Marketing and Financing Home Ownership: Mortgage Lending and Public Policy in the United States, 1918-1989

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Since the early part of this century, there have been extensive efforts by business, government, and the media to promote urban and suburban home ownership as a superior way of life to tenancy. President Hoover captured this attitude in an important national speech in 1931: "they never sing songs about a pile of rent receipts" [15, p. 2]. Ironically, one of the main goals of this broad coalition was to make owning more like renting in one crucial respect: the flow of cash expenditures. If people could purchase a house with a small initial outlay and modest monthly payments, then the economic barriers to home ownership would disappear for the majority of moderate income families. Installment selling was the key to success and the essential instrument was the long-term, high-leverage, amortized first mortgage loan. Dramatic institutional changes in mortgage lending, public policy, and the real estate industry brought about an increase in the percentage of non-farm owner occupied housing in America from 37% in 1900 to 64% today.

A nationwide "Own Your Own Home" campaign was launched in 1918 by the U.S. Department of Labor and a wide network of industry groups, particularly the National Association of Real Estate Boards and the National Federation of Construction Industries, the latter including both contractors and building materials and equipment manufacturers and distributors. The campaign was launched during the post-World War I urban housing shortage and wave of labor strikes and social unrest. The government's objective was to defeat radical protest and restore political stability by encouraging urban workers to become home owners. The industry's objective was to stimulate new investment, construction, and sales in the private residential property market. In addition, both industry and government leaders viewed home ownership as a potentially powerful generator of long-term economic growth.

The leaders of this extensive public relations and advertising campaign were businessmen. The movement was directed by Franklin T. Miller, Chairman of F.W. Dodge, an information services business for the construction industry. He was assisted by Paul C. Murphy, a real estate broker from Portland, Oregon, and K.V. Haymaker, a Detroit savings and loan executive. Miller was editor of the *American Contractor* and vice-president of the National Federation of Construction Industries. Murphy was a national spokesman for the real estate boards, and Haymaker played a central role in the U.S. League of Local Building and Loan Associations. A key aspect of their promotional efforts on behalf of the Secretary of Labor and the U.S. government was to stimulate the flow of home mortgage lending by

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encouraging bankers to make more money available to builders, to purchasers, and to thrift institutions.[1]

That mortgage lending by mainstream financial intermediaries should be important for the construction and sale of small urban dwellings represented a major structural change from the mid-19th century. Credit for urban home ownership was not easily available in the 1850s or 60s, especially not from financial institutions. Much of the lending that did occur was done by land subdividers, builders, brokers, local investors, or friends and relatives of the purchasers. Some of these loans were secured by land contracts, which left ownership in the hands of the seller, rather than mortgages, where ownership was transferred to the buyer. Land contracts were easily foreclosed if any payments were missed and there was usually no opportunity of redemption for the borrower.

Mortgage loans generally were for only one-third to one-half the purchase price of the house and were for very short terms of one to three years. Often they carried high effective interest rates and loan fees when funds were available, which varied considerably in different areas of the country. The short terms of the loans meant that borrowers needed to constantly refinance, taking the risk that if no new funds were advanced when the entire face value of the loan was due, then default and foreclosure might soon follow.[2]

By the 1880s real estate subdividers such as William E. Harmon had initiated methods of selling urban subdivision lots on land contract with as little as five percent down and modest monthly payments. These techniques proved highly successful in inducing urban land sales, particularly during boom periods. Housing, however, was much more expensive in relation to the average family's income and accumulated savings. Many people had to build their own houses by hand, become landlords for part of their property, and severely economize on basic private and public improvements to be able to afford owner occupancy.

