GUARANTEEING FIRST MORTGAGE REAL ESTATE BONDS

BY

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Mr. Chairman, Gentlemen, I should like to begin my remarks with an apology, as I have had very little time to prepare this talk and will have to refer to my notes from time to time. Usually a little story is not amiss and I am reminded of one characteristic of the colored race.

A Southerner had in his employ a colored retainer who was forever talking to himself. One day the Southerner asked Rastus, "What is the idea of talking to yourself all of the time?" "Boss," answered Rastus, "There is two reasons why I talks to myself; in the first place I lak's to talk to an intelligent man more than anything else in the world, and in the second place, I lak's to listen to one." But I realize that I am talking to an intelligent audience and I will endeavor to be brief and to the point.

I suppose most actuaries are Scotch, please pardon my reference to the noble race. It is often mentioned that the English and the Scotch make the best actuaries and accountants because of their national trait for close figuring, and it has been said that a Scotchman was too tight to pay attention. I suppose most of you are familiar with the definition of "efficiency" which consists of buying goods from a Jew and selling them to a Scotchman at a profit. But sometimes I think that instead of ridiculing thrift so much, most Americans ought to start practicing it.

Gentlemen, to get into the mortgage business, I might go back to the start of guaranteed mortgage companies. I think it is some forty or forty-one years ago that the Title Guarantee and Trust Company was started, and in my opinion it is the outstanding institution of New York in the guaranteed mortgage field. My view is perhaps a little prejudiced because most of our people are products of that institution and one of our men was long President of it.

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The mortgage business I think is a business alone and it is useless to attempt it without the following: First, you must have large capital and second, you must have a capable Board of Directors thoroughly conversant with real estate and mortgage practice. Then you can start to build your organization. Some seven years ago we started the Prudence Company which is a subsidiary of a corporation by the name of Realty Associates, started in 1901. We put in two millions of dollars getting started; this was to be used in advertising and in getting the organization together. We lost $1,250,000 the first two years, but we soon overcame that and we increased our capitalization until we have, today, $29,000,000 in capital funds, about fourteen million in capital, surplus and reserves and fifteen million in revolving funds. I will explain later the purpose of a revolving fund in this business. This gives you an idea of the capital required to conduct the mortgage business conservatively; by conservatively, I mean that the mortgage house should carry its loans through to completion; in other words, it should not sell against a set of plans or a hole in the ground: it shouldn't sell the security when there is nothing there. Most of the difficulties and troubles in the majority of mortgage loans happen before completion and while the credit risks of most builders are all right in good times, in average times they are not so good. I think our business is highly specialized. You must first have the fundamental basic knowledge of real estate and the investor. That is especially so when you are guaranteeing everything you sell. There are no "ifs" or "ands" about the guarantee of conservative real estate first mortgage houses in New York. By that I mean in New York City where there are four or five of what we deem to be the leaders of all the real estate first mortgage companies; those who have been in business a considerable number of years and have built up large capital, surplus and reserve funds and who guarantee what they sell and who only sell against completed properties.

After you have your Board and have accumulated enough capital you can start your organization and one of the first departments you have to organize is an Appraisal Department made up of a chief appraiser and several assistants. In our company due to the size of New York City we have a separate appraisal department for each Borough and each of these departments is complete in itself and is headed by an expert appraiser. Ordinarily the city is divided up into sections and the assistants keep all of the data in regard to applications for loans, etc. The chief appraiser should be a pretty good man himself. Naturally he is a young man, not too young, not a boy. He must know the locality, keeps in touch with all that is going on in the district an makes his reports in detail. He gets details of sales that do not appear in the business papers. Those sales are all kept on record. Details of sales are also gotten from the stamps that are used. Stamps are not as reliable because a broker may put on more stamps than necessary for reasons of his own or they may be affixed by an inexperienced person. The appraiser must be familiar among other things with the rents, building vacancies; know whether a building is renting well, or whether it is vacant most of the time, and what the rents are, because fundamentally real estate is not at all different from a railroad or an industry, as the consideration of earning power is a very important one. The value of a railroad or an industrial security is judged by the earning power of the property or company instead of the physical value of the property. This is just as true in the case of real estate mortgages. The value of real estate is simply a capitalization of its net earning power. As the values must be based on income and the appraiser must use judgment as to what that income is and that of course requires experience. At the present time we are at the peak of high rentals and high values, most people think.

