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CHAPTER 1

INTRODUCTION

Joshua Clark nearly lost his house. It was a typical bungalow in Coeur d'Alene, Idaho, with six rooms, one bath, and a cedar-shake roof, home to Joshua, his wife, Sarah, and their teenage son. The family had saved enough from Joshua's work as a truck driver for Inland Motor Freight to put down $1,750 in cash for the house that they bought for $3,000 in March 1929, near the end of the 1920s boom. They borrowed the rest from the Citizens Savings and Loan Society in nearby Spokane, Washington. Putting down 50 percent or more of the value of the house was routine at the time. It ensured borrowers had much to lose if they stopped making payments on their houses, and with limited competition among lenders, borrowers had few options.[1]

Sadly, Sarah soon fell ill and died in the early 1930s. As her health deteriorated, the doctor bills mounted. When Sarah died, Joshua still owed on his mortgage loan and medical debts. In other economic times, he might have been able to find a way to repay the debts through hard work and thrift. The early 1930s was not such a period. Like many Americans, Joshua couldn't get out of debt. Throughout the 1920s he had been making $2,000 a year or more. In 1933 his income was only about $1,200, and that was better than in 1931 and 1932. He tried to work overtime, but with nearly 20 percent of Idaho workers having lost their jobs in the first two years of the Great Depression, such overtime work was not easy to come by. He could sell his house and rent, but because there were few buyers and housing prices had dropped, that would not have solved the problem.[2]

In October 1931 Joshua stopped making mortgage loan payments. At some point, Citizens began to warn of foreclosure. The city and county governments also likely began pressing him to take care of $290 in property taxes, unpaid after 1930. But neither the local government nor Citizens moved quickly to foreclose. Instead, Joshua stayed in his home for two and a half years after stopping payments and before applying to the Home Owners' Loan Corporation (HOLC) in May 1934. The HOLC had been created one year earlier during the first days of the Roosevelt administration, to help mortgage borrowers like Joshua hold on to their homes and work their way out of debt. Citizens may have stalled because the housing market was in grave decline in 1931 and 1932. In such an environment, Citizens would have been stuck with a house it could not easily sell. Furthermore, with no one living there and maintaining the house, it would have lost value. Citizens sought to protect its investment. If the economy improved, Joshua might begin to repay, and if he could not, then foreclosure could be reconsidered in a stronger market. After all, Citizens would not have expected the Great Depression to last as long or become as severe as it did.

By mid-1934, however, Joshua's mortgage was an investment that the bank probably wished it did not have, but could not easily get rid of. In 1933 Idaho adopted a mortgage moratorium law that legally delayed foreclosures. Of the forty-eight states at the time, twenty-seven passed moratoria as a way to pause the system in the midst of a torrent of foreclosures. Idaho also adopted a law that would have limited Citizens' ability to get a court order, called a deficiency judgment, under which Joshua would have been liable for the balance of his loan if the sale of his property was not enough to clear his debt. By 1934, Citizens simply stated, "We are not willing to carry him." This was a decision that many lenders eventually reached by 1933 or 1934, and they directed their borrowers to find financing elsewhere or face foreclosure.[3]

Both Joshua's inability to pay and Citizens' unwillingness to carry him were common. By 1933 foreclosures were widespread across the country, as lender forbearance did not last indefinitely. Just a few years earlier in the 1920s, the situation had been quite different. Both lenders and borrowers expected property values at least to stay stable and in many areas to rise. Lenders took comfort in relatively conservative lending standards. By requiring large down payments, lenders had wide margins of safety in case of foreclosure. Foreclosures had been limited in the nonfarm sector during the 1920s. When they did happen, the lenders were accustomed to quickly recouping their losses by selling into a strong market. Lenders were well compensated for these risks with interest rates that were fairly high by modern standards. But it is the rare mortgage loan system that is built to deal with credit problems on the scale of those generated by the Great Depression. As nonfarm foreclosures piled up between 1926 and 1933, it became clear that the 1920s mortgage loan system was not up to the task. Foreclosures reached all parts of the country. As a sign of the times, after four years of depression, in the spring of 1933 a thousand New Yorkers met at church every Monday night, to pray for those facing foreclosure.[4]

