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The Culture of American Homeownership and the Savings and Loan Crisis: How a Political-Economic Strategy Can Lead to Financial Catastrophe

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The Culture of American Homeownership and the Savings and Loan Crisis: How a Political-Economic Strategy Can Lead to Financial Catastrophe

Abstract

Sarah P. Gibbons, College '09, History

The Savings and Loan Crisis: A Morality Play of Modern American Finance

Owning your own home is often considered as big a part of American life as voting or apple pie. But who or what created this culture of home ownership, and has it always been beneficial to America's economy and citizens as a whole? I will explore the encouragement of home ownership by the U.S. government and how it has led to economic catastrophe for America in the form of the Savings and Loan Crisis of the late 1980s. I will trace the government-sown culture of home ownership beginning with the New Deal, explore historical motives and reasoning for this mission, and explain in an historical context how this culture led to, and worsened, the Savings and Loan Crisis.

Comments

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**The Culture of American Homeownership
and the Savings and Loan Crisis:**
How a Political-Economic Strategy Can Lead to Financial Catastrophe

Sarah P. Gibbons

**A Senior Thesis
Submitted in partial fulfillment of the requirements for
Honors in History*
University of Pennsylvania
and
2008–2009 Penn Humanities Forum
Undergraduate Mellon Research Fellowship**

Dedication

I dedicate this thesis to my parents, who made my collegiate dreams realities; to Professor Raff for his knowledge, insight, and encouragement; and to the rest of the American History Section of the Honors Program for their unwavering commiseration (and of course, for their support.)

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“A nation of homeowners...is unconquerable.”

-President Franklin D. Roosevelt

Introduction

In a classic scene from Frank Capra's 1947 film *It's a Wonderful Life*, Peter Bailey, a small town savings and loan manager, sits at the dinner table of his home and tries to convince his young son, George, to take over the family business. George, who is eager to travel the world and escape the familiar clutches of picturesque Bedford Falls, dismisses the notion of spending the rest of his life issuing mortgages from the "shabby little office" of the Bailey Bros. Building & Loan Association. His father, who would die later that very night, responds with some philosophical last words: "I feel that in a small way we are doing something important. Satisfying a fundamental urge. It's deep in the race for a man to want his own roof, walls, and fireplace. We're helping him get those things in our shabby little office." After his father dies, George Bailey forgoes his dreams of travel to exotic foreign lands and remains in sleepy Bedford Falls. He nobly takes over the family business and supplies the town's modest residents with home mortgages denied to them by the villainous town banker, Mr. Potter. George Bailey and his father were not considered shrewd businessmen, but "men of high ideals" and revered members of the local community.

Peter Bailey's final speech to his son embodies an American economic, political, and social philosophy that has reached far beyond the walls of savings and loan associations: the notion that owning a home is a fundamental aspect of American life. Homeownership has burrowed deep into the American psyche, as much a part of the national identity as democracy or apple pie. By operating his savings and loan institution in Bedford Falls, George Bailey was originating the American Dream for average folks and perpetuating the American culture of homeownership.

How did this culture come to be? The answer is deeply rooted in the economic history of the United States in the twentieth century. This history spans depressions, recessions, and economic booms and busts. It has held strong through multiple wars, cultural revolutions, and some of the most tumultuous decades of the nation's history. Since the 1950s, homeownership has been a majority characteristic of the American people, and currently, 66 percent of Americans own their own roof, walls, and fireplace. The party which is largely responsible for American homeownership levels and for creating the political-economic culture of homeownership is the federal government.

From the New Deal of the 1930s to the savings and loan crisis of the 1980s, the federal government has pursued a policy of active encouragement of homeownership in the United States. Presidents from Franklin Delano Roosevelt to Ronald Reagan and Congresses on varied sides of the political spectrum have made the spread of homeownership in America a high priority, increasing accessibility to and affordability of mortgages in order for the greatest number of Americans to own their own homes. This policy goal has taken various forms over the decades: legislation, new government agencies, a tax provision, and special treatment of institutions of mortgage finance have all been pursued with consistency and determination. These initiatives working in concert have increased the affordability of homeownership and spread the privilege to millions of Americans who would not have had financial access otherwise. But the fruits of this affordability and accessibility were not simply increased levels of homeownership. These government initiatives created a culture of American homeownership: a national mindset that designated homeownership as integral to the economic and social well-being of the country.

The federal administration of this culture has at times throughout its history placed the goal of widespread homeownership over financial reality, pragmatism, and sound judgment. This prioritization has resulted in special treatment for the institutions of this culture that can divert from the most rational economic path, breeding vulnerability and potential for financial catastrophe. This phenomenon was embodied in the savings and loan crisis of the 1980s, which cost the federal government and the American taxpayer billions of dollars in lost federally-insured funds. Despite the savings and loan crisis's exceptional price tag, the debacle was not an isolated incident in American economic history. Instead, it was part of the greater story of the American culture of homeownership, a history which this thesis will attempt to trace.

The first chapter will discuss the homeownership initiatives of the New Deal in the 1930s. Franklin Delano Roosevelt was the first to foster the culture with large-scale government intervention. The catalyst for this activity was the Great Depression, during which millions of Americans risked losing their homes to foreclosure and millions more were barred from homeownership by paralyzed credit markets. The dramatic measures Roosevelt took to refashion and spur homeownership during the Depression, the motives for the government's actions, the public reaction, and the results of the initiatives will be outlined and analyzed.