An application is made for a loan, the application is looked over and passed upon and if we are interested the property is then examined by experts from our loan, appraisal and engineering departments and a full report made to the Loan Committee who have to pass upon it. The Loan Committee is made up of men who are experienced in all phases of real estate mortgage financing. This committee should always be composed of men experienced in real estate and banking matters. We think we have the finest Loan Committee, Mr. Frank Bailey, Mr. Arthur H. Waterman, Mr. Louis J. Horowitz. Mr. Leo S. Bing and several others who are not quite so familiar to you are on it.

Our appraisal department alone costs about $500,000 a year. That is just the expense as it produces nothing but data, details and opinions as to values. When you get through building your appraisal department you get to the engineering department. This is also most important.

In many boroughs and many cities, the code in reference to building construction is not lived up to. You cannot depend on the political appointees of any municipality to live up to rules and regulations and pass proper judgment on plans and construction. We have to watch plans carefully to see that we get a properly constructed building. The engineering department passes on the plans. You would certainly be surprised if you saw the number of plans that are drawn up that are all wrong. Plans without enough closet space, insufficient lighting, poor layout, lack of sufficient elevators, plumbing, etc., are some of the things that have to be watched. As long as there is the required number of cubic feet to a building, that is all that seems to matter to some people. These are only some of the elements that we have to consider when making a loan. It is nonsense to say that if a building contains a certain number of cubic feet that is all that is necessary. A poor building might contain the same number of cubic feet as a well built building, but the latter will rent better and give a higher return on the investment. It will have less vacancies than a poorly planned one. Prominent architects often make plans but practical experience in handling real estate is needed in addition to theory. The engineering department also passes on the amount of the advances to be made from time to time on the building. It knows all about the building, how much of the work is done and how much is to be done, and they base their figure for advances on that.

A good many laws are passed every year for the purpose of helping the mortgage business. We have passed in our State during the last year some legislation of very material help to the mortgage business which allows a foreclosure for interest or taxes or an installment of principal without declaring the full amount due. This is a help to the borrower, a help to any guaranteeing company and to the investor. You cannot just take any appraiser's word for values as there are all kinds of appraisers. I am sorry to say this but there are only a few real good ones. It is much better to have your own appraisal department headed by a real expert having thoroughly competent men under him.

In this mortgage business the same as in the ordinary run of business, the borrower doesn't pay more for his money than he does for anything else. One great fallacy is to have a very high class architect figure the cost of the building and have somebody figure the cost of the land then add the two figures together and submit that as the value of the property. That is all wrong. The two must be taken together to be figured properly and by the one appraiser. In figuring the income, we use what is called a work sheet, everything being shown in detail on one side for the operating expense and the other side for income. The operating expense includes charge-off for proper expenses; allowances for interest, taxes, foreclosure expense, vacancy, etc., that might accrue if your appraisal is wrong and you have to foreclose on the property. Sometimes your judgment may be wrong, or a mistake may be made in figuring, and these allowances must be made. I think you will agree that we might be at the peak of prices; in fact we think we are and also we believe most cities of this country are over-produced in hotels and office buildings, and at this time we are not making mortgage loans on either of these types, regardless of the equity behind the mortgage. Also in New York City I will say that changes of streets, subways, etc., have created bad fluctuation in values, but the percentage of loss occasioned by such changes is very small in a large volume of business such as ours.

