American Enterprise Institute for Public Policy Research

December 2007

Financial Services Outlook

# Crisis Intervention in Housing Finance: The Home Owners' Loan Corporation

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*The Home Owners' Loan Corporation (HOLC), little known or remembered now, has an instructive history, beginning in 1933 during a housing and mortgage finance collapse of a severity unimaginable today. The HOLC was a very large government intervention designed to reduce the burden on borrowers while increasing the liquidity of mortgages—the same goals being pursued in current policy debates—but the HOLC was also designed to be temporary and as self-supporting as possible. It grew in the mid-1930s to refinance 20 percent of all the mortgage loans in the country, then was wound down and liquidated, returning a small surplus to the U.S. Treasury in 1951.*

The end of 2007 finds us in the midst of the housing and mortgage finance bust, which has inevitably followed the housing and subprime mortgage bubble. Public discussion is full of proposals and programs for both legislative and "jawboning" government interventions to reduce the rising number of foreclosures, stabilize the credit markets dealing in mortgage-backed securities, and improve the functioning of the housing finance system. Early December, for example, brought the "Paulson Plan," orchestrated by Treasury Secretary Henry M. Paulson—most notable for having mortgage servicers postpone for five years having certain subprime adjustable-rate mortgages (ARMs) reset to higher interest rates in order to reduce future defaults.

We are now in a predictable, recurring phase of housing finance busts. We have often been here before, historically speaking. There is a political imperative to Do Something, and there are always reasonable economic or financial rationales, so government actions are always taken. It is only a question of which ones. "Nothing is worse than doing nothing," said Paulson in a recent speech on housing finance problems.[1] This is probably not true in economics, but it is absolutely true in politics.

Government actions can be of two general types: those that try to permanently improve the structure of the housing finance system and those that are temporary. Temporary actions are taken to avoid a self-reinforcing downward spiral or debt deflation, to "bridge the bust" and then to be withdrawn as normal private market functioning returns. The fundamental idea behind them is that markets need time to adjust and recover. Temporary programs should inhibit personal choice and the long-run innovation and efficiency of the market as little as possible, and they should not bail out careless lenders and investors or speculative borrowers.

In a financial panic, everybody wants to get a government guarantee. To some extent, in one form or another, such guarantees are usually provided.

Prime examples, still very much with us, are three institutional creations of the 1930s, all involving government guarantees. The possible expanded use of each is prominent in current discussions. The first is the Federal Housing Administration (FHA), the government's own subprime mortgage credit provider, set up in 1934 to make mortgages more liquid by adding government credit to make them

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acceptable to investors—especially to commercial banks and life insurance companies—and to renew the market for selling and buying mortgages. The FHA has recently begun a special program in which it issues insurance for the refinancing of subprime loans. This role might be significantly expanded by legislation.

Fannie Mae, set up and capitalized by the government in 1938 as the Federal National Mortgage Association, is also available for an expanded role in the housing market recovery.[2] Originally, Fannie's sole purpose was buying FHA loans to support their marketability. A 1938 observer commented that "the possible expansion of this organization is recognized,"[3] but he would no doubt have been surprised to learn that Fannie has become a $2.5 trillion company. It is certainly big enough to buy some FHA-refinanced subprime loans, a possible temporary role for it in our current bust.

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The Federal Home Loan Banks (FHLBs), proposed by Herbert Hoover in 1932, have already expanded their role and recently become quite prominent for their remarkably large loans to certain financial institutions: $50 billion to Countrywide, $50 billion to Washington Mutual, and almost $100 billion to Citigroup. In 1932, many savings and loan associations (S&Ls) were unable to honor withdrawals from their savings accounts or make new mortgage loans because they had no cash. The idea was that the FHLBs would make loans to S&Ls secured by their mortgages, which the FHLBs would finance by selling government-sponsored bonds. That is exactly what the FHLBs are doing today, only on a far grander scale.

