Office of the Comptroller of the Currency

Moments in HISTORY

Policy Connections From the History of the Federal Banking System

The History of National Bank Real Estate Lending: Part I (1863-1980)

Roger Tufts, Supervision Risk and Analysis, OCC
and
Bianca Werner, Supervision Risk and Analysis, OCC

The Office of the Comptroller of the Currency (OCC) has supervised national banks since 1863. This article describes the history of national bank participation in the market for real estate-secured lending. The article also describes how the OCC's and legislative thinking on real estate lending has evolved. We divide the 160 years of the OCC's history as the chartering authority for national banks into three intervals: 1863 to 1914, 1915 to 1980, and 1981 to 2022. Part 1 of this two-part series focuses on the first two intervals, a period of just under 120 years, when the system of national banks evolved from having no authority to lend against real estate to becoming a major participant in the real estate-secured lending market.

1863 to 1913: Prohibition on lending secured by real estate

For many decades prior to the establishment of the OCC, commercial bank real estate lending had been controversial. Thomas Kane noted that the original 1863 National Banking Act "conferred authority upon national associations to loan money 'on real and personal property.'"[1] One year later, the initial draft of the 1864 amendments to the act included that same language. However, during debate, the words "real and" were removed at the urging of Representatives James Brooks of New York and George Boutwell of Massachusetts. The four arguments against allowing national banks to lend against real estate collateral were (1) the real bills doctrine, (2) the illiquidity of real estate mortgage loans, (3) interest rate risk, and (4) monopolistic advantage.[2]

[1] Thomas Kane, *The Romance and Tragedy of Banking*, (New York: The Bankers Publishing Company, 1923), 85.

[2] These arguments that criticize national bank real estate lending apply equally to state chartered banks.

The real bills doctrine

The "real bills doctrine" was a fundamental conceptual criticism of bank lending against real estate collateral. Though not generally highly regarded today, the doctrine held considerable sway in the 1800s. The doctrine argued that banks should lend only when loans were collateralized by short-term assets (i.e., bills). An example is a company that makes cotton shirts would purchase $100 of cotton cloth from a textile company. The textile company would send a bill for $100 payable within 90 days. The shirt company would endorse that bill, indicating its willingness to pay within that timeframe. In effect, this bill had become what today would be called short-term commercial paper of the shirt company. The shirt company expects to repay that bill from the proceeds of the shirts that it sells. Next, the textile company could offer to sell that short-term loan to a bank. The bank, in turn, would discount the note by paying the textile company an amount less than $100, depending on the market rate of interest for a 90-day loan to a borrower with the credit risk of the shirt company. If the credit risk of the shirt company warranted an annual interest rate of 4 percent, the bank would pay roughly $99 for the bill, with the expectation of receiving $100 at maturity. This represents a discount of $1 on the $100 maturity value and is in effect a 4 percent interest rate on $100 for 90 days.

These steps of the transaction conform to the real bills doctrine because the underlying transaction is supported by the real production of a good or service. This example is contrasted with lending that supports non-real activity, such as speculation in the stock market. Bankers in the early- to mid-1800s did not typically advocate lending against stock or bond collateral.[3] Similarly, bankers that had other lending alternatives, in particular East Coast banks with larger urban populations and industry, did not lend long-term against real estate collateral.[4] That would not have been consistent with conventional real bills doctrine banking. However, the history of financial crises from the late-1800s to the stock market crash of 1929 has shown that large New York banks often lent short-term against stocks and bonds using call loans, for which the bank could demand immediate repayment.

The illiquidity of real estate loans

In 1863, real estate loans were illiquid. Each property, as well as the health and life expectancy of the borrower, was unique. In addition, should the borrower default, the lender needed to follow the law in foreclosing on the property. Owing to difficulties in traveling to monitor collateral and the borrower who owed on a long-term obligation, real estate lending remained inherently a local market through the 1920s. Data highlights the absence of financial institutions serving as intermediaries between real estate borrowers and investors. In the United States in the early-1890s, only 30 percent of mortgages were held

[3] Former Comptroller Hugh McCulloch, in his October 1876 address at the American Bankers Association, argued that, "As banks are commercial institutions, created for commercial purposes, preference in discounts should always be given to paper (that is) based upon actual commercial transactions… It is no part of their business to furnish their customers with capital, nor should loans be made under any circumstances for operations in stocks …" In *Proceedings of the Convention of the American Bankers' Association held at Philadelphia October 1876,* 27.