The second chapter begins with one of the defining historical events of the history of homeownership in the United States: the end of World War Two. Sweeping legislation coupled with millions of new, young American families gave birth to American suburbia and achieved the goal of making a majority of Americans homeowners. Two new government mortgage agencies chartered in 1968 and 1970, Ginnie Mae and Freddie Mac, will also be

assessed for their impact on the culture of homeownership and their effects on the American economy.

In the third chapter the history of the savings and loan (or “thrift”) industry will be outlined in relation to the administration of the culture of homeownership. Rebuilt during the Great Depression to serve as a “model lending institution” of mortgage finance, the history of the thrift industry is a prime example of how the prioritization of homeownership over financial realities can lead to economic vulnerability. From the 1930s to 1980, the federal government “over-regulated” the thrift industry to preserve it as the model lending institution of the homeownership culture. When this policy drove the industry towards insolvency, the federal government veered sharply in the opposite direction, “under-regulating” the industry from 1980 until 1989. While all the federal actions that fell under the umbrellas of these two trends (legislation, regulatory measures, and lack thereof) were meant to preserve the industry, most contributed to its epic failure by the late 1980s. The unfolding of this failure (the savings and loan crisis) and its consequences for the federal government and America as a whole are traced in chapter four.

When considering this history of the culture of American homeownership (which eventually lead to the savings and loan crisis), it is important to bear in mind several themes which render the history a cohesive whole as opposed to a sundry collection of laws, agencies, and lending institutions. The first is that a majority of these government initiatives promoted homeownership against the tide of financial reality. This meant that the government was forced to artificially “prop up” many of these institutions, a risky proposition as some became prominent parts of the economy. Another shared theme is the initiatives’ establishment of homeownership as an American right as opposed to a luxury to

be enjoyed by the privileged few. A third prevalent theme uniting the history of the culture is the vulnerability of its institutions to moral hazard, the idea that a party protected from risk will behave differently than if it were fully exposed to risk. For the institutions of the culture of homeownership, this often meant taking financial risks (whether it was originating mortgages for low income borrowers or engaging in risky investment activity) with the security inherent in federal government backing (direct or implied). The quagmire of this moral hazard is defining of the culture: if the federal government didn't insulate these institutions from risk, then many of their operations would not have been possible. Without their operations, homeownership would not be accessible to as many Americans and the nation would not be able to produce the levels of homeownership to which it has become accustomed.

This 70-year history is fraught with a variety of institutions and initiatives and a cast of colorful characters: ambitious presidents, idealistic economists, critical journalists, sleazy lobbyists, patsy politicians, and courageous regulators. It begins with the Great Depression and Roosevelt's New Deal.

Part One: Creating the Culture of American Homeownership

The New Deal and New Government Programs: Creating Modern Mortgage Finance and the Culture of American Homeownership

The catalyst for widespread and structured government policy intended to foster and protect homeownership in the United States was the Great Depression of the early 1930s. Before this period, the standard single-family home mortgage in America would be almost unrecognizable to the average homeowner of today. A majority were short term loans with a period of only three to fifteen years, at loan-to-value ratios below 50 to 60 percent.¹ The pre-1933 mortgage was also a “nonamortizable balloon instrument,” meaning that the homeowner paid the entire balance of the loan in a lump sum at the end of the loan period² (Vandell 301). If a homeowner could not afford to pay the balloon payment in its entirety at the end of the loan period, he would commonly refinance the difference with either the same or a new lender in order to pay off his home. When the banking crisis hit in the early 1930s, however, banks who were strapped for cash were forced to call in mortgages as they became due (Monroe 6). Since the severity of the crisis meant that all banks faced the same liquidity problems and required this money, the refinancing that had greased the wheels of the old system of mortgage lending came to a halt. Homeowners who had borrowed mortgage money with the expectation of refinancing were forced to default by the thousands, and others who joined the growing ranks of the unemployed were also unable to make their mortgage payments (Monroe 6). A painful wave of foreclosures swept across the country, numbering as many as 250,000 foreclosures per year between 1931 and 1935. At the worst

¹ A loan-to-value ratio or “LTV” indicates the amount that a home buyer wishes to borrow set over the appraised value of the home in question. For example, if you wished to borrow \$100,000 for a \$200,000 home, the LTV would be 100,000/200,000 or 50%. The higher the LTV, the riskier the mortgage since more of the cost of the home is borrowed and less is paid for in the initial down payment.

² As opposed to incremental payments throughout the life of the loan.

point of the Great Depression, nearly 10 percent of the nation's homes were in foreclosure (Green and Wachter 95). Compounding the severity of the situation was the fact that property values in the weakened economy were plummeting, hurting both homeowners whose properties were now less than the value of their mortgages (which provided an additional incentive to default on the loan) and banks which were repossessing homes that were worth less than value of the original loan³ (Monroe 6).