Enter the HOLC, a federally owned corporation created in June 1933. The HOLC was charged with buying the mortgage loans of home owners "in hard straits largely through no fault of their own" from lenders like Citizens, and then refinancing them on more generous terms. The HOLC itself adopted the "no fault of their own" frame to emphasize that the origins of the mortgage crisis lay largely in the general economic collapse. Joshua must have felt that the characterization fit him when he applied to the HOLC for refinancing in May 1934 after two and half years of not paying his mortgage. The HOLC had his house appraised and found the value had fallen nearly 20 percent, from $3,000 in 1929 to $2,500 in 1934. Citizens and Joshua were in better shape than many, because average housing prices had fallen roughly 35 percent or more in many parts of the country. After several months of evaluating the loan and negotiating with Citizens, the HOLC purchased the loan in February 1935.[5]

The HOLC treated this like most of its cases. Using HOLC bonds, the agency purchased Joshua's loan from Citizens for the full value of the debt that Joshua still owed Citizens. Citizens received a good deal. It got rid of a "toxic" loan—on which it had received at best sporadic payments for two to three years—in exchange for HOLC bonds, which were equal in value to the full amount of the various debts that Joshua owed the lender. Citizens even received the lost interest that Joshua had not paid, and did not have to deal with the costs of foreclosing on a home and then trying to repair and sell it in a market in which almost nothing sold. On its books, Citizens jettisoned a toxic asset with low expected value and replaced it with a no-risk asset of much higher value.

Once the HOLC owned Joshua's original loan, they replaced it with a new one that better reflected his situation. The principal on the HOLC loan consolidated his various debts, including all the principal and interest he owed his old lender, unpaid taxes, and the cost of repairs ordered by the HOLC. The repairs included new shingles on the roof and new paint for the outside woodwork. The rest of the loan terms were generous. The interest rate was 5 percent, when even borrowers who were in good shape in the Mountain West faced rates of 8 percent in the private market. The rate was particularly low given that Joshua hadn't been paying his mortgage loan and property taxes for more than two years. No regular lender would have made him a loan at *any* interest rate. The payments on the HOLC loan were spread evenly over fifteen years in an amortized arrangement, so that there was no big balloon payment at the end. Instead of trying to pay an immediate bill of roughly $300 in property taxes and losing his home when the Idaho mortgage moratorium ended, Joshua now had a newly repaired home and a low monthly payment.

There are more than a million stories like Joshua's to be found among the people whose loans were bought and refinanced by the HOLC between 1933 and 1936. Ray was a researcher at a large department store in Chicago for twenty years but lost his job and found his gray hair to be a barrier to reemployment. He was considering moving in with his daughter and son-in-law. Lee, a real estate broker in Detroit, was living in his foreclosed house as a tenant because his lender was not legally able to sell it until 1935. His mother helped him out with the rent. Antonio, a stonemason in Princeton, New Jersey, and Edwin, a dance instructor in Detroit, each lost their steady stream of customers as the economy nose-dived. These were all people whom the HOLC deemed in danger of losing their homes "through no fault of their own."[6]

In just three years the HOLC refinanced loans for a million borrowers like Joshua, Ray, Lee, Antonio, and Edwin. By 1936, 10 percent of American nonfarm home owners were HOLC borrowers. Nearly as many applied to the HOLC and were turned down. For some of those failed applications, HOLC negotiations with the lenders broke down, while for others the HOLC determined the borrowers had enough resources to repay their loans without aid. The large scale of the HOLC's operation shows just how much havoc the foreclosure crisis wreaked throughout the nation during the Great Depression. This book explains how the HOLC worked and the impact it had on borrowers, lenders, local housing markets, and taxpayers.