Builders and brokers were eager to market their products and services by providing housing credit, and they frequently made second, third, and even fourth mortgages at effective interest rates of 18-20% in order to finance home sales for buyers who could come up with a down payment of only one-fifth the purchase price. Better-capitalized lenders were still needed to make first mortgage loans, and by the latter part of the 19th century, mutual

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[1]The discussion of the "Own Your Own Home" campaign is drawn from the papers of the U.S. Housing Corporation, Record Group 3, National Archives, Washington, DC; the papers of the Division of Building and Housing, the President's Conference on Unemployment, and Franklin T. Miller at the Herbert Hoover Presidential Library, West Branch, Iowa; and the pages of the *American Contractor.*

[2]For comprehensive lists of sources on the history of real estate and housing finance see [35, 36, 37]. For early studies of mortgage lending see [32, 33, 35]. The best historical data on this topic come from the Financial Research Program and the Studies in Capital Formation and Financing at the National Bureau of Economic Research. These volumes include [1, 10, 12, 19, 23, 30].

savings banks, life insurance companies, and state-chartered commercial banks were increasingly entering the market. Rising real incomes and property values in many cities turned real estate mortgages into good collateral for ambitious lenders. The institutional share of residential mortgage debt increased from 49.5% in 1896 to 66% by 1912. The total percentage of owned homes that were mortgaged grew from 27.7% in 1890 to 39.7% in 1920. In New England and the Middle Atlantic states more than half of all owned homes were mortgaged by 1920. Rising dollar volumes of debt, higher loan-to-value ratios, and loans on smaller, moderately priced houses were additional trends in this era when "sweat equity" was beginning to be replaced by "easy credit" [12, p. 192; 35, pp. 45-6, 53-4].

The most important home mortgage lending institutions to emerge in the latter half of the 19th century were the building and loan associations, today called savings and loans (S&Ls) or thrifts. These institutions pooled small savings deposits into mortgage loans, primarily for member-depositors. They made loans to families wishing to buy an old house or build a new one, and also to builders to construct houses. The mortgage instruments were for much longer terms than anything else available, in some cases for up to 12 years. Also, the first mortgage loans were for a higher percentage of value than from any other source, frequently for at least 60% and occasionally for as much as three-fourths of the property's value. Finally, the loans were "amortized"--the borrower was obligated for modest regular monthly repayments of principal and interest rather than for large balloon payments of the principal due at the end of the loan term. The amortization idea was an adaptation of the concept of a continuing savings plan. In order to attract members, S&Ls paid high interest on deposits, or "shares," which meant that they also charged higher interest on first mortgage loans than most other institutional lenders. Also, the amortization feature resulted in larger monthly loan repayment costs to the borrower than a balloon mortgage, so the safer and more stable S&L method did not appeal to everyone.[3]

While the commercial bankers were only fair-weather friends of the builders and brokers, often withdrawing credit when it was most needed, the S&Ls were more reliable allies. For one thing, S&Ls had no other purpose than to make residential mortgage loans, so their business depended on increasing home construction, sales, and financing. For another, many of the S&Ls were controlled by builders and realtors and were used primarily as a credit instrument to promote sales and development. But S&Ls, like builders and brokers, still were dependent on commercial bankers for much of their short-term financing needs. During the credit crunch of 1918, however, these three sectoral partners began searching for new means of pumping money into home building and home ownership.

Franklin Miller and K.V. Haymaker devised a plan for a system of federal building loan banks modeled on the recently-created Federal Reserve

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[3]A broad history of S&Ls is provided in [8]. For an earlier view see [2, 3, 4] and various publications such as the *American Building Association News* and the *Building and Loan Annals*.

System and the Federal Farm Loan Banks. The idea was to establish a liquidity reserve on which the S&Ls could draw to continue making home mortgage loans during times of "tight money." In 1919 a bill was introduced in Congress to establish these banks, but it did not pass until the financial crisis of the Great Depression and the strong support of President Hoover led to the creation of the Federal Home Loan Bank System in 1932. S&Ls had grown enormously both in number and volume of mortgage loans during the 1920s and many of them crashed hard during the banking panic of the early 1930s.