Short of assets and fearful of additional losses from defaults combined with falling property values, banks in 1930s America simply stopped lending. This shortage of credit, along with mortgage defaults by the unemployed and financially struggling, resulted in a precipitous drop in homeownership levels. According to the U.S. Census Bureau, aggregate homeownership rates for the United States fell from 47.8 percent in 1930 to 43.6 percent by 1940, the lowest level of the century (Appendix A). Some states, such as New Jersey, Pennsylvania, and North Dakota saw levels drop by close to 10 percent (U.S. Census Bureau). These numbers are indicative of the grave economic situation faced by Franklin D. Roosevelt when he took the office of President in 1933, and he responded with a plan which attempted to correct the banking crisis, address the plights of millions of Americans who were jobless and financially desperate, and save large-scale corporate capitalism (Bernstein 267). His administration responded with a plan that matched the scope of the crisis at hand, the New Deal, a collection of programs and agencies which widely targeted the nation's economic crisis with everything from banking legislation to labor legislation to public-works programs.

³ The problem of these "bad loans" is similar to what occurred when the housing bubble rocked the United States economy in 2007.

Tellingly of the political, economic, and cultural goals of the United States government under Roosevelt, a portion of the New Deal recovery program was aimed at both aiding existing embattled homeowners and creating readily achievable and expanded opportunities for homeownership for the average American. These agencies, the Home Owner's Loan Corporation (HOLC), the Federal Housing Administration (FHA), and the Federal National Mortgage Association (FNMA or Fannie Mae) were the cornerstones of the U.S. government's efforts to intervene in the housing finance market in order to spread homeownership to the widest possible swath of the America public. They mark the beginning of the government's efforts to shore up the U.S. economy with mortgage finance and created the heritage of homeownership that still exists in the United States culture and economy today. The actual effects of these agencies on home finance and homeownership levels, their methods, as well as their purpose (and the validity of that purpose) are widely debated among economists and historians alike. Two of the agencies, the Federal Housing Administration and Fannie Mae, are still significant aspects of mortgage finance in America, and serve as examples of how government backing of home-financing institutions can be a catalyst for moral hazard.⁴ While HOLC was disbanded in 1936 after having served its immediate purpose in a time of crisis, FHA and Fannie Mae lived on in U.S. mortgage finance, creating homeownership opportunities with the backing and implicit support of the U.S. government.

Permanently altering the basic structure of mortgage finance in America, these agencies rang in a new era of homeownership in the United States, one that was based on debt. With the use of the Home Owner's Loan Corporation, the Federal Housing Administration, and the Federal National Mortgage Association, the government had

undercut the issue of affordability for millions of Americans, but their new homes and new lives were “fenced in” by a much more entrapping force than white pickets. Mortgage debt in the form of long-term loans with high loan-to-value ratios became a permanent fixture on the suburban horizon. In order to place HOLC, FHA, and FNMA into the context of the culture of American homeownership, the history of each must be examined and assessed.

The Home Owner’s Loan Corporation (HOLC)

The first agency of the New Deal triad of homeownership was the Home Owner’s Loan Corporation, chartered in 1933. HOLC was created to solve the immediate problem of home foreclosures affecting millions of Americans due to the inability to refinance because of the credit crunch, financial inability to make interest or tax payments, or inability to repay the principal on the mortgage. When President Roosevelt called upon Congress to pass the legislation that created HOLC, he cited an urgent need “to protect small home owners from foreclosure and to relieve them of a portion of the burden of excessive interest and principal payments incurred during the period of higher values and higher earning power” (“Protect Small Home Owners from Foreclosure”). HOLC functioned by raising funds with the sale of government-backed bonds. It utilized these funds to purchase defaulted mortgages from financial institutions and to refinance existing indebtedness under different terms and a new structure (Green and Wachter 95, Hearth 17). This loan structure would become the basis of the modern mortgage. Instead of the short-term, nonamortizable loans with low LTV s that existed prior to the 1930s, mortgage loans administered by HOLC were fixed-rate, long-term (typically 20-year), fully-amortizing⁵, and featured much higher LTV s (Green and Wachter

⁵ “Amortizing” indicates that the principal is repaid over the life of the mortgage, instead of in a lump-sum payment at the end of the term.

95). These terms voided the issue of refinancing that had led to the thousands of foreclosures in the beginning of the Depression, enabled the loan to be repaid incrementally over a much longer period of time, and required a significantly smaller down payment to purchase a home.

Over the lifetime of HOLC, which lasted only three years, one million mortgages were purchased, reinstated, and converted to terms that were more financially manageable for Depression-era Americans (Green and Wachter 95). While these terms brought homeownership into the financial reach of many more Americans, they did not remove the element of risk inherent in mortgages. The risk was simply transferred elsewhere; from balloon payments that necessitated refinancing to the high loan-to-value ratio (the frequency of default is higher for high-LTV mortgages, indicating that this is a riskier loan for the borrower. A large number of defaults are also risky for the lender in times of economic downturn when the prices of repossessed homes fall)⁶. As one skeptical journalist stated in 1935, “No one has to be told that an 80-percent loan on a first mortgage is not a good business proposition” (Flynn, “Other People’s Money: Holding the Bag for the FHA” 215). Thus, in response to a severe financial crisis the federal government widened the accessibility of homeownership to Americans while modifying, not lessening, the economic risks inherent in mortgage finance.

