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CHAPTER 10

THE COST TO TAXPAYERS AND SUBSIDIES TO THE HOUSING MARKET

Private investors were not rushing to create their own version of the HOLC in 1933. Anyone with the ability to raise money on the bond market as the HOLC did would have had grave doubts about using that ability to buy up residential mortgages. After all, mortgage lending was a troubled business: lenders saw their balance sheets falling apart after four years of depression, and there seemed to be no end in sight.

This should give us pause when thinking about how the HOLC was financed. The HOLC had a major advantage because it benefited from the backing of the federal government. That was why it was able to tap the bond market so easily. In discussions of the HOLC during recent years, the common conception has been that the HOLC was profitable, and these concerns about taxpayer exposure to the HOLC are typically put aside as unrealized risks. However, our close review in this chapter suggests that if the loan-refinancing program is separated from the HOLC's other activities and if all of its costs are accounted for, it actually was responsible for a small loss to taxpayers. Data from the Comptroller General of the United States, which estimated the HOLC loan program's revenues and costs, indicate that the loan program lost about $53 million, or about 1.8 percent of the roughly $3 billion loaned out through the program. Of course, any evaluation of the program should not be based on these figures alone, as the HOLC had offsetting benefits for lenders, borrowers, and housing markets, as documented in other chapters, as well as additional costs.

The loss would have been larger had the HOLC not been able to borrow as cheaply as it did, with the benefit of the federal guarantee. This reduction in borrowing costs was effectively a net subsidy to housing markets. To gauge the size of the subsidy, had the HOLC been forced to pay an additional 1 percent in interest on its bonds in absence of the federal guarantee, its interest costs would have risen by roughly $300 million, and the subsidy to housing markets would have risen from roughly 2 percent to 12 percent of the value of the loans it made.

How Much Did the HOLC Cost Taxpayers?

A number of advocates for a new HOLC in the current era have stated that the HOLC loan program made money. To some extent, this discussion is a distraction, as profitability should not be the only consideration, given the wide range of costs and benefits of the program. A loss could be justified if the program delivered large benefits. But it is important to get the facts right.

The claim of profitability appears to have first received national attention in April 1946 and was anticipatory. For example, an article in *Time* on April 22, 1946, stated that "when the Home Owners Loan Corp. was created, Congressional sibyls prophesied that the Government would lose at least $1 billion. Last week HOLC's spry old board chairman, John Henry Fahey, produced figures to show how wrong they had been. When HOLC is finally liquidated in 1948, he said it will show a net profit of some $11,000,000."[1] Since then, the claim has been repeated. David Mason, in his history of the savings and loan industry, cites an article titled "HOLC Closing Out with Profit to U.S." in the *Boston Globe* from April 7, 1946. The claim was also added to the *Wikipedia* entry on the HOLC in July 2007, with citations to a 1979 piece on the HOLC. It then became a key part of the popular conception of the HOLC during public discussions in 2008.[2]

The profitability story seems to gain credence with a quick skim of the HOLC's final report, which states that the US Treasury had established the corporation with a starting capital of $200 million in 1933 and 1934 and that the HOLC repaid $214 million to the Treasury in its final liquidation eighteen years later.[3] At the time, $200 million was a significant sum; it is the equivalent of $3.3 billion in 2010 dollars after adjustment for inflation. However, since the economy has grown much larger over the past several decades, the more relevant comparison is to the size of the economy, as measured by GDP.

A $200 million investment in 1934 was about 0.3 percent of GDP; the same percentage of 2010 GDP would be about $46 billion. The risk to taxpayers was that this $200 million would not be paid back in full if the HOLC lost money. There was a further risk that if the HOLC lost enough money, not only would the federal government lose the $200 million investment, but it might also have had to pay out additional funds to cover its guarantee of HOLC bonds.

This story, however, does not carefully account for the costs borne by the Treasury on behalf of the HOLC but not reported by the HOLC in its final report in 1952. HOLC accounting reports took a narrow view of its costs and revenues, without thinking too much about alternative uses of its funds elsewhere in the government, or about costs borne by other agencies to support HOLC operations. In contrast, the Comptroller General thought more about the net costs of the program from the entire government's, and thus the taxpayers', perspective. One item that the Comptroller General identifies is the time cost of money. The Treasury was not willing to give out $200 million to just anyone who in twenty years could repay the $200 million. That is bad business, even for a government agency, and no bank would be willing to make such a loan. If the Treasury did not care about inflation, it could have just held onto the cash with no risk. On the basis of inflation alone, $1 in 1934 was the equivalent of $1.94 in 1952, implying that the HOLC would have had to pay back $388 million in 1951 to break even on the investment in real (inflation-adjusted) terms.[4] At the very least, the federal government could have chosen to pay down the federal debt by $200 million in 1933 and avoid nearly twenty years' worth of interest payments. Alternatively, it could have used the money to fund any of the many other Depression-era programs designed to bolster the economy. The Comptroller General estimated that the cost for supplying funds to the corporation was $91.9 million, which had not been listed in the HOLC final report. Mainly these costs consisted of interest paid to holders of the $200 million in bonds the Treasury had issued to fund its initial investment in the HOLC.[5]

The Comptroller General was also careful to take into account the fact that the HOLC actually ran three programs. In this book, we generally discuss only the HOLC's loan-refinancing program. However, the HOLC also invested $100 million in the Federal Savings and Loan Insurance Corporation and $223.9 million in federal and state savings and loan associations.

