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CHAPTER 11

CONCLUSION

The Roosevelt administration and Democratic Congress created the HOLC in 1933 in response to a relentless foreclosure crisis that threatened large numbers of home owners and appeared to be getting much worse. When Franklin Roosevelt proposed the HOLC to Congress in 1933, he asked legislators to take the historic step of creating a new role for the federal government in dealing with the housing industry: “The broad interests of the nation require that special safeguards should be thrown around home ownership as a guaranty of social and economic stability, and that to protect home owners from inequitable enforced liquidation, in a time of general distress, is a proper concern of the Government.”

To achieve these ends, the legislation called for the creation of a government-sponsored corporation that issued bonds to purchase and refinance mortgage loans. The goals of the HOLC were to help lenders by removing toxic assets from their books and to assist borrowers in trouble through no fault of their own, while minimizing losses for the taxpayer.

How the HOLC fared can be summarized broadly in four statements. First, the HOLC was effective in purchasing a large number of distressed loans from lenders because it offered them a good bargain. Second, the HOLC delivered relief to borrowers by liberalizing loan terms and servicing these loans patiently, but the HOLC typically did not provide significant reductions in the principal owed. Third, the HOLC’s purchases and refinancing of loans helped stave off damage from the foreclosure crisis of the 1930s but could not reverse

all of its impacts. Finally, close examination of the HOLC's finances suggests that the HOLC had losses on its government accounts of about 2 percent of the value of loans made, while the subsidy to home owners and lenders might have ranged as high as 12 to 22 percent.

Given the recent mortgage boom and crisis, an obvious question is whether a modern HOLC would work well today. It is clear that a new HOLC could not operate in the same way that it did in the 1930s because of the substantial differences between the structures of loans and mortgage markets in the early 1930s and the current era. Modern structures have evolved from foundations set by the HOLC and other New Deal housing policies. The evolution has altered some of the constraints under which borrowers and lenders operate today. However, it has not altered the basic economic forces present in all mortgage markets that shape how we should think about an economic intervention like the HOLC. In general, the challenge of loan modification or refinance programs in any era is to strike a balance across three sometimes conflicting goals—to secure lender participation, to provide borrowers with relief, and to not break the public's bank in the process. In performing these functions, the historical HOLC can be seen as setting a template for one particular type of intervention, a modern bad bank that issues bonds guaranteed by the government to purchase and finance distressed loans from private lenders.

We provide context for the discussion of our four principal results by first pointing out important long-term changes in the institutional structure of mortgage and housing markets since the 1930s that made a difference in how the HOLC was structured and how it operated. In discussing the results, we also illustrate fundamental issues involved in loan modification programs by comparing the HOLC program to the two largest federal programs that have been implemented during the recent mortgage crisis. We close with a discussion of how the experience of the HOLC sets expectations for current and future mortgage modification programs.

Changes in the Institutional Environment

The HOLC was a product of its time. When the Roosevelt administration and Democratic Congress introduced the HOLC in 1933, they started with a blank slate, given that there had been little prior federal involvement with residential mortgage markets. Fewer than 45 percent of nonfarm households owned

their homes at the time, and the foreclosure crisis was revealing the shortcomings of the traditional types of contracts (short-term, interest-only, and share-accumulation B&L loans) that were popular in the mortgage market. On the other hand, borrowers had substantial equity in their homes when these loans were made in the 1920s because loan-to-value ratios on first mortgages were generally at most 60 percent. The relatively low level of indebtedness among borrowers provided plenty of room for the HOLC to aid borrowers by adjusting the terms of repayment without cutting the principal owed on the loans. Thus, the HOLC was in a position where it could purchase troubled loans from lenders at near full value and still do a great deal to improve the terms of the mortgage for borrowers.

The experiences of the 1930s led to numerous changes in nonfarm mortgage markets that set the institutional environment for the crisis in the early 2000s. Since World War II the typical home mortgage loan in the United States has been structured much like HOLC loans, although with even higher loan-to-value ratios and longer periods for repayment. But unlike in the 1930s, the federal government was already involved in housing finance in several ways before the mortgage crisis of 2007, including through Federal Housing Administration and Veterans Administration loan insurance, and the implicit guarantees behind Fannie Mae and Freddie Mac. These and other subsidies had been supported for decades by both Democratic and Republican policy makers to expand home ownership in the United States. As a result, legislators in 2007 did not have the luxury of facing the kind of blank slate that existed in 1933 when a mortgage crisis could be ameliorated simply by providing access to loans with fifteen-year maturities, 80 percent loan-to-value ratios, and lower-than-prevailing private-market interest rates.

