

GUARANTEERING FIRST MORTGAGE REAL ESTATE  
BONDS

BY

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I am informed that your Society has been told with much emphasis, that corporate surety companies are not equipped to guarantee the payment of principal and interest of first mortgage real estate bonds, and I have been asked to give you my reasons why such companies are equipped to write this line on a satisfactory basis.

If I undertook to give you all the reasons which occur to me why these companies should continue to write these guarantees, this paper would, no doubt, become tiresome to you. The subject is too vast to permit of intelligent analysis in the short time allowed me, therefore, I will content myself with outlining only those points which the underwriters of this line have learned to consider most important.

However, before proceeding with the development of these points, let us pause for a moment and consider a gigantic force, which is everywhere and which must be taken into account by the underwriters.

As we all know, this is an age of tremendous activity in which every line of human endeavor is crowding its advancing steps hard upon the heels of those preceding. This rapid-fire progress is producing an enormous accumulation of liquid wealth, with the result that all human life is feeling the impulse and pressure its building up has created. In the last two decades, this irresistible force has completely changed the standard of living of even the most modest of us, and it has followed, that what was good enough fifteen to twenty years ago, is not good enough now. All this is growth, but it is a vigorous, healthy growth and it travels hand in hand with the march of civilization.

This growth means, in a broad sense, improvement, which in turn demands not only the existence of liquid wealth, but the intelligent, conservative and helpful use of it.

In the very nature of things, this demand must be met, not foolishly or carelessly, but with intelligence; not with a stingy

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hand but with a liberal heart, controlled with broad conservatism. If it is not met in the latter spirit, growth will be stifled, if not actually throttled.

This being true, humanity has a duty to perform, and that portion of it, equipped by inclination and training to aid in the development of growth, owes it to the common cause to lend a helping hand.

With this picture before us standing as a background for the detail which will follow, we turn to the particular class of development we are proposing to deal with—the development of real estate. As a direct result of the irrepressible growth of development in all material things, is the urge to build or improve the homes in which we live and the offices, shops and factories in which we transact business, and as we have seen, there has been accumulated, particularly in this country, a vast fund of liquid wealth which should be available for use in financing the development of real estate.

It, therefore, has come about that there is—

1. An immense volume of real estate improvement demanding attention.
2. A large and insistent demand for funds to use in financing this class of improvement.
3. An insufficiency of funds available for this type of financing, due largely to the fact that the owners of it have not as yet been sufficiently convinced as to the worthiness of this type of investment.

This brings us to a consideration of two propositions—

(a) The great demand for funds for use in financing the development of real estate, and

(b) Where these funds are to be procured.

As a result, there has developed, roughly speaking, three sources which are now advancing these funds. (1) Banks, trust companies and private lenders; (2) trust companies of the type of the Title Guarantee & Trust Co. of New York, creating first mortgages on real estate and selling them without corporate surety guarantee of the payment of principal and interest, and (3) mortgage companies of the type of the Empire Bond & Mortgage Corporation, of New York, creating first mortgages on

real estate and selling the same with corporate surety guarantee as to the payment of principal and interest at maturity.

To those who know the situation it has been apparent for some time, that the funds for investment produced by these three classes of lenders are not sufficient to meet the legitimate demand for the same, and I think that this is largely due to the fact that up to this time the owners of funds which ought to be available for use in this market, while fairly satisfied that a security of this type is sound if properly produced, are not by any means convinced that it is sufficiently liquid to suit their purposes.

For the purposes of this discussion, the first class of mortgage lenders referred to need not be dwelt upon further as the methods followed are as old as the hills and usually operate locally and on a restricted basis. But as between Class 2, which sell securities without corporate surety guarantee, and Class 3, selling their securities with corporate surety guarantee, there is a sharp controversy as to which method of producing and marketing is best for the investor, a controversy which may well serve to bring out the good points in their respective methods but which, in our judgment, is not very valuable for increasing the interest of investors in these types of securities.

This brings us to a discussion of the point at issue, namely; "are surety companies properly equipped to guarantee the payment of principal and interest of first mortgage real estate loans"?

Our answer to this question is "yes" but it must be understood that this answer is limited to those surety companies which are writing this form of undertaking. What we mean to say, is that in our opinion the surety companies which are writing these guaranties are fully equipped to perform effectively every function which should be performed in properly underwriting this line, and in order that you may see that this broad statement is based upon an analysis of all of the important factors developed by the investigation of any risk, we herewith furnish an outline of the policy adopted by one of the mortgage companies in making first mortgage loans, for which the Maryland Casualty Company, which I happen to represent, is guaranteeing the payment at maturity of principal and interest of first mortgages, and in calling attention to this so-called policy, we desire to point out that the loan policy of any mortgage company is a very important

factor to be considered, and its personnel, methods, and policies in negotiating and closing its loans are of the first importance to any surety company proposing to guarantee the mortgages it negotiates.

This mortgage company has adopted a policy which it expresses as its "Fourteen Point Policy," as follows:

1. A general survey is made of the location ascertaining the adaptability of the kind of improvements contemplated for the neighborhood.

2. All buildings of a similar nature within a reasonable area are visited in order to obtain the prevailing rentals, number of vacancies and general demand for space.

3. Real estate firms in the neighborhood are interviewed to ascertain asking and selling prices for similar land in the location.

4. Transit facilities are gone into and class of tenants are investigated.

5. The plans and specifications are carefully inspected to see whether the layout conforms with modern and economical requirements and the materials, class of construction and specified finish are in accordance with our requirements.

6. The plans are figured to ascertain the cost of construction.

7. All figures are then compiled into a set-up sheet and referred to the vice-president in charge of the loan department for his inspection and check-up.

