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Housing markets in a time of crisis: A historical perspective

by Price Fishback, Thomas R. Brown Professor of Economics, University of Arizona, Jonathan Rose, policy advisor, Federal Reserve Bank of Chicago, and Ken Snowden, professor of economics, University of North Carolina Greensboro

As the coronavirus (Covid-19) public health crisis unfolds, a second crisis in the economy is developing as well. One economic concern, among many, is the debt burden of households. Early reports point to a surge in unemployment claims during March 2020, raising the prospect that widespread unemployment is likely to impair the ability of households to make payments on their home mortgages and other loans in the months ahead. This represents a potential crisis in mortgage markets, as borrowers who are temporarily unemployed—but for an unknown period—may face default on their mortgages.

Many unemployed mortgage borrowers will likely still find themselves with positive equity in their houses, depending on the course of house prices. But the risk that they will remain unemployed for an indefinite period will undoubtedly limit their ability to borrow against that home equity. Moreover, mortgage originators are likely to focus their capacity instead on the large volume of still-employed borrowers seeking to benefit from the drop in long-term interest rates.[1]

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Policymakers have already begun to respond. On March 18, the Federal Housing Finance Agency (FHFA) announced that the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac would provide forbearance for 12 months to their borrowers impacted by the coronavirus. The U.S. Department of Housing and Urban Development (HUD) announced a 60-day moratorium on loans insured by the Federal Housing Administration (FHA). New York Governor Andrew Cuomo also announced that mortgage payments could be deferred for 90 days in New York State. The details of these proposals have not been announced, and these details are important because these proposals will run up against constraints of existing contracts. In any case, these policy proposals will certainly continue to evolve as the Covid-19 crisis unfolds and the scope of defaults becomes clearer.

The scope of mortgage defaults depends on a number of factors, including the extent and duration of unemployment, the path of house prices, household liquidity, and the pace of reemployment once the public health crisis is over. Critically, foreclosure proceedings generally do not begin until borrowers have missed three to six months of payments. If, say, the effects of the Covid-19 crisis ease significantly by September, foreclosure proceedings may only be in their early stages at that point, and only for borrowers who missed all of their payments during the crisis. In the worst-case scenario, however, in which the crisis rages on for a year or more, leading to widespread and long-term unemployment, a nationwide mortgage crisis becomes more likely.

The United States has experienced nationwide mortgage crises before—notably including the financial crisis of 2007–09 and the Great Depression. In this *Chicago Fed Letter*, we discuss mortgage forbearance initiatives during the Depression era and highlight some lessons for today.

In 1934, about 40% of urban homeowners were in default on their mortgages. Over the course of the 1930s, 10–20% of all homeowners lost their homes through foreclosure or similar means. In response to this crisis, the federal government established an emergency agency, the Home Owners' Loan Corporation (HOLC). The HOLC bought and refinanced one million delinquent mortgages between 1933 and 1936, representing roughly one-fifth of the nation's mortgages on nonfarm owner-occupied one-to-four family residential properties. Its scope was therefore immense.[2]

Looking at the HOLC in the context of today's unfolding crisis, we offer several observations.

First, the federal government is in a position to act much faster today than during the Depression. Prior to the Depression, the federal government had no involvement in nonfarm home financing. The Home Owners' Loan Act was the last significant legislation passed in President Roosevelt's first 100 days, and this was nearly four full years after the onset of the 1929 recession. From this late start, though, the HOLC set up operations in an extraordinarily short amount of time given the scope of its operations and the fact that it started from scratch. But it still took six months for the corporation to buy its first loan after its enabling legislation was passed.

Today, the GSEs, including Fannie Mae and Freddie Mac, control $4.8 trillion of mortgage-backed securities (MBS) in the $11.1 trillion of one-to-four family home mortgage market.[3] Federal efforts to address mortgage defaults that operate through those entities have the potential to deliver much faster results than the HOLC, and indeed they have already started given the FHFA's announcement last week.

However, this approach will only affect the GSEs' borrowers, not the several trillion dollars' worth of loans held in the portfolios of other financial institutions. These loans disproportionately represent parts of the country with higher house prices, because the GSEs have limits on the size of loans they can make. An open question is whether the FHFA plan could spill over into the non-GSE market; for example, by stabilizing property values.

State-level debt forgiveness initiatives have several antecedents in American history.

Second, the HOLC came on the heels of state government efforts to enact foreclosure moratoria similar to Governor Cuomo's proposal. As there was little federal government response to the housing crisis during the first few years of the Depression, 25 of 48 states stepped into the void by enacting laws to bar foreclosure. Such state-level debt forgiveness initiatives have several antecedents in American history but were most widespread during the Depression.[4] These laws allowed borrowers to remain in their homes as long as mortgage debtors made certain minimum payments, specified as an interest rate or some court-calculated rent. The moratoria were contested for years, but ultimately upheld by the Supreme Court in the 5–4 *Blaisdell* decision.[5] Many of the borrowers who delayed foreclosure through these moratoria likely applied to the HOLC for refinancing.