The HOLC as a Response to a Mortgage Crisis Following the 1920s Boom

The New Deal created many programs that attempted to cope with the economic depression, addressing unemployment rates that exceeded 20 percent for several years, disastrous drops in farm incomes, and myriad other problems not rooted in the housing sector. The HOLC was specifically designed to address the crisis in nonfarm housing and needs to be understood within the context of the housing market and mortgage finance system in which it operated.

A residential construction boom in the 1920s accompanied a wave of innovations that transformed the residential mortgage loan industry. The boom had begun to slow by the late 1920s, and the Great Depression turned a softening housing market into a deeply troubled one that involved hundreds of thousands of foreclosures in the first half of the 1930s.

The expansion of mortgage debt during the 1920s involved the use of a variety of contracts, including short-term loans with balloon payments at the end, longer-term contracts offered by building and loan associations (B&Ls) with uniquely structured monthly payments, and a rapid expansion of junior mortgages. Each of these was fundamentally different than the typical modern mortgage loan contract. The older contracts seemed to work well in the 1920s but turned out to be quite vulnerable to the shocks in income and housing prices that took the country by surprise during the Depression.

By the time the HOLC was created in the spring of 1933, the mortgage crisis had been gathering force for nearly three years, and the mortgage and housing markets were in free fall. In 1931 President Hoover and a Republican Congress tried to deal with the problem by developing the Federal Home Loan Bank system, which was designed to provide more funds for lenders facing short-term problems. States also tried to stem the tide by enacting foreclosure moratoria beginning in early 1933. Neither was able to turn the tide of foreclosures. By 1933 a coalition of borrowers, lenders, and real estate professionals throughout the United States sought immediate and dramatic action at the federal level.

During Roosevelt's first hundred days in office, the HOLC was created to buy troubled mortgages from lenders and refinance them. The goal was to stop house-price declines by delaying foreclosure and modifying the terms of payment so that borrowers had more time to find jobs and generate income flows once the economy improved. A critical element in evaluating this program, therefore, is to assess its underlying rationale that the private mortgage market in 1933 could not resolve the mortgage crisis it had created. Although individual lenders recognized the costs imposed on the economy by the foreclosure crisis, such as empty homes and downward pressure on house prices, no individual lender could alter the crisis on its own, and therefore had little incentive to take these costs into account when choosing between foreclosure and modification of a loan.

Collective action in the form of a large-scale modification program like the HOLC was proposed as a solution and was supported by a variety of groups including borrowers, lenders, and real estate professionals. But collective action by the private sector was limited at best. By 1933 private lenders had not successfully developed anything remotely like a large-scale "bad bank" to deal with the foreclosure crisis. There were many types of lenders facing different types of regulations and incentives. More fundamentally, financing for such a venture likely would have been difficult. If private bad banks had issued bonds to the public in order to fund such an operation, they would have had to pay high interest rates, which in turn would have required them to charge higher interest rates to borrowers, reflecting the risks inherent in those troubled loans. In turn, higher interest rates would have increased the probability that borrowers would default on the loans, creating even more risk. In contrast, the federal government guaranteed the HOLC bonds, allowing the HOLC to obtain funding at a much lower cost and to offer low interest rates to borrowers.

Then and Now

Modern readers will evaluate the HOLC with fresh perspective, created by their own experiences, which likely are heavily shaped by the mortgage crisis of the early 2000s. The housing boom of the 1920s and bust of the 1930s rival the huge rise and fall in housing markets during the first decade of the 2000s, but the mechanisms underlying the parallel events were not always the same. Loans were more conservatively underwritten in the 1920s, creating a margin of safety, but nevertheless the nonfarm mortgage finance system was far more fragile in 1930 than in 2007. In the 1930s, Fannie Mae and Freddie Mac were not around to purchase loans and keep the credit flowing, so new loans disappeared from 1932 to 1934 to an extent without parallel. Because of this the

HOLC was able to play a unique role in providing credit to those like Joshua, whose lender was "not willing to carry him." At the same time, the conservative underwriting standards of the 1920s left the HOLC room to maneuver when modifying the loans it purchased.