Within the modern environment, the federal government has deployed several programs to aid lenders and home owners involved in the mortgage crisis of the early 2000s. The most prominent among these, the Home Affordable Modification Program (HAMP) and Hope for Home Owners (H4H), have focused, as did the HOLC, on modifying distressed loans. In addition, the Treasury, Federal Deposit Insurance Corporation, and Federal Reserve have taken other extraordinary steps to prevent financial markets and institutions from failing. These activities include taking ownership stakes in large banks, as the Reconstruction Finance Corporation had in the 1930s, but also bailing out Fannie Mae, Freddie Mac, and AIG, the largest insurer in the world. A

broad comparison of the impacts of all of the programs implemented during the mortgage crises of the 1930s and the early 2000s is beyond the scope of this book, but they certainly shape the context in which the loan modification programs operated.

Attracting the Participation of Lenders

Lender participation was a major design constraint for the HOLC during the 1930s and remains a major constraint today for any government-led modification program. HOLC officials deliberately offered lenders good bargains to make sure that they could refinance a large share of loans for deserving borrowers whom they thought could successfully repay modified loans. Lenders received HOLC bonds that were valued at or near the full debts owed to them, including principal and interest, and any insurance or property tax payments they had made on behalf of borrowers. Moreover, because some lenders balked at accepting the initial bonds that carried federal guarantee of interest only, within a year the HOLC was given the ability to issue new bonds that were fully guaranteed. Altogether, the HOLC replaced the risky mortgages on lenders' books with safe and liquid bonds.

Today, the HOLC approach of purchasing loans directly from lenders would be substantially more complicated than it was during the 1930s, partly because of the much higher prevalence of securitization. The fragmented ownership that results from securitization creates difficulties in purchasing loans that do not arise when a loan has a single owner. These complications help explain why neither of the two main modification programs put in place by the federal government beginning in 2008 was designed to replicate the HOLC's model of whole-loan purchases.[1] The different structures of these programs, however, should not distract us from the fact that obtaining lender participation is a difficult problem today, just as it was in the 1930s. Broadly speaking, the calculus of lender participation remains largely the same. Lenders negotiate with the government over each mortgage and then decide whether to accept the government's offer to participate.

The first major modern modification program in recent years, H4H, was created under the Bush administration. Like any modification program, participating in H4H presented both benefits and costs to lenders. H4H was designed mainly as a debt reduction program and asked lenders to reduce eligible borrowers' debts to 96.5 percent of market value. For first-lien hold-

ers, this cost of participation was meant to be balanced by the availability of insurance against redefault on their new modified loans through the Federal Housing Administration. Some direct payments were also eventually available for second-lien holders as an incentive to extinguish their claims.[2]

The second major modification program in recent years is HAMP, created under the Obama administration. HAMP focuses on the affordability of monthly payments for borrowers rather than on the total amount of debt relative to property values. The program's magic number is thirty-one, the target maximum for the borrowers' monthly payments as a percentage of their monthly incomes. HAMP meets this target in three successive steps, first by lowering the interest rate, then (if necessary) by extending the length of the loan, and finally (if necessary) by leaving some principal to be paid as a lump sum at the end of the loan rather than month by month. The incentive for lenders' participation is mainly a set of direct payments from the Treasury to loan servicers and investors.[3]

Lender participation was a critical constraint in limiting the number of modifications through H4H, which reached fewer than 600 borrowers even though it was designed and funded to reach about 400,000.[4] The carrot of FHA insurance was evidently not enough to convince lenders to grant debt reductions as the program required. HAMP's design was in part a response to the problems with lender participation in the H4H program. HAMP has worked to make modifications attractive to the owners and servicers of loans by adding payments designed to make the net present value of the flow of payments under the HAMP modification exceed the net present value of the lender's *expected* flow of payments from staying with the original loan. Nevertheless, the number of HAMP modifications has been considered a disappointment because its 1.1 million permanent modifications through April 2011 have fallen well short of the 3 or 4 million originally anticipated. HAMP has reached about 1.5 percent of nonfarm homes, a much smaller percentage of home owners than the 10 percent reached by the HOLC.[5]

There are several reasons why the HAMP has reached a smaller share of home owners than the HOLC did. One reason is that the math of HAMP participation requires finding a way to deliver relief to borrowers without principal reductions, even as many already had loans with high loan-to-value ratios and generous repayment terms by historical standards. HAMP has less leeway to provide better terms for borrowers than the HOLC, barring principal reductions. In general we suspect that the HAMP subsidies in the loan refinancing

do not compensate lenders to the same extent the HOLC loan purchases did, but a careful study needs to be performed to document this claim.