After a loan is made most everybody thinks you are through with it. No guaranteed mortgage house is through with the loan until the loan is paid off. I am not trying to be critical as to the surety companies. If they went to the same expense that we do, they could guarantee loans too, but I say that they are not equipped to do it. They haven't the organization nor the capital to do this and that is what I want you to keep in mind. Surety companies don't watch advances. They have no way to follow the guarantee after the loan is made. On the other hand we have an organization that finds out whether the owner pays his taxes; if it is kept up, etc. If it is near the ocean, if it has a water frontal, we make what we call a frontal loan. By a frontal loan we mean our mortgage is so worded that in case of heavy storms or erosions by sea; or shifting sands, causing damage to the property on which we have the mortgage; we can go in and make the necessary repairs in the event that the borrower does not repair the damage. It might mean putting in new bulkheads and jetties and some fill, the expense of which would have to be paid by the borrower. All those things have to be watched and they are only a few of the things done by a mortgage guarantee house.

I don't believe the surety companies get any part of the preferred business. I say this because the borrower goes first to a life insurance company, from there to a savings bank, from there to a guarantee mortgage company, from there to some of the other bond houses that don't guarantee their goods, and finally to the surety companies. Why do they ask for your guarantee? Because none of these others will take the loan. Because you can do it cheaper and the borrower doesn't have to pay for your guarantee. Now that is in a small way the substance of the mortgage business. I have not touched on the matter of the sales department or the bookkeeping and record end of the mortgage business. These are very important, but I have tried to be as brief as possible.

(EDITOR'S NOTE: At the conclusion of his address Mr. Greve invited the members to ask questions. The following is a transcript of the discussion.)

Q. I would like to know whether you feel it is good business for surety companies to guarantee the individual mortgages that are placed as collateral or part of an issue against a mortgage? I understand National Surety Company guarantees only principal and interest of the entire loan.

A. As I stated before, I do not think the surety companies are properly equipped to guarantee mortgages; however, to anyone who has the proper organization for guaranteeing mortgages it is especially good business to guarantee individual mortgages placed as collateral provided they guarantee all of the mortgages behind the collateral. Some of the surety companies guarantee only part of an issue, which is the worst thing you can do as partial guarantees are unfavorable to the surety company or to any guarantor because they might have to bid in the property at a foreclosure sale at an amount equal to or greater than the entire loan to make good its guarantee; and if you have to do this you are forcing yourself to protect the other fellow who has no guarantee and it is apt to cost you money. You can guarantee most any type of mortgage, provided you have enough knowledge.

Q. What do you think of the individual mortgage and the small home owner?

A. There is no question about the small home owner or the individual mortgage. The small home owner is the best risk. From our experience it is proved that they are the most reliable and during the last twenty years $220,000,000 has been loaned by one company to small home owners with a loss of only $20,000. It would take some of you fellows a long time to figure the percentage of loss on these figures. Last year one of the title companies' sales amounted to $160,000,000. Their loss due to foreclosures for the same period amounted to $125,000. Considering the volume of business done this is negligible.

Q. Some of the surety companies guarantee the entire issue of bonds. If anything went wrong or one of the issues went into default would it bankrupt the surety company?

A. I cannot imagine a piece of real estate that goes to nothing, yet there are some examples in Florida where the shrinkage is stupendous. They have hotels and office buildings ten stories high, or more. I don't know what they want the office buildings for and I think it would be well if six or eight stories were chopped off, but taking the Florida cases as an extreme example I do not feel that the surety companies who guarantee an entire mortgage against one of these propositions would go broke. But they would have to take a substantial loss.

Q. Isn't it true that the cost of the surety bond is passed on through the investment and taken out of the investor?

A. In the case of a surety guarantee to the bondholder it is customary for some of the companies to charge the customer one-half of one per cent and in some cases one per cent. If, however, you are referring to the bond of completion, I would say that borrowers go to brokers as a rule to place the loan and they look for the cheapest places to borrow first. Brokerage is usually high. A good bulk of the new issues comes through the speculative markets and while the borrower doesn't want to pay any more than he has to, he would have to stand the cost of the completion bond.

Q. How do you figure your guarantee compares with the surety company guarantee?

A. We feel that our guarantee or the guarantee of any one of of the five leading companies in New York is superior to a surety company guarantee, due to the fact that we have an organization that is built purely from a view point of making and selling a special security with an unconditional guarantee. We do everything. Put in our own money first, do not sell until completion and have the proper facilities for full investigation before the loan is made and for the proper follow-up after the loan is sold. Furthermore, we are guaranteeing only one commodity whereas a surety company is guaranteeing thousands of different risks.