An important part of the history of HOLC to understand, however, is that the government created this alphabetical not just to keep John and Jane American from being booted from their home. The government trend of aiding mortgage finance institutions in

⁶ The Federal Deposit Insurance Corporation (FDIC) found that “the frequency of default and the severity of losses on high LTV loans far surpass those associated with traditional mortgages and home equity loans” (“Interagency Guidance on High LTV Residential Real Estate Lending”).

times of economic instability (which would be echoed later in the history of savings and loan industry) also began with HOLC, as it bought up the worthless assets of defaulted mortgages out of the banks' bleeding portfolios.⁷ With this action, HOLC sought to aid the American financial system as much as the American homeowner. In his message to Congress, President Roosevelt stressed this dual mission by describing what the HOLC would provide for those invested in the U.S. financial system as well as for those who held mortgages in danger of default:

“...the plan of settlement will provide a standard which should put an end to the present uncertain and chaotic conditions that create fear and despair among both home owners and investors” (“Protect Small Home Owners from Foreclosure”).

Some, however, were critical of this aid to the banks. In the words of one historian writing in the 1940s, “HOLC aided some owners who were being put out of their homes...though mainly it served as a handy method for helping out lending institutions whether they needed help or not” (Abrams 218-219). Clearly, there were some who felt that lending institutions did not deserve as much financial assistance as regular folks who faced foreclosure.⁸

Whether HOLC provided a greater financial benefit to homeowners or lending institutions during its three-year lifespan is difficult to determine, and although illustrative of the dual goals of the agency, the question should not distract from the historical significance of HOLC to the thesis at hand. Most relevant is its establishment of key elements of the culture of American homeownership: modern mortgage terms which increased affordability

⁷ Recall that because home values fell during the Depression, the homes in default were worth less than the value of the original mortgage. The bank could not sufficiently recoup its losses from a defaulted mortgage by repossessing the home.

⁸ Extending this helping hand to lending institutions also carried an element of moral hazard. The precedent of government assistance in a time of crisis could have emboldened these institutions to act with less financial prudence in the future.

for a dramatically larger number of Americans and special assistance for the institutions of mortgage finance. Created in the historical context of the Great Depression and the New Deal, many of these measures made economic sense. However, the policies and precedents of HOLC endured well beyond the agency's lifespan and the Depression itself, affecting the history of American homeownership long after it was disbanded.

The Federal Housing Administration

The Federal Housing Administration (FHA) was created by Congress in 1934 under Section 203(b) of the National Housing Act. While HOLC was formed to solve the immediate problem of home foreclosures, this second alphabetical of the New Deal's housing initiative was meant to increase the availability of credit and encourage lenders to start issuing mortgages again, as housing starts had fallen dramatically from 700,000 per year in the 1920s to only 93,000 in 1933 (Vandell 301) (Appendix B).⁹

When enacted, Section 203(b) of the National Housing Act enabled a far-reaching loan insurance program which blurred the lines of private mortgage finance and government intervention in a dramatic attempt to jump start the housing industry. Under this program, the Federal Housing Administration insured for the lender one hundred percent of the loan amount of owned single-family homes in the case of default (Vandell 301). FHA was meant to be a financially self-sustaining institution, without funding from the federal government or taxpayers. Instead, the borrower paid a small insurance premium upon the issuance of the mortgage and a small annual insurance premium that declined over the life of the loan.

These small premiums formed the reserves that would be used to compensate lenders in the

⁹ Housing starts indicate the number of new homes constructed in a given time period.
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case of default (Green and Wachter 95).¹⁰ The philosophy behind the new insurance program was that if the full faith and credit of the U.S. government stood behind selected mortgages and the full value of the mortgage was insured, then lending by mortgage financing institutions was essentially risk-free, and their aversion to issuing new mortgages should end (Monroe 3).

In addition, similar to HOLC's revision of standard mortgage terms, FHA standardized mortgage products and underwriting procedures. These measures (which are familiar parts of the mortgage application process today) included appraisals of the property in question, property inspections, quality ratings, and credit checks to assess the financial capability of the borrower. Section 203(b) also reinforced the new mortgage terms purported by HOLC, insuring loans that were longer term, fully-amortizing, and at a higher LTV that was initially 80 percent. It restricted interest rates, and only insured loans under \$16,000 (a generous sum, considering the median home price in 1930 was only \$4,778). The loan maximum was later reduced to \$6,000, yet this still covered 85 percent of the nation's homes under the umbrella of FHA insurance (Vandell 301-302). Considering the basic credit checks of the borrower and the loan amount maximum, the FHA loan insurance program was clearly intended to cover a wide swath of the American home owning public: every income bracket of borrower except for the very poor and the very rich was included. The FHA measures weren't a targeted attempt at aiding a certain demographic or a specific home finance issue that resulted from the Great Depression. They were meant to revolutionize the process of home buying for lenders and borrowers alike and provide a permanent buffer against the type of credit crunch that forestalled housing starts in the early 1930s.

¹⁰ Note that this is quite different from how HOLC was funded. HOLC drew an initial \$200 million from the U.S. Treasury and was authorized to issue an additional \$300 million in bonds (Green and Wachter 95).