The structure of the HOLC also differed in important ways from the interventions of the years after 2007. Most importantly, the HOLC both bought and refinanced troubled mortgages, while recent policy has worked to prevent foreclosures without purchasing the loans from the lenders. As a result, the HOLC owned the loans for the long term, had the ability to control how the loans were serviced, and had a strong incentive to use that ability to make continued efforts to avoid foreclosures. These efforts were matched by the actions of Congress, which liberalized HOLC loan terms even further in 1939 to avoid widespread defaults among HOLC borrowers.

What We Have Learned

Throughout the book, we show how the HOLC affected the housing finance market and the broader economy during the 1930s. Ultimately, the HOLC's impact can be summarized in four broad statements.

First, the HOLC served as a "bad bank" by buying "toxic assets" from lenders. The HOLC could not force lenders to participate: the only way it could succeed at buying a large number of loans was by offering lenders a good deal. It usually paid prices that were nearly as large as the full debts owed to lenders. In this way the HOLC addressed the problem of toxic assets that modern policy has struggled with since the financial meltdown in 2008. The goal was not just to bail out everybody in the market, though. Instead, the agency was selective in its purchase of loans. They focused on the loans of home owners in trouble "through no fault of their own" and who were likely to repay their loans once they had survived the hard times and reached firmer footing.

Second, the HOLC succeeded in reaching a large number of distressed home owners—about one in five of all nonfarm mortgage borrowers—by refinancing their mortgages on generous terms even though its ability to deliver debt reductions was limited. The HOLC's goal was not simply to bail out borrowers but also to keep people who were likely to repay in their homes until the hard times were over. To this end, the agency wrote loans large enough so that borrowers could pay off tax debts and, if necessary, repair their homes. The HOLC provided these loans at below-market interest rates to borrowers who had no real chance of getting refinancing anywhere else. Until June 1936—the first three years of the HOLC's operations—borrowers had the option of paying interest only and then settling into the normal features of the new loan. The loans were amortized into equal monthly payments, so no large payment loomed at the end of the loan, and the repayment schedule was spread over fifteen years. Although long-term amortized loans were offered in some corners of the housing finance market before 1930, in just a few short years the HOLC gave its borrowers access to these loans, part of a wholesale change in lending practices across the country.

Third, the HOLC reduced the damage caused by the foreclosure crisis of the 1930s, but it did not reverse all of its impacts. Most directly, the HOLC ended up foreclosing on 20 percent of its borrowers. In the broader market, the HOLC did not fully resolve home owners' problems, as the nationwide foreclosure rate continued at high levels through 1937. Overall, housing prices and home ownership declined in the 1930s, but they would have declined still further without the HOLC. We have not been able to measure the impact of the HOLC on the largest housing markets with much confidence, but our research shows that HOLC activity in many communities had large, positive impacts on maintaining housing values and home-ownership rates. In a typical small community, HOLC lending staved off about a 16 percent decline in the value of homes and kept about 11 percent more home owners in their homes.

Finally, by the time the HOLC dissolved itself in 1951, it lost a total of about $53 million, or roughly 2 percent of its total lending volume of around $3 billion. Recent discussions of the HOLC have mistakenly emphasized that it actually made money and thus did not impose costs on taxpayers, but our careful examination suggests that this perception is mistaken. In addition, there was an implicit subsidy to housing markets because the federal government guaranteed the HOLC bonds and thus allowed the corporation to issue them at lower interest rates. Had the HOLC needed to pay an extra 1 percent in interest on the bonds it issued, the cost of the program to the taxpayer would have risen from about 2 percent to about 12 percent. The HOLC was not free, but neither did it cost taxpayers much money in the grand scheme of the federal budget. At a relatively low cost, the HOLC was able to prevent a substantial number of foreclosures and significant loss of home value.