Q. Do you expect to have any losses?

A. Yes we expect some losses in bad times and we set up a proper reserve to take care of them. To date, however, we have not had any losses. The usual losses in the guaranteed companies are very small, they always get the preferred mortgages, but it is not human not to make mistakes at some time or other. Many of the companies who can't sell their bonds themselves and whose credit isn't any too good go and buy a surety guarantee in order to try to sell the goods and we think that this is a risk.

Q. Isn't it true that some mortgage companies get into trouble because they don't handle each loan separately and because they put all their funds and mortgages into one pot?

A. No. The answer to your question is that the men behind the companies don't have the proper knowledge and experience in the real estate mortgage business and that is the reason for the trouble. You can't run a business properly unless you know all that there is to know about it.

Q. What is the purpose of your company's revolving fund?

A. The revolving fund is to enable us to carry through our building loans. This fund amounts to $15,000,000 and is with the Central Union Trust Company. We put our building loan mortgages in this fund and advance to the borrowers from same as the building progresses, on the reports from our engineering department. In this way we carry all of our mortgages through to completion and not one cent of any mortgage is offered to the public until the building is fully completed and income-producing. Many companies as you know sell the so-called security to the public before a spade of earth has been turned and simply against a set of plans and specifications.

Q. You mean by this that you take a risk when you sell against a building which is uncompleted?

A. Ordinarily the bondholder would be taking a considerable risk, but it is possible to so rig the business that you can sell against uncompleted properties, but we do not feel that this is the proper kind of business when you are guaranteeing everything that you do.

Q. What is the basis of your guarantee? The capital invested in your business?

A. Our guarantee fund is composed of capital, surplus and reserves of over $14,000,000. This is in the form of bank deposits in the state of New York, securities and first mortgages. We have nothing behind our guarantee but first mortgages, securities and cash and the securities are mostly such as are legal for savings banks in the state of New York.

Q. Is this capital and surplus invested in your mortgages?

A. Yes, we invest our money in first mortgages, buy them back, sell them again and thus make a turn-over. History has shown that a conservative real estate first mortgage is the safest investment known and over a period of time it also offers the highest yield.

Q. Suppose you have two buildings exactly alike. One is a 60% loan and the other an 80% loan; is there any difference in the rate of interest in these two?

A. There might or might not be a difference in the rate of interest, but there usually would be a difference in the initial cost of the loan. We do not make 80% loans. In the case of the 80% loan the fundamental 20% depreciation is out and the mortgagee gets it. We will not guarantee depreciation. I don't think anybody can live and guarantee 80% loans, but you can bet your last dollar that if the mortgagor owned both of the buildings that he paid a lot more to get the 80% loan than he did to get the 60% loan regardless of the rate of interest in the two cases.

Q. What is a conservative ratio of outstanding guarantees to capital, surplus and reserves?

A. I think a conservative ratio is twenty to one.

Q. Is it about that with your Company now?

A. No it hasn't reached that point as yet.

Q. How do you select the territories in which you operate?

A. It is purely a matter of judgment in choosing the right place for doing the best business. I might add that we are now experimenting with an office in Jamaica, Long Island. We are trying to get our personnel together so we can operate from that end. When we feel that we want to branch out we send out investigators and make a careful study of all conditions in the territory selected. In this investigation we do not mecessarily stick to purely conditions as affecting the first mortgage industry but make a careful survey of everything. We then try to figure the best section in which to commence the next operation.

Q. How do you secure diversification in your mortgages?

A. We loan on all types of property except absolute specialties, by the latter I mean a business building that is constructed for just one specific business and which is not readily adapable to other kinds of business. Churchs and legitimate theaters also might be called specialties, however, a theater which had stores on the street front, which is carrying the interest and amorization charges on the loan without regard to the theater itself would be considered a good loan. We do not buy anything but individual loans and we have them on many different classes of buildings. I will give you an illustration. We recently took an issue from the Famous Players, some twenty-five million in all. We didn't sell or guarantee this issue, but have sold it to another bond house. The reason being that the issue includes too many theaters for us so we merely acted as negotiators. We know pretty well how many hotels, office buildings, apartment hotels, two and three-family houses, industrial buildings and garages there are in any section of the country, but we make it a practice never to loan on too many buildings in any one industry nor to loan too much on any one class of property or too much in any one section of a city.