In order to understand the profitability of the loan purchase and refinance program, we also need to separate out the latter two operations. Furthermore, when considering the mortgage program, we need to take into account not just the $200 million initial investment by the Treasury, but also the ongoing subsidy provided by the federal government's guarantee of the $3.09 billion in HOLC bonds.

Table 10.1 uses information from the Comptroller General's report to show the cumulative income and cost to the federal government at the end of the program. It does not use the standard business methods of discounting to obtain the net present value. Instead, it simply adds up the costs and expenses over time to come to an accumulated amount at the end of the period.

The income and expenses for the HOLC loan purchase and refinance program at the top of table 10.1 show that the HOLC received cumulative interest payments of around $1.2 billion from its borrowers and had a net profit on its rental and sale of foreclosed properties of $25.8 million. The HOLC paid $598 million in interest on bonds that supported the loan and refinance program. Additional interest costs covered by the US Treasury were about $83 million (part of the $91.9 million cost of supplying funds noted above). The HOLC also had administrative and operating expenses of around $263 million over the life of the program. In addition, it had losses on loans and insurance-related issues of about $338 million. Altogether, after subtracting $1.282 billion in total expenses from the $1.229 billion in total income, it is apparent that the HOLC loan program lost about $53 million. This is about 1.8 percent of the value of the loans it refinanced, roughly $53 per loan.

Now we have the facts—the HOLC lost about $53 million to the government while refinancing about $3 billion worth of loans. While this indicates the program was not profitable, as is often claimed, it clearly was also not a large source of loss to the federal government.

Foreclosures were a main source of the HOLC's expenses and were the most significant expense item that was not really under the HOLC's control. With such expenses amounting to about $337 million, the implied loss was about 33 percent on average across all of the roughly 200,000 foreclosed properties. Since most of these foreclosures took place in the late 1930s before the economic expansion of the next decade, the HOLC's finances were particularly bleak in that period. Had the HOLC been evaluated in 1938 based on current *mark-to-market* accounting standards for financial institutions,

Table 10.1. Net costs to the federal government of HOLC programs

Loan program	
Income	$1,229,560,289
Interest on loans and related advances	$1,192,016,623
Net income from property operation	$25,818,935
Premiums on sales of loan accounts	$2,241,649
Miscellaneous	$9,483,082
Expenses	$1,282,857,703
Interest and other financing expenses within the HOLC	$598,120,287
Interest expenses covered by US Treasury	$83,190,679
Administrative and operating expenses	$263,539,744
Losses: loans and related transactions	$337,154,236
Losses: fidelity and casualty	$372,053
Losses: fire and other hazards	$367,536
Losses: other	$113,168
Net income	–$53,297,414
Other programs	
Income	$74,380,282
Dividends and interest on investments in savings and loan associations	$44,745,479
Dividends on investment in Federal Savings and Loan Insurance Corporation	$28,217,076
Interest on investments in government securities	$1,417,727
Expenses	$98,917,426
Interest and other financing expenses within the HOLC	$62,617,849
Interest expenses covered by US Treasury	$8,709,321
Administrative and operating expenses	$27,590,256
Net income from other programs	–$24,537,144

Sources: Comptroller General of the United States (1953, 9, 27–28); Federal Home Loan Bank Administration (1952, 3, 4, 15).

Notes: The HOLC final report and the Comptroller General's audit did not separate out some of the costs for the loan program, the investment in the Federal Savings and Loan Insurance Corporation, or the investments in savings and loan associations. We prorated the costs based on the proportions of the investments listed in the HOLC final report. The HOLC sold $3.09 billion in bonds to finance the loan program. It also invested $100 million in the Federal Savings and Loan Insurance Corporation and $223.9 million in federal and state savings and loan associations. Thus, the proportion of the interest costs and operating costs assigned to the loan program was 0.9052, and the rest was assigned to the investments in the Federal Savings and Loan Insurance Corporation and the savings and loan associations.

which require firms to evaluate their assets at the resale prices of the assets, it is very likely that the HOLC would have been considered insolvent in the late 1930s. However, economic fortunes changed in the very late 1930s and 1940s, the Mead-Barry Act liberalized loan terms for HOLC borrowers in 1939, and the HOLC's loan portfolio improved enough to deliver the financial results reviewed above.

The discussion has focused on the HOLC loan purchase and loan refinancing program because that is the focus of this book and because it would only muddy the waters to evaluate the costs of that program combined with the HOLC's investments in the Federal Savings and Loan Insurance Corporation and in savings and loans. The income and expenses for those investments, at the bottom of table 10.1, show that the HOLC lost about $24.5 million on those operations after taking into account the two programs' shares of the Treasury costs of supplying funds.

