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## CHAPTER 7

# THE LENDERS' GOOD DEAL

Most discussions of the HOLC focus on the relief given to borrowers. The HOLC itself always emphasized the borrowers' side of the program in public and in its annual reports. The name, the *Home Owners'* Loan Corporation, was meant to reinforce that mandate to focus on the home owners. Yet aid to lenders was a major part of the program. For every borrower whose debt was refinanced by the HOLC, there was at least one lender who voluntarily sold its loan to the HOLC. Thus, the HOLC was much more than a mortgage refinance program. It also served as a "bad bank." The HOLC purchased nonperforming loans from lenders by exchanging them for HOLC bonds that were guaranteed by the federal government. The lenders were therefore able to replace the nonperforming loans on their books with risk-free bonds that could be readily sold. Essentially, the lenders were able to dump their "toxic assets" on the HOLC, putting them in better positions to make new loans.

The key to success in reaching borrowers was getting lenders to sell their troubled loans. If the HOLC had demanded that the lenders take a "haircut" by offering only 50 cents per dollar of the debts owed by borrowers, lenders likely would have balked. In that scenario, with few loan purchases the HOLC would have been unable to reach those borrowers who were in trouble "through no fault of their own." To achieve a large size, the HOLC had to offer terms that lenders would accept.

Of course, lenders did have some interest in selling these nonperforming assets. On the typical loan sold to the HOLC, borrowers were in arrears on

principal for over two years, and lenders had often made some tax and insurance payments to allow the borrowers to stay in their homes. If a lender refused an HOLC offer and held on to its loan, foreclosure was likely the next move. Foreclosure was and still is a long and uncertain process during which the lender would have to pay taxes and cover maintenance costs for the property. In many states, the process was slowed further by mortgage moratoria laws enacted to delay foreclosures. As some offsetting compensation, the lender might have been able to rent the home for some rental income. When trying to sell the property, the lender faced a deeply depressed real estate market; therefore, the sale price likely would not cover the full debt that was owed.

Lenders were more likely to accept HOLC offers the closer those offers came to covering the accumulated debts owed by the borrowers. Giving lenders a good deal was not without a cost, however, as any additional dollar spent in purchasing loans from lenders was a dollar that the HOLC tried to recoup from borrowers. The bargaining process with lenders became somewhat of a balancing act between the relief provided to lenders and to borrowers.

In the final analysis, the lenders did well in their negotiations with the HOLC. In one sample of HOLC loans from New York, New Jersey, and Connecticut, slightly over half of the lenders received an amount in HOLC bonds equal to all that they were owed, including the principal on the loan, the taxes and insurance they had paid, and the unpaid interest on the loan. This was likely a substantial improvement compared to their situation if they had foreclosed on the house and sold it in 1933 when market values had fallen 20 to 40 percent. Before 1930 first mortgage loans were generally written for less than two-thirds of the appraised home value, so lenders might have recovered the principal on the original loan through foreclosure, though at a delay. They might not have gotten back much unpaid interest, taxes, or insurance. In these cases a lender could have sued for a deficiency judgment against the borrower. But by 1933 court cases and legislation had curtailed the use of deficiency judgments in many states. Even where they had not, a suit against most borrowers would have cost a great deal in legal fees with little chance of recovering money from people who had likely lost their jobs or had some other disaster befall them.

### The Need to Encourage Lender Participation

Officially, borrowers were the ones who made applications to the HOLC for their loans to be refinanced. However, an application was successful only if

the HOLC was able to buy the loan from the lender. The sale of the loan was a voluntary transaction because the HOLC could not force the lender to participate. Each borrower had signed a mortgage contract with his or her lender, and the Constitution generally prevents governmental infringement on private contracts at will. This is a key constraint on any program that is designed to modify or refinance mortgage loans. In fact, winning the participation of lenders has been a central issue in modern mortgage modification programs, as the modern programs have struggled to give lenders enough incentive to voluntarily put modifications in place. Understanding how the HOLC won the participation of lenders is central to understanding how the HOLC refinanced as many loans as it did.

