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CHAPTER 2

The Legal Framework of Life Insurance Company Mortgage Lending

As investors in the real estate market, whether as mortgagees or as owners of property, insurance companies are subject to the whole body of real estate law and regulation. In addition, their real estate financing activities are affected by certain sections of the insurance laws of the states in which they are organized and to a lesser degree by the insurance laws of other states in which they do business. Since the real estate financing activities of life companies are significantly affected by this legal framework, a description of the relevant statutory and administrative laws is essential to the present study. But in view of the fact that a separate monograph in this series deals with general real estate law and regulation [1] this chapter will be restricted to a discussion of those sections of state insurance laws that have a direct bearing on real estate finance. Examples of statutory limitations on mortgage financing and real estate investment are drawn from the laws of different states in order to show the range of variation; other examples are used to illustrate such common features as can be found in state legislation.

Limitations on Mortgage Investments

State statutes fall into a roughly standard pattern as regards their statement of conditions on which life insurance companies may invest the reserves of their policyholders in mortgages. The general formulation of the laws is to the effect that a domestic life insurance company (i.e., a company incorporated or chartered in the state in question) may invest in bonds or notes secured by mortgages or deeds of trust on unencumbered real estate, but this broad grant of power is ordinarily accompanied by certain limiting provisions. First, in-

[1] Miles L. Colean, *The Impact of Government on Real Estate Finance in the United States* (National Bureau of Economic Research, Financial Research Program, ms. 1949).

surance companies are generally restricted to loans on "improved" real estate, a device obviously intended to guard against an unwanted variety of "land" speculation. However, the term "improved" real estate requires definition. Most states, as illustrated by the Illinois law, include farm land used for tillage or pasture among improved properties.[2] Michigan law stipulates that the property should be improved or income-producing, or both, and permits loans on vacant plots provided only that 60 percent or more of the plot is under contract of sale and that the contract is pledged as additional collateral.[3] Florida law is more liberal, making no mention of mortgage lending restrictions beyond specifying that the $100,000 minimum required capital must be invested in government securities or in mortgage loans on unencumbered, improved property the market value of which exceeds the amount loaned by not less than 50 percent.[4]

Second, in stating the requirement that mortgage security should be unencumbered (i.e., that the mortgage must be a first lien on the property) the statutes ordinarily cite in detail certain permissible types of encumbrances, such as taxes or assessments—if not due and unpaid—mineral or timber rights, rights of way, rights in walls, public utility easements, building restrictions, etc. Nor do they ordinarily include leases among encumbrances if rents and profits from them are reserved to the owner. There must, of course, be no right of re-entry or forfeiture by which the mortgagee's lien can be cut off, subordinated, or otherwise disturbed.[5]

Third, and of greater interest from the viewpoint of this study, are those statutory provisions, varying widely among the states, that place limits on the amount of funds that life insurance companies may invest in mortgages. The Illinois statute, which limits the investment in any one mortgage to an amount not exceeding $10,000, or 2 percent of the company's admitted assets, whichever is greater, may be cited as an example of this type of limitation.[6] The New York law differs somewhat and involves an additional principle: mortgages on single properties are limited to $25,000, or 2 percent of the insurer's

[2] Jones' *Illinois Statutes Annotated,* 1939 Rev., Vol. 11, art. 8, § 125 (1), (e).

[3] Compiled Laws of the State of Michigan, 1929, Vol. 3, § 12305.

[4] Florida Statutes, 1941, Vol. 1, § 626.04.

[5] Consolidated Laws of New York, 1940, bk. 27, § 81 (6), (a).

[6] Jones' *Illinois Statutes Annotated,* 1939 Rev., Vol. 11, art. 8, § 125 (1), (e).

total admitted assets, whichever is greater, and in the aggregate they are limited to not more than 40 percent of the company's total admitted assets.[7] Limitations of this character are of little or no consequence to large companies but they probably influence greatly the large number of very small companies in the industry. Out of an industry total of 349 in 1945, 68 companies had total assets of less than $1 million. For them, laws of the Illinois and New York type would effectively block participation in the urban mortgage market, outside of the financing of single family dwellings and small multifamily and nonresidential structures.

State statutes may also make specific provision for investment of life company funds in perpetual leaseholds (District of Columbia), real estate sales contracts, purchase money mortgages, or in leaseholds of fixed term, provided a stated unexpired term obtains at the time the loan is made (forty years in Minnesota,[8] fifty in Massachusetts,[9] and ninety-nine in Ohio [10]).

Finally, it should be noted that investments by life insurance companies in mortgages insured by the Federal Housing Administration, and in that portion of mortgage loans guaranteed by the Veterans' Administration, are generally exempt from the limitations discussed above, as well as from most of the restrictions dealt with below.[11]

Limitations on the Amounts Loanable on Specific Properties

Other provisions of state laws place an upper limit on the amount that may be loaned against a property of given appraised value. This is termed the maximum loan-to-value ratio. As indicated above, insured and guaranteed loans are generally exempt from this and other

7 Consolidated Laws of New York, 1940, bk. 27, § 81 (6), (a).

8 Minnesota Statutes Annotated, 1946, Vol. 6, c. 60, § 40.

9 Annotated Laws of Massachusetts, 1948, Vol. 5A, c. 175, § 63 (7).

10 Ohio Code Annotated, 1948, § 9357 (H), (b). The Ohio statute also provides that the leasehold be renewable forever and that "the amount loaned thereon plus the value of the ground rent capitalized at 5 percent does not exceed 60 percent of the total market value of the real estate, buildings and improvements . . ." Ohio permits investment in shares of building and loan associations up to 5 percent of admitted assets in any one association.

