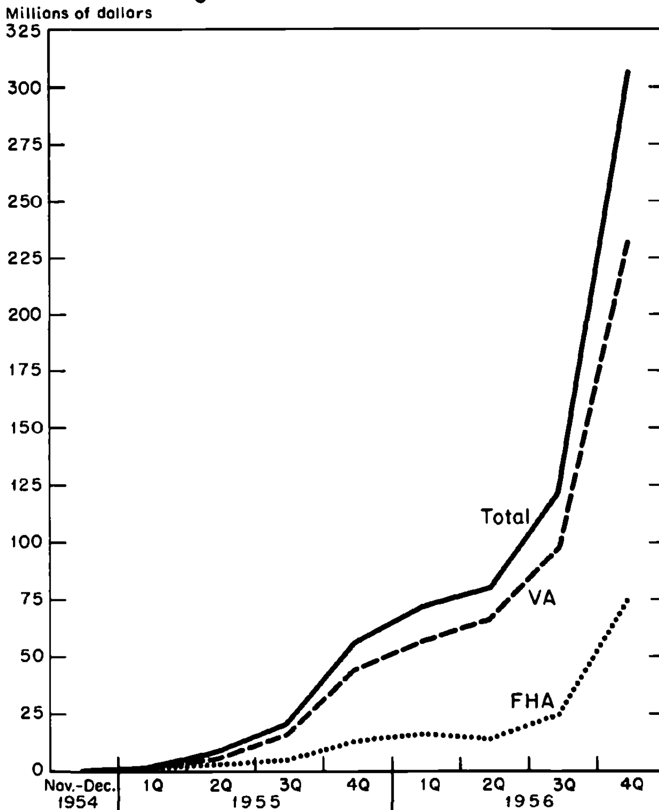
Programs for Special Assistance, Management, and Liquidation

As previously noted, FNMA's new charter provided for two other separate functions: special assistance for mortgages originated under certain housing programs; and management and liquidation of the existing mortgage portfolio.

Under the special assistance program, FNMA is authorized to purchase or make commitments to purchase such home mortgages as the President shall decide to be in the public interest. His decision is contingent upon

"(1) the conditions in the building industry and the national economy and (2) conditions affecting the home mortgage investment market, generally, or affecting various types of home mortgages." Mortgages purchased under the program, at prices to be determined by FNMA, are limited to

CHART 28
Mortgage Purchases of FNMA Under Reorganized Secondary Market Program, November 1, 1954–1956



SOURCE: Federal National Mortgage Association.

what (while perhaps not at the time acceptable to private institutional investors) would meet those standards under usual circumstances. Sellers of such mortgages are required, instead of purchasing FNMA stock, to pay fees—½ of 1 per cent of the mortgage amount, and 1 per cent for commitments to purchase. The special assistance program is supported entirely by loans from the Treasury. Mortgages designated eligible for special assistance include those on housing in Alaska and Guam, on housing in

defense or military programs and for victims of major disasters, on co-operative housing projects, and on housing built under urban renewal programs. By the end of 1956, only about $20 million in commitments to purchase mortgages was outstanding, and less than $1 million in mortgages had been purchased.

FNMA's function of managing and liquidating its portfolio of mortgages purchased or committed for before November 1, 1954 ("with a minimum of adverse affect upon the home mortgage market and a minimum loss to the Federal Government") is financed by borrowing from the Treasury and by sale of unguaranteed debentures to private investors. The first public offering (January 1955) was $570 million of three-year debentures. These and subsequent obligations are distinct from those issued under the secondary market program, and proceeds from their sale are for the reduction of the Association's indebtedness to the Treasury.

FNMA Mortgage Purchases and Sales, by Type of Investor and by Geographic Area

Comparable data are not available on FNMA sales and purchases of mortgages by type of financial institution, by geographic area, or separately for the periods before and since the Association's 1954 reorganization. The data at hand, however, indicate clearly the dominance of mortgage companies among FNMA's customers. As shown in Table 29, for example, from 1949 through 1956, mortgage companies comprised three-fourths of all sellers of mortgages to FNMA.