[4] Throughout the 1800s, loans had very short maturities, which was in keeping with the real bills doctrine. For example, in 1900, 35 percent of all loans in New York City were on demand, callable at any time. In the banks located in the 19 reserve cities, 29 percent were on demand. The on demand percentage was much lower at country banks, where the on demand proportion was only 12 percent.

by financial institutions, and these mortgages were generally not amortizing notes.[5,6] Mutual savings banks in New England and the Mid-Atlantic states accounted for half of that 30 percent institutional share. Commercial banks accounted for less than 3 percent (i.e., less than 1 percentage point) of that 30 percent institutional share.

The vulnerability of banks to a run by depositors reinforced the hesitancy of banks to hold long-term assets. Unlike in 1870, when deposits were only 1.9 times the quantity of the government bond-secured national bank notes, by 1900, deposits were 7.7 times the quantity of bank notes.[7] In the event that a bank was confronted by a run on deposits, the short term bills (i.e., loans) could be rediscounted by selling the assets to other banks, thereby providing the necessary liquidity to withstand the run. Long-term real estate loans did not provide that liquid access to funds in times of stress.

Interest rate risk

Throughout the first 70 years of existence, the OCC advocated for a prohibition on the payment of interest on checking accounts.[8] Yet, it was not until the 1933 Glass-Steagall Act that Congress finally enacted that prohibition, while at the same time creating the Federal Deposit Insurance Corporation to insure deposits up to a stated limit, originally set at $2,500. In 1933, demand deposits at national banks were 33 percent of their total liabilities.[9] Thus, from 1863 to 1933, paying interest on a short-term liability to fund a long-term real estate loan exposed a bank to the risk that market interest rates might rise. If rates rose, the bank would generally have to respond by raising the rate it paid on deposits to retain those deposits, while the longer-term loan did not reprice. This interest rate risk was another rationale for prohibiting national banks from lending against real estate collateral.

Monopolistic advantage

In 1864, banks were often located in very small towns. Because national banks generally could not open branches in addition to the main office, some legislators thought the national bank charter would become the dominant charter type in small towns that could support only one bank. This led to the concern that national bank officers in small towns would lend against real estate indirectly by using their monopoly power in deposit-taking to benefit themselves and associates through speculative real estate deals.

[5] Kenneth Snowden, "The Evolution of Interregional Mortgage Lending Channels, 1870-1940: The Life Insurance-Mortgage Company Connection," in *Coordination and Information: Historical Perspectives on the Organization of Enterprise*, edited by Naomi Lamoreaux and Daniel Raff, (Chicago: University of Chicago Press, 1995), 220.

[6] The other 70 percent of mortgages were private transactions between the buyer and seller.

[7] OCC, *Annual Report of the Comptroller of the Currency* (1900), 34 – 38, and OCC, *Annual Report of the Comptroller of the Currency* (1870), 597.

[8] Comptrollers Hiland R. Hulburd (1867–1872) and John Jay Knox (1872–1884) both strongly criticized the payment of interest on checking accounts. In his recommendations for legislative changes to the National Banking Act, Comptroller Knox suggested a compromise; in exchange for a prohibition on the payment of interest, the then prevailing tax of one-half of 1 percent on all deposits could be repealed. He would have retained the tax on checking accounts that were paid interest.

[9] OCC, *Annual Report of the Comptroller of the Currency* (1933), 49.

Limited national bank lending

The 1864 National Bank Act revised the 1863 act and contained very limited permissibility for national banks owning or lending against real estate collateral. The act specified:

> That it shall be lawful for any such association to purchase, hold, and convey real estate as follows:
>
> First. Such as shall be necessary for its immediate accommodation in the transaction of its business.
> Second. Such as shall be mortgaged to it in good faith by way of security for debts previously contracted.
> Third. Such as shall be conveyed to it in satisfaction of debts previously contracted in the course of its dealings.
> Fourth. Such as it shall purchase at sales under judgments, decrees, or mortgages held by such association, or shall purchase to secure debts due to said association.
>
> Such associations shall *not* purchase or hold real estate in any other case or for any other purpose than as specified in this section. Nor shall it hold the possession of any real estate under mortgage, or hold the title and possession of any real estate purchased to secure any debts due to it for a longer period than five years.[10,11]

Apart from the ability to own real estate for the purpose of conducting its business, a strict reading of the law only allowed banks to accept real estate as additional collateral for a loan evidencing distress, which was an already-existing debt to the bank. This restriction made national banks relatively unimportant participants in real estate lending until 1913, when the Federal Reserve Act of 1913 slightly expanded permitted national bank activities. Interestingly, the 1913 act required the OCC to collect information on several types of institutions, including both OCC-supervised and non-OCC supervised institutions, and to report that data in the OCC Annual Report. Data collected from national banks and these other providers of mortgages are summarized in Table 1 that follows.