11 See Mason's *1940 Cumulative Supplement to the Compiled Laws of the State of Michigan, 1929,* c. 241A, § 12242-11 and Wisconsin Statutes, 1947 (19th ed.) 206.34 (1c).

restrictive rules, but most states specifically limit loan-to-value ratios on other types of mortgages. The maximum is usually set at 50 or 66⅔ percent of the appraised value of the property, generally the latter; it is never below 50 and if above 66⅔ percent the law generally requires that the lending agency conform to certain provisions regarding maximum term and amortization of the loan balance or that it accumulate special loss reserves against the contracts, or both. For example, the New Jersey law permits loans up to 75 percent of appraised value if fully amortized, and if the company carries as a reserve the amount by which the loan exceeds 66⅔ percent of the appraised value of the property.[12] Similarly, the Wisconsin law, which limits a company to 50 percent loans, permits loans up to 60 percent of the property's appraised value if provision is made for complete amortization within fifteen years.[13] Leasehold loans may be limited to a smaller percentage and there may be a requirement, though not in all states, that the loan be reduced to an amount not above a specified percentage of the appraised value of the security if the value of the security falls.

In view of the dependence placed by state laws on property appraisals, it is natural that they should set standards of one sort or another that are intended to give validity to appraisements. For example, the Ohio law requires a written evaluation under oath by two real estate owners resident in the same county or local district where a property is located or by a "qualified land appraiser." [14] The New York law, on the other hand, merely states that no mortgage loan may be made by an insurer "except after an appraisal made by an appraiser for the purpose of such investment." [15]

LIMITATIONS ON THE GEOGRAPHICAL SCOPE OF LENDING

A third general type of provision, also meant to place a limitation on the assumption of investment risks, is that which restricts insurance company mortgage investments to those made on "real property located in the United States," as in New York law,[16] or, as in New

12 New Jersey Statutes Annotated, 1939, tit. 17, c. 24, § 1, (b).

13 Wisconsin Statutes, 1947 (19th ed.) 206.34 (1c).

14 Ohio Code Annotated, 1948, § 9357 (H), (a).

15 Consolidated Laws of New York, 1940, bk. 27, § 81 (6), (a).

16 *Ibid.*

Jersey,[17] to properties located in the United States and Canada. Maine's law is more restrictive, limiting its companies to loans on properties located in the New England states, a practice stemming from the fact that Maine savings banks are regulated in this way and that Maine subjects its insurance companies to the same investment requirements.[18] In most cases, however, the restrictions applying to life insurance companies are far more liberal than those applying to savings banks, savings and loan associations, and commercial banks. In Massachusetts, for example, savings banks are not permitted to lend on property in states noncontiguous to Massachusetts, or in places more than twenty-five miles distant from their main office, but insurance companies may lend on property in any of the forty-eight states and in the District of Columbia.[19]

The above limitations refer to statutory provisions applying directly to mortgage loans and imposed by states on their own chartered insurance companies. Reference should also be made to the Texas law which requires that at least 75 percent of the legal reserve required by the domicile state on policies written on the lives of citizens of Texas shall be invested by "foreign" companies (i.e., insurance companies chartered in other states) in Texas securities and Texas real estate.[20]

Provisions Relating to Maturity and Amortization

In one respect insurance companies operate within a more liberal legal framework than do other mortgage lending agencies. State laws generally do not limit insurance companies with respect to the length of term for which mortgage loans may be made or the schedule on which repayments must be made. The only condition on which restrictions of this type may be imposed is where the original amount of the loan exceeds two-thirds of the appraised value of the property. In such cases the law may require that all, or part, of the loan be amortized in a specified period.[21]

17 New Jersey Statutes Annotated, 1939, tit. 17, c. 24, § 1, (b).

18 Revised Statutes of the State of Maine, 1944 (8th Rev.) Vol. 1, c. 56, § 63.

19 Annotated Laws of Massachusetts, 1948, Vol. 5A, c. 175, § 63 (7) and c. 168, § 54 (first).

20 Vernon's *Civil Statutes of the State of Texas, Annotated,* 1925 Rev., Vol. 14, c. 4, art. 4765.

21 As in the Wisconsin statute cited in footnote 13, above.

Provisions Relating to Equity Investment in Real Estate

Finally, state insurance laws contain a variety of provisions affecting real estate investment by life companies. These provisions are primarily concerned with three questions: under what conditions may real estate be acquired; how much may an individual company invest in this form; and how long may specific properties be held in the owned real estate account?