No longer with us, although active in the 1930s and 1940s, was the Reconstruction Finance Corporation (RFC), another government corporation, which made temporary investments in more than six thousand banks to help them survive the debt deflation. The RFC became a power in the land but eventually fell out of favor and was abolished in 1953. At a state level, there are now various initiatives to create funds that will make loans to refinance subprime mortgages at more favorable rates, and the Treasury Department is proposing that the states be authorized to finance these with tax-exempt bonds. Such funds are a close analogy to the idea of HOLC.

## The Situation in 1933

One knowledgeable analyst recently described the current bust as "the worst housing downturn since the Great Depression."[4] But while our own situation is serious and painful, it is minor compared to what was happening then. The Home Owners' Loan Act of 1933 was drafted and enacted during a financial and economic collapse virtually impossible for people today even to imagine. About half of mortgage debt was in default.[5] Compare this to September 30, 2007, when total defaulted mortgages (ninety days or more past due plus loans in foreclosure) were 2.95 percent. Even in the highest-default states of Ohio, Michigan, and Indiana, where the housing bust is compounded by the employment problems of the domestic automobile industry, the default rates range from 5.06 to 5.44 percent.[6]

Of course, the default rate on the riskiest mortgage loans—subprime ARMs—is much higher, with a national average of 15.6 percent. But these loans represent only about 7 percent of outstanding mortgages.[7] They do not begin to pose the challenges of the 1930s.

In 1933, unemployment had reached about 25 percent. Thousands of banks and S&Ls had failed, and all financial institutions were temporarily closed in March. (The number of banks fell by about 8,000, or 35 percent, and the number of S&Ls by about 1,500, or 13 percent, between 1930 and 1935.)[8]

The amount of annual mortgage lending dropped by about 80 percent between 1930 and 1933, from $3.4 billion to $663 million.[9] Private residential construction in the same period dropped over 80 percent.[10] States were passing moratoriums on foreclosures. The average borrower that HOLC eventually refinanced was two years delinquent on the original mortgage and about three years behind on property taxes[11]—and, at least according to one account, "some citizens even formed lynching parties for sheriffs attempting to conduct foreclosure sales."[12]

The prelude to this crisis was of course a period of good times and confident lending and borrowing:

> 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. . . . 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 payments on the mortgage debt. Mortgage contracts often called for no reduction in 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.[13]

Ah, yes: interest-only loans, balloon payments, the assumption of rising house prices, and firm belief in the easy availability of the next "refi." This may sound familiar. Then came massive defaults, falling prices, and a debt deflation's downward spiral: mortgage defaults, tightening credit, reduced demand for houses, foreclosures, falling house prices, greater defaults, failure of lenders, even less credit, further reduced demand, more foreclosures, foreclosed properties creating greater supply for sale, further falling prices, more defaults, failure of more lenders, no credit, further falling prices and the resulting "frozen" markets.

## Refinancing Defaulted Mortgages

That was the context for the creation of the Home Owners' Loan Corporation. This government intervention to help stabilize the downward spiral in housing finance grew to have about 20,000 employees[14] but was from the beginning designed as a temporary program. As one contemporary wrote in 1935, "This was to be in every sense of the word an 'emergency' institution which was to relieve the mortgage strain and then liquidate."[15]

From the perspective of 1941, another analyst observed:

> The Home Owners' Loan Corporation met the immediate crisis. . . . HOLC lending was only a temporary measure. . . . Creditors were relieved of a crushing weight of frozen assets in a time of great stress, and debtors obtained more favorable credit terms than had ever before prevailed in this country. It was well understood that in the HOLC no permanent socialization of mortgage lending was intended.[16]

By the spring of 1933, said the principal historian of HOLC, "demands for direct action by the government were insistent and nearly unanimous."[17] In April, Franklin D. Roosevelt proposed legislation with the following goals:[18]

- "protect the small homeowner from foreclosure"
- "relieve him of part of the burden of excessive interest and principal payments incurred during the period of higher values and higher earning power"
- "declare that it was a national policy to protect home ownership"
- "put the least possible charge on the federal Treasury"
- "avoid injustice to the investor"

Congress moved quickly in the midst of the crisis, and only two months later, on June 13, the resulting Home Owners' Loan Act became law. Its Section 4, designing HOLC, took up only three and a half pages of text. The act directed the creation of HOLC as a government corporation, with the members of the one-year-old Federal Home Loan Bank Board serving as directors without additional compensation. The Treasury was authorized to invest $200 million in HOLC stock to capitalize the corporation.

