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Accounting for Mortgage Companies

By J. L. Pyle

The mortgage company came into existence some ten or fifteen years ago. Its growth has been phenomenal as it occupies a field without much competition. It is in many respects unique. It is a private corporation and operates under the general corporation laws of the state in which it is chartered. It has very broad powers. It is not under the supervision of any state department. It is not limited to any particular method or field for lending money. The business activities of the mortgage company are supplementary to the work of a bank or trust company, but the accounting methods are different.

Mortgage companies are divided into four general classes, designated according to their different activities:

1. Companies granting only first-mortgage liens or first mortgages;
2. Companies granting junior liens or second mortgages;
3. Companies granting both first and second liens or mortgages;
4. Companies acting as refunding agents for both the first and second groups.

While, as a general rule, it may be said that the accounting methods used by all four groups are similar, yet a general knowledge of the activities of the different groups is necessary in order to make the proper application to the particular needs of each group.

Group 1. To this group belong those mortgage companies operating under what I will designate as the "Baltimore plan". These concerns purchase first liens or first mortgages on apartments, dwellings, etc., to the extent of fifty or sixty per centum of the appraised value. Such liens are usually for a term of from three to five years and are amortized over that term by monthly payments. These payments may be equal as to the principal with interest on the reduced balance, or the interest for the term may be added to the mortgage principal and the total divided by the number of months in the term of the lien.

The mortgages are then turned over to a trust company acting as a trustee, which holds them, together with other mortgages,

for the benefit of bondholders. Bonds or debenture notes have been issued against these mortgages in amounts of not less than $100,000, but ranging from $100,000 to $1,000,000; these notes or bonds being in denominations of $100, $500 or $1000. These bonds are usually guaranteed against loss of principal and interest by surety companies, the mortgages underlying the bonds being fully protected with fire and tornado insurance and title insurance. The bonds are usually underwritten by bond and security houses and sold throughout the United States by the correspondents. The profit derived by the mortgage company is the percentage of the service charge and the difference in interest rate on the mortgages and the interest paid on the bonds. For instance, if first mortgages in the hands of the trustee are from those states where the interest rate is seven per centum and a three per centum service charge can be obtained, and the mortgage company must pay six per centum on its bonds, the mortgage company will have three per centum from which it must pay for the cost of guaranteeing the bondholders against loss by a surety company, the cost of selling the bonds, the cost of printing the bonds and the percentage to a correspondent, if one has secured the mortgage, leaving but a small balance of profit. From the difference between the rate of interest received on the mortgage, which is seven per centum, and the six per centum paid on the bonds, must come the cost of interest and principal collection and the administrative expenses of the mortgage company. From this outline it will be seen that the mortgage company faces a serious problem unless it can secure the necessary volume of business. Volume is the factor which determines the dividend.

A slight variation of the Baltimore plan is a concern which acts as a correspondent for the big life and fire-insurance company, but particularly the life-insurance company. Insurance companies have grown to be a real institution in the affairs of men. The admitted assets as of September 30, 1927, of fifty-two legal reserve life-insurance companies were $12,810,378,000, and these fifty-two companies had 91.1 per cent. of the admitted assets of all United States life companies. Of these assets 43.2 per cent. were in mortgage loans:

Total farm mortgage investments of life companies.........	$1,972,310,000
Other mortgage " " " "	3,564,130,000
	$5,536,440,000

The farm-mortgage investments constituted 15.4 per cent. of all life-insurance company admitted assets and "other mortgages" constituted 27.8 per cent.

The "insurance type" mortgage companies are very numerous, especially through the middle-western and southern states where trust funds are not so readily available as in the eastern states. Many of these companies guarantee the principal and interest to the insurance company or at least agree to take over the property in the event the mortgage is foreclosed. Several mortgage companies specializing in farm mortgages have failed in their attempt to live up to their end of the agreement.

The service charges collected by these types of mortgage companies are often in the form of notes which are really second or third liens against the property. These notes are payable at a definite period or they may be a series of notes spread over the term of the mortgage. Care must be exercised in the handling of these control accounts.

Group 2. To this group belong those companies which specialize in the purchase of second liens. These companies as a general rule purchase with their own funds the second liens, securing their funds from the sale of stock and collateral trust certificates, using their second mortgages as the collateral for bank loans, etc.

A few mortgage companies have been successful in disposing of collateral trust notes. The banks are not educated to the value and advantages of second mortgages as collateral for investment securities. So the practice is not general. One or two companies have been able to use the Baltimore plan in their second-mortgage financing. Still other companies have used ten-year debenture notes. These issues often carry a brokerage fee of ten to fifteen per cent. and can be handled for that reason only in large amounts.

These mortgages are purchased by two different methods:

1. The mortgage which is a term loan of the reducing type is purchased at a discount.

2. The mortgage has a term of one year and may or may not be a reducing lien, and a service charge, bonus or premium is charged to the borrower of the money for the service rendered in securing the loan.

As a general rule the first method is the one used, as by the purchase from the owner of the mortgage, and not direct from the

owner of the property or the borrower, the question of usury is avoided. For when the mortgage is in existence and can be acquired from the mortgagee by purchase, the usury statute does not apply, whatever the purchase price may be. Some few states permit the charge of a bonus, and in those cases the second method is the more desirable.