Between 1920 and 1930 total residential mortgage debt tripled. The S&Ls alone mortgaged 4.35 million properties, totaling more than 15 billion dollars in loans [3, p. 58]. Debt-to-equity ratios were changing dramatically as people were borrowing much larger amounts relative to the total purchase prices and to their incomes and savings. However, much of this financing consisted of a crazy quilt of land contracts, second and third mortgages, high interest rates and loan fees, short terms, balloon payments, and various other high risk practices that crashed like a house of cards when the commercial banks suffered a liquidity crisis after 1929 and real estate plummeted in value as market demand began to disappear. By 1933 nearly half of all home mortgages were in default and there were a thousand foreclosures a day. In the wake of this panic of defaults and foreclosures, the federal government intervened to structurally transform the rules of the financial game.[4]

The chief lobbyists for the massive government intervention in housing finance were the leaders of the "Own Your Own Home" coalition. New housing starts had dropped over 90% from the peak of 937,000 units in 1925 to the trough in 1933. Real estate sales transactions of all types were down in volume and value. The builders, realtors, and building products industries wanted to stimulate home mortgage lending by stabilizing the financial system and making it easier for prospective borrowers to come up with down payments and monthly payments. Many S&L leaders argued that thrifts were the solution, and they limited their political support to legislation designed to strengthen their own institutions. Construction and realtor interests favored federal help for the thrift industry, but they also wanted assistance for all of the other mortgage lenders as well. Most S&Ls, however, opposed any programs of benefit to competing financial institutions.

Many of the commercial banks, savings banks, and life insurance companies had withdrawn from home mortgage lending during the early 1930s in the face of liquidity problems and falling property values. Their proposals for improving the system of home financing consisted of making borrowers come up with larger down payments, imposing stricter appraisal and underwriting standards, and passing laws to expedite mortgage foreclosures.[5]

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[4]On the 1920s and early 1930s see [11, 13, 14, 27, 34].

[5]For example, see the recommendations of the Committee on Finance of the 1931 President's Conference on Home Building and Home Ownership. The committee was headed by Frederick H. Ecker, president of the Metropolitan Life Insurance Company [13].

As both the bank problem and the depression worsened in 1933, however, many of these financial institutions began lobbying for short-term federal intervention to save them from potential insolvency. Most were not interested in making long-term changes in private mortgage lending practices.

The Federal Home Loan Bank System merged and reorganized the bankrupt S&Ls, created new federally-chartered associations, and helped provide liquidity to the thrifts to free them from dependence on commercial bank credit. The Federal Savings and Loan Insurance Corporation, set up by Congress in 1934, greatly strengthened the attractiveness of S&Ls to savers by insuring deposits and also helped standardize thrift institution management. S&Ls also were granted a series of income tax and regulatory benefits in recognition of their special position as primarily home mortgage lenders. With these structures and programs in place, thrifts became the principal source of private credit for single-family housing. Later in the 1950s, 60s and 70s other federal actions further enhanced the position of the S&Ls. In 1966 Regulation Q put a ceiling on savings deposit interest rates and gave thrifts a one-quarter point advantage over time deposit accounts offered by commercial banks. The Federal Home Loan Mortgage Corporation ("Freddie Mac") was established in 1970 to provide a secondary mortgage market for S&Ls, making it possible for thrifts to expand their lending activities even when deposit growth was slow or declining.

There were other dramatic structural changes in the 1930s. The federal government created the Home Owners' Loan Corporation (HOLC) in 1933 and the Federal Housing Administration (FHA) in 1934. The HOLC refinanced more than three billion dollars of shaky or defaulted mortgages, largely held by commercial banks, and introduced long-term (15 year) self-amortizing loans to many lenders and borrowers who were not familiar with the concept. While the HOLC was a temporary operation that stopped making loans in 1936, the FHA was a permanent program that launched a revolution in housing finance. FHA's mutual mortgage insurance system reduced the investment risk for lenders and enabled them to make longer-term, higher-leverage loans at lower interest rates. New federal and state laws to stabilize and restructure the commercial banking system, plus the establishment of the Federal Deposit Insurance Corporation (FDIC) in 1933, eventually enabled commercial banks to participate in the FHA program and become major lenders of long-term home mortgages. Life insurance companies and mutual savings banks also took advantage of the FHA program. By the 1970s FHA had spawned many private competitors in the mortgage insurance business, such as the Mortgage Guarantee Insurance Corporation (MGIC). These private companies have played an increasingly important role in home mortgage lending, starting with the S&Ls, who never liked the FHA program, as well as with other types of lenders serving higher income borrowers than FHA currently serves.