Given the level of government intervention in the mortgage market represented by FHA, the extent of Americans covered under the program, and the permanence of the measures (unlike HOLC, FHA did not disband after serving its immediate purpose of unfreezing lending during the Great Depression), it is easy to conceptualize FHA as a government instrument meant to directly encourage homeownership in the long term. President Roosevelt stated himself in 1934, “in pursuing this policy we are working toward the ultimate objective of making it possible for American families to live as Americans should” (“Roosevelt’s Plan for Security” 141). It also serves as the beginning of a history of government encouragement of homeownership that excludes all but the gravest concerns over the credit and financial standing of the borrower. The Federal Housing Administration represented the maiden voyage of the federal government through the stormy sea of a mortgage debt heavy economy. Roosevelt’s administration placed homeownership rates as a priority over the assessment of the financial ability of the individual borrower. This risky bargain has formed the historical basis of government intervention into the United States mortgage market.

To achieve its aims, FHA employed various methods in its early years to increase housing starts and purchases. Some of these methods included partnering with local chambers of commerce, lumber interests, and private builders whom it allowed to display the FHA shield as a misleading assurance to potential home buyers (many Americans were under the false assumption that FHA insurance provided a mode of protection against personal default, while in truth the program only insured lenders). It also engaged in a persistent, if not aggressive, propaganda campaign, distributing millions of pieces of literature, circulating movies, and sending hundreds of salesman into the field all trumpeting the benefits of home

buying. Even bolder still, FHA worked closely with realtors, training them at “better selling meetings” and sponsoring expositions. The relationship between FHA leadership and private building interests was so cozy that building materials dealers paid the charges for nationwide radio broadcasts in which government officials sang the praises of homeownership. An FHA Deputy Administrator described this partnership best in a speech to an audience of builders, boasting “Gentleman, the National Housing Act is a profit-producing ‘sales tool’ for builders” (qtd. in Abrams 224-225).

Why was this partnership between FHA, a government entity, and those who personally profited from home sales inherently unfair to the American public? Because in the 1930s, in the interest of fulfilling its mission to increase the number of housing starts to pre-Depression levels, FHA was allowing builders and realtors to push homeownership on Americans under false pretenses. An FHA loan provided no protection to the home buyer against foreclosure. But undoubtedly, the government-fueled “ballyhoo” surrounding the Federal Housing Administration undoubtedly led some Americans to purchase homes who would have otherwise viewed themselves as more financially suited to rent. The FHA was providing different private players in the housing industry with ammunition to target Americans who may have been financially vulnerable to mortgage default.

Public discourse surrounding the actions of the Federal Housing Administration appear to be split between those who were skeptical of how much effect FHA was actually having on the economy and those who viewed it as an integral instrument for economic recovery. In the camp of the former was John T. Flynn, one of the most famous political commentators of his day. He wrote on political-economic issues for some of the country’s leading publications. A left-wing populist and supporter of the interests of workers and small

businessmen during the Depression, Flynn soon turned against the New Deal because of his vehement hatred of “big government” bureaucracy (Kazin 172). During the 1930s he wrote a regular column for leftist bulwark *The New Republic*, cynically titled “Other People’s Money.”¹¹ In a series of columns from 1935, Flynn blasts the Federal Housing Administration for claiming superfluous credit for housing starts and home improvements:

“The Federal Housing Administration has reports from banks that over \$30,000,000 has been advanced by these banks for modernization loans. The F.H.A. claims credit for all these loans, which, of course, it is not entitled to, since a large part of them would have been made by the banks anyhow. But it claims a good deal more... In New York City, for instance, alteration plans for the five boroughs during the entire year involved the spending of \$28,000,000. But this was only \$5,000,000 more than in the very bad year of 1933 when there was no F.H.A.” (Flynn “Other People’s Money: Uneasy Bankers” 303).

Flynn is also critical of the hoopla for homeownership drummed up by the government touting of FHA programs, and, after having been announced “with such a blast of trumpets as has accompanied nothing else in the New Deal save the N.R.A.” deems the enterprise to be largely ineffectual:

“The government agreed to guarantee loans on real-estate properties up to 80 percent of the appraised value of the property. Apparently, loans of this kind have been made. How many it is difficult to say, since the ballyhoo put out by the F.H.A. is so confusing in its comprehensive and blatant claims that no one can tell just what has

¹¹ The phrase “other people’s money” was coined by Louis Brandeis in the early twentieth century. It is commonly used in a critical tone to refer to speculation or to those who lose “other people’s money” through risky investments or financial gambles (Fraser 286).

happened there, save that the scheme has been a pretty big failure” (Flynn “Other People’s Money: Holding the Bag for the F.H.A” 215).

The editorial lead of *The New Republic* writing in the same publication in 1939, however, calls FHA an “innocent victim” of political infighting within the Democratic Party and admonishes: “The FHA is one of our most hopeful institutions for economic recovery” (T.R.B. 305)¹² Four years after his original attack on the bureaucracy surrounding FHA, John T. Flynn supported the agency in its bid to lower interest rates for mortgage-seekers from six to five percent (perhaps because of his championing of the average American). He accepted the idea that FHA could increase home building in this manner, calling anything that would raise the cost of building homes “a crime against recovery” (Flynn “Other People’s Money: Interest Rates and Money Pools” 165). The fact that such diverging opinions were featured in the same publication, some of which were written by the same journalist, is indicative of the varied feelings of the public concerning the federal housing initiatives as well as the New Deal in a time of national financial crisis.

