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PREVALENT PRACTICE OF VARIOUS FINANCING ORGANIZATIONS
DEMANDING EXTREMELY HEAVY "KICKERS" ON MORTGAGE AGREEMENTS
FEDERAL HOME LOAN BANK BOARD

B-168802
4-9-70

RESTRICTED

Report to Senator Howard H. Baker, Jr., pursuant to his request.

The report contained certain information concerning the practice of various financial institutions of including "kickers" and "piece-of-the-action" in mortgage agreements. The "kickers" and "piece-of-the-action" entitle the lenders to share in the revenues from the mortgaged properties in addition to receiving interest on the loans.

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REQUEST DATED JANUARY 12, 1970, ENCLOSING COPY OF
LETTER FROM CHARLES E. TIBBALS CONCERNING THE
PREVALENT PRACTICE OF VARIOUS FINANCING ORGANIZATIONS
DEMANDING EXTREMELY HEAVY "KICKERS"

B-168802
4/9/70

RESTRICTED

This report was issued pursuant to the request of Senator Howard H. Baker, Jr., for information regarding alleged practices of various financing organizations.

The alleged practices referred to "kicker" or "piece of the action" provisions in mortgage agreements which entitle the lender to share in the revenue from mortgaged property in addition to receiving interest on the loan.

We presented information on this matter obtained primarily through discussions with officials of the principal Government agencies responsible for regulating and supervising banks and savings and loan associations, and for insuring mortgages. The report was not submitted to the various agencies for their review and comment.

Note: No index prepared.

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Revised



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B-168802

Federal Home Loan Bank Board

APR 9 1970

Emery
Dear Senator Baker:

In response to your request of January 12, 1970, we have obtained certain information concerning the practice of various financial institutions brought to your attention by Mr. C. E. Tibbals in a letter dated August 16, 1969.

In his letter Mr. Tibbals stated that:

*** it should be brought to your attention the prevalent practice of various financing organizations demanding extremely heavy 'kickers.' As you know, it has been a prevalent practice to expect points in addition to the interest but now they are demanding and getting a 'piece of the action,' commonly as much as 20 to 25% and reportedly as high as 50%.

*** this [practice] originated with insurance companies but it has spread into the B&L's and even into banks. In private housing, sizable 'kickers' such as this are impractical with the end result this type of financing is nonexistent in some areas. ***.

"It seems to me that these practices are unfair because, with the small amount of money that is available to building, the institutions are taking undue advantage of a difficult situation. They, in effect, have a monopoly and by obtaining a substantial portion of the income from the property they are spreading or forcing this monopoly into areas they normally do not enter other than as an investor. ***."

The terms "kicker" and "piece-of-the-action" are commonly used to refer to a provision included in a mortgage agreement which entitles the lender to share in the revenue from the mortgaged property in addition to receiving interest on the loan. The lender's share in the revenue from a mortgaged property may be a percentage of gross income, net income, gross rent, or any subsequent increase in income or rent from a mortgaged property. Mortgage agreements including such provisions are related to the financing of income-producing properties--apartment houses and commercial properties. Available data indicates that the largest mortgage lenders on apartments and commercial properties are insurance companies, savings and loan associations, and banks.

Our information was obtained primarily through discussions with officials of the principal Government agencies responsible for regulating and supervising banks and savings and loan associations and for insuring mortgages. The discussions concerned (1) the magnitude of piece-of-the-action mortgage financing, (2) the effect such financing has had on the availability of mortgage funds for private housing, and (3) regulations or rulings by the various agencies regarding this type of financing. The officials contacted were from the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Housing Administration.

In summary, there was no data readily available concerning the magnitude of this practice or what effect this type of mortgage financing has had on the amount of mortgage money available for private housing. In addition, only the Federal Home Loan Bank Board and the Office of the Comptroller of the Currency have issued opinions or taken positions with respect to piece-of-the-action mortgage financing.

Most of the officials we contacted cited insurance companies as the biggest practitioners of this type of mortgage financing. Insurance companies are regulated by the various States.

Presented below is the information we obtained concerning piece-of-the-action mortgage financing as it relates to the above Government agencies.