The Depression moratoria resemble the recent announcement by Governor Cuomo that mortgage payments could be deferred for a 90-day period. These state-level debt forgiveness initiatives can be thought of as forbearance on the cheap. They attempt to interpose in private contracts, which is a delicate legal approach at best. In general, private contracts pose a fundamental constraint on loan modification proposals. In the mortgage field, these contracts today involve loan contracts, servicing contracts, and MBS contracts. Such efforts, therefore, fundamentally contrast with the "big pockets" approach of the HOLC and FHFA, which use the federal government's access to capital to work around existing contracts.

Third, the HOLC had big pockets, as do the GSEs today. Big pockets allow them to work around existing contracts rather than trying to modify them. The HOLC bought mortgages outright, refinanced them, and then owned and serviced the new mortgages itself. This required deep pockets. All HOLC refinancings were voluntary, by both lenders and borrowers, but did not depend on lenders doing anything except selling their claims.[6]

FHFA's approach will require big pockets as well. Most likely, FHFA's plan involves Fannie and Freddie invoking "disaster" clauses in their servicing contracts that require servicers to offer forbearance to affected borrowers. Importantly, Fannie and Freddie's servicing contracts require servicers to advance missed principal and interest payments until a borrower is 120 days delinquent. The advances on principal and interest payments are forwarded to MBS holders, as required by those contracts. Servicers recoup these advances only after the loan becomes current again or completes foreclosure.[7] These advances represent a potentially acute strain on servicers that will have to be funded in some manner. Servicers have credit lines, but it is doubtful whether existing lines are sufficient to fund 120 days' worth of advances during a nationwide forbearance campaign. An open question, therefore, is whether Fannie and Freddie will change their policies to reimburse servicers more quickly. The bottom line is that FHFA's plan, by arranging for forbearance while not dissolving the underlying mortgage or MBS contracts, requires deep pockets, just as the HOLC's did.

An ancillary benefit of the deep pockets approach is that it ensures that funding continues to flow to municipal governments via property taxes and to property insurers. The HOLC refinanced unpaid real estate taxes in addition to mortgage debts, directing sorely needed funds to local governments. Fannie and Freddie likewise reimburse servicers for advancing tax and insurance payments on behalf of borrowers who miss payments.

Fourth, big pockets come with big risks, but borrowers today are likely to have better risk profiles than the typical HOLC borrower. HOLC borrowers had been in danger of foreclosure, at the depth of the Depression, during a time of depressed and uncertain housing values. Moreover, the HOLC loaned to them using liberal appraisals. Ultimately, the rise in house prices during World War II was critical in determining the fate of the HOLC's borrowers and the program's financial returns. Most of the HOLC's foreclosures occurred before World War II, when reemployment and restrictions on new building combined to raise house prices significantly, reversing the Depression-era declines.[8] In the end, the HOLC foreclosed on 20% of its loans, a substantial amount that reflects the limits to forbearance without a significant recovery in housing values and a return to full employment.

Today's crisis, in contrast, arose suddenly, at a time of strong economic and employment growth. Before the Covid-19 crisis hit, borrowers generally had positive equity, having enjoyed steady rises in house prices over the past several years. The future of house prices remains unknown, though, and will depend critically on the duration of the public health crisis and the pace of reemployment after the crisis.

Fifth, a central tool of the HOLC's approach was forbearance of principal payments, but for many the key source of relief was the ability to refinance at all. The HOLC allowed borrowers to make no principal payments until mid-1936, while still requiring interest payments at a rate of 5% (less than the typical 6% that prevailed in the 1920s). This allowed many borrowers with reduced incomes to continue to afford their monthly mortgage payments, at least until 1936. Indeed, most of the HOLC's foreclosures occurred between the end of 1936 and the beginning of World War II, when employment had not yet fully recovered and house prices remained at or near their Depression troughs.

Forbearance of principal payments delivered relief principally to borrowers who previously had long-term amortizing loans. (The HOLC's loan term was 15 years, compared with the typical 11–12 years for amortizing loans at the time.) However, short-term balloon loans were also common in the 1920s. For borrowers with balloon loans, the HOLC's principal forbearance likely made no difference to their short-term mortgage payments, which were already interest only. But the corporation likely delivered relief instead by offering them an opportunity to refinance at a time when private lenders were largely out of the market.

Finally, forbearance proposals today must address head on the role of servicers. The HOLC bought mortgages at a time when most mortgages were held in portfolio of the lenders who originated those mortgages, and who serviced the loans as well. The HOLC emphasized patient and flexible loan servicing to avoid foreclosure if at all possible. Today, servicing and loan ownership have been fundamentally separated, and servicing rights are bought and sold like financial products. Servicers' incentives, contractual obligations, and access to credit are key factors shaping the delinquency process.