The actions of the Federal Housing Administration during the 1930s also gave birth to a side effect of government intervention in the mortgage market which endured throughout the economic history of the United States in the twentieth century and beyond, resulting in catastrophic financial consequences during the savings and loan crisis and the housing bubble of the 2000s. This side effect is the encouragement of entrepreneurial risk and an explosion of moral hazard in the private sector as a result of the government’s mission to increase homeownership levels in the United States. In the case of FHA, the insurance that the government provides to lenders against borrower default insulates the lender from risk. Free from this risk (which is usually the encouragement to make the most sensible financial

¹² “TRB” is the ghostwriter initials used by the editorial lead of *The New Republic*.
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Sarah P. Gibbons, College ‘09

decisions), the lender has an incentive to produce as many loans as possible despite the actual financial ability of the borrower to own a home. Although FHA did assess borrower viability prior to the issuance of the mortgage, the moral hazard inherent in insuring the mortgages for the benefit of the lenders began a tradition of reckless mortgage lending in the United States. Construction of a shaky foundation for the American economy had begun.

The Federal National Mortgage Association (Fannie Mae)

The third link in the trinity of New Deal agencies meant to stimulate and maintain high levels of homeownership was the Federal National Mortgage Association, commonly referred to as Fannie Mae or FNMA. Fannie Mae was created in 1938 in an effort to construct from scratch a secondary market in FHA mortgage loans (Green and Wachter 96). It was the first in a family of “national mortgage associations”¹³ (Meyerson 71) that entered the federal government as a player in the private mortgage market, creating a new quasi-public, quasi-private “government housing bank” (Villani 137).

Fannie Mae was created in the wake of HOLC and FHA to act as a financial bastion in the new mortgage infrastructure that the government had built. Originally, the National Housing Act (which created FHA) provided for the establishment of privately owned and financed national mortgage associations which were to be chartered by FHA and whose purpose was to buy and trade FHA mortgages in a secondary market to stimulate the flow of funds through the system (Hearth 17). Long term mortgage loans of up to 30 years made purchasing a home more affordable and the federal insurance of the FHA removed the adversity to lending; but still-wary investors in the 1930s had neither the means nor the

¹³ The Government National Mortgage Association (Ginnie Mae) founded in 1968 and the Federal Home Loan Mortgage Corporation (Freddie Mac) founded in 1970 are discussed in Chapter 2.

desire to invest in a 30-year credit instrument (Villani 137). As a result these institutions proved unable to secure adequate private investment and most soon failed (Hearth 17). Since the federal government had reinvented the mortgage into a product that no one wanted to invest in, it was forced to create its own financial institution and act as the broker itself. The first federal attempt at creating a secondary mortgage market came in the form of the RFC Mortgage Company, established under a section of the Reconstruction Finance Corporation Act. However, the RFC Mortgage Company, like the FHA-chartered private mortgage associations, proved incapable of purchasing a large enough volume of mortgages to make a dent in the struggling 1930s mortgage market (Hearth 17).

In a third attempt to finance the FHA mortgage machine, Roosevelt established a new national mortgage association, the Federal National Mortgage Association, by executive order in 1938 (Hearth 17). Fannie Mae was a nation mortgage association meant to buy, pool, securitize, and resell FHA (and later VA)¹⁴ mortgages in order to funnel money back into lending institutions (which could then issue additional mortgages). According to a report from the Congressional Budget Office, “The FNMA was chartered as a federally owned and operated national mortgage company to trade mortgages backed by the federal government” (Congressional Budget Office (Leigh) 83). In May of 1938, John Broderick reported on this new investment tool offered by Fannie Mae in the *Wall Street Journal*:

“The Federal National Mortgage Association notes which are to be sold Wednesday will have to have an abbreviated title like other obligations of the Government and its agencies. So last week traders tentatively dubbed them the “Fanny Mays,” an adaptation of the initials of the title. Sounds like the name of a mule” (Broderick 1).

¹⁴ Additional information on the history of the VA mortgage program is provided in Chapter 2.
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Fannie Mae issued bonds for purchasing mortgages at par, so affluent investors could invest confidently in mortgages that had originated in communities with little local capital (Green and Wachter 96). This system successfully improved the flow of mortgage capital from affluent to struggling areas (Stegman 146), aiding in the government's mission of increasing accessibility to mortgage funds.

The secondary market for mortgages, as supported by the United States government, is a development as important to the history of the modern American mortgage (and the history of homeownership in America) as the modern mortgage terms set by HOLC and FHA. Without the operations of Fannie Mae, the modern mortgage that Roosevelt's administration had engineered with its long maturity, high LTV s, and accessibility to less wealthy Americans would not have been financially possible.

What Did the People Think? The American Public's Reaction to the New Deal

Embodying drastic change not only in the mortgage and homeownership sectors but in everything from banking to public works, the New Deal was unsurprisingly a rather controversial topic while its immediate effects were being felt in the 1930s and 1940s. While unfortunately there aren't comprehensive public opinion polls targeted specifically at the topic of the New Deal housing agencies, there are a multitude that address the New Deal and Roosevelt in general, offering clues concerning the public temperament for the drastic change the agencies embodied. A *Literary Digest* poll of 65,000 persons from October 1934, while the New Deal was still young, showed a drift away from support of the President since the previous spring. However, a contemporary analysis of the poll results concluded that "many of those who, 'on the whole,' are now dissatisfied with the New Deal oppose it from

the left rather than from the right” (“The Drift Away from Roosevelt” 325). In other words, the public did not condemn the daring measures taken thus far in the New Deal (of which HOLC and FHA would be a part), but were disappointed that Roosevelt had not pursued even more radical means to spur economic recovery. In this light, it would appear that the American public in the 1930s was operating under a “desperate times, desperate measures” mentality that may have looked favorably on the federal remake of the mortgage market (whether the public supported these measures only in a time of economic crisis or in a more permanent capacity can only be guessed at).