SAVINGS AND LOAN ASSOCIATIONS

All federally chartered savings and loan associations (Federal associations) and those State-chartered savings and loan associations that have their accounts insured by the Federal Savings and Loan Insurance Corporation are regulated by the Federal Home Loan Bank Board. The Board, an independent agency, directs the operations of the Corporation and supervises the operations of the 12 Federal home loan banks. (The banks provide reserve banking facilities for member savings and home-financing institutions.)

At December 31, 1968, all operating savings and loan associations--including State-chartered associations whose accounts are not insured by the Federal Savings and Loan Insurance Corporation--held mortgage notes totaling about \$131 billion. This amount consisted of mortgage notes of about \$110 billion on one- to four-family homes, \$11 billion of mortgage notes on residential properties with five or more units, and about \$10 billion of mortgage notes on commercial and other properties.

Officials of the Board were unable to provide us with information regarding the extent to which mortgage agreements with piece-of-the-action provisions were being used by savings and loan associations, or what effect such provisions have had on the availability of mortgage funds for private housing.

The Board's General Counsel has ruled that Federal associations are not authorized to invest in an "equity interest" in a project they finance. In two issued opinions, the General Counsel stated that:

"A Federal association is not authorized to engage in a transaction in which it makes a loan on the security of a first lien on real estate, and, in addition, receives an equity interest in the project, whether stock in a corporation or a share in the project income."

"A Federal association may receive a percentage of the gross rentals in addition to a specified rate of interest. Such an agreement would not constitute the association a holder of a prohibited equity interest in the project."

In the first cited opinion, the Federal association was to receive a share of net income of the project. The General Counsel noted that this placed the association in the position of an equity holder in the project because the association was assuming the same risks as an equity owner--the association's return was dependent upon the profit-making ability of the project. The General Counsel stated that such an arrangement could result in an association's making unsafe loans because "an association might be willing to make a high risk loan if the profit potential were high enough."

In the second cited opinion, the Federal association's piece of the action was based on a percentage of gross income from the project. The General Counsel stated that this does not constitute an equity interest since this "arrangement does not place the lender in the position of an equity holder in the project because his right to receive a share of the gross income removes him from the risks carried by an equity holder."

Whether a Federal association receiving a percentage of rents from a project would have, in effect, an equity interest in the project, the Chairman of the Federal Home Loan Bank Board stated:

"A percentage of rents may or may not constitute a part of the return rather than an equity investment, depending on the details of the transaction. Such factors as whether the percentage is based on gross rents or net rents and whether payment of such percentage is coextensive with the loan term would have to be considered. In addition, it should be noted that a transaction involving a percentage of rent may be subject to state usury laws. *** "

With respect to State-chartered associations that have their accounts insured by the Federal Savings and Loan Insurance Corporation, the Board's position is that "the law of the state in which they are located is controlling as to their power to make loans and other investments." An official of the Board informed us that the Board would involve itself with an insured State association's lending activities only if they constituted unsafe or unsound practices.

BANKS

Three Federal agencies have regulatory and supervisory jurisdiction over most commercial banks--the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System.

The Federal Deposit Insurance Corporation insures deposits in banks qualified for deposit insurance. National banks that are chartered by the Comptroller of the Currency and all State banks that are members of the Federal Reserve System are required to be insured. State banks that are not members of the Federal Reserve System may become insured upon application for insurance and approval thereof.

The Corporation is responsible for making periodic examinations and supervising the activities of insured State banks that are not members of the Federal Reserve System. The Comptroller of the Currency examines and supervises the activities of national banks. The Board of Governors of the Federal Reserve System examines and supervises the activities of State banks that are members of the Federal Reserve System.

At December 31, 1968, insured banks held real estate loans of about \$83 billion secured by residential properties and real estate loans of about \$26 billion secured by other properties, excluding farm land.

Federal Deposit Insurance Corporation

The Corporation, an independent Government agency, insures deposits in banks qualified for deposit insurance and makes periodic examinations

and supervises the activities of insured State banks that are not members of the Federal Reserve System.

Officials of the Corporation informed us that the Corporation had not issued any regulation, directive, or opinion regarding piece-of-the-action mortgage financing and that they had no information concerning the extent of such financing by banks.

The officials stated that the Corporation is concerned primarily with what a bank pays for its money, not what a bank receives for a loan. According to these officials, the lending activities of the banks the Corporation supervises are controlled primarily by the various State banking authorities and the Corporation would involve itself only if the subject activities constituted unsafe or unsound practices.