TABLE 29
Percentage Distribution of Sellers of Mortgages to FNMA, 1949–1956

Type of Seller	Per cent
Mortgage companies	75
Savings and loan associations	12
Banks and trust companies	11
Insurance companies	2

SOURCE: Federal National Mortgage Association.

Mortgage companies were also the largest purchasers of mortgages from FNMA, as shown in Table 30, but not so dominant as in sales. The dominant position of mortgage companies as sellers to FNMA is, of course, consistent with the character of their activities, but the large volume of purchases from FNMA needs explanation. Most of those purchases were

TABLE 30

Number of Purchasers and Amount of Purchases of Mortgages from FNMA, and Percentage Distribution of Each, August 1949–June 1955

TYPE OF PURCHASER	Number of Purchasers	*Amount of Purchases* Total	FHA (millions)	VA	PERCENTAGE DISTRIBUTION OF: Purchasers	*Amounts Purchased* Total	FHA	VA
Mortgage companies	228	$506	$104	$403	38	36	21	44
Life insurance companies	54	355	135	220	9	25	27	24
Savings and loan associations	111	149	28	120	19	10	6	13
Mutual savings banks	63	186	109	99	11	13	22	8
Commercial banks	104	156	83	73	17	11	16	8
Casualty insurance companies	6	21	17	4	1	2	3	[a]
Others	27	50	30	20	5	4	6	2
Total	593	1,423	506	917	100	100	100	100

NOTE: Includes only institutions purchasing $200,000 or more mortgages during the specified period.

SOURCE: Information in FNMA booklet "Investors Purchasing $200,000 or more of FHA-insured and VA-guaranteed mortgages from the Association during the period August 1949 through June 1955."

[a] Less than 0.5 of 1 per cent.

for resale to ultimate investors, and were made between mid-1953 and mid-1954 under the "one-for-one program" (see Chapter 2) in exchange for FNMA take-out commitments. The assurance of firm take-out commitments from FNMA enabled mortgage companies to carry on a mortgage originating business when such commitments were not readily available from private investors.

Among the main types of financial intermediaries, those purchasing the largest volume of mortgages from FNMA were also the most active purchasers in private secondary markets—life insurance companies and savings banks. Savings and loan associations and commercial banks, however, also accounted for a significant proportion of purchases. Life insurance companies were the dominant purchaser of both VA and FHA mortgages, but among other types of institutions there was considerable variation by type of mortgage.

Relative to their total numbers, only a small proportion of the main financial intermediaries were users of FNMA's secondary market facilities. Only 54 life insurance companies (of an approximate 1,000) and only 63 savings banks (of more than 500) bought mortgages from FNMA between 1949 and 1956; in sharp contrast, relatively large numbers of mortgage

companies used the Association's facilities. To be expected in view of marked differences in characteristics and asset sizes among types of financial intermediaries, the group accounting for the largest number of purchasers did not always account for the largest volume of mortgages purchased (Table 30).

The geographic distribution of FNMA's secondary market activities is indicated in Table 31. The data on purchases and sales are not strictly

TABLE 31

Geographic Distribution of FNMA Mortgages Purchases, 1954, and Sales, 1945–1955

(amounts in millions of dollars)

	Purchases			*Sales*	
State	Mortgage Portfolio Nov. 1, 1954	Percentage Distribution	*State*	Sales during Aug. 1949– June 1955	Percentage Distribution
California	453	19	New York	318	22
Texas	280	12	California	111	8
Michigan	249	11	Texas	109	8
Florida[a]	140	6	Michigan	107	8
Oklahoma[b]	137	6	Massachusetts	87	6
Total	1,259	53	Total[c]	732	51
All other states	1,109	47	All other states	691	49
Total	2,368	100	Total	1,423	100

SOURCE: Data from Federal National Mortgage Association.

[a] Accounted for 3 per cent of sales.

[b] Accounted for 2 per cent of sales.