In 1938, at the end of the formal period ascribed to the New Deal (and after HOLC and FHA had been operating for a few years), a Gallup poll of 3,000 Americans found that 56 percent of those surveyed were in support of President Roosevelt, a small but comfortable majority. However, a solid 71 percent said that they would like to see the Roosevelt Administration be “more conservative” during the next two years (“Government Spending/Roosevelt Administration”). If “conservative” can be taken to indicate a preference for less government intervention in private matters such as business and finance, then public support for the housing finance measures may have been waning. However, it is possible that the public did not include mortgage finance under this umbrella, since the government creating housing agencies from scratch was quite different than regulating already existing institutions. Another poll conducted by The Roper Organization in 1940 which drew on the opinions of 5,000 Americans also indicates general support for Roosevelt as a president and person, but less enthusiasm for New Deal programs and measures in general. When asked for views on the upcoming presidential election, a majority of those polled indicated “There is no question but what the country needs is a man like Roosevelt for

the next 4 years” (another popular answer was “While there may be some reasons against having Roosevelt for another term, on the whole it would be better to have him than Willkie”). When asked for specifics as to why Roosevelt should be reelected, the most popular answer out of many with 418 selections was “He has done a lot for the country” (trailing with 257 selections was “Like the New Deal Measures”). The most enthusiastic support for Roosevelt can be seen in a question inquiring if “Roosevelt is a real friend of the common people and will continue to help them all he can,” to which 60 percent agreed (one can imagine how his agencies which made homes affordable for the “common people” may have contributed to this response). Only 41 percent of those surveyed, however, agreed that most of the New Deal measures should be continued (“National Politics”). Based on these results which are from soon after the close of the New Deal and before the economic boom enjoyed during World War Two, the American public had mixed opinions concerning how much the nation had benefited from government intervention in the financial crisis.

After ten years of retrospect on the New Deal, *Fortune Magazine* and The Roper Organization polled roughly 4,000 Americans in 1948 on the topic of “Broad Changes in the World Since World War II.” This poll found that Franklin Delano Roosevelt was the most admired man in America during the previous fifty years (FDR won this title in a landslide over fifteen other men: he was selected 1,651 time while his nearest competition, General Eisenhower, was selected 614 times). A majority also believed that the New Deal measures under Roosevelt had considerably shortened the Great Depression and lessened its severity on the people. Sixty-three percent also believed that the New Deal had done more good than harm. If the assertion that the New Deal lost support during the Depression years for not

doing enough to help the economy recover was true, then perhaps the same Americans viewed the program more favorably in retrospect and outside the throes of economic crisis.

Popular publications of the time serve as another barometer of national opinion, and not surprisingly, liberal-leaning and conservative-minded publications were split over whether Roosevelt, the New Deal, and government intervention in the mortgage market were beneficial to America and her citizens. *The New Republic*, then a liberal publication, tended to fawn over Roosevelt, attributing heroic characteristics to the President. One editorial from 1939, written by social issue commentator Heywood Broun, attributes to the President “the best traditions of the function which the Chief Executive of the United States should assume.” Tellingly of the author’s opinion of the President’s motives he also extols: “he draws his commission from the American people themselves” (Broun 71). An article from 1934, however, which examines Roosevelt’s program before Congress for an extension of the New Deal, echoes similar sentiments as the author who attributed Roosevelt’s falling poll numbers in 1934 to a public who believed that Roosevelt was not doing enough to keep his promise of economic recovery. It praises the New Deal in theory and ideal, but not in practice. In regard to the legislation that created FHA, the author states:

“This bill embodies a governmental attempt to revive the building industry by stimulating the flow of mortgage money and other loans—a helpful thing to do in a depression if it can be done, but not a plan to provide decent houses for the people who need them. This is an attempt at recovery pure and simple, without reconstruction” (“Roosevelt’s Plan for Security” 141).

If liberal journalists were opining that not enough had been done by the government to intervene in the realm of housing, it is likely that the government intervention in the

mortgage market in the form of HOLC, FHA, and FNMA was not opposed in theory or intention.