The Office of the Comptroller of the Currency

The Office of the Comptroller of the Currency--headed by a Comptroller--was created as a separate bureau within the Department of the Treasury to administer the National Banking System. The Comptroller is responsible for the execution of laws relating to national banks and in this capacity promulgates rules and regulations governing their operations. The Office exercises general supervision over national banks' operations, including making periodic examinations of the banks.

An official of the Office informed us that the Office had no information concerning the magnitude of piece-of-the-action mortgage financing or the effect of such financing on the availability of mortgage funds for private housing.

With respect to national banks' participating in piece-of-the-action mortgage financing, the Office's position is that:

"A national bank may take as consideration for a loan a share in the profit, income, or earnings from a business enterprise of a borrower. Such share may be in addition to or in lieu of interest. The borrower's obligation to repay principal, however, shall not be conditioned upon the profit, income, or earnings of the business enterprise."

The Board of Governors of the Federal Reserve System

The Board of Governors of the Federal Reserve System, an independent Federal agency, has among its responsibilities the supervision and examination of insured State banks that are members of the Federal Reserve

System. Under a policy of decentralization, the Board has delegated to the Federal Reserve banks some phases of Federal Reserve supervisory activities, notably the bank examination function. The Board, however, directs and coordinates the supervisory work of the Federal Reserve banks, reviews the results of their examination activities, and determines broad supervisory policies.

An official of the Board informed us that the Board had not issued any regulation, ruling, or opinion with respect to piece-of-the-action mortgage financing and that the Board had no information regarding the magnitude of this practice or its effect on the availability of mortgage funds for private housing.

The official stated that the lending activities of State member banks are supervised primarily by the various States. He stated also that the Board would involve itself only if a bank's lending activities violated Federal statutes or constituted unsafe or unsound practices.

MORTGAGE INSURERS

The Federal Housing Administration (FHA), Department of Housing and Urban Development, and the Veterans Administration (VA) administer mortgage insurance programs under which lending institutions (mortgagees) are insured against loss in financing first mortgages on various types of housing. FHA does not make loans, nor does it plan or build houses. The VA, in addition to providing mortgage insurance, makes direct loans to eligible veterans to purchase or construct homes.

Federal Housing Administration

FHA, a noncorporate business-type agency, has among its principal purposes the responsibility to act as a stabilizing influence in the mortgage field and to facilitate home ownership. The largest volume of insurance written by FHA insures mortgages which finance the purchase of small homes (one to four families) and the purchase and construction of multifamily housing projects. At June 30, 1968, FHA had about \$58.6 billion of insurance in force, of which about \$48.7 billion represented mortgage insurance on one- to four-family properties.

FHA officials were unable to provide us with specific information regarding the extent to which piece-of-the-action provisions were being included in mortgage agreements, or what effect such provisions have had on the availability of mortgage funds for private housing.

The officials stated that FHA had no formal policy with respect to piece-of-the-action mortgage financing. One of the officials noted that control of this particular type of financing was the responsibility of those agencies charged with monitoring the activities of the financial institutions--banks and savings and loan associations--that act as mortgagees.

Veterans Administration

Because the VA programs primarily involve single-family dwellings, we did not discuss with VA officials the various aspects of piece-of-the-action mortgage financing.

During fiscal year 1968, VA guaranteed over 220,000 loans made by private lenders and made about 12,000 direct loans to eligible veterans. Of the approximately 232,000 guaranteed and direct loans, only 72 were for other than the construction or purchase of homes.

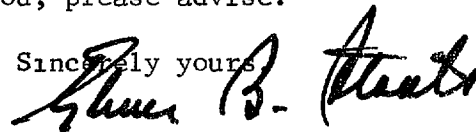
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We wish to bring to your attention that a bill--H.R. 16403--to prohibit equity participation financing by banks, savings and loan associations, and insurance companies was introduced in the House of Representatives on March 11, 1970. The bill defines "equity participation" as including (1) a share in the profits, income, or earnings from the business enterprise of the borrower, (2) warrants to purchase stock of the borrower at a fixed price, and (3) shadow warrants entitling the lender to compensation based upon changes in the market price of the borrower's stock over a specified period.

This report was not submitted to the various agencies for their review and comment.

We trust that the above information will serve your purpose. If we can be of further assistance to you, please advise.

Sincerely yours,



Comptroller General
of the United States

The Honorable Howard H. Baker, Jr.
United States Senate