How much was $200 million worth in 1933? If simply adjusted to the current dollars by the Consumer Price Index, it would be worth about $3 billion today. If adjusted by the change in GDP per capita since 1933, it would be about $20 billion. As a proportion of GDP, it would be over $46 billion.

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The act originally authorized HOLC to issue $2 billion in bonds, or ten times its capital. Using the same three adjustment factors, this would be the equivalent of about $30 billion, $200 billion, or $468 billion today: a significant commitment however measured. Putting the scale in current context, $200 billion is in the range of total losses forecast for the current mortgage bust.

The bonds could have maturities up to eighteen years—and eighteen years later HOLC was liquidated—and interest rates of up to 4 percent. The original act provided a government guarantee for the interest payments only, not the principal. This did not work so well, because in a panic, everyone wants a government guarantee. With the principal of the bonds having today what we would call "GSE status," rather than the full faith and credit of the government, they became marketable only at fairly large discounts to par. So the act was amended to make them fully guaranteed by the government as to principal and interest.

The fundamental idea was that HOLC would acquire defaulted residential mortgages from lenders and investors,

giving its bonds in exchange, and then refinance the mortgages on more favorable and more sustainable terms. The lender would thus have an earning marketable bond—although with a lower interest rate than the original mortgage—in place of a frozen, nonearning asset.

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The lender would often take a loss on the principal of the original mortgage, receiving less than the mortgage's par value in bonds, reflecting the lower value of the underlying property. In other words, "the appraisal was too low to permit the refinancing of all the debt against the property, in which case the original lender sacrificed part of his claim."[19] This realization of the loss of principal by the lender (which loss had already happened in economic terms), or "the willingness of lenders to compromise,"[20] was an essential element of the reliquification program—just as it will be in our current mortgage bust.

Reflecting its status as a temporary intervention, the act authorized HOLC to make such exchanges for three years. HOLC's investment in any mortgage was limited to 80 percent of the appraised value of the property, with a maximum of $14,000. With an 80 percent new mortgage, therefore, the maximum house price to be refinanced would be $17,500 in 1933 dollars. Adjusting this by the Consumer Price Index would result in a current house price of about $270,000. Using the Census Bureau's change in median house prices since 1940 would suggest a current equivalent of approximately $1 million—so HOLC could be imagined to be able to operate today even with California house prices.

What does "appraised value" mean in the middle of the housing and financial collapse? A key HOLC program was to develop its own theory of appraised value and a large operating organization to carry it out. Using the estimated market price, the replacement cost of the house, and the capitalization of an estimated rental value, HOLC arrived at a kind of intrinsic value that "generally yielded appraisals above prevailing market prices."[21] This obviously enhanced its ability to carry out refinancings and may be viewed as allowing de facto loan-to-value ratios of more than 80 percent.

The act set interest on the new mortgages to be made by HOLC to refinance the old ones it acquired at not more than 5 percent. The spread between this mortgage yield and the cost of HOLC bonds, which fell to 3 percent and then even lower, generated an average spread of about 2.5 percent. (With long term Treasury rates of about 4 percent today, an equivalent spread would give a lending rate of 6.5 percent.) In the optimistic case, HOLC's spread, along with the support of the $200 million equity from the Treasury, would have covered both HOLC's expenses and its own credit losses as an at-risk lender to formerly defaulted borrowers. The credit performance would, of course, be greatly helped by a recovery of house prices in time. In the long run, it actually worked out this way.

