FDR's answer to loan mess would prove useful today

by Dean Calbreath

Once upon a time, there was a nation where, during an era of prosperity, large numbers of citizens used short-term, interest-only loans to purchase their homes. They were apparently unaware that once the good times ended, they would be saddled with unbearable debt. Which is exactly what happened in America roughly 75 years ago.

During the Roaring '20s, the typical mortgage was an interest-only loan that ended with a massive balloon payment. That bears a slight resemblance to the adjustable interest rates that were so popular in recent years.

As the country lurched into the Depression, banks froze up and could no longer dole out credit - sometimes not even to the most qualified of borrowers. Because homeowners could not refinance, their only recourse was the soup line. By 1933, the year that America's 32nd president, Franklin Delano Roosevelt, took office, many of those payments were coming due, resulting in 1,000 foreclosure filings a day.

Which is why Roosevelt felt compelled to create a program that could have some useful applications today.

During his first year in office, Roosevelt created the Home Owners Loan Corp., or HOLC, to help debt-laden borrowers pay off their mortgages. The HOLC took borrowers out of their high-interest loans and put them into 15-year loans - financed through federal bonds - with rates fixed at about 5 percent. Unlike many government bureaucracies, this was specifically designed to be a short-term program, intended to extend loans for three years and then oversee those loans for an additional 15 years.

With the HOLC and the Federal Housing Administration, the Roosevelt administration virtually created the long-term loan, which soon evolved into the 30-year, fixed-rate mortgage.

The loans took some getting used to. Nat Rogan, who headed the HOLC operations in California's San Diego and Imperial counties, took pains to explain to borrowers that they needed to pay the principal as well as the interest on their loans.

"This policy is in keeping with sound mortgage lending and in the real interests of the homeowner borrower, as proved by generations of experience among financial institutions," Rogan said.

The local business community had nothing but praise for the program, which not only helped people keep their homes, but also funded home-renovation projects that provided employment for construction workers.

"San Diego's not to be counted as a laggard in matching up with this opportunity," said the city's Merchants Association. "No other single enterprise will employ so much useful labor."

From 1933 to 1936, more than 1 million people relied on HOLC loans, covering one out of five mortgaged homes. Close to 80 percent of the borrowers made good on their payments and kept their houses. When the HOLC shut down in 1951, it returned a slight profit to the government.

"It was a huge success," said Leonard Rosen, who heads the Pitbull Mortgage School in San Diego. "It was one of the things that Roosevelt did that he never got enough credit for, because it wasn't sexy. His real goal (with the HOLC) was twofold: to create stability from both an economic and social perspective."

Rosen said that many of the elements of the Home Owners Refinancing Act, which created the HOLC, would be useful today.

In San Diego County, for instance, the number of defaults more than tripled from 8,843 in 2006 to 28,984 in 2007, according to recent data by Default Research, a real estate tracking firm in Pennsylvania. Although foreclosure rates of the early 1930s still tower over today's rates, foreclosures and defaults are advancing at a dangerous pace, as borrowers struggle to keep up with their adjustable-rate mortgages, lending mechanisms that were not available in the Roaring '20s.

"Our problems of today do not begin to approach those of 1933," Kevin Pollock, a fellow at the conservative American Enterprise Institute, told Congress last year. "But I suggest that HOLC could be usefully studied by anybody thinking about this issue."

Jack Guttentag, a Wharton School economist who was formerly chief of the domestic research division at the Federal Reserve Bank of New York, said the HOLC has greater strengths than some of the mortgage fixes being proposed by the White House, Congress or the Federal Reserve.

Guttentag said the Bush administration's main proposal has been for lenders to voluntarily freeze adjustable-rate mortgages for borrowers who have not missed a payment on their loans but who would have problems making payments once the rates adjust upward.

Economists estimate that Bush's proposal would help as little as 7 percent of troubled borrowers. "That takes a little pressure off, but it's only for people who meet a very difficult standard," Guttentag said. Moreover, the proposal would keep borrowers in adjustable-rate mortgages rather than transfer them to more stable fixed rates.

Unlike Bush's proposal, a HOLC-like fix to today's mortgage crisis would essentially extend prime loans to subprime borrowers, putting them into long-term, fixed rates rather than the temporarily frozen adjustable rates promulgated by the White House.

HOLC loans would also be open to far more borrowers than Bush's narrowly crafted proposal. Under Roosevelt, after all, HOLC loans often went to help borrowers who had lost their homes buy them back out of foreclosure. Few people in the White House, Federal Reserve or Congress would envision enacting such a daring program today. But the fact is, it worked.

The proposals from the Federal Reserve and Congress so far have mostly concentrated on tightening mortgage-lending standards, which is like closing the barn door after the cows have already been slaughtered and served up on the dinner table.

Among the proposals are plans to require more documentation from borrowers, to ban or severely limit the use of adjustable rates and to clamp down on subprime lending. While those proposals might have helped a year or two ago, the problem now is that credit is too tight, rather than too loose.

"Those are counterproductive ideas," Guttentag said. "The market has changed so dramatically that clamping down on lending requirements has done no good whatsoever and may do some harm."

Dave McDonald, president of the San Diego chapter of the California Association of Mortgage Brokers, agreed.

"The Federal Reserve is tightening up the guidelines at absolutely the wrong time," McDonald said. "It's a reactive policy instead of a proactive policy. As it is now, a lot of people who are paying their bills and got into their lending programs rationally won't have a loan program to go into (after their interest rates rise)."

Although academics praise the HOLC, they doubt that it will be re-created in today's political environment. "It won't meet the Bush administration's requirement that little or no government funding be involved (in a mortgage fix)," Guttentag said.

But maybe state governors, such as California's Gov. Arnold Schwarzenegger, with his newfound affinity for

Roosevelt, might be willing to make a stab at reviving the HOLC.

In his recent State of the State speech, Schwarzenegger said he drew inspiration from Roosevelt.

"FDR did not ignore the problems of the Depression because times were tough," he said. "No, he addressed those problems in big visionary ways because times were tough. He saw the problems, and he acted on behalf of the people and the nation."

Well, here's one Roosevelt program he could consider. Not only did it address a problem in a big visionary way, but it even turned a profit in the end - something that cannot be said of many government programs.