In the 1940s the Veterans Administration home loan guarantee program provided an even more affordable alternative for millions of

returning World War II veterans. Under the VA program, an eligible veteran could buy a house in most cases with no down payment at all.[6]

With the establishment of the Federal National Mortgage Association ("Fannie Mae") in 1938, another approach was added to the public policy potpourri that was to have extremely important consequences in the postwar decades. Fannie Mae initiated a strong secondary market for FHA-VA mortgages, helping to smooth out real estate business cycles as well as geographic differences in availability of funds and provide a greater degree of liquidity for lenders. The explosive growth of mortgage companies beginning in the late 1940s was partly attributable to the growth of Fannie Mae. Mortgage bankers originated a large volume of FHA-VA home loans and promptly sold them to Fannie Mae, life insurance companies, or mutual savings banks, earning additional fee income for continuous servicing of the mortgages.[7]

In 1968 Fannie Mae became a quasi-private corporation providing a secondary market for all types of mortgage loans, with the newly-formed Government National Mortgage Association ("Ginnie Mae") serving exclusively the FHA-VA market. Two years later Freddie Mac was established to serve the thrift industry. This rapidly growing secondary market tapped new sources of investment funds for home mortgage lending, and the range of sources was vastly expanded in the 1970s and 1980s to reach institutional investors such as pension funds and global investors like Japanese banks with the new financial instruments of mortgage-backed securities issued by Fannie Mae, Ginnie Mae, Freddie Mac, and other institutions.

As a result of residential mortgage securitization and the trillion dollar secondary mortgage market, the former liquidity problems of the primary home mortgage lenders have been superseded. These financial institutions now can act as the mortgage banking industry has been operating since the 1940s, originating and servicing loans for a percentage fee, but selling them to investors for quick returns on the principal balance. Particularly with the severe difficulties of the thrift industry during the 1980s, the secondary market and mortgage securities institutions, including the major private investment banking houses, play a much more dominant role in mortgage lending to assure a stable, year-round supply of funds at more competitive interest rates. The problems of "disintermediation," the cyclical shortages of savings deposits in mortgage lending financial institutions, have been largely solved through securitization and the secondary market. Supply of capital is now more

[6]For general overviews of federal housing policy see [5, 22, 28, 31, 39].

[7]On the early growth of Fannie Mae see [16]; on its special relationship to mortgage banking see [18, 20].

regular and plentiful, though the price is often much higher since the savings deposit rate ceilings of Regulation Q were lifted in the early 1980s.[8]

Conclusion

The creation of modern suburbia and affordable home ownership for nearly two-thirds of American households has been an important accomplishment. Better houses in newer communities have become increasingly available for larger numbers of people, particularly since the 1940s. The national rate of non-farm home ownership jumped 20 percentage points in just two decades, reaching 61% by 1960. The great success of federal housing policy was based on an idea drawn from private business marketing: installment credit. The various New Deal programs adapted the building and loan association model of making long-term amortized first mortgage loans with relatively small down payments and modest monthly installments, and vastly extended this approach to a large number and wide range of financial institutions, increasing the length of first mortgage loans from 3 to 30 years or longer, decreasing the down payments from 50% to 10% or less, and significantly lowering mortgage interest rates. By these methods the federal government promoted "Own Your Own Home" without initially concerning itself with reducing the total purchase costs, total financing costs, or total production costs of the houses being marketed (in fact, under the new arrangements, the total interest costs over the life of the mortgage actually increased). The only costs that mattered to the home buyer were the down payment and the monthly loan repayments, which by the late 1930s included casualty insurance and property taxes.

Owning a home became like paying rent, and sometimes it was cheaper. In the early 1950s it cost no down payment and only fifty dollars a month to own a Levittown house, significantly less than the monthly rent on comparably sized New York apartments. The home ownership advantage was further enhanced by the federal income tax deductions permitted for mortgage interest payments and state and local property taxes, which became increasingly important as the amount of mortgage borrowing and the level of income taxes both rose substantially beginning in the 1940s.