The HOLC knew that lenders were willing to turn down their offers if the lenders found those offers to be inadequate. HOLC officials in Michigan noted that in their dealings with Prudential Insurance, for example, the insurance company would "accept no losses. In rare exceptions, they will accept an amount equal to their capital investment."[1] In another case a home owner and mortgage borrower in Hartford, Connecticut, believed his property to be worth $5,000, but an HOLC appraisal estimated the value to be only $3,420. Meanwhile, the borrower owed $3,755 to the lender for the principal of the loan and unpaid interest payments, and $175 to the local government for back taxes. After following its procedures, the HOLC offered at most $2,500. The lender's lowest offer was to reduce their claim to $3,000. Neither the lender nor the HOLC would bridge that gap, and the application never succeeded.[2]

Lenders who held first mortgages could rationalize their reluctance to accept losses in their negotiations with the HOLC. Traditional underwriting standards during the 1920s typically set maximum loan size at 50–60 percent of the home's value, and many lenders imposed even more conservative standards. These relatively low loan-to-value ratios were set so that lenders would be assured of recovering their investments even if property values fell dramatically, as they did in the early 1930s. Although borrowers used second mortgages to increase the share of the home value that they borrowed, first mortgage lenders had reason to claim that they, just like borrowers, held distressed loans because of broad market forces rather than their own lax underwriting standards. Against this backdrop, lenders might have felt it was prudent to foreclose on their homes and wait patiently for the housing market to improve rather than take an immediate loss by selling to the HOLC.

**Table 7.1. Reasons that HOLC applications were rejected or withdrawn**

| *Reason for rejection or incompletion* | *Number* | *%* |
|---|---|---|
| Inadequate security | 103,145 | 17.9 |
| Lack of distress | 72,778 | 12.6 |
| Failure of applicant to cooperate | 56,186 | 9.7 |
| Property of nonhomestead type | 46,353 | 8.0 |
| Mortgagee's refusal to accept bonds | 44,446 | 7.7 |
| Unstable credit or income of mortgagor | 43,249 | 7.5 |
| Property primarily for commercial use | 27,668 | 4.8 |
| Defective or insufficient title | 20,362 | 3.5 |
| Miscellaneous | 73,361 | 12.7 |
| Application withdrawn | 90,094 | 15.6 |
| Total | 577,642 | 100.0 |

*Source*: Harriss 1951, 24.

How often did the lenders and the HOLC fail to come to agreement? The only systematic evidence available comes from an internal HOLC study of the first 577,642 applications that were either rejected by the HOLC or withdrawn, about two-thirds of failed applications over the life of the program. Of the reasons listed in table 7.1 for the lack of success, 17.9 percent failed due to "inadequate security," which indicated that the value of the house (i.e., the security) was not large enough for the HOLC to make an offer that the lender would accept.

Another 7.7 percent were not completed because the lender refused to accept HOLC bonds. The refusals likely occurred before April 1934 when the federal government was guaranteeing only the interest and not the principal on HOLC bonds. After the government fully guaranteed the bonds, it is unlikely that there were many refusals, and the unwillingness to accept bonds as indicated in table 7.1 may have been just another way to say that no deal was struck. There were enough refusals at first, though, to indicate that lender participation was a real concern.

The guarantee of the bonds was itself a major concession to lenders, and in a very meaningful way it transferred the risks of the program from the lend-

ers to the taxpayers. When the bonds were not fully guaranteed, lenders bore the risk. In such a structure, lenders would bet that their distressed and non-refinanced mortgages were worth less than HOLC bonds that were backed by a large pool of mortgages restructured by the HOLC. Evidently, lenders and bond market participants had significant doubts. Ultimately, the transfer of this risk to taxpayers was a large effective subsidy to lenders.

### How the HOLC Achieved Lender Participation

The HOLC was able to reach such a large size because it made lenders offers that were attractive enough to convince them to participate. Part of the attractiveness came from the guarantee of the bonds given to the lenders, but the attractiveness was also in large part due to the generous values of bonds the HOLC offered, relative to the debts owed to the lenders. In other words, the HOLC was able to make offers with values greater than the lenders would realize by refusing the HOLC's offer and likely having to foreclose.

When the HOLC bought a loan, it had the capacity to offer any price that it liked. However, the law creating the corporation capped the value of a new HOLC loan at 80 percent of the appraised value of the property. Therefore, the HOLC had a choice. If the HOLC paid a lender more than 80 percent of the property's appraisal value, it would have automatically created a loss for itself on the purchase of the loan, since it could not ask the borrower to pay back that large an amount. Of course, taking a loss is something they could have decided to do in the name of relief, but HOLC officials ruled out such a strategy in practice. Consequently, the appraisal was central to determining the maximum payment available to the lender, which in turn was the main determinant of lender participation. Fundamentally, the HOLC gave lenders a good deal. It did this by implementing a generous appraisal strategy, which raised the cap on maximum allowable payments to lenders.