[c] These states together accounted for less than 0.5 of 1 per cent of purchases.

comparable. Purchase data refer to the location of properties securing mortgages in the Association's portfolio on the date of its last reorganization. Sales data refer to the location of purchasers of FNMA-held mortgages during the six-year period ending June 1955. Since practically all of FNMA's mortgage acquisitions were from sellers located in the same states as the property securing the mortgages, the figures may be considered conceptually close enough for valid comparison. And differences in dates and timing should not invalidate broad comparison.

The concentration of mortgage purchases among five states in the West, Southwest, and South reflects the postwar real estate building boom and the shortage of private capital in those rapidly growing regions. Conversely, the large volume of sales in the East (New York and Massachusetts), chiefly to savings banks and life insurance companies, is a reflection of

excess capital in need of investment outlets. At that time, FNMA was serving the useful secondary market function of channeling funds from capital excess to capital short areas. The appearance of three states—California, Texas, and Michigan—among the most important in sales as well as in purchases is due mainly to the large volume of sales made to mortgage companies in those states under the "one-for-one program." It is likely that without FNMA sales under the program those states would not have ranked so high in FNMA sales activity. Even including "one-for-one" sales, however, it is clear that the significance of those three states as purchasers from FNMA is far less than it is as sellers. The reverse is true of New York and Massachusetts investors in FNMA-held mortgages. Because of the nature of their business, and as indicated by their limited volume of sales to the Association (less than ½ of 1 per cent of the total), those institutions were buying for permanent portfolio investment rather than to assure FNMA's commitment for later mortgage originations.

Junior Mortgage Financing

An appraisal of the institutional framework of the postwar mortgage market would not be well rounded without reference to the nature and character of the market for junior or second mortgage financing. Limited data and market observation indicate substantially increased use of junior mortgages since World War II.[28] Yet, there is little organized knowledge and no regularly reported information on the volume, nature, and character of the junior mortgage market.

Within the scope of this study, it has been possible to determine only in broad outline the salient features of that market—participants, pricing and operating techniques, types of mortgages and properties, and relationship of primary and secondary markets. Our limited knowledge of markets for junior mortgage financing needs to be expanded and techniques for keeping abreast of current developments in that field need to be developed. In the meantime an analysis is offered here based primarily on market interviews with professional participants located in a few large eastern cities.

SIZE OF THE MARKET

Comprehensive data on the postwar volume of junior mortgage debt secured by residential—but not other—properties are available only for

[28] *Census of Housing, 1950,* Vol. IV, *Residential Financing,* Part 1, United States; *National Housing Inventory, 1956,* Vol. II, *Financing of Owner-Occupied Residential Properties, United States;* Fred E. Case, "The Uses of Junior Mortgages in Real Estate Financing," *Journal of Finance,* March 1955; William N. Kinnard Jr., "Junior Mortgages in Real Estate Finance: A Case Study," *Journal of Finance,* March 1956.

1950 and 1956 from the Bureau of the Census. Even for the residential sector, since data for those two years do not cover the same categories, estimates are necessary. Estimates, shown in Table 32, indicate that the total volume of outstanding junior residential mortgage debt nearly tripled between 1950 and 1956—from $1.5 billion to $4.2 billion. The increase

TABLE 32
First and Junior Mortgages on Residential Properties, 1950 and 1956

Type of Property and Mortgage	*1956* First Mortgage (1)	Junior Mortgage (2)	Percentage Ratio (2) ÷ (1) (3)	*1950* First Mortgage (4)	Junior Mortgage (5)	Percentage Ratio (5) ÷ (4) (6)
			AMOUNT (billions of dollars)			
Total	112.1	4.2	3.7	42.9	1.5	3.6
1- to 4-family	99.0	3.2	3.2	35.9	1.2	3.3
Conventional	55.1	3.0	5.5	21.2	0.76	3.6
Federally underwritten[a]	43.9	0.2	0.4	14.7	0.43	2.9
Multifamily	13.1	1.0	7.6	7.0	0.35	5.0
			NUMBER (thousands of units)			
Total				9,443	824	8.7
1- to 4-family				9,172	785	8.6
Conventional				6,588	459	7.0
Federally underwritten[a]				2,584	326	12.6
Multifamily				271	39	14.4

SOURCE: For 1950, data were derived from *Census of Housing, 1950*, Vol. IV, *Residential Financing*, Table 2, and pp. 157, 159, 317, 319, 348, 349, 467, 469, 549, 551, 589, 591, 601, 602.

