CHAPTER 1

Background of Home Owners' Loan Corporation Legislation

In the twenties, as in every period of favorable economic conditions, mortgage debt was entered into by individuals with confidence that the burden could be supported without undue difficulty, and mortgage loans were made by financing agencies with satisfaction over the quality of the investment.[1] One explanation was that over long periods the value of land and improvements had often risen enough to support the widely held belief that the borrower's equity would grow through the years, even though it was small to begin with and not always built up by regular repayments of the mortgage debt. Mortgage contracts often called for no reduction of principal, and were ordinarily written for what would now be regarded as a relatively short term (three to five years), but renewal was generally taken as a matter of course by both borrower and lender.[2]

[1] See Ernest M. Fisher, *Urban Real Estate Markets: Characteristics and Financing* (National Bureau of Economic Research, Financial Research Program, 1951) Chapter 4, for a discussion of the role of debt and equity funds in the financing of home ownership. It is estimated that about five out of every six home buyers had recourse to borrowing in 1946; in 1931 a number of builders and brokers on the West Coast reported to the President's Conference on Home Building and Home Ownership that 13 and 9 percent, respectively, of their sales were for all cash. Fisher, *op. cit.*, Chapter 4, p. 1.

[2] About 20 percent of the sample of urban mortgage loans made on one- to four-family dwellings by twenty-four leading life insurance companies during the period 1920-29 were unamortized loans; the average length of contract for new loans was about six years. See R. J. Saulnier, *Urban Mortgage Lending by Life Insurance Companies* (National Bureau of Economic Research, Financial Research Program, 1950) Table B4, pp. 130-31, and Table B7, p. 136. Slightly under 12 percent of the sample of loans on residential properties (one- to four-family dwellings) made during the period 1918-31 by thirty-nine Massachusetts mutual savings banks required amortization, according to John Lintner, *Mutual Savings Banks in the Savings and Mortgage Markets* (Harvard University, Graduate School of Business Administration, Division of Research, 1948) Table 52, p. 413. The statement in the text is less true of junior debt, whose reduction by quarterly, semiannual, or annual repayments over three to five years was more generally required than periodic reduction of first mortgage debt. During the twenties, interest rates were enough higher than they have been in recent years to make it far more difficult to find in the family budget funds for reduction of principal while meeting interest costs.

What had generally been regarded as a reasonably sound arrangement by all parties concerned proved to be very weak when a set of interrelated forces combined to bring on a severe depression after 1929 and to disrupt seriously the structure of home-ownership finance. Without attempting to assign relative weight to the different factors, or necessarily to state which came first in a causal sense, the most important of them can be indicated briefly.

The ability of individual borrowers to meet mortgage payments was reduced by large-scale unemployment and by income reductions generally, and also by the necessity of meeting payments on instalment sales contract obligations, which had increased sharply in the twenties. This condition quickly led to tax delinquency, mortgage interest default, and ultimately to a wave of foreclosures. Financial institutions frequently faced serious liquidity problems as receipts of new savings declined just when depositors and shareholders or policyholders increased their demands for cash. Some companies were made insolvent by declining asset values. These insolvent and illiquid institutions were compelled to dispose of real estate under the most unfavorable conditions. The result of those sales—forced or nearly so—along with tax sales was to depress prices and, further, to undermine the security of other mortgage investments. In this context mortgagors were frequently unwilling to continue debt payments, and lenders—individuals as well as companies—were unable, hesitant, or altogether unwilling to renew matured contracts or to make new loans. Potential buyers, who were eventually to enter the market and supply some demand for properties, were unready to make purchase commitments. These and other factors and conditions were, as is well known, mutually unsettling and self-aggravating.

In 1932 a system of federal home loan banks was established to provide rediscount facilities for home-lending institutions.[8] The system was built on traditional concepts of financial soundness; whatever the intention of its founders, it was not designed to give help in cases of emergency distress. In effect, the federal home loan banks could give aid only where risk was slight, where the need was insignificant. The effort, therefore, produced no appreciable amelioration of the situation, and conditions became steadily worse. In March

[8] July 22, 1932, c. 522, 47 Stat. 725. Indirect aid was provided by Reconstruction Finance Corporation assistance to financial institutions. Many states passed moratoria statutes which reduced foreclosures and the pressure for forced sales.

1933, millions of people faced the loss of their homes, lenders faced heavy investment losses, communities badly in need of funds suffered from an inability to collect property taxes, and the construction industry, which if revived would contribute significantly to general economic recovery, was at a virtual standstill.