Q. Do you intend to branch out?

A. Yes. Branching out can be done but it is a slow process and a very expensive one. Ordinarily a branch office will not pay for several years. It requires a lot of money to get started and while everybody thinks it is very easy you must have considerable capital and surplus. We don't believe in getting rich over night but believe that the slow conservative road is better.

Q. Do you loan against small mortgages?

A. Yes, we make hundreds of loans against individual homes which we sell in New York state mainly to savings banks. These mortgages are legal for savings banks and also legal for trust funds in our state.

Q. How can you compete with the insurance companies and banks?

A. We compete with them in this way. We solicit our own loans. We have loan negotiators in the field following up every possible lead and trying to loan the other fellow some money. Furthermore, we are in such a position that when we find a borrower whose proposition is attractive, we can give him an immediate answer and give him the money at once. Many of the insurance companies and banks may investigate the loan, but before they can accept it it might have to go before their next loan meeting and many times they are not in a position to loan the money at once even if they do accept the loan, but tell the borrower to come back at the end of the month or two months. The borrower is usually willing to pay a little additional for prompt service.

Q. Would your loan on a private residence be higher than a savings bank would loan?

A. No, we sell our mortgages to savings banks.

Q. Do you retain any of a mortgage yourselves?

A The answer to this is yes and no. In the first place we make building and permanent loans and we retain the building loans ourselves until completed before selling. We may then sell the whole issue to a savings bank or to the public. Permanent loans of course can be sold at once. We make and sell only first mortgages and do not sell any seconds ourselves. We have what we call three classes of goods. First, we have a bond which is a first mortgage collateral bond issued against a group of first mortgages deposited with an independent trustee. We also sell what is called a Certificate which is a participation in one specific mortgage. These are sold legal for trust funds in New York state. We have also had a number of legal issues in the state of New Jersey. In the third case we sell the individual mortgage. These mortgages range from $2000 to $2,000,000, and in the case of insurance companies and savings banks we often sell them mortgages of one million or over. In all three cases the goods are unconditionally guaranteed as to both principal and interest. Individual mortgages are legal for savings banks.

Q. If you have a default on a payment of principal and interest on a mortgage would you take it over?

A. Yes, we could do that. We don't take property, however, to hold or operate, but immediately sell same. Of course you have to consider the circumstances. In the case of mortgages on small homes the people are usually a little late in their payments, they are seldom prompt. However, they simply need following up and we have a very efficient system of follow-up and so far have not had any trouble in getting the money. Individual home owners are not dishonest; they are merely sometimes a little lax in their business methods as applied to their own home. In the case of the guarantee company, however, it has to pay its interest on the date when due. In the case of our company, we will cash coupons on our bonds fifteen days before the interest date if they are brought to any of our offices. This is a special accommodation. In the case of interest checks on certificates or mortgages, the checks are mailed out by us to the investor the night before in territory adjacent to New York, but if the investor lives far away such as in Texas or California we make it a point to see that our checks to all these distant customers are mailed four or five days earlier so that they will receive same on the date due. In most cases on our larger mortgages, however, the interest is always ahead of time and it is only exceptional cases in which it is sent to us a day or two late. Conservative money can only be made in a conservative mortgage business by doing a large volume of business and giving service.

Q. With experience but no capital could a surety company do as you have done?

A. No. You can't take the conservative loans without capital. Suppose you make a million dollar loan on a certain building in Boston, you want to borrow that money, most bond houses you say will loan you the money, however, they will charge you interest on the entire million dollars right from the start. We don't. We charge interest on the money as it is advanced. If a builder wants fifty or a hundred or two hundred thousand dollars, as the building proceeds he only pays interest on the amount drawn and then when the full amount has been paid to him and the mortgage closed, then only do we begin charging him interest on his total loan. It requires a large amount of capital to carry the building loans through to completion if you do any volume of business.