For 1956, data in col. 1 are from Technical Paper 13, Table 1, p. 38. Col. 2 figures are estimates derived on the assumption that the percentage increase between 1950 and 1956 in junior mortgages on the various types of properties bore about the same relationship to the increase in first mortgages as was the case for owner-occupied one-family properties shown in Table 33.

[a] For junior mortgages, refers to VA only.

was about the same as that for outstanding first mortgage debt. The 824,000 junior mortgages in 1950 had probably expanded to well over 1 million by the end of 1956.

A more meaningful indication of the postwar growth in junior mortgage financing is seen in developments in the conventional, as distinct from the federally underwritten, sector. In 1950, a substantial part of the outstanding volume of residential junior mortgages were VA-guaranteed—nearly

TABLE 33

First and Junior Mortgages on Owner-Occupied One-Family Unit Properties, 1950 and 1956

Type of Property and Mortgage	1956			1950		
	First Mortgage (1)	Junior Mortgage (2)	Percentage Ratio (2) ÷ (1) (3)	First Mortgage (4)	Junior Mortgage (5)	Percentage Ratio (5) ÷ (4) (6)
	AMOUNT (billions of dollars)					
Total	82.8	2.1	2.5	27.7	0.9	3.2
Conventional	37.5	1.9	5.1	15.2	0.5	3.3
Federally underwritten[a]	45.3	0.2	0.4	12.5	0.4	3.2
	NUMBER (thousands of units)					
Total	12,713	867	6.8	7,052	622	8.8
Conventional	6,900	714	10.3	4,840	322	6.7
Federally underwritten[a]	5,813	513	2.6	2,212	300	13.6

SOURCE: *National Housing Inventory, 1956,* Volume II, *Financing of Owner-Occupied Residential Properties, 1958,* and U.S. Department of Commerce release, "Mortgage Debt on Owner-Occupied, One Dwelling Unit Properties, United States, 1950 and 1956," July 12, 1958.

The total amounts of first and junior mortgages outstanding at the end of 1956 (cols. 1 and 2) were taken from *National Housing Inventory,* Volume II, p. 3, fn. 1. The breakdown of these totals between conventional and federally underwritten mortgages was derived by multiplying the average amounts of loans outstanding by the number of loans outstanding.

[a] For junior mortgages, refer to VA only.

one-half those on owner-occupied one-family properties (Table 33), and over one-third of those on all one- to four-family properties (Table 32). The VA-guaranteed second mortgages were made in combination with an FHA-insured first mortgage under a special federal program that was discontinued May, 1950. The 50 per cent decline in VA-guaranteed second mortgages between 1950 and 1956—from $400 million to $200 million—has obscured somewhat the real nature of the postwar expansion in basic junior mortgage financing.

The Census Bureau, reporting on financing of owner-occupied one-family properties in the 1956 national housing inventory, announced that junior mortgage debt increased more slowly than first mortgage debt between 1950 and 1956.[29] Actually, quite the reverse was true in conventional mortgage markets—the only meaningful sector for junior mortgage finance. While the number of conventional first mortgages on owner-occupied one-family properties increased by little more than 40 per cent

[29] Bureau of the Census, press release, July 12, 1958.

between 1950 and 1956, the number of second mortgages more than doubled. The much faster growth of second mortgages increased their proportion of the number of outstanding first mortgages from 6.7 to 10.3 per cent (Table 33). Similarly, the amount of second mortgage debt outstanding on owner-occupied one-family properties nearly quadrupled between 1950 and 1956—$0.5 billion to $1.9 billion—while the amount of first mortgages only slightly more than doubled.

The growth of junior mortgages on total one- to four-family properties was estimated to have paralleled that on owner-occupied one-family properties. The $3 billion junior mortgage debt outstanding at the end of 1956 was 5.5 per cent of the amount of first mortgage debt compared with 3.6 per cent in 1950 (Table 32). Junior mortgages on large-scale residential properties were a greater proportion of both number and amount of first mortgages in 1950 and 1956 than was the case for smaller residential units.