HOLC entered business in a situation in which "[i]t was even more apparent that all kinds of investments in real property were thoroughly discredited. . . . Just to mention real estate bonds in many groups caused the same kind of self-conscious laugh that came from references to investment trusts."[22] Its mission to try to stabilize the downward spiral of mortgage defaults and house price declines was well understood by the 1933 *New York Times*:

> It seems reasonably clear that if a considerable portion of properties now under foreclosure are refinanced, such properties will no longer be offered at forced sale and at desperately low prices . . . while every distressed property which is refinanced will release capital to the mortgage holder.[23]

The *Times* also understood the losses that the mortgage holders would be taking: "Many mortgage liens will be larger than 80 percent of any fair appraised value of the properties, so that security holders will, in such cases, take substantial reductions from the face of their security if they trade for bonds as allowed under this act."[24]

Were mortgages traded for bonds anyway? They were.

## A Massive Temporary Intervention

During its life, HOLC made more than 1 million loans to refinance troubled mortgages—about 20 percent of all the mortgage loans in the country.[25] By 1937, it owned almost 14 percent of the dollar value of outstanding mortgage loans.[26] This was a remarkable scale of operations. Today, 20 percent of all mortgages would equal about 10 million loans, and 14 percent of outstanding mortgages would

be worth about $1.4 trillion—roughly the total of all subprime mortgage loans.

As an at-risk lender, HOLC turned down about 46 percent of applications. In an interesting historical parallel, it made the largest number of loans in Ohio, followed by Michigan[27]—the two states with the highest default rates today. Although HOLC tried to be as accommodating as possible with its borrowers, it ended up itself foreclosing on about 200,000—20 percent—of its loans.[28] Losses on these foreclosures averaged 33 percent of HOLC's investment.[29] Since all these loans started out in default, close to foreclosure, this seems to be a respectable performance.

Of course, any preferential refinancing program for defaulted loans runs the risk of encouraging otherwise capable borrowers to change their financial behavior to qualify for the more favorable terms being offered by the government. As was argued in 1935:

> The mortgage portfolio of [HOLC] . . . includes many excellent mortgages, where borrowers quite able to discharge their obligations to private institutions have voluntarily defaulted and obtained the more preferential Government financing intended for citizens really in distress.[30]

This appears to be an inevitable cost of all such interventions.

Another problem confronted by HOLC was that the mortgages of the 1920s, like those of the 2000s, were often accompanied by second mortgages. These second liens had to be addressed so that the favorable refinancing terms did not end up bailing out the second mortgage investors. Therefore, "in closing an HOLC refinancing agreement, all lienholders were required to sign releases for amounts not refinanced." In this process, "the holder of a second mortgage was not without bargaining power," and in some cases the second mortgage–holders prevented the HOLC refinancing.[31]

As in the 1930s, achieving refinancing in today's bust will require dealing in many cases with second liens, which have little, if any, market value but nonetheless confer some bargaining power.

## Finale . . . and Future?

Section 4 of the Home Owners' Loan Act provided that "[t]he Board shall proceed to liquidate the Corporation when its purposes have been accomplished, and shall pay any surplus or accumulated funds into the Treasury."[32] This intent was carried out, as documented in the *Congressional Record* in 1951:

> The HOLC has now closed its books, locked its doors and gone out of business as a leading mortgage holding agency of the government. This was reported to the Home Loan Bank Board today following delivery of an HOLC check for nearly $14,000,000 of surplus to the United States Treasury representing the financial results of the Corporation's 3.5 billion dollars rescue task of the depression years.[33]

A review of HOLC's life from later that year pointed out that these financial results reflect HOLC's advantage of borrowing at government rates, and $14 million is a modest return on $200 million used for eighteen years. Considering that "it was feared that the HOLC venture might bring losses of up to a half billion dollars to the government," however, and that HOLC instead turned out to be "a social experiment which apparently has paid its way," the review judges HOLC a success and the end of its story "sufficiently unique to constitute news."[34] This 1951 eulogy ends in speculation:

> In the future, it may never be necessary for a comparable experiment to be undertaken. But again, history had a way of repeating itself. If so, perhaps Congress might well be justified in feeling that a second HOLC might play a significant role, should a future planned program of widespread refinancing for housing prove to be essential.[35]

As the housing and mortgage bust of 2007 continues into 2008, the lessons of HOLC again are relevant and well worth studying.