[10] This is the original text from Section 28 of the National Bank Act, June 3, 1864. The text has changed a number of times over the years.

[11] Other researchers have found "that some banks, particularly those farther west, had a considerable portion of their loans in real estate mortgages despite legal prohibitions on originating such loans. Such prohibitions appear to have been evaded by incorporating real estate as secondary collateral after the origination of the loan." Charles W. Calomiris and Mark Carlson, "National Bank Examinations and Operations in the Early 1880s," Finance and Economics Discussion Series, Division of Research & Statistics and Monetary Affairs, Federal Reserve Board, 2014-19, https://www.federalreserve.gov/econres/feds/national-bank-examinations-and-operations-in-the-early-1890s.htm.

Table 1: Loans secured by real estate at financial institutions in 1913[a]

Institution type	Count of institutions	Total assets of those institutions (millions)	Loans secured by real estate in those institutions (millions)	Real estate loans as a percent of total assets
National banks	7,473	$11,036.9	$76.8	0.7%
State banks	14,011	$4,143.1	$555.6	13.4%
Savings banks	1,978	$5,225.5	$2,303.7	44.1%
Private banks	1,016	$182.8	$35.2	19.3%
Loan and trust companies	1,515	$5,123.9	$576.3	11.2%
Building and loan associations	6,273	$1,248.5[b]	$1,166.1[c]	93.4%
Total	**25,993**	**$26,960.7**	**$4,713.7**	**17.5**

Source:
[a] 1913 Annual Report, pp. 37, 60, 75, 768-773.
[b] 1914 Annual Report, p. 99.
[c] Estimated using the proportion (93.4%) of real estate loans in the 20 building and loan associations in Washington, D.C. in 1913.

The data in Table 1 is convincing evidence that national banks were not meaningful participants in real estate lending in 1913. The $76.8 million in real estate loans at national banks in 1913 was less than 1 percent of their total assets and only 1.6 percent of the total $4.7 billion of real estate loans[12] made by the six types of institutions in Table 1. The largest share was held by savings banks, which accounted for 49 percent of the total real estate loans.[13] Savings banks were predominantly East Coast and California institutions in 1913. The savings banks in the 11 states, from Maine to Maryland, plus the District of Columbia held $1.8 billion of the $2.3 billion in real estate loans of savings banks, or 76 percent.[14] California savings banks had a 14 percent share of the total real estate loans of savings banks.

The building and loan associations, which first appeared in the United States in the 1830s, provided a unique and important form of real estate lending. In 1912, there were roughly 2.5 million members of the 6,273 building and loan associations. These had total deposits of over $1 billion, with most of their assets in real estate loans to their members. Members of a building and loan association, "… held shares in the institutions and, in return, had borrowing privileges as well as the right to dividends. Broadly speaking … members committed to make regular payments into the association and took turns taking out mortgages with which to buy homes… From their advent in the 1830s until their demise during the Great Depression, building and loan associations were generally small and local."[15]

[12] The percent of real estate loans held by national banks in 1913 is calculated as 100 × ($76.8 million / $4.7 billion).

[13] The percent of real estate loans held by savings banks in 1913 is calculated as 100 × ($2.3 billion / $4.7 billion).

[14] These comprise the Northeast category in OCC annual reports: Maine, New Hampshire, Vermont, Massachusetts, Rhode Island, Connecticut, New York, New Jersey, Pennsylvania, Delaware, Maryland, and the District of Columbia.

[15] David A. Price and John Walter, "Private Efforts for Affordable Mortgage Lending Before Fannie and Freddie," *Federal Reserve Bank of Richmond Economic Quarterly* 102, no. 4 (2016): 321-351.