Q. Do you think a surety guarantee is needed?

A. No. In the first place you don't need any surety company guarantee if you have both the ability and capital to run your business and in the second place you can sell your goods better on your own guarantee which is far better than the guarantee of any surety company. In our case we have more money behind our guarantee than any surety company and as stated before, this guarantee is only behind our securities and doesn't have to cover a multitude of various risks. In our case we don't have to put the borrower to any additional expense; we don't charge him anything more for the guarantee. We charge the investor for that, but he is assured that we believe in what we sell him and we say if your security is as good as you say it is why not so certify by endorsing your all on the security to show your faith.

Q. The bond house that has to get the surety guarantee on a proposed loan also has to get some money to advance to the borrower. How does he do it?

A. Yes, it is very true that the builder must make payment to contractors for materials and work done. Very few builders have the capital to finance their building through without a loan. Now, unless the mortgage or bond company has the capital of its own to finance the loan to completion it has to go out and sell the construction loan to the public. Many real estate loans are made and sold to the public before the building is up, sometimes and in fact, very often, even before the old buildings are torn down, the entire issue of bonds to cover the new proposed building is in the hands of the public and these are sold in the guise of first mortgage real estate bonds and they should be called by their proper term, construction bonds. The mortgage guarantee companies don't conduct their business in this way.

Q. When such a company as the one mentioned in the last question buys a surety company guarantee does it ever dispense with the guarantee?

A Yes, sometimes they may sell an issue without a guarantee or they may sell only part of the issue guaranteed and the other part unguaranteed.

Q. Do your customers dispense with the guarantee?

A. No, in the first place we don't sell anything unguaranteed and our customers seem willing to leave their money with the guarantee company. This is a funny thing to say, but the ordinary investor doesn't know what he is buying. He buys on the reputation of the company and the faith he has in it. It seems that the fact that the company has seen fit to guarantee with its own capital, surplus and reserves, its securities, that he has more faith than he would in one who didn't.

Q. Do you believe that in order to successfully launch a mortgage company it is necessary to start on a very large scale?

A. I don't think a mortgage company can be successful unless it has a very considerable amount of capital.

Q. You mean you can't start out in a small way?

A. I don't think so.

Q. Is it that competition is too great?

A. No. It is true that you have competition with the life insurance companies, savings banks and trust companies and now along come the national banks. Of course by having a surety company guarantee your mortgages it enables the small financier of good judgment to start a mortgage company. Don't construe from my remarks that a fellow can't do it. It can be done. Some fellows are satisfied with small profits and to wait a long time to get any place. I am talking generally. Probably that is the reason why they want the surety company, but the surety company can't make any money on a small volume of business of that kind. To do that business safely they must do the same as we do; put the builder and contractor on the bond, and another reason why they must do as we do is because they are guaranteeing, really they are buying the bond when they guarantee.

Q. Would you say, Mr. Greve, that it was a lack of capital that was the cause of the failure of Miller and Adair?

A. No. The Adairs are very nice people, but it was too bad that both of these concerns knew nothing about their business. They got into the bond game and yet they didn't know anything about it. After they had profitably picked the mortgages they turned around and lost on every bond they handled and you can't do business without volume. You must have an organization to carry your overhead, to get your information on loans to sell, etc., and unless you can sell what you take you are not going to get very far; and as I stated before, it is not good policy and you can't live long upon loans ranging from 80% to 100% of the value of the property.

Q. What are real estate bonds ordinarily netting the investor, that is, what is the rate of interest?

A. In today's market guaranteed mortgages, bonds and certificates yield five and five and one-half per cent.

Q. How long are the maturities at these rates?

A. Seven to ten years, that is as long as any of the maturities run with the guaranteed houses.

Q. Is there any reason for that?

A. Yes, long maturities in real estate bonds are not conservative. There are too many uncertainties and changes in real estate such as changes in neighborhood, changes in land value, depreciation of property and changes in the times.