The importance of appraisals is illustrated by the example of Julia Carter, whose debt to the New Michigan Building and Loan Association totaled $3,700. This was a promising case for the HOLC. Internal correspondence noted that "the New Michigan B&L is not very anxious to take this piece of property back as they would have to spend about $1500 in taxes and repairs before the place could be rented."[3] Foreclosure would just have allowed New Michigan to rent the property and perhaps generate some revenue before trying to sell it in a bad market.

New Michigan bargained with the HOLC over the extent of the write-down of the debt. HOLC internal memos document the HOLC's attempt to pay the B&L as much as they could:

> We have had the appraisal reviewed to determine whether or not it could be raised to take care of the various obligations which the property is encumbered with. Everybody agrees that the appraisal is, at the present time, as high as it can possibly be. Of course, you know, under the law, we are not allowed to loan over 80% of the appraisal amount. Therefore it would be impossible to increase the amount of the offer. The offer may appear to be low, but this is because no taxes have been paid since 1928 and the house is in need of some repairs.[4]

The important part of this quote is how it describes officials trying to raise the appraisal as high as they could get it, in order to pay lenders high prices. The HOLC's appraisals were generous in the sense that they were on average significantly above the HOLC's own estimates of the prices at which the properties would have sold in the depressed markets in the mid-1930s.

To see the importance of the distinction between appraisals and market values, consider the example we construct in table 7.2. Imagine a home that was purchased in 1929 for $2,000, with a loan of $1,000. By 1934 the market price of the home had fallen 40 percent to $1,200. The borrower also owed

**Table 7.2. An example of how appraisal methods affected the HOLC's maximum loan amounts**

| | |
|---|---|
| Original purchase price in 1929 | $2,000 |
| Price estimates in 1934 | |
| Market price in 1934 | $1,200 |
| Long-run appraised value in 1934 | $1,500 |
| Debts owed in 1934 | |
| Original principal on loan | $1,000 |
| Missed interest payments and taxes | $200 |
| Total | $1,200 |
| Loan limits from different appraisal methods | |
| 80 percent limit with 1934 market price of $1,200 | $960 |
| 80 percent limit with long run appraised value of $1,500 | $1,200 |

$1,200 to the lender because he had missed $200 in interest and tax payments and still owed the original $1,000 in principal. Had the HOLC appraised the home at its 1934 market price of $1,200, the rule limiting the loan to no more than 80 percent of the appraisal would have meant that the most the HOLC could offer to refinance was $960. If the HOLC offered the lender $960 in bonds for the loan debt of $1,200, the lender would have needed to decide whether it was worth giving up $240 out of the debt owed to transfer the loan to the HOLC. Most lenders were not willing to accept a deal in which they would take a haircut of $240, or 20 percent of the debt owed.

The logic of the 80 percent limit provides an easy source of inference when thinking about individual cases. As an example, the first deal struck in New York State was relatively straightforward.[5] The Rachlin family from the Bensonhurst neighborhood of Brooklyn, New York, had fallen behind on their payments after Mr. Rachlin lost his job in October 1931. At the time the loan was purchased, the Rachlins owed $8,400 to their lender on a house with an appraised value of $13,500. The newspaper article describing the Rachlins' situation did not discuss the terms of the HOLC transaction, but we can make some educated guesses. The HOLC likely bought the loan for the full $8,400 owed, and the lender likely took no loss, given that the 80 percent loan-to-appraisal ratio was not exceeded. Since the Rachlins owed another $300 to New York City tax authorities, the HOLC's restructured loan for the Rachlins entailed a slightly higher principal debt of about $8,700. Potentially the loan could have been larger had the HOLC determined that some emergency repairs were needed to preserve the property and protect the value of the loan collateral.