Federal Reserve Act of 1913

Though the prohibition imposed by the 1864 act on national bank lending was in place until the 1913 act, many smaller national banks had earlier advocated for changing the law. Of particular concern to small national banks was the fact that state-chartered banks, which outnumbered national banks 2-to-1 in 1913, were often permitted to lend against real estate collateral. These small national banks also argued that real estate was the best available collateral with which to secure their loans. As described by O.M.W. Sprague,

> Inability to lend on mortgage security has been the most serious disadvantage experienced by country national banks in competition with state institutions. Land has been by far the best local security available over large parts of the country. Rural bankers have, in fact, taken it into account in making loans and by various devices have succeeded in making it the security for many of the loans which they have granted. Under the Federal Reserve Act all banks, except those in central reserve cities, may lend for periods not exceeding five years (up to) twenty-five per cent of their capital and surplus, or one-third of their time deposits, on the security of unencumbered and improved farm land to fifty per cent of its market value.[16]

1915 to 1980: 65 years following the 1913 act

Legislative changes to the 1913 act

The 1913 act was amended many times over the next 70 years. By 1916, national banks were permitted to lend against other forms of improved real estate besides farmland, albeit with only a one-year term. In the 1920s, Congress increased the term for non-farm loans to five years and eased the balance sheet restrictions on capital and deposits. Congress made further changes in the 1930s, loosening more of the constraints by permitting exceptions for some types of construction loans and for loans insured under government programs. The amendments increased the maximum loan to value (LTV) to 60 percent, lengthened the maximum term to ten years, and removed the geographic restrictions.

Throughout the 1950s and 1960s, Congress adjusted the balance sheet constraints, the restrictions on LTV, and the maximum term. The revisions also included exceptions to the definition of real estate loans. For example, an exception was granted for short-term loans to finance the construction of commercial or industrial buildings. In 1955, Congress raised the maximum LTV again, to 66.67 percent, and extended the maximum term to 20 years. By the end of the decade, Congress raised the maximum LTV to 75 percent. In 1964, Congress again increased the maximum LTV to 80 percent and the maximum term to 25 years. By 1970, Congress raised the maximum LTV to 90 percent and the maximum term to 30 years.

In response to the stress caused by high inflation in the 1970s and early-1980s, Congress passed the Garn-St. Germain Depository Institutions Act of 1982. This act removed all the balance sheet constraints on LTV and maturity. Congress found that the historical restrictions on national bank real estate lending were "at odds with today's marketplace"[17] and removed several restrictions. Since then, national banks

[16] O.M.W. Sprague, "The Federal Reserve Act of 1913," *The Quarterly Journal of Economics* 28, no. 2 (February 1914): 213-254. Sprague was also the author of *History of Crises under the National Banking System*, (Washington: Government Printing Office, 1910).

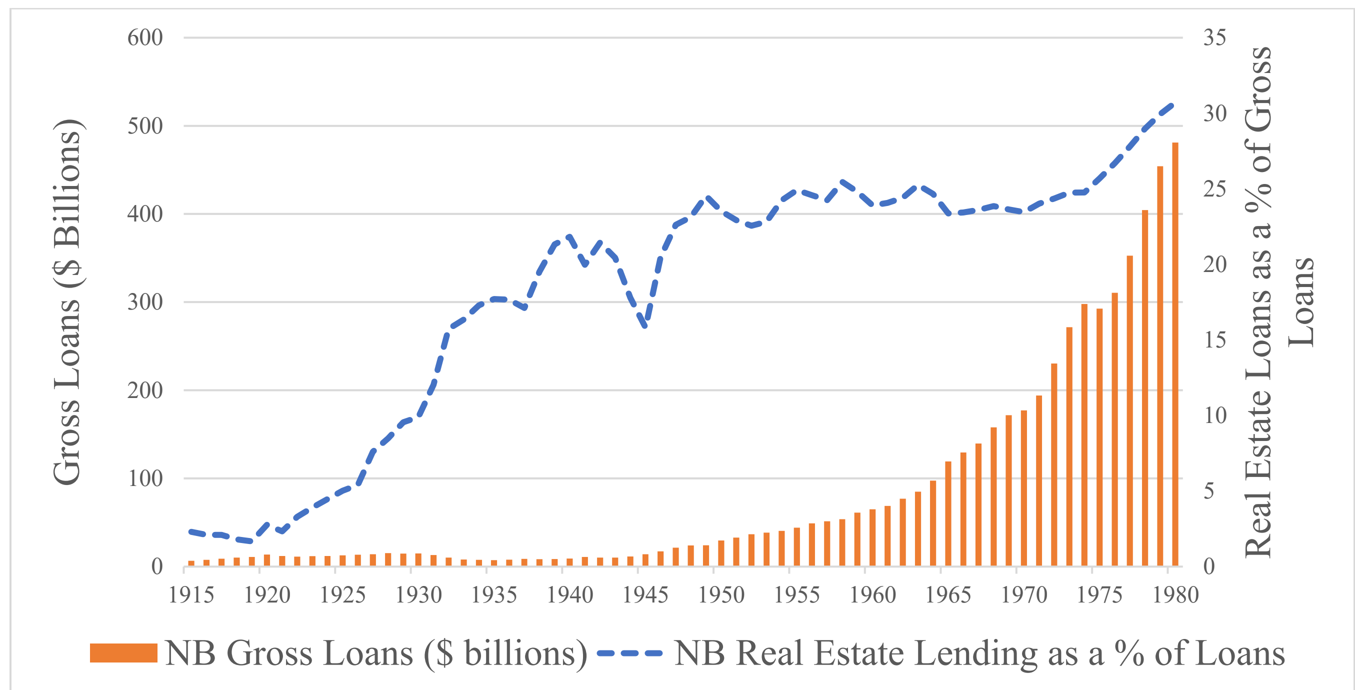
[17] Senate Report 97-536, "Depository Institutions Amendments of 1982," September 3, 1982, 25.