Servicers are typically obliged to cover borrowers' missed payments for some period, and are compensated only after foreclosure or when borrowers make up the payments. Kim, Laufer, Stanton, Wallace, and Pence (2018) note that this burden is particularly large for servicers in the Ginnie Mae market (now $2 trillion in size), which are required to continue making payments to investors, insurers, and tax authorities throughout the life of the loan. In contrast, as noted above, servicers for Fannie Mae and Freddie Mac are responsible for principal and interest payments for only 120 days, but this would likely be a large strain as well during a nationwide forbearance campaign. By being responsible for missed payments, servicers have an incentive to shepherd loans through the foreclosure process quickly. For servicers to participate effectively in a principal forbearance scheme, they must have the incentive to do so. Servicers must also have the liquidity to forward mortgage payments for an extended period, but their access to such capital can be fragile. Indeed, during the financial crisis of 2007–09, access to funding became severely constrained for servicers. In response, the Federal Reserve made asset-backed securities, backed with servicing assets, eligible for its Term Asset-Backed Securities Loan Facility (TALF).

Conclusion

The Depression saw two basic approaches to mortgage forbearance: the "big pockets" approach of the HOLC and the "forbearance on the cheap" approach of state governments. The HOLC used the power of the federal government's access to credit to buy out existing contracts and refinance them on terms that gave forbearance to borrowers. State governments, in contrast, interposed themselves in those contracts via foreclosure moratoria. Beyond the legal distinctions between the two approaches, the HOLC's approach infused new capital not just into the mortgage market, but also to state and local governments via property taxes. In addition, it gave the HOLC direct control over servicing practices. But it entailed substantial risks and saw a 20% foreclosure rate that would have been higher had property prices not increased during World War II.

Today, the federal government's massive presence in residential mortgage finance positions it to fund substantial forbearance that can mitigate and perhaps inoculate the mortgage market from the viral pandemic. FHFA's approach resembles in many ways the HOLC's big pockets strategy. It uses Fannie and Freddie's access to capital markets, based to no small extent on their federal sponsorship and ongoing conservatorship, to keep the flow of funding going not just to MBS investors but also to local governments and insurance companies. It also arranges for patient and flexible loan servicing. The average borrower that may need forbearance today is likely more creditworthy than the average HOLC borrower, but the success of forbearance will depend critically on the path of house prices and the performance of servicers, not to mention the duration and scope of the public health crisis.

Notes

[1] At the time of this writing, average mortgage rates have whipsawed, falling to historic lows and then rising substantially, likely due to conditions in the mortgage-backed securities market that have driven up funding costs.

[2] Price V. Fishback, Jonathan Rose, and Kenneth Snowden, 2013, *Well Worth Saving: How the New Deal Safeguarded Home Ownership*, Chicago: University of Chicago Press. Crossref, https://doi.org/10.7208/chicago/9780226082585.001.0001

[3] The $11.1 trillion figure is from the Z.1 release of the Board of Governors of the Federal Reserve System; the $4.8 trillion figure is from the Urban Institute Housing Finance Policy Center monthly chartbook. In addition, Fannie and Freddie own a relatively small amount of mortgages in their portfolios.

[4] Lee J. Alston, 1984, "Farm foreclosure moratorium legislation: A lesson from the past," *American Economic Review*, Vol. 74, No. 3, June, pp. 445–457; David C. Wheelock, 2008, "Changing the rules: State mortgage foreclosure moratoria during the Great Depression," *Review*, Federal Reserve Bank of St. Louis, Vol. 90, No. 6, November/December, pp. 569–583, Crossref, https://doi.org/10.20955/r.90.569-584; and Andra Ghent, 2014, "How do case law and statute differ? Lessons from the evolution of mortgage law," *Journal of Law and Economics*, Vol. 57, No. 4, November, pp. 1085–1122, Crossref, https://doi.org/10.1086/680931.

[5] Available online, https://supreme.justia.com/cases/federal/us/290/398/.

[6] Nearly half of the HOLC loan purchases involved no principal reductions, with the HOLC refinancing unpaid principal, interest, and real estate taxes combined. In the rest of the cases, though, lenders agreed to accept less than the total amount of principal and missed interest payments they were owed, an acknowledgement that these lenders were unlikely to recoup their full debts anyway. But the HOLC sought to avoid this outcome, by appraising properties using liberal long-run standards so that they could fit as many loans under their 80% loan-to-value cap as possible.

[7] You Suk Kim, Steven M. Laufer, Richard Stanton, Nancy Wallace, and Karen Pence, 2018, "Liquidity crises in the mortgage market," *Brookings Papers on Economic Activity*, Spring, pp. 347–428. Crossref, https://doi.org/10.1353/eca.2018.0004

[8] Ultimately, on a pure accounting basis the HOLC made a profit, but on a discounted cash flow basis a small loss. Moreover, the HOLC implicitly provided a large subsidy to borrowers that should be accounted for in considering its financial returns. The federal government absorbed the risk of the HOLC in two ways. First, the U.S. Treasury provided the HOLC's initial capital. Second, the rest of its funding came through bond issuances, which carried a federal government guarantee.

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