In making appraisals HOLC officials often stated that they were taking a long-run view of the value of the home.[6] Since home prices had fallen by 20 to 50 percent between 1930 and 1934 in most parts of the country, a long-run view of home values gave the HOLC substantial leeway in setting an appraisal value that was substantially higher than the 1934–1935 market prices of the homes. By picking an appraisal value of $1,500, partway between the prices of $2,000 in 1929 and $1,200 in 1934, the HOLC could purchase the $1,200 debt for the full value from the lender and then refinance the full $1,200 owed by the borrower.[7]

To increase its ability to accommodate lenders, the HOLC raised many of its appraisals in this fashion. A sample of HOLC loans from New York, New

Jersey, and Connecticut provides the only evidence currently available that allows comparisons of the HOLC appraisals to their estimates of mid-1930s market prices for the same properties. For the properties in the sample, the final appraisal exceeded the market price estimate in 58.5 percent of the observations, equaled it in 10.6 percent, and was lower in 30.9 percent. Across all observations, the average markup was 4.2 percent. For properties on which the HOLC ultimately foreclosed, appraisals appear to have been raised more on average, as 76.8 percent of the HOLC's appraisals exceeded the estimated market price, and the average markup was 6.3 percent.[8]

These aggregate statistics include many cases in which borrowers had debts well below the 80 percent debt-to-appraisal limit. In such cases, it did not matter much if the appraisal was higher or lower than the market price estimates, because the HOLC was able to pay lenders and tax authorities the full amounts owed to them without violating the 80 percent debt-to-appraisal limit when writing new loans to the borrowers. In the tristate sample, the HOLC was in fact much less likely to have high appraisals (relative to market price estimates) when borrowers had low debts. In contrast, when borrowers had high debts, the HOLC was much more likely to have high appraisals, allowing them to pay higher amounts to lenders than if they had stuck to market price estimates. In this way, borrowers would be left with debts that were technically not in excess of 80 percent of appraisals, though they could be in excess of 80 percent of market price estimates.[9]

HOLC officials candidly described their desire to accommodate lenders in internal memos. For example, a March 1934 memo reviewing New Jersey lending contains a description of appraisals being manipulated in order to accommodate existing debts:

> It has been the policy of the Camden Office to endeavor in every way to make appraisals that will fit the present encumbrances, in total, of the property. The Fee Appraiser, along with his order for appraisal, is given a copy of the preliminary appraisal. He is given a recapitulation sheet showing the amount due, including all existing liens, and showing the amount of appraisal that will be necessary to cover same, already imported on the recapitulation sheet. He has received specific instructions, supposed to have come from the State Appraiser, directing them that inasmuch as we are bailing out the owner, make the appraisal high enough to cover

> it. The District Appraiser, in case the appraisal does not fit, attempts to suggest and argue with the Fee Appraiser to raise his appraisal to fit the picture.[10]

All of these adjustments of appraisals were made possible by the fact that the bill establishing the HOLC neglected to specify an appraisal methodology. Instead it allowed the HOLC to develop and implement its own methodology. The HOLC could not loan more than 80 percent of the appraisal for any given property, but since the definition of an appraisal was up for grabs, this constraint was significantly weakened. In the process, it is not surprising to learn that lenders encouraged the HOLC to manipulate appraisals in this fashion. A letter from the HOLC's state manager of Connecticut reported the lenders' encouragements to the national office: "We are being criticized by certain lending institutions in the State of Connecticut for what they claim is a lack of proper interpretation of the spirit of the HOLC Act and we are supposed to interpret the act as allowing us to make the appraisals liberal."[11]

It is worth noting that when the HOLC bought loans for less than the full value of the debt, it did not necessarily represent real losses to lenders. Had the HOLC not come along, many lenders likely would have never received the full amount of interest that had not been paid on the loan. Further, we can find no evidence that the HOLC sought to increase its leverage by bargaining with lenders over multiple loans at once. It appears that lenders negotiated with the HOLC over each loan separately. This may have been for the sake of expediency, given that multiple loans from a single lender were unlikely to have been ready for negotiation at any given point in time. Nevertheless, it suggests that for every loan purchased from a lender, the lender expected the HOLC bonds to be a more attractive investment than the loan itself.

## How Lenders Fared

The HOLC never gave much information about its negotiations with lenders. In one of its annual reports, it estimated that across all of its loans, 7 percent of borrowers' outstanding debts were forgiven by lenders, on average.[12] Otherwise, we rely on the tristate sample for information. The sample gives a similar figure, indicating that 9 percent of borrowers' outstanding debts were forgiven by lenders. Therefore, in aggregate, lenders appear to have recouped over 90 percent of what was owed them, including principal on the

loans, missed interest payments, and the lenders' payments for taxes and insurance.