*AEI research assistant Karen Dubas and editorial assistant Evan Sparks worked with Mr. Pollock to edit and produce this* Financial Services Outlook.

## Notes

1. Henry M. Paulson, "Remarks by Secretary Paulson on Actions Taken and Actions Needed in U.S. Mortgage Markets at the Office of Thrift Supervision National Housing Forum" (speech, Office of Thrift Supervision National Housing Forum, Washington, DC, December 3, 2007), available at www.ustreas.gov/press/releases/hp706.htm (accessed December 12, 2007).

2. Also available for an expanded role is Freddie Mac, which was not created until the Emergency Home Finance Act of 1970.

3. Spurgeon Bell, "Shifts in the Sources of Funds for Home Financing, 1930–1937," *Law and Contemporary Problems 5,* no. 4 (Autumn 1938): 514.

4. Mark M. Zandi (remarks, Office of Thrift Supervision National Housing Forum, Washington, DC, December 3, 2007).

5. Fred Wright, "The Effect of New Deal Real Estate Residential Finance and Foreclosure Policies Made in Response to the Real Estate Conditions of the Great Depression," *Alabama Law Review* 57, no. 1 (Fall 2005): 240.

6. Mortgage Bankers Association, *National Delinquency Survey*, September 30, 2007.

7. Ibid.

8. R. Dan Brumbaugh Jr., *Thrifts under Siege* (Cambridge, MA: Ballinger, 1988), 7.

9. Spurgeon Bell, "Shifts in the Sources of Funds for Home Financing, 1930–1937," 515.

10. Fred Wright, "The Effect of New Deal Real Estate Residential Finance and Foreclosure Policies Made in Response to the Real Estate Conditions of the Great Depression," 258.

11. Rosalind Tough, "The Life Cycle of the Home Owners' Loan Corporation," *Land Economics* 27, no. 4 (November 1951): 325.

12. Fred Wright, "The Effect of New Deal Real Estate Residential Finance and Foreclosure Policies Made in Response to the Real Estate Conditions of the Great Depression," 240.

13. C. Lowell Harriss, *History and Policies of the Home Owners' Loan Corporation* (New York: National Bureau of Economic Research, 1951), 7.

14. Ibid., 5.

15. Morton Bodfish, "Government and Private Mortgage Loans on Real Estate," *Journal of Land & Public Utility Economics* 11, no. 4 (November 1935): 404.

16. David M. French, "The Contest for a National System of Home-Mortgage Finance," *American Political Science Review* 35, no. 1 (February 1941): 54.

17. C. Lowell Harriss, *History and Policies of the Home Owners' Loan Corporation*, 9.

18. Ibid.

19. Ibid., 25.

20. Ibid.

21. Ibid., 2.

22. Coleman Woodbury, "Integrating Private and Public Enterprise in Housing," *Annals of the American Academy of Political and Social Science* 190 (March 1937): 165.

23. "Realty Aid Seen in Home Loan Act," *New York Times*, July 2, 1933.

24. Ibid.

25. C. Lowell Harriss, *History and Policies of the Home Owners' Loan Corporation*, 29, 31.

26. Spurgeon Bell, "Shifts in the Sources of Funds for Home Financing, 1930–1937," 510.

27. C. Lowell Harriss, *History and Policies of the Home Owners' Loan Corporation,* 33.

28. Ibid., 71.

29. Bert Ely, "The Resolution Trust Corporation in Historical Perspective," *Housing Policy Debate* 1, no. 1: 53.

30. Morton Bodfish, "Government and Private Mortgage Loans on Real Estate," 404.

31. C. Lowell Harriss, *History and Policies of the Home Owners' Loan Corporation*, 36–37.

32. See section 4(k), original text, *Home Owners' Loan Act, U.S. Code* 12 (1933), §§1461 et seq.

33. Adolph J. Sabath, "Statement Relative to the Record and Passing of the H.O.L.C.," 82nd Cong., 1st sess., *Congressional Record* 97 (May 25, 1951), H 6041.

34. Rosalind Tough, "The Life Cycle of the Home Owners' Loan Corporation," 329, 324.

35. Ibid., 331.