The tremendous social costs imposed by these conditions of deep depression are vividly and movingly revealed in the files of the Home Owners' Loan Corporation. Demands for direct action by the government were insistent and nearly unanimous. On April 13, 1933, President Roosevelt sent each house of Congress a short message urging passage of legislation that would (1) protect the small home owner from foreclosure; (2) relieve him of part "of the burden of excessive interest and principal payments incurred during the period of higher values and higher earning power"; and (3) declare that it was a national policy to protect home ownership. Furthermore, he advocated a plan that would put the least possible charge on the federal Treasury and that would avoid injustice to the investor.[4] Although a detailed legislative history of the administration bill immediately introduced to accomplish these ends is not necessary here, certain observations on it may help in understanding the purposes and later development of the HOLC.

Senate hearings[5] were started after a week's delay but were terminated after two days to speed action. There was some criticism of the $10,000 limit set in the original bill on the mortgages that would be taken by the HOLC. This figure was said to be too low for the large cities but was defended on the ground that the demands for aid would be so great that the limited funds should be concentrated to help small home owners, where the need was alleged to be greatest. It was also argued that present values were so depressed that $10,000 would cover a far larger group of houses than might be expected, and the cost of the program to the government would be greater if higher-valued and more speculative properties were included. In view of later developments in appraisal methods it is interesting to note that Mr. Horace Russell, general counsel for the Federal Home Loan Bank Board, testified that no standard of valuation was fixed

4 *New York Times,* April 14, 1933, 2: 3, 4.

5 U. S. Congress, Senate, Hearings before a Subcommittee of the Committee on Banking and Currency on S. 1317: *Home Owners' Loan Act,* 73rd Congress, 1st Session (1933) especially pp. 8, 12-15, 24, 37-38, 57, 60, 68.

by the bill, pointing out that an early provision for limiting loans to 50 percent of normal value had been changed to 80 percent of "present-day value" because of the impossibility of determining the former. Furthermore, one witness specifically told the committee that in the depressed state of the market "present value" was unfair and unreliable. Some doubt was expressed as to the safey of 80 percent loans, but their justification was argued on the ground that the small home owner would generally make a sincere effort to protect a 20 percent equity. The 5 percent interest charge was said to be too low to cover all expenses and the expected losses, but this again, openly recognized as a subsidy, was justified by Mr. Russell, speaking for the Administration, as a proper relief measure.

One witness supporting the broad outlines of the bill listed fourteen faults, the general tenor being that not enough relief was granted.[6] The fifteen-year amortization period was criticized as being too short and the limitation to owner-occupied dwellings as unfair to the owner who had moved out and rented his dwelling to raise funds to help carry the mortgage.[7] Another witness opposed the bill in principle, arguing that general recovery was the essential need and that nine out of ten lenders were already giving reasonable consideration to mortgagors. This dissent was exceptional, though the New York State League of Savings and Loan Associations adopted a resolution denouncing the proposal and stating that "every reasonable consideration is now being extended by our institutions to every worthy home owner whose economic distress is caused by unemployment or other adverse conditions beyond his control." [8]

Proposals advanced during debate in the House of Representatives, some of which were ultimately adopted, included guaranteeing of the principal of HOLC bonds, extension of the coverage of the Act to four-family houses and to buildings used for commercial purposes, such as small stores, raising of the maximum value of buildings eligible for a loan to $20,000, a lower interest rate, direct cash loans,

[6] A delegation claiming to represent 500,000 families in the New York metropolitan area called at the White House to ask for more liberal terms, especially a three-year moratorium on mortgages secured by owner-occupied houses and an interest rate of 3 percent. *New York Times,* May 12, 1933, 4:2 and May 13, 1933, 1:2.

[7] In fact, the statute as passed authorized loans on homesteads and did not require the borrower to be an occupant at the time the loan was made. See June 13, 1933, c. 64, 48 Stat. 128, Sec. 2 (c).