A comparative look at pre-World War I proportions of first and second mortgage debt may be instructive. In early 1934 outstanding junior mortgage debt was 8.7 per cent of the number and 4.4 per cent of the amount of first mortgages outstanding on owner-occupied properties.[30] Those percentages were larger than in 1950, on either owner-occupied one-family or all one- to four-family properties. But by the end of 1956, following a rapid expansion, conventional junior mortgages were more important relative to first mortgages than in 1934. The 1956 proportions of second to first mortgages could hardly have been so high as they were during the height of the real estate boom in the 1920's, however, when FHA and VA programs were unknown and low loan-to-value ratio first mortgages were the general rule.

Without comprehensive data on the volume of junior mortgages outstanding on nonresidential properties, fragmentary market evidence suggests that such financing is at least as important as it is in residential markets. Study of one small local mortgage market (Middletown, Connecticut), for instance, suggests that for most years back to 1920 the volume and relative importance of junior mortgages on nonresidential properties were substantially greater than on residential properties.[31]

NATURE AND PURPOSE OF JUNIOR MORTGAGE FINANCING

Findings on the nature and purpose of second mortgages in different parts of the country suggest a number of different explanations. In a study of

[30] David L. Wilkens, *Residential Real Estate*, New York, NBER, 1941.
[31] Kinnard, *op. cit.*

the Los Angeles market it was found that most mortgages on owner-occupied properties were created to finance their purchase.[32] In Middletown, Connecticut, on the other hand, junior mortgage debt placed on properties already owned substantially exceeded that incurred for purchase.[33] Second mortgages used to finance property purchases in Middletown usually involved transfer of funds rather than of credit. In Los Angeles most second mortgages were "purchase-money" mortgages taken back by the seller of a property, rather than new money furnished by a lender. The findings of the present limited investigation suggest that on owner-occupied properties, at least, most postwar second mortgages were originated as deferred purchase-money mortgages in connection with real estate transfers. The Middletown pattern may represent a rather specialized case—a small local market isolated from outside sources of mortgage funds. The pattern in Los Angeles, which parallels that in eastern cities surveyed in this study, is probably more representative of the nature of second mortgage market activity as a whole.

In the booming real estate and construction market of the twenties, the extensive use of junior mortgage financing had a rather definite purpose—to supplement first mortgage loans available to buyers from lenders only at relatively low loan-to-value ratios. In the post World War II decade, the needs of buyers changed. Liberalized mortgage credit under federal mortgage programs and changed mortgage lending attitudes among private lenders combined to lessen the need for junior mortgages. As real estate values rose and equities increased, however, mortgages on existing properties were lowered relative to values. New buyers often found it necessary to refinance completely or obtain supplementary credit to finance purchases. Frequently, the existing first mortgage on a property was a long-term low-interest rate FHA or VA loan. Prospective purchasers found such mortgages desirable and sellers found they enhanced the value of their property, especially in periods of tight credit when interest rates were rising. Transfers of such properties, therefore, were frequently made subject to (or with assumption of) the existing first mortgage supplemented with a purchase-money second mortgage taken back by the seller.

With the generally more liberal financing terms for new than for existing properties, many sellers found that a favorable price for used property could be obtained only by taking a purchase-money mortgage in lieu of cash over the primary mortgage. Even for new houses, however, many builders financing construction under conventional mortgages found it

[32] Case, *op. cit.*
[33] Kinnard, *op. cit.*

necessary to take purchase-money second mortgages in order to sell completed houses. In Los Angeles it was found that during 1952 and 1953, for example, an increasing number of builders and contractors were listed as mortgagees in recordings of junior mortgages.[34]

Purchase-money mortgages have been commonly created, also, in the sale of multifamily rental and commercial properties. A large proportion of second mortgages created in transfers of such properties, however, represented actual transfers of funds from lender to borrower, rather than extension of credit from seller to purchaser. Limited information suggests, also, that the frequency of second mortgages on those properties initiated for loans not associated with purchase was higher than on small residential properties.