In considering lender participation with the HOLC, it is important to realize that it was not inevitable that the HOLC would secure the participation of such a large share of lenders and borrowers. HOLC officials made deliberate choices to achieve liftoff by offering lenders prices for their loans that were close to the full value of the debts. Today, a similarly deliberate effort would be needed to build a program to the same size as the HOLC. Putting aside the benefits to borrowers or the housing market, the benefit of such a policy to lenders would likely be different than in the 1930s and a bit unclear. In the 2000s the federal government has already assumed substantial risks in mortgage markets by bailing out Freddie Mac and Fannie Mae. This has ensured a continuous supply of funds for new loans (as long as those loans conform to the standards for Fannie and Freddie, an important if), which was lacking in the 1930s. Further, generous payments to lenders could set precedents for future bailouts that, in turn, would create incentives for lenders and borrowers to take more risk because they believe the government would act again to save them in a future crisis. However, we are not aware of any evidence that the HOLC set such a precedent in the decades following its liquidation.

Providing Relief for Borrowers

In both the 1930s and 2000–2010, home foreclosure crises developed when borrowers faced a combination of declining incomes and declining home prices. In the 1920s, when future HOLC borrowers took out their original loans, the borrowers would have been considered prime borrowers based on modern credit standards. However, when they tried to refinance their loans during the foreclosure crisis of the early 1930s, they were typically in deep trouble. They had few resources available to repay the principal on their loans. Further, many had lost jobs or seen their hours cut sharply, so they no longer were good prospects for refinanced loans. Meanwhile, home prices also fell by 20 to 40 percent, cutting into home owners' equity. In a significant majority of cases, the home owners did not owe more than the value of their homes because the loan-to-value ratios of HOLC borrowers were generally limited to 50 to 60 percent on a first mortgage, and 80 percent on two mortgages combined. However, the value of a home was difficult to define in a dysfunctional housing market in which borrowers could not easily obtain refinancing and buyers could not easily get credit. This combination of declines in income,

housing values, and lender assets led to a large number of foreclosures even though many borrowers did not owe lenders more than the value of their homes.

The Great Recession of 2007 was not nearly as severe as the Great Depression, yet declining incomes and housing prices also have played major roles in the recent foreclosure crisis. Two-thirds of HAMP participants have experienced job loss or income cuts. Meanwhile, declining home prices left many borrowers underwater because the loan-to-value ratios for modern mortgages at the time of origination typically ranged from 80 to 100 percent.

When the HOLC refinanced loans, relief for HOLC borrowers came primarily from a variety of devices that lowered monthly payments, including delayed payment on the principal until June 1936, lower interest rates, and longer loan durations. The HOLC arranged for some debt forgiveness, but borrowers' HOLC loans totaled more than 90 percent of their prior debts on average, and debt reductions were often related to accrued interest rather than principal. The HOLC had no specific target for monthly payments relative to borrowers' incomes. The modern HAMP program does have such a target and has followed a similar strategy of lowering interest rates, lengthening loan duration, and delaying principal payments. Even more than the HOLC, very few HAMP modifications have taken an additional step of reducing the principal on the loans, although a separate small program involving principal reductions has been established.[6] The HOLC, however, had more room to improve the terms of the loan without such reductions because the original loans in the 1930s started with shorter loan durations, higher loan-to-value ratios, and higher interest rates before modification.

When employment prospects remained weak late into the 1930s, the HOLC delivered more relief by lowering the interest rate on its loans and allowing loan durations to be extended to twenty-five years. These liberalizations, along with economic growth in the 1940s, helped cure a large part of the HOLC's significant problem with delinquent borrowers.

The HOLC also delivered relief to its borrowers through its servicing practices. The HOLC generally delayed foreclosures on delinquent loans while trying to determine whether there was some chance the borrower could repay if given more time. The HOLC's service agents in a number of cases took the process a step further and tried to help home owners find jobs and resources with which to repay their loans. In the process the HOLC also sought to take into account the impact of additional foreclosures on housing markets. After

taking possession of properties on which it foreclosed, the HOLC repaired the homes, rented them out, and tried to time the sale of the homes to avoid lowering housing prices within local markets.