The Size of the Subsidy from the Government Program

Because the HOLC purchased about $3 billion worth of mortgages, the $200 million capitalization from the Treasury was not nearly enough to finance more than a small portion of its activity. We have focused so far on whether that initial investment of $200 million was profitable, but there is also the larger question of the risk to which taxpayers were exposed through the other $2.8 billion of funds. These funds came to the HOLC via bond issuance, and since the bonds were guaranteed by the federal government, taxpayers were potentially on the hook to repay them. This guarantee was in effect a subsidy given to lenders and borrowers through the HOLC's loan purchase and refinance program.

In financing the loan program, the HOLC had a major advantage over any private firm that tried to run such a program because the federal government and American taxpayers were backing the HOLC bonds. One way of observing the importance of the federal guarantee is by noting the change in interest rates on HOLC bonds during its first two years of operation. On the original HOLC bonds issued in 1933, the government guaranteed the interest but not the principal. This essentially created a firewall to protect taxpayers. The principal of the bonds was backed by the underlying mortgages and nothing else. If enough of the loans defaulted in that initial arrangement, there might not have been enough revenue to pay the bonds in full. In compensation for that risk, the HOLC offered a 4 percent interest rate on the original bond issue. In comparison, high-grade corporate bonds of similar length were paying 4.11 percent.[6]

The riskiness of its initial bonds proved problematic in the early days of the HOLC. As noted in chapter 6, the first bond issues in 1933 were reportedly treated with some skepticism by the market, and they traded for prices as low as 80–85 cents on the dollar. This complicated the HOLC's loan purchase activities, as lenders were reluctant to take on bonds, given the risk and uncertainty. When the HOLC was transacting with the lenders, it wanted the lenders to treat the bonds as worth their face value rather than the value at which the bonds were trading, but some lenders balked. This was enough of a discount to make lender participation a bit more difficult to obtain, but it was not a crippling problem. Representative Thomas Busby from Mississippi noted that the bonds "were not good to the financial investors because they did not have Uncle Sam's Guarantee."[7] President Roosevelt weighed in as well, asserting a "moral obligation in respect to these bonds."[8]

As a result, in April 1934 Congress and the president enacted legislation that guaranteed the principal on HOLC bonds as well. This meant that HOLC bonds were de facto equivalent to US Treasury securities, the only effective difference being that a specific revenue stream from the HOLC would be devoted to repaying them. In fact, the act creating the HOLC required that principal payments on HOLC mortgages be solely used to retire HOLC bonds, a requirement that helped ensure that the HOLC would eventually close down rather than become an open-ended government program. When the HOLC issued its new A series bonds in May 1934, the interest rate was 3 percent, nearly a percentage point below the 3.91 rate for high-grade corporate bonds. From that point forward, HOLC bonds were generally issued at rates that were from 0.6 to 1 percent lower than for high-grade corporate bonds of longer than one year. The HOLC also issued some one-year bonds that carried interest rates about 0.2 percentage points lower than one-year rates on high-grade corporate bonds.[9]

In making calculations the way the Comptroller General made them for the HOLC, a 1 percent increase in the interest rate for the loan program would have increased its costs by roughly $300 million, increasing its net loss from $53 million to $353 million. The new cost would have been about $353 per loan, or 12 percent of the total loan value. A discussion from chapter 5 is relevant here, regarding whether a privately financed bad bank would have been a realistic alternative to the HOLC. A privately financed bad bank that matched the HOLC's foreclosure experience—foreclosing on 20 percent of its loans at a loss of 30 percent on each loan—would likely have been required by investors to pay interest rates on its bonds at least 1 percent higher in compensation for the risk. Interest rates would have been 2 percent higher if a foreclosure share of 30 percent had been anticipated. Thus a bad bank seeking capital from private bond markets might have faced interest rates that were higher by 2 percent or more than the risk-free government rate. Had the interest rate on private bad bank bonds been 2 percent higher than on the HOLC bonds, the subsidy would have risen to roughly $653 million, or 22 percent of the value of the HOLC loans made.

Fortunately for the taxpayers, the federal government never had to come through with the guarantee of HOLC bonds. The interest and principal on the bonds were eventually paid off from interest and principal payments on the loan portfolio, rental and sales revenue from foreclosed properties, and revenue from the HOLC's other programs. Two forces were probably most responsible for the relative financial success of the HOLC. One was the ability to borrow cheaply on the bond market, given the federal government's guarantee of its bonds. The other force was the economic recovery of the late 1930s and early 1940s, along with the economic environment of World War II, which raised housing prices and incomes, greatly stemming the tide of foreclosures that had persisted into the late 1930s. As one observer of the HOLC noted, "The war boom fortunately intervened to save HOLC from embarrassment and converted a speculation into an ostensibly costless investment."[10]