MARKET PARTICIPANTS

The chief source of credit for second mortgages, whether of the deferred purchase or money loan type, is the individual or the closely-held private corporation. The reason is that financial institutions are generally precluded by law from accepting junior liens on real property, unless they also hold the first lien. In 1950, individuals and others held about 85 per cent of the total volume of junior mortgage debt outstanding on residential properties.[35] The surveys in Los Angeles and Middletown for later years indicate the continued dominance of individuals in the market for second mortgages. If the 1950 Census finding approximated the 1956 situation as well, then individuals held an estimated $3.6 billion in second mortgages at the end of 1956. This was about one-fourth of the $14.8 billion in total mortgages held by individuals at the end of 1956.[36]

Many diverse types of individuals and firms maintain varying professional interests in junior mortgages and make a market for them. The interests may be incidental to main activities, sideline investments, or the primary or sole activity. The chief types of market participants are real estate brokers, real estate speculators, mortgage brokers, mortgage traders, mortgage investors, and investment syndicates under trust arrangements.

Real estate brokers not infrequently have to find a market for purchase-money mortgages in order to negotiate property sales successfully. Real estate speculators typically operate by acquiring properties as cheaply as possible in all-cash transactions, and selling quickly at the highest possible prices by accepting minimum down payments and purchase-money

[34] Case, *op. cit.*, p. 48.

[35] *Census of Housing, 1950, Residential Financing.*

[36] Saul B. Klaman, *The Volume of Mortgage Debt in the Postwar Decade*, Technical Paper 13, New York, NBER, 1958, Table 1.

mortgages over a new first mortgage. Usually the speculator sells his purchase-money mortgages quickly to get cash for continued operations.

Some mortgage brokers and traders limit their activities essentially to transactions in the market for junior mortgages. While the number of such operators is unknown, in the markets investigated there seemed to be few relative to the volume of transactions. Brokers in second mortgages perform the same function as brokers in other services or commodities do by bringing buyers and sellers together for a price. Traders, on the other hand, operate by actually acquiring second mortgages with their own funds and reselling generally to individual investors for a profit. Operating techniques of brokers and traders vary as indicated in the next section.

Investors in second mortgages comprise several different types of individuals and firms. Professional investors acquire mortgages for their own portfolios, either by purchasing already created purchase-money mortgages or lending funds directly on the security of junior property liens. Investment-minded individuals acquire second mortgages occasionally for a supplementary income or, if retired, for major income. The investment syndicate, in which individuals pool funds to acquire second mortgages, is usually organized as a corporation by an attorney or accountant who generally acquires and manages investments under a trust arrangement.

MARKET ORGANIZATION AND TECHNIQUES

The diverse groups of participants play their roles in highly specialized, widely scattered local markets. Transactions in primary and secondary markets are closely related, and little organization exists in either market. Primary transactions are essentially of two types: execution of a purchase-money mortgage by buyers and sellers of property; actual transfer of funds to finance purchase or continued ownership of property. The professional mortgage broker, trader, or investor plays a fundamental role in both types of transactions; in execution of a purchase-money mortgage, he is part of the immediate primary transaction; in transfer of funds, he is a necessary link to secondary sources of funds.

Sources of funds for second mortgages, largely noninstitutional, are usually not known to prospective borrowers. The services of a mortgage broker are generally essential to any primary junior mortgage transaction. He typically maintains a classified file of investor clients obtained chiefly through advertisements, circular letters, and word-of-mouth.[37] The

[37] When second mortgage funds are available from relatives or friends, resort to the professional market is of course not necessary. Kinnard noted in his study that "a considerable number of family or 'friendship' loans" were recorded in Middletown, Connecticut.

broker's fee paid by the borrower for placing second mortgages varies with the amount of loan and between cities. In one large eastern city, typical fees are 2 per cent for the first $50,000 of loan and 1 per cent for the rest. For small loans, the percentage charge is much higher to provide a minimum fee, usually set by the broker. A major deterrent in placing "new money loans," on second mortgages in many states is restrictions on interest rates allowed under existing usury laws. Maximum interest rates under those laws vary widely between states, from 6 per cent in Washington, D.C. and New York, to 10 per cent in Florida and California, and 12 per cent in Connecticut. In some states corporations may not plead usury, and hence corporate owners of property—usually large-scale multifamily and commercial—can borrow on second mortgages more easily than individuals can.[38] In states where usury rates are low relative to yields in the open market, individuals can negotiate direct money loans only by giving to lenders large discounts through devices that circumvent the intent if not the letter of the laws.

