Interregional mortgage interest rates: 6% vs. 10%

Timeline
pre-1880 – mortgages are financed with loan brokering
1880-1890 – growth of debentures among large firms
1893 – mortgage crisis in Western US and failure of 90% of mortgage firms

Two means of financing mortgages
Mortgage brokering
   Match a loan to an investor
   No binding guarantees – investor bears risk in the event of a default on the loan
Debentures
   Investors purchase bonds backed by a pool of loans
   Loan quality certified by the trustee in whose account the loans are held

Costs
Mortgage brokering
   Costly marketing and matching process
   High costs in defaults
      Replacement loans
      The broker still has to pay the investor (or face loss of reputation)
      In severe cases, foreclosure
   Premiums to mitigate this risk
Debentures
   Advertising easier because of the trustee
   Matching unnecessary
   The mortgage company must always pay investors => greater systematic risk
Some overhead: paying the trustee, legal and administrative costs unique to debentures

**Consequences**

For loans of a particular quality, debentures were more efficient at risk-sharing

Diversification

=> large geographical size encouraged

Systemic risk of debentures reduced by having a mortgage brokering arm

=> the same firms issued both financial products

Firms’ ability to issue debentures was highly dependent on how successful they had been before 1880

The riskiest (or in general, the most difficult to broker) loans were preferentially financed with debentures

Mortgage companies earned higher gross returns on debentures than brokered loans.

**Failure**

The legal structure of debentures forced firms to pay off their investors or face defaulting.

Incentives were such that firms wanted to operate with as little on-hand capital as possible

Minimal regulation

Few firms were able to weather the 1893 system-wide shock to the mortgage market

**TRANSITION** From Agents on the frontier to Agents in financial markets

Key Argument is that agency problems get worse as financial structure gets more complex

One Solution is a delegated monitor

Problems are severe but over time the financial market grows; and with both private and later public institutional change, access to credit is increased.

Railroad financing and the rise of J-P Morgan

Savings rate in the US very high but still large difference in the cost of capital relative to Europe.

But severe problems in the enforcement of contracts.

1837 13 States who borrowed money to finance improvement default on their debt

From 1860s forward railroads who access London capital market but face excessive competition also default (there is no bankruptcy). They are reorganized often at the expense of shareholders and bondholders and to the benefit of insiders
Major scandals with the building of the transcontinental railroad (late 1860s) and in competition on the east coast (Chapters of Erie) in the 1880s and 1890s

Then J-P Morgan steps in (as do other intermediaries) who insist on having control. This is the delegated monitor

Not much discussion until 1907 when Morgan organizes a fund to stabilize the New York financial market during a panic and decides which financial firms will be saved and which will not. This display of power lead to anger within the financial community and the rise of arguments in the press of the pernicious effect the money trust.

What does the money trust do?

Can we measure that?

Morgan argues that the financial sector and his firm in particular add value

What does the banker who is concerned about his reputation do

Can we measure that?

What is really measured?

High returns relative to book value seem to be an important element

1) Because he creates monopoly (good for shareholders bad for the economy)
2) Because he picks the right company (Warren Buffet Good for shareholder irrelevant to the economy)
3) Because he makes the firms more efficient (Good for shareholders and the economy)

Problems from the policy perspective: what is the price of a Morgan solution?

Delong’s data

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<th>Morgan Partner</th>
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Somewhat more profits, but not in utilities. Why?
But then outside utilities where do the profits come from. Monopolization, or improved efficiency?

Fig. 6.1 Relative prices and earnings of Morgan and non-Morgan companies, 1910–12

High returns relative to book value seem to be an important element.

Why not control for before vs after.