Mass marketing through installment sales eventually made possible vast changes in land planning and development and in housing construction, strongly encouraged by the FHA and other federal, state, and local government agencies, as well as by many developers, builders, and lenders. These changes reduced housing production costs and dramatically increased the supply potential for the real estate industry to build affordable houses in new communities. Large-scale developers, or "community builders," were able to obtain broad advance financing to serve the tremendously widened moderate-to-middle income suburban housing market and could achieve

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[8] For background on recent changes in mortgage markets and housing finance see [6, 9, 21].

substantial economies in producing not only vast tracts of houses but fully-improved neighborhoods.

This system has proven so successful that many other countries have copied it. Australia, for example, made major strides in home ownership by revamping home mortgage lending the "American way" with easy, cheap, long-term, high-leverage credit [17]. Yet in the United States, where the percentage of home ownership grew steadily for four straight decades, the rate of owner occupancy has been declining since 1980. As the price of housing has escalated through inflation, speculation, changes in household incomes, demographic composition, supply restrictions, and other factors, many borrowers and lenders today are resorting to junior mortgages, higher down payments, balloon mortgages, home equity loans, and a host of other practices that were common in the 1920s. In high-cost areas such as the Northeast and the Pacific Coast, many potential first-time home buyers are unable to come up with the down payments required or to afford the monthly costs of loan repayment. For many people today, especially young adults, owning a home is no longer comparable to renting. The potential gains of ownership are larger than ever, and the income tax subsidies are still inviting, but the cost barriers are an enormous deterrent.

Congress has been looking for solutions to the recent home ownership affordability problems primarily by tinkering with mortgage finance through traditional and new methods of facilitating installment sales, including lowering the down payment requirements for FHA-insured loans, allowing larger loan amounts under FHA and VA programs, permitting FHA and VA to handle more adjustable rate mortgages (ARMs) that carry a somewhat lower interest rate as long as inflation remains low, and liberalizing FHA and VA underwriting guidelines regarding the borrowers' minimum annual debt service-to-income ratios. Other suggestions include authorizing tax-free savings accounts to help first-time home buyers accumulate the down payments, raising the IRS ceiling on the amount of tax-exempt mortgage revenue bonds and mortgage credit certificates that can be issued by state and local governments, and encouraging Fannie Mae and Freddie Mac to loosen their standards for purchasing home mortgages in the secondary market.

The chief lobbyists for this legislative and administrative package are the modern "Own Your Own Home" coalition: the National Association of Realtors, the National Association of Home Builders, and the Mortgage Bankers Association of America. The latter two represent relatively new industries that are a direct outgrowth of federal housing programs since the 1940s. The thrifts, which had been major players in the "Own Your Own Home" lobby until the mid-1980s, became so preoccupied with their industry's financial crisis and the problems of the FSLIC that they essentially withdrew as active leaders of the crusade for home ownership in national policymaking.

On the industry side, solutions to affordability mostly revolve around new financial mechanisms to make it easier for the home buyer to borrow funds while providing greater economic protection for the mortgage lenders and investors. New loan instruments include ARMs to protect lenders from the interest rate risk of future inflation, graduated payment mortgages (GPMs) that reduce the initial loan repayment costs by deferring these costs to later

years when the borrowers' incomes may be higher, and shared equity mortgages that offer lower borrowing costs in the early years of the loan by adding to the principal amount due and betting on long-term increases in the property's value. These and other alternative mortgage instruments (AMIs) are the main response of the home ownership industry and certainly of its financial wing, though home builders and land developers in particular have also studied and proposed public policy reforms and technological changes designed to reduce the costs of producing and servicing housing.[9]

The commitment to marketing home ownership by devising new and better methods of installment purchase remains steadfast. Business and government leaders in 1989 still view the issues remarkably like Herbert Hoover saw the future back in 1931: "I notice that some...have contended that the development of city and urban life necessarily has driven us to less and less possible ownership of homes. I do not agree with that. The very development of transportation, the advantages of distribution of industry today make the ownership of homes far more feasible and desirable than ever before. But it involves vast problems of city and industrial management which we should have the courage to face. It involves also a great problem of finance....that is, how we can make a home available for instalment purchase on terms that dignify the name credit ..." [15, pp. 3-4].

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