Companies are ordinarily permitted to own property necessary for the conduct of their business, but the amount of this class of real estate that may be held is subject to certain limitations. In Arizona, companies may invest up to 50 percent of their subscribed capital stock in home office property after investment of $50,000 in bonds and mortgages.[22] Illinois requires that the real estate held for office purposes must not exceed 5 percent of the total admitted assets, except by approval of the director of the state insurance department.[23] Massachusetts permits such investments up to 10 percent of the company's admitted assets and Wisconsin up to 20 percent; [24] Michigan allows investment in home office property by stock companies up to 20 percent of their admitted assets, provided the commissioner approves the investment and has obtained the certification of at least three resident property owners, appointed by him, that the property has a value not less than the company's proposed investment.[25] And some states place no special limitation on the amount of property held for business use, but a general limitation on property holdings may be contained in the law, as in New Jersey, where real estate holdings are limited to 5 percent of admitted assets, excepting property for accommodation of business and housing projects.[26]

Beyond this general power to own property, state laws provide, though not uniformly, that companies may hold property acquired through foreclosure or in satisfaction of indebtedness previously owed to the company, property acquired to protect or enhance the

[22] Arizona Code, 1939, Vol. 4, c. 61, § 325, (3).

[23] Jones' *Illinois Statutes Annotated,* 1939 Rev., Vol. 11, art. 8, § 128 (1), (a).

[24] Annotated Laws of Massachusetts, 1948, Vol. 5A, c. 175, § 64; Wisconsin Statutes, 1947 (19th ed.) 201.24 (2).

[25] Compiled Laws of the State of Michigan, 1929, Vol. 3, § 12298.

[26] Revised Statutes, Cumulative Supplement, 1939, New Jersey, 17:24-1 (b).

value of other real estate,[27] and property acquired in exchange. As regards the latter, California requires that it must not increase the company's real estate investment,[28] and Illinois stipulates that it must not exceed 2 percent of the insurer's total admitted assets.[29] Companies are also permitted to improve properties acquired in any of these ways.

Specific limitations are not usually set on the amount of properties thus acquired that may be held by life companies, but the statutes frequently provide that these properties must be disposed of within a stated interval. This interval is ordinarily set at not longer than five years, except that a company may usually hold the property for a longer period provided it has the approval of the state's insurance supervisory authority.[30]

In addition to the right to hold property necessary for the conduct of their business, or acquired in the exercise of their powers as mortgagees, insurance companies have recently been granted the power under the statutes of several states to hold equities in real estate properties which have been acquired, either by purchase or construction, for investment purposes. In New York, for example, the insurance law provides that until December 1, 1949, housing projects may be undertaken within fifteen miles of any city of 75,000 or more population in any state where the company does business, provided that the aggregate investment in such properties does not exceed 10 percent of the company's total admitted assets on December 31 next preceding the date when the land was purchased.[31] Further, the New York law permits domestic companies to invest for income in other commercial and industrial property,[32] provided (*a*) that the aggregate amount of such real estate acquisitions and their improvement does not at any time exceed 3 percent of the company's total admitted assets, (*b*) that the investment in land and improvement for no single parcel shall exceed one-fourth of 1 percent of total admitted assets, and (*c*) that properties shall be depreciated at not less

27 Insurance Code of the State of California, 1944, Div. 1, pt. 2, c. 2, art. 2, § 1151.6.

28 Insurance Code of the State of California, 1944, Div. 1, pt. 2, c. 2, art. 2, § 1150, (g).

29 Jones' *Illinois Statutes Annotated,* 1939 Rev., Vol. 11, art. 8, § 128 (1), (e).

30 In some cases the provision is for a three-year period plus one two-year extension.

31 Laws of New York, 1946, c. 96, restricted companies to "emergency" housing; this limitation was removed by Laws of New York, 1946, c. 557.

32 Agricultural properties and other types of minor importance are excluded.

than 2 percent annually, and by an additional amount equal to the excess over 4 percent of net income on all properties of this type held as investments.[33]

A more general statute, aimed at the same objective, was passed in Connecticut. It provides that up to 5 percent of a company's total admitted assets may be invested in ways not specifically permitted under the charter or under the Connecticut laws regarding the investments of life insurance companies.[34]

Finally, the New Jersey law permits life insurance companies to invest up to 5 percent of their total admitted assets in real estate for residential construction in any city within the state,[35] and also to purchase or hold residential or business property, other than that noted above, for income-producing purposes, provided *(a)* that the state insurance commissioner approves the investment and *(b)* that the aggregate amount of the holding does not exceed 5 percent of the company's total admitted assets.[36] Statutes to the same general effect, although varying in liberality, have been added recently to the laws of California, Illinois, Massachusetts, Minnesota, Pennsylvania, and Wisconsin.

[33] Laws of New York, 1946, c. 509.

[34] 1945 Supplement to the General Statutes, State of Connecticut, c. 218, § 826h.

[35] New Jersey Statutes Annotated, 1939, tit. 17, c. 19, art. 2, § 8.

[36] Revised Statutes, Cumulative Supplement, 1939, New Jersey, 17:24-1 (b).