Because of interest rate limitations that operate in primary market transactions, many brokers and traders and investors confine their activities to the secondary market. Those transactions involve chiefly purchase-money mortgages, on which—through legal discounts or bonuses—effective yields are raised substantially above contract interest rates. The active secondary market exists because purchase-money mortgages created in primary transactions are often not retained by the individual sellers of property or real estate speculators. Rather than hold such second mortgages created as part of real estate purchases, they seek to convert them into immediate cash through real estate and mortgage brokers, mortgage traders, or directly through sale to known investors. Ultimate investors are located in the way already described for the primary market.

Marketing techniques vary widely among professional operators. Brokers rely either upon circularized notices listing mortgage offerings with details on prices, outstanding balances, underlying properties, first mortgage characteristics, and rents and expenses (for income-properties) or upon attempts to make their offices into organized market places with mortgage offerings available. Some mortgage traders have adopted programs of selling second mortgages to individuals under repurchase agreements. The trader warrants to repurchase, at the request of the investor, any second mortgage in default for at least forty-five days at the original sale price

[38] New York State's 1956 legislation permitting corporations to interpose a defense of usury with respect to mortgage credit on one- and two-family houses (General Business Law 346) has made new second mortgage money loans on such properties more difficult to obtain.

minus principal payments received. Such traders interviewed in this study had capital investment equal to at least 10 per cent of their outstanding obligations.

Both brokers and traders depend for their supply of second mortgages upon realtors, builders, and speculators who find it necessary to arrange junior financing. Recently those groups have increasingly used the advance commitment technique, basic in the market for first mortgages. The second mortgage broker or trader, for example, makes an advance commitment (after the usual inspections and approval) to a real estate operator or builder to buy or find a market for purchase-money second mortgages created in a real estate transaction.

PRICES AND TERMS OF JUNIOR MORTGAGES

Commonly, a second mortgage transaction is made at a specified contract interest rate, combined with a discount or "bonus" on the face value of the note given by the seller or borrower to the investor. The discount is almost always a part of secondary market transactions. It is also frequently used in primary markets, where maximum interest rates under usury laws are low relative to secondary market yields. Occasionally, contract interest rates truly reflect yield, but evidence on this point is not readily available in public or other records. That reported rates on second mortgages are only a little higher than rates on conventional first mortgages is explained in large part by use of the technique of discounting and by the effects of usury laws.[39]

Traded prices of second mortgages vary widely between and within local markets. Many characteristics of second mortgage markets contribute to varying prices for mortgages of similar quality: their local character, the limited organized outlets and investors, and the lack of knowledge of one-time participants seeking to sell purchase-money mortgages. Varying prices are also attributable to the imperfect nature of the market and to the varying quality of the "paper." Quality of so imperfect a product is often a matter of individual judgment. Professional investors, however, generally look to the same set of criteria in establishing prices for second mortgages. The more important are: location of property; type and characteristics of property; borrower's credit worthiness; terms of first and second mortgages—regular payments to principal, length of loan, and interest rate; amount of equity in property; amount of second mortgage note; age of second mortgage—new or seasoned.

[39] Compare Tables 7 and 8 of *Census of Housing, 1950, Residential Financing*.

The location of the property securing a second mortgage is of obvious importance because of the variation in state foreclosure laws. It is especially important in judging the quality of a mortgage offered in a market in a metropolitan area including more than one state. In addition to the obvious bearing on mortgage quality of the kind and condition of the property, higher rating is usual for second mortgages on income properties. Owners are often corporations with favorable credit ratings—essential for marketing a second mortgage at almost any price. In addition, the value of such properties can be ascertained in relation to income produced.