Servicing loans has become an important issue in the modern era as well. The HOLC directly acquired the servicing rights, as they were typically not unbundled from loan ownership during the 1930s. While modern programs have avoided replicating the HOLC's strategy of purchasing whole loans, it would be possible for a modern program to purchase only the servicing rights on them. Nevertheless, no modern program has attempted this, as far as we know, perhaps because the HOLC's track record as a loan servicer is not widely known.

While HAMP has not involved direct government servicing of modified loans, the program was designed to address servicer incentives by providing direct payments in a "pay-for-success" approach to modification. Nevertheless, there have been many difficulties with the post-modification servicing of HAMP loans, including the suspension of two of the nation's largest servicers due to poor performance. Fundamentally, most servicing contracts today do little to encourage servicers to pursue modifications or ensure the success of modified loans, and HAMP leaves those contracts intact. For example, servicers often receive fees for executing foreclosures but receive nothing for doing detailed case work for a modification, and are often required to cover any missed payments. In general, the modern servicing industry has been designed for routine tasks like payment processing, resulting in a lean structure that has trouble with the inherently labor-intensive process of modifying loans. Federal regulators have stated that servicers "misapply payments, lose paperwork, file incorrect foreclosure affidavits, or simply do not answer the phone or make available knowledgeable staff persons."[7] The recent "robo-signing" scandal is symptomatic of these problems. We do not yet know the contribution that servicer behavior will make to reducing the number of foreclosures within the HAMP program, but we expect it to be less important than in the HOLC, based simply on the differences in the structure of the two programs.

The HOLC's Impact on Housing and Mortgage Markets

The 1930s were a disastrous decade for housing and mortgage markets. On a national basis, foreclosures were still elevated for most of the 1930s, and the HOLC itself foreclosed on 19 percent of its loans. The decade between

1930 and 1940 recorded the only decrease in the nonfarm home-ownership rate during the twentieth century, from 45 to 40 percent. In addition, over the decade nominal home values decreased by nearly 40 percent, and housing construction remained well below 1920s levels.

The HOLC was able to repair some of the damage from the foreclosure crisis by preventing even greater declines in housing values and home-ownership rates in many communities. In a typical small community, HOLC spending staved off about a 16 percent decline in the value of homes and kept about 11 percent more home owners in their homes. The impact on larger communities with over fifty thousand people is more difficult to parse statistically and remains unclear at this point.

The HOLC's repair of the damage without promoting full recovery underscores the limitations of policy in counteracting the powerful forces of an economic downturn. After all, the HOLC was a massive program, and our research indicates it distributed its loans to areas in a pattern that reflected the severity of housing market distress, rather than the need for general relief or political considerations. Altogether, the HOLC refinanced about 20 percent of the nation's nonfarm residential real estate loans from 1933 to 1936. If another HOLC existed today, it would have to refinance roughly $2 trillion of loans to replicate that record. Thus, if any program could be a panacea for a mortgage crisis due to size and distribution alone, the HOLC would be that program. The fact that it was not tells us just how large the problems were in the housing market at the time.

Even when successful, policies like the HOLC do no more than remove a potentially important impediment to the adjustment process. At the time, there were no mortgage guarantees from the Federal Housing Administration, Veterans Administration, Fannie Mae, or Freddie Mac that protected the owners of loans or securities from the risk of default, and lenders did not have the protections of the liability insurance provided by agencies like the Federal Deposit Insurance Corporation. In the absence of such guarantees, the financial accelerator was more powerful than it is today. In turn, this increased the value and impact of an intervention like the HOLC.

HOLC Finances

Close examination of HOLC finances suggests that the program lost about $53 million in the government accounts from its loan-refinancing opera-

tions, which came to about 2 percent of the value of the loans made. This performance was much better than forecasted by skeptics when the program was created, but disputes the perception in modern commentary that the HOLC actually made a small profit. In looking back on the actual course of history, it is easy to forget the uncertainty that existed in 1933 about how much the HOLC would cost, and to underappreciate the risks borne by taxpayers who guaranteed the HOLC's bonds. Counterfactual history can be a dubious exercise, but is useful in challenging the natural tendency to view past events as deterministic rather than the result of various historical contingencies. When the HOLC began operations, observers had only broad notions of how much the program would cost, and few were confident they knew how large a program the HOLC would actually be. Some of the key contingencies that buoyed the HOLC's finances include the economic expansion of the late 1930s and 1940s, as well as the effect of World War II on property values.