have been permitted to offer real estate loans "subject to such terms, conditions, and limitations as may be prescribed by the Comptroller of the Currency by order, rule, or regulation."[18]

The growth in national bank real estate lending since 1915

The growth of national bank real estate lending evolved after the passage of the 1913 act. In addition to the legislated amendments described above, several events, such as the Great Depression and World War II (WWII), served as catalysts for the increased national banking activity in the market. By 1963, the 100th anniversary of the national banking system, national banks had become an important intermediary for real estate lending.

Figure 1: National bank real estate lending: 1915–1980



Source: OCC Annual Reports

Given the very constraining lending eligibility requirements in the 1913 act, national bank lending remained limited until the real estate boom of the 1920s and the partial easing of the constraints. As evidenced in Figure 1, while gross loans of national banks more than doubled from $6.7 billion in 1915 to $14.9 billion in 1930, the share of real estate loans increased more than four-fold, reaching 9.9 percent of loans in 1930.

Then, with the Great Depression of the 1930s, the proportion of loans collateralized by real estate grew rapidly, reaching 22 percent of loans in 1940. Much of the increase in the proportion was attributable to the fact that other lending volumes collapsed during the Depression. Aggregate loans at national banks fell from $14.9 billion in 1930 to $9.2 billion in 1940, a reduction of almost 40 percent over 10 years. During WWII, loans at national banks grew rapidly, increasing by more than 50 percent. However, because wartime production diverted resources to those overarching needs, real estate lending did not