The terms of both the first and second mortgages are important in determining the quality of junior liens. The terms of the first have an effect since inability of the borrower to carry first mortgage payments jeopardizes the security of the second. If the second mortgage is not fully amortized at maturity, the remaining balance and length of life of the first may be decisive when the second mortgage becomes due and payable. If the first mortgage may be easily refinanced to provide funds to pay off the junior lien, the quality of the second mortgage is enhanced. The terms of the second mortgage directly affect its quality in the market. The longer the maturity and the larger the proportion of the loan remaining to be paid off at maturity, the larger the discount. The higher the contract rate of interest, the lower the discount.

The amount of equity a second mortgage borrower has in his property is a major consideration. It is a measure of protection against declines in real estate values. It is also a measure of the borrower's interest in maintaining ownership, especially in bad times. The amount of the second mortgage note sometimes influences the rate of discount, because small notes at rates equal to rates on larger ones are not acceptable to investors when each involves equal quality and servicing. A seasoned mortgage that has proved its soundness will command a higher price than one recently created.

The wide range of quality factors and other market imperfections in the second mortgage market lead to wide variation in prices and yields. Yields, as noted earlier, are a function of the contract interest rate, discount, and maturity. Limited observations indicated that, in late 1956, with contract interest rates between 5 and 8 per cent, discounts on second mortgages secured by owner-occupied properties ranged from 2 to 6 per cent per year of remaining maturity and on those secured by income properties between 2½ and 4 per cent per year. Within the range of typical maturities this means that total discounts ran from a low of 6 to 9 per cent to a high of 40 to 50 per cent, resulting in yields to investors of

from 8 to 25 per cent. Yields in the 10 to 15 per cent range seemed quite common in secondary markets investigated.[40] The high yields are due, in addition to unusual risks, to conditions prevailing in the second mortgage market: imperfect knowledge of the market; limited sources of funds; borrowers' need for credit not available from financial institutions; and the willingness of sellers, able to obtain inflated prices for properties on the basis of purchase-money mortgages, to discount such mortgages heavily for cash.

Junior mortgages on most types of property carry maturities ranging between 3 and 12 years, considerably shorter than maturities of first mortgages. The 1950 Census survey figures indicate that the median term on conventional junior mortgages on owner-occupied properties acquired in 1949 and 1950 was 8 years, compared with 11 years on conventional first mortgages. Only one-eighth of conventional junior mortgages were written for maturities of 15 years or more, compared with over one-fourth on conventional first mortgages. The difference between terms on the two types of conventional mortgages was somewhat narrower on rental properties. Apparently, since 1950 maturities on junior mortgages have shown little change, while maturities on conventional first mortgages have lengthened somewhat.

Required amortization on junior mortgages increased markedly between 1950 and 1956, just as it had for first mortgages. Census data show that regular payments on principal were called for on 82 per cent of conventional second mortgages outstanding on owner-occupied one-family houses at the end of 1956, compared with 70 per cent in 1950. Comparable figures for conventional first mortgages were 91 and 78 per cent respectively.[41] A smaller proportion of rental property mortgages—firsts and seconds—are regularly amortized.

Limited evidence obtained in this study suggests that partial amortization of second mortgages on both residential and nonresidential properties is at least as common as full amortization. Some brokers and traders found that junior mortgages requiring partial amortization only, with payment in full at the end of a relatively short term (3 to 5 years), were more marketable than those requiring full amortization in a relatively long period (8 to 11 years). Investors preferred to commit funds for short-term mortgages with opportunity to renew or liquidate loans at the end of the contract period. Other professional investors, however, characterized the partially

[40] In the 1953 survey of Los Angeles mortgage brokers, Case reported discounts varying from 20 to 50 per cent.

[41] *National Housing Inventory, 1956*, p. 4.

amortized junior mortgage as the contract with "a happy hope" clause, and avoided it. The larger the "balloon payment" required at termination, the stronger the faith needed that the contract would be fulfilled in the stated period. These investors preferred to put their funds in the more realistic longer-term fully amortized mortgages.