[8] *New York Times,* May 27, 1933, 19:1.

and removal of the tax exemption from HOLC bonds. The bill passed the House by a vote of 383 to 4.[9]

Senate floor consideration of the bill began early in June, other measures having received higher priority during late April and May. The main change in the Senate version was the addition of a provision for cash loans up to 50 percent of the present value of the property in situations where the lender would not accept bonds. After much floor debate the interest rate on cash loans was fixed at 6 percent, although there was some effort to set the interest rate on cash loans equal to that of the mortgage being replaced in order to discourage applications aimed merely at saving interest. The Senate Committee on Banking and Currency also added a provision requiring the central office to make uniform rules for appraisal. The only apparent dissatisfaction with the Home Owners' Loan Act was that it might not give adequate aid quickly enough; it passed without record vote, and there was no debate on the conference report.[10]

The Congressional Act followed the general outlines of the original Administration proposals.[11] Major provisions of interest were:

(1) The Federal Home Loan Bank Board was directed to create a new agency—the Home Owners' Loan Corporation—with a maximum capital of $200 million (to be provided by the Treasury, which in turn was to secure funds from the Reconstruction Finance Corporation). The members of the FHLB Board were to be the directors of the HOLC.

(2) The HOLC was authorized to issue not more than $2 billion (later increased to $4.75 billion)[12] of its own bonds (in any denominations prescribed by the Board) for cash sale or for exchange for home mortgages. Maximum interest rate on its bonds was 4 percent, maximum maturity eighteen years. Interest (and later both interest and principal) was guaranteed by the United States Government. The bonds were exempt from all taxes (national, state, or local) except surtaxes (that is, the interest on the bonds was exempt from the normal income tax but not from the progressive surtax), estate, inheritance, and gift taxes.

9 *Congressional Record,* Vol. 77, Part 3, 73rd Congress, 1st Session (1933) pp. 2474-2507, 2567-88.

10 *Ibid.,* Vol. 77, Part 5, pp. 4974-95.

11 June 13, 1933, c. 64, 48 Stat. 128.

12 May 28, 1935, c. 150, 49 Stat. 293, Sec. 11.

(3) For three years, the Corporation could exchange its bonds for mortgages (and other obligations and liens) on homes or homesteads provided that (a) no loans were made for more than 80 percent of the HOLC property appraisal or for more than $14,000, (b) the property contained dwelling facilities for not more than four families, and (c) the total value of the property did not exceed $20,000. Cash could be advanced to pay for taxes, necessary maintenance and repairs, and for incidental expenses of the loan, and not over $50 to cover amounts above the face value of bonds transferred.

(4) The Corporation's mortgages were to be the first lien on the property. Interest rates were not to exceed 5 percent of the outstanding balance, the principal of each loan to be amortized in not more than fifteen years by payments at monthly or other regular intervals, subject to extensions. Loans with no amortization during the first three years were permitted.

(5) Loans on the same general terms could be made to finance recovery or redemption of homes lost by foreclosure or voluntary surrender within the two years following foreclosure. Refinancing of loans was also authorized to aid lending institutions in distress.

(6) Cash loans for payment of taxes could be made on the same general terms on otherwise unencumbered properties up to 50 percent of the appraisal; cash loans were also permitted up to 40 percent of the appraisal, but for as much as 6 percent interest, in cases where creditors would not accept HOLC bonds.

(7) Very wide authority was given the HOLC in the management of its affairs. For instance, in hiring staff, it did not have to comply with civil service regulations; in renting space and buying supplies, it did not have to go through ordinary channels of government procurement.

References to other provisions pertinent to this study will be made in later chapters.

It is not possible to determine precisely what the measure's sponsors expected of it, but some important propositions seem clear: Congress and the President wanted to use government resources speedily to help a large section of the public; yet while it was generally expected that there would be a loss, perhaps sizable, the Act was designed to limit the Treasury's loss. There was very little conception as to how the organization would operate, what its problems would be, or how long it would last. The groups to be benefited were narrowly limited in the original draft and were definitely above the lowest economic standard; even as finally passed, some members of Congress probably felt that many deserving families would get no aid and that others would get too little. There was serious doubt as to the acceptability of the bonds, yet it was clear that if the bonds were not accepted the plan would fail. Little concern was expressed for lenders, and not much attention was paid to the probable secondary effects of the Act.[13] In short, the main objectives of the sponsors of the HOLC were clear but mixed. This mixture of objectives, and the appearance of new and important developments as operations proceeded, complicate greatly an evaluation of the accomplishments of the HOLC.

13 These included the restoration of values generally by checking liquidation and helping reverse the process of cumulative deflation, encouraging new expenditures for rehabilitation and remodeling, making basic revisions of the mortgage structure, reducing interest rates, and aiding local governments in the collection of property taxes.