8. If then found satisfactory and the amount of loan applied for does not exceed the percentage policy adopted by us, the set-up is prepared in final form for submission to the following:

- (a) The loan committee.
- (b) The executive committee.
- (c) The board of directors.

9. Before a loan is submitted to the executive committee it must first receive the unanimous approval of the loan committee. When the loan committee has approved, the executive committee considers the loan and if found to be satisfactory, the same must be approved by them without a dissenting vote to be accepted.

10. When the foregoing has taken place, an underwriting agreement is entered into with the borrower.

11. Application is made for a title policy insuring the property and all agreements are submitted to our attorneys for their approval.

12. In the case of a construction loan, a bond in form satisfactory to us must be furnished by a responsible surety company, guaranteeing the completion of the building free and clear of all claims and liens.

A sworn financial statement is also required from the borrower showing that the borrower has sufficient cash resources or secondary financing which, when added to the net proceeds of the bond issue, will pay in full for the land, improvements and all disbursements and carrying charges.

References are carefully checked, the history of the borrower is looked into and trade reports are procured.

13. Appraisals from independent recognized appraisers, (members of local real estate boards) are required, giving value of land, estimated cost of construction, value of completed buildings and estimated gross and net income of building.

14. When the above is complied with, then and only then is the issue closed, the mortgage executed and the bonds offered for sale.

All acts of the executive committee are presented to the board of directors for their approval.

It is our opinion, based upon observation and a rather intimate knowledge, that mortgage companies writing this line follow the foregoing or similar policies in developing their loan underwriting, and that, generally speaking, most of them are taking great pains in developing and analyzing the facts, and are taking very little for granted in their underwriting.

Surety companies should not deal with mortgage companies for the purpose of guaranteeing their issues, whose policies do not measure up in every substantial particular to the policy we have outlined, nor should they deal with mortgage companies whose personnel for the administration of such policy does not measure up to the standard expressly required in the making of conservative loans.

From the foregoing it will be seen, that the mortgage company, if it follows faithfully the steps outlined in the foregoing loan policy, or its equivalent, has decided that it is its business to make good loans, and it follows, that if its personnel is honest

and experienced in the making of good loans and is trained to follow the steps outlined in this policy, it will produce first class loans, and it also follows, that if it makes first class loans, surety companies will be perfectly safe in guaranteeing the payment of principal and interest thereof.

At this juncture the question naturally arises as to what may be deemed good loans.

I have heard this question propounded a great many times and now know of no better general definition than that a good loan is one in which the investor can depend that the principal, including amortization payments, interest, taxes and assessments, will be paid as the same mature, but it must be borne in mind that the production of a loan that will make such a record, involves great care to ascertain first, that all the facts are before the underwriter, and second, that these facts are such as to insure these results.

With this before us we now come to the surety company's standpoint of view, and it seems to me that the following requirements of the surety underwriting furnish an excellent answer to those who have been willing to say that surety companies are not equipped to write this line on a satisfactory basis:

*General.*

1. A surety company should not execute its guarantee except to overcome sales resistance.

2. A surety company should not execute its guarantee except for a corporate lender of sound financial standing, administered by a personnel experienced in making good first mortgage loans, and following closely a loan policy similar to that hereinbefore outlined.

3. A surety company should only guarantee payment of principal and interest of the underlying mortgage or mortgages, and only when the owner and the lender apply for the same and appear as coprincipals in the bond containing the guarantee.

*Specific.*

4. A surety company should require of the mortgage company a full statement of the details of its investigation, the statement being along the lines and in conformance with the points outlined in the loan policy referred to.

5. A surety company should thoroughly check the mortgage company's said statement both for the purpose of verifying the the same and for forming the surety company's independent conclusions.

6. In forming its conclusions the surety company should pay particular attention to the following:

(a) The type of the improvements must be generally harmonious with the character of the neighboring improvements and must be deemed a dependable producer of income during the maturity of the principal debt, sufficient to pay fixed and operating charges and a reasonable factor of safety.

(b) The conclusion must be reached that the transportation facilities serving the location are so good that occupancy therein will continue to be desirable throughout the period of the maturity of the loan.

(c) The conclusion must be reached that the estimated income (gross and net) of the proposed security is not out of line with other estimates of value reached with the use of other factors.

7. A surety company should require the mortgage company to refrain from making any loan wherein the principal is in excess of 65% of the true value of the security, and should take necessary steps at least once a year to ascertain definitely that the mortgage company is operating within this policy.

By way of recapitulation of what we have heretofore said, it is apparent that the surety company writing these guaranties is taking unusual precautions to protect the purchasers of its securities in that—

1. It deals only with approved mortgaged companies whose loans in the aggregate do not at any time exceed twenty times its capital and surplus.

2. It requires the mortgage company to fully indemnify it in each case.

3. It requires in its possession all title, fire and casualty insurance necessary to protect it.

4. It requires a good loan and takes every reasonable precaution to obtain it.

5. It reinsures from 75% to 80% of its liability on each risk.

It will, therefore, be seen that there is no real reason why surety companies should not successfully conduct the business

of issuing these guaranties. They have had a long experience in adjusting claims involving every conceivable kind of any investigation, and in my opinion are ideally equipped to make unusually searching investigations and to dig up the real facts.

Finally—it is our firm conviction, that when the vast body of investors who like real estate but who are not yet convinced as to the desirability of guaranteed first mortgage real estate bonds, really become acquainted with the extreme care the surety company is taking to warrant it in issuing its certificate of approval of these loans—for that is what it means—they will not only approve of this type of investments but will buy them.