Mortgages purchased at a discount whether they be first liens or second liens present a slightly difficult problem from the accounting viewpoint. If all the discount should be carried direct to the profit-and-loss account, the government would weigh down heavily on the mortgage company. For that reason, it is the practice to set up the discount as an unearned profit or credit, charge the account with such proportion of each payment as is presented by discount and credit the corresponding profit-and-loss account with that sum as a profit. The income-tax department has made the following ruling:

> "Ruling under article 42, revenue act of 1926, *Regulations 69*, I. T. 1650, II-1 C. B. 48.
>
> "A taxpayer was engaged in the business of dealing in mortgages, purchased at a discount. The income of each taxable year should include that proportion of each payment upon principal received in that year which the total profit to be realized upon payment of the mortgage, representing the difference between the purchase price and the face value, bears to the face value of the mortgage."

The keeping of such information and the calculation of the discount earned involves considerable labor but the difference in reduction of taxes justifies the expense. Probably the best method of handling the detail is to carry a separate account on each individual ledger card or loose-leaf ledger page and, as a payment is recorded, to calculate the earned discount of that payment. A calculating machine is an almost indispensable assistant.

Group 3. This classification is a combination of the first two groups discussed and is the type which is coming more and more into use. This condition is brought about by the competition of the savings banks, building-and-loan associations and an increasing number of individuals who lend small amounts on second mortgages, the large volume constituting a real competitor. National banks under certain rules which are being established by the comptroller of the treasury department may also enter this field.

Another important factor is that second-mortgage companies find it necessary to control the first mortgage, to make sure that the first mortgages will not be called, which of course would em-

barrass the company holding the second liens. The holder of the second lien virtually guarantees the principal and interest of the first lien. Consequently, the second-mortgage company has gone into the first-mortgage business in order to protect itself against embarrassment and possible loss.

Group 4. During the last year or so there has come into the mortgage field a new factor which, although it has not made itself felt as yet, will in time to come be most important. This factor consists of mortgage companies which are being established on a plan similar to that of the federal reserve banks. Mortgage companies throughout the United States will become stockholders in certain central companies, and these central companies will act as rediscount agents for first or second mortgages which the member companies will send them. Thus the member companies will have an opportunity to keep their funds liquid at all times as the central company will operate under the Baltimore plan already explained. Then, too, there are some central systems operating under the plan of purchasing fifty-one per cent. of the common or control stock of established mortgage companies in different sections of the United States, placing a few of their own directors on the board of directors of the local company but as far as possible retaining the local management. The local member company sends in the mortgage and is reimbursed. The central company finances itself through the sale of these mortgages sent in by the local companies by the employment of the Baltimore plan.

BOOKS AND RECORDS USED

For the smaller company with assets of less than one million dollars, the best accounting records are as follows:

Record of cash received

A columnar cashbook of from ten to twenty columns can be used; making the distribution of each cash item as it is received. A miscellaneous column with an account-number column will provide a distribution for the unusual items. Payments on account of mortgage principal may be posted to a single column and arranged according to subsidiary ledgers at the end of the month; or a separate column may be used for each ledger.

For the larger mortgage company deposit tickets may be used and classified at the end of the day and one posting made.

Record of cheques drawn

A columnar record similar to the record of cash received should be used. As the mortgage company is purely a financial concern, the cash records merely represent the daily debits and credits to the principal asset and liability accounts. Consequently the cash received and cash disbursed records are similar in design.

Mortgages receivable

The mortgages-receivable account is one which will give considerable concern to the mortgage-company accountant. Its total may run into the millions and be composed of thousands of individual mortgage accounts. So numerous are these accounts that some method must be adopted that will insure their ready proof at the end of the month or the accounting period. If the mortgage company is a national one, perhaps the best method is to have the subsidiary ledgers arranged according to location with proper alphabetical or numerical subdivisions. If the mortgage company is a local one, the subsidiary ledgers may have alphabetical or numerical subdivisions, although the alphabetical divisions are the most satisfactory. Local conditions must be the determining factor in the design of the subsidiary ledger, but, whatever the design may be, unless the account is brought into accord in each accounting period with the control account the design is worthless.

Below will be shown a card ledger form common to the mortgage business:

NAME ________________ Guarantee No. File No.
LOCATION ________________
ADDRESS ________________ Expires Monthly Payment

County Tax Paid	City Tax Paid	Life Ins. Co. Policy No. Amt. $ Assigned to	1st M't'gee Address 2nd M't'gee

AMOUNT FIRST MORTGAGE $ AMOUNT SECOND MORTGAGE $

PAYMENTS ON PRINCIPAL		BALANCE	PAYMENTS ON INTEREST			
Date Paid	Amount		Date Due	Amount	Date Paid	Amount

FIRE INSURANCE
Company
Policy No.
Amt. Expires
Holder

WINDSTORM INSURANCE
Company
Policy No.
Amt. Expires
Holder

ADD. FIRE INSURANCE
Company
Policy No.
Amt. Expires
Holder

REMARKS:

PAYMENTS ON PRINCIPAL		BALANCE	PAYMENTS ON INTEREST			
Date Paid	Amount		Date Due	Amount	Date Paid	Amount

Whether a bookkeeping machine is better than a pen-and-ink posting is a matter which depends on the size of the company. Usually each account will have only a single posting per month and the company must have a sufficient number of accounts to justify the expenditure for the machine equipment.

While the financial problems involved in the mortgage companies are often varied and intricate and while the volume of detail is great, the actual accounting problems are not difficult and not unlike those of a trust company. But the volume of detail and the method of handling the discount for income-tax purposes make mortgage-company accounting a subject which requires much study and research.