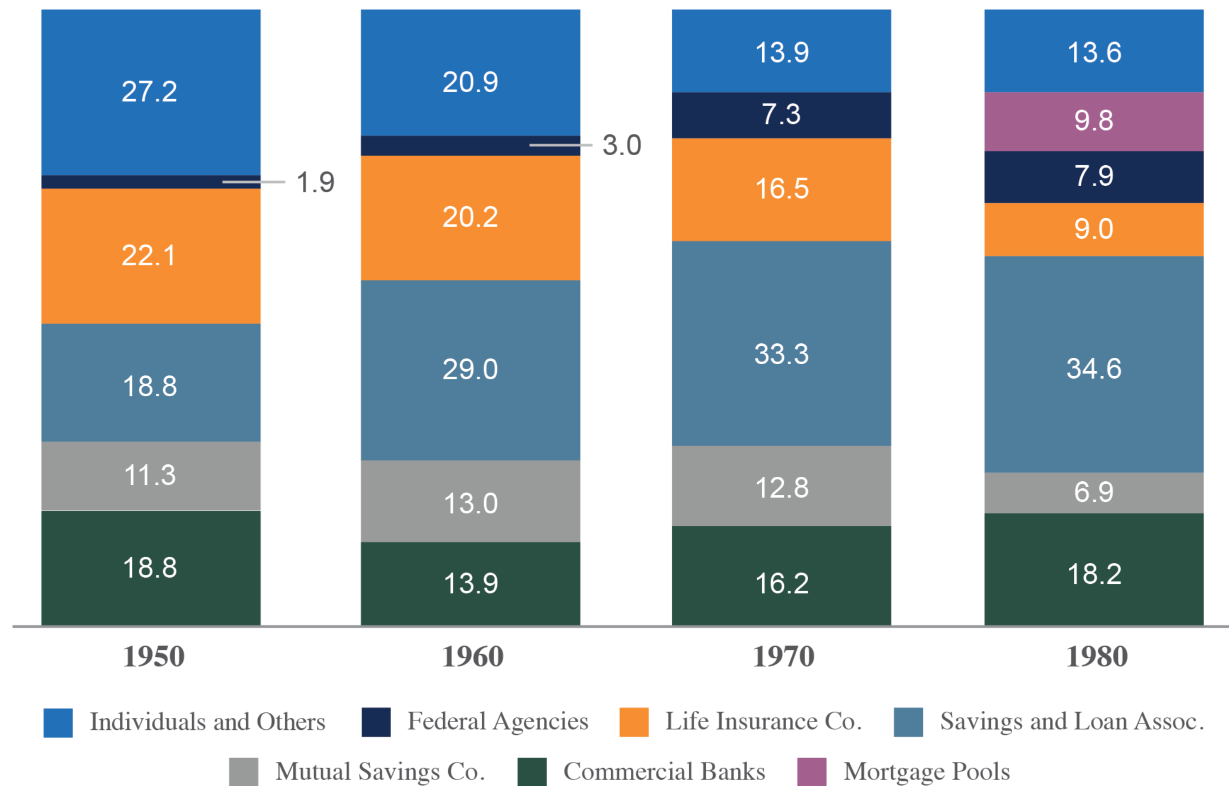
[18] 12 USC 371.

keep pace. Real estate lending as a percentage of aggregate loans at national banks decreased 6 percentage points to 16 percent in 1945.

After the war, consumers' demand for housing grew, such that, by 1949, real estate lending increased to 25 percent of aggregate national bank loans. The proportion of real estate lending stayed roughly constant over the next 25 years (the 25 percent proportion in 1974 was the same as 1949's). However, during this interval, gross loans increased more than 10-fold, implying that real estate loans also rose 10-fold. This period encompassed the tenure of Comptroller James Saxon, who liberalized a regulatory structure that had not evolved significantly since the 1930s and expanded the range of permissible activities for national banks.

Figure 2 shows the shares of real estate loans provided by significant lenders. From 1950 to 1980, total real estate lending increased 20-fold from $73 billion to $1.5 trillion. Though mutual savings banks lost some of their market share, the share held by commercial banks was roughly stable, at 18 percent. The national bank share of the commercial bank holdings of real estate loans rose slowly over this interval from 51 percent in 1950 to 56 percent in 1980. In contrast, loans held by savings and loans created by the 1932 Federal Home Loan Bank Act grew rapidly after the Great Depression and WWII. Similarly, by 1980, the government sponsored housing finance agencies (with the creation of Fannie Mae in 1938 and Freddie Mac in 1970) and pools of mortgage-backed securities substantially increased their shares. The rising shares of lending by banks, savings and loans, and the agencies resulted in the decreased share of lending by insurance companies and individuals.

Figure 2: Proportion of total real estate lending by type of holder



Source: Federal Reserve Bulletins (1981, 1974, 1962, 1957)

Conclusion

The 1864 prohibition on national bank direct lending against real estate collateral was almost entirely effective for the first 50 years of the national banking system. Notwithstanding their protestations for a level playing field with respect to savings banks, building and loan associations, and state-chartered banks, national banks were irrelevant in real estate lending, having *de minimis* holdings. Even the modest lessening of the restrictions implemented by Congress in 1913 did not lead to a meaningful increase in lending until restrictions on maturity and LTV were lessened further in the 1920s and 1930s. Then, the share of real estate loans at national banks increased largely because of the collapse in overall bank lending in the 1930s. After WWII, national banks shared in the very rapid growth in real estate lending, driven by inflation and the changing composition of the stock of U.S. housing and U.S. households.

In Part II of this article, we will review the accelerating pace of change in the U.S. mortgage market in the 1980s as innovative mortgage instruments for households and the structuring of mortgage securities in the secondary market set the stage for the Financial Crisis of 2008.