In slightly more than half of the tristate sample, lenders took no losses at all, as they received HOLC bonds in amounts that fully covered all the debts owed to them. In these cases, the borrowers' debts did not exceed the 80 percent limit, and therefore HOLC officials did not even ask them to consider forgiving debt. In the rest of the cases, slightly less than half the sample, some amount of voluntary debt forgiveness by lenders was involved, particularly second-lien holders, although often the amounts forgiven were small and involved accrued interest rather than principal debt.

Perhaps the most interesting cases are those in which borrowers had two lenders and at least one of the lenders had to forgive some debt in order for the loan to be accepted because the borrowers' total outstanding debts exceeded 80 percent of the HOLC appraisal at the time of application. About 25 percent of the borrowers in the sample satisfied these criteria, owing debts this high on at least two loans. In these cases, some lender had to take a haircut, and over 95 percent of the junior lien holders indeed forgave some debt. It is natural that losses were so widespread among junior lien holders because these lenders were last in line to receive payments in a foreclosure, and, in fact, it is somewhat difficult to explain why a small number of them actually did not take losses in these cases. Half of these second-lien holders took fairly substantial cuts, receiving one-third of their claims or less. In comparison, the first-lien holders in these cases did better. Over half took no haircut at all, and three-quarters recovered at least 94 percent. Therefore, the conservative underwriting standards of the 1920s, with low loan-to-value ratios of first mortgage loans, truly did protect first mortgage lenders from losses.

Across the whole sample, only about a third of first mortgage holders forgave any debt when selling loans to the HOLC, and the average recovery among first mortgage lenders was over 96 percent. In contrast, 70 percent of second mortgage lenders forgave some debt, and their aggregate recovery rate was much lower, around 45 percent. The payments from the HOLC to junior lien holders did not always represent their entire compensation, however. The HOLC in some cases allowed an original, recalcitrant junior lien holder to create a new second mortgage, subordinate to the new HOLC mortgage. The second mortgages could not exceed 20 percent of the HOLC appraisal, so that when the second mortgage was combined with the HOLC mortgage, the total

debt remained no more than 100 percent of the appraisal value. These payments underscore the main finding that the HOLC went to great lengths to offer enough to lenders to ensure that they participated in the program.[13]

The tristate sample relates to loans actually made by the HOLC and therefore does not capture applications that failed because lenders refused to forgive debt. We know that such cases existed from the examples given in this chapter, which were taken from loan files stored at the National Archives. The evidence presented in table 7.1, moreover, suggests that perhaps about 18 percent of applications failed because of those refusals. The rate of refusal was not so high, however, as to prevent the HOLC from aiding a large proportion of distressed home owners.

Finally, in considering how lenders fared, it is important to consider that lenders ended up holding bonds that paid only 3 percent interest per year and gave up loans with interest rates ranging between 6 and 8 percent per year. Lenders were willing to do so, of course, because they were likely not receiving interest payments on their loans and faced additional losses given the likelihood of foreclosure, while the low return on the HOLC bonds was guaranteed by the federal government.[14] This guarantee, together with the HOLC's appraisal methodology, created an attractive opportunity for lenders, so that the HOLC was able to refinance more than a million loans.

## Consequences for Borrowers of the Lenders' Good Deal

The HOLC's emphasis on accommodating lenders, by adopting higher appraisals that delivered higher payments to lenders, had consequences for borrowers. It constrained the HOLC's ability to offer debt reductions to borrowers when it refinanced loans. Reductions in debt were sought only for borrowers with incumbent debts that exceeded 80 percent of the appraisal. If that threshold was not reached, the HOLC required such borrowers to repay the full debt they owed the lender. Even so, the generous terms offered on the refinanced loans described in the next chapter show that the borrowers generally received a good deal as well.

The HOLC's generous approach to lenders benefited borrowers in another sense. In the HOLC's role as a bad bank, the assistance it provided lenders also helped repair the mortgage market and the housing market in general. Had the HOLC loan purchase program not been created, mortgage lenders throughout the nation likely would have been forced to resort to protracted

foreclosure proceedings against hundreds of thousands of borrowers between 1933 and 1936. In doing so, lender capital and lending capacity would have been frozen for several years longer, making it difficult for potential home owners to get credit; the housing crisis would have become much more severe, and recovery postponed even longer.