Another key turning point in the HOLC's finances was the guarantee of its bonds. We have noted that at first many lenders balked at accepting HOLC bonds, which initially bore the federal government's guarantee only on their interest payments. Congress and the president could have taken a hard line and refused to change the financial design, but they instead chose to fully guarantee the bonds in 1934. This concession is worth repeating because it had profound implications for the allocation of the program's financial risk. Had the HOLC financed its program without the guarantee, the interest rates on its bonds would likely have been at least 1, and possibly up to 3, percentage points higher. A 1 percentage point increase in the interest rate on HOLC bonds would have added approximately $300 million to the HOLC's costs, or roughly 10 percent of the value of the $3 billion in loans made. Thus, the subsidy provided to mortgage markets by the HOLC's activity likely would have been at least 12 percent of the value of the loans made. Each additional 1 percentage point rise would have raised the subsidy by another 10 percent of the value of the loans.

To put the HOLC's risks and costs into perspective, it is useful to review how the federal government has supported Fannie Mae and Freddie Mac starting in September 2008. Both companies, which buy and securitize a large portion of US residential mortgage loans, were privately held before the recent crisis but had implicit public support. That support was made explicit in September 2008 when the federal government began recapitalizing the two companies.

By the middle of 2012, the Treasury had invested roughly $185 billion, over 1 percent of GDP, in preferred stock of the two enterprises, but the ultimate losses associated with the government backstop could be significantly lower or higher than that number.[8] The scale of the amounts invested in Fannie and Freddie demonstrate the risk taken on by the HOLC in the mid-1930s when it purchased and refinanced troubled mortgage loans that were equal to approximately 4 percent of GDP.[9] The risks associated with the investment were also greater because the HOLC specialized in distressed loans, whereas Fannie and Freddie own or guarantee a large number of loans that have shown no sign of trouble so far.

The HOLC ran risks because it owned loans, and therefore was exposed to potential losses from foreclosure. In contrast, the most significant modern loan modification program, HAMP, has avoided ownership of loans. Instead, it has given lenders incentives to renegotiate loans with their borrowers; therefore, HAMP and taxpayers are not taking direct risks. Though H4H entailed risks for taxpayers through insuring modified loans against redefault, this has ultimately been a moot risk for taxpayers since so few lenders and borrowers availed themselves of the program.

The narrow focus on the HOLC's costs should also not overshadow the more important fact that programs like the HOLC are conceived because mortgage crises themselves are very costly to society. Even though the subsidy provided to home owners and lenders by the HOLC might have been as high as 22 percent of the value of the loans, the benefits that came from staving off foreclosures and preventing further declines in home values may well have more than covered the size of the subsidy.

Setting Expectations for Mortgage Resolution Policies

The HOLC experience offers an important lesson for setting expectations about any public policy that is implemented to resolve a mortgage crisis. These crises tend to be lengthy, difficult, and costly to resolve because homes are long-term durable goods, mortgages are long-term financial assets, and financial crises typically lead to longer economic downturns, which can feed back into the financial crises. The mechanism is familiar. It takes time for home owners to default, and for lenders to foreclose, after housing prices, employment, and household income begin to fall. When the number of foreclosures finally rises, the downward pressure on housing prices is intensified

and causes additional deterioration in the balance sheets of home owners and mortgage lenders. Mortgage resolution programs are implemented at this point so that these latter shocks do not shut down housing and mortgage markets and thereby lengthen and deepen the original distress within them.

The nation was six years past the peak of a building boom, three years into a general foreclosure crisis, and had seen housing prices fall by nearly a third when the HOLC was established in 1933. By that time distress was so widespread that more than twenty states had imposed some form of moratorium to delay additional foreclosures that threatened more than one-fifth of home owners and nearly every mortgage lender. The HOLC was created in response to this environment and prevented hundreds of thousands from losing their homes while helping to prop up housing prices. Despite these successes, the HOLC still ran into its share of problems. By 1941 the HOLC had foreclosed on nearly one-fifth of its own loans and was still dealing with many delinquent borrowers. The HOLC experience suggests that in nearly every setting, any modification process will likely be a lengthy and painful process involving a significant number of reversals of fortune for those involved.