Right-leaning publication *The Saturday Evening Post*, on the other hand, had since the Crash of 1929 opposed any government intervention in the economy, and espoused instead that the “American virtues of hard-work and self reliance” were the solution to the economic crisis (Cohn 233-234). As the New Deal began, concerned *Post* editor George Lorimer called in an editorial on “capitalists and reformers” to check their behavior in favor of the “safe middle ground of common honesty and common sense” (Cohn 236). As it followed, the publication was harshly critical of much of the New Deal as the reason behind sharp increases in government spending and bureaucracy. An article (which should perhaps be classified as an exposé) entitled “The Spenders” by Raymond G. Carroll, demonizes the alphabeticals, or New Deal Agencies, calling the New Deal “a political machine developed behind the screen of humanitarian and eleemosynary alphabeticals” (Carroll 70). Carroll produces a scorecard of spending for the twelve largest alphabeticals (in which he includes both HOLC and FHA), which he names the “dirty dozen.” He paints a picture of government lackeys who staff the agencies driven mad with the funds at their disposal and jockeying with each other for their place in history:

“So we have the petty wars between the alphabeticals; their quarreling over which has made the best showing, which has got off with the least criticism, which shall have the largest slice of the last current emergency appropriation and which establishment the sooner will pass into a permanent phase of the government” (Carroll 68).

Clearly, the American Right was opposed to much of the New Deal including the bureaucratic and spending patterns of HOLC and FHA, which were the tools of federal

encouragement of homeownership in the 1930s. Given its opposition to the means the administration was employing to achieve its goal, the Right was likely unsupportive of government intervention into the mortgage market, which had previously been a private enterprise.

One of the most interesting ideological discrepancies between Left and Right can be found in the support of the former and staunch opposition of the latter to the New Deal as a social initiative, an issue that relates directly to the government's encouragement of homeownership with HOLC, FHA, and Fannie Mae¹⁵. In an appeal for the continuance of the New Deal in 1944, a column in *The New Republic* attributes omnipresence to the program which is almost spiritual:

“The New Deal is something bigger than any one person, bigger even than the President of the United States and the greatest figure in the United Nations. It can be disowned—that is, any person can disassociate himself from it. But it cannot be dropped...the New Deal is and has always been far more than a slogan. It has been a conception of government. It has been a general social direction. It has been a program of social action...the New Deal as a fact and as an aspiration is the essential thing” (“The New Deal Must Go On” 6).

These types of associations to the New Deal must have been apparent (and controversial) as early as 1936, as *The Saturday Evening Post* dedicated an entire column to the issue in June of that year. It opposes the very idea of the New Deal that the column from *The New Republic* reveres:

¹⁵ As will be discussed later in this chapter, increasing the affordability and access to owned, single-family homes was surrounded by as much ideological as economic rhetoric.

“Over a three-year period, the President has very clearly stated his final objective in his speeches and has shown what it is in the legislation he has advocated. In his own words, it is “a new social order,” and just what he means by that he has clarified in one considered utterance and piece of “must” legislation after another...implicit in his policy is the supplanting of fundamental American ideals of life, liberty and government by others that are alien to our soil” (“Pussyfooting About the President” 22).

The Roosevelt administration’s goal of creating the reality of homeownership for millions of Americans using debt, FHA insurance, and government financial institutions may have been one of the ideals that *The Saturday Evening Post* viewed as alien to the American political-economic landscape. The magazine was not only opposed to the means (the “alphabetical” HOLC and FHA) but the mission as well. *The New Republic*, on the other hand, viewed these social goals as an essentially permanent part of post-Great Depression America. History proves *The New Republic* was correct in its expectation. The culture of American homeownership, as invented and administered by the U.S. government beginning in the 1930s, did become a lasting part of the political-economic landscape of America.

Motives

Given the wide-reaching effect of these agencies on the mortgage structure, the American homeowner, and the United States economy as a whole, an exploration of the government’s motives for increasing homeownership during the Great Depression is more than warranted. An examination of various contemporary sources such as magazine and journal articles as well as more recent works by historians point to three primary motives: the

stimulation of the economy through home construction, to build a “better society” by transforming Americans into “better citizens” through homeownership, and to curb radicalism and social unrest in a time when much of the nation was economically downtrodden. These three motives existed simultaneously in the minds of Roosevelt’s administration, the press, and the public as a whole during the 1930s and early 1940s. However, similar sentiments in support of homeownership have been voiced in the post-World War Two Period and beyond, indicating that these motives did not die when the American economy recovered after the war.

The first motive, which is purely economic in nature, was to stimulate the suffering Depression-era economy which had stifled home construction to dismal levels (housing starts, or new homes constructed, had fallen from 700,000 a year in the 1920s to an anemic 93,000 in 1933) (Vandell 301). It is economic logic that the more homes built the more jobs that will exist in construction and that building suppliers will do a better business. However, there are a multitude of industries tied to new home construction that benefit from (and sometimes depend on) high levels of housing starts, for example: appliance and consumer durable manufacturers, furniture manufactures, and landscapers. As the logic goes, the financial success of these industries and others should trickle down and benefit the economy as a whole. Roosevelt’s administration embraced this logic in the form of FHA and Fannie Mae, which were intended to reenergize housing starts by encouraging financial institutions to start lending again and by channeling funds back into the mortgage system to create additional loan availability. According to one historian, it was “college economists invited to Washington in the depressing thirties” who had proposed the idea of activating home building to stimulate the economy, and “pressure from beleaguered lenders and materials

manufacturers” strengthened the administration’s resolve to act (Abrams 55). This motive was also popularly espoused by contemporary economists. One, writing in 1941, cites the “pyramiding of secondary jobs and services” that would come from this encouragement of construction and that would hopefully hasten relief from economic depression (Husband 46). Others in the media also encouraged this home-building strategy of economic stimulus, calling it “the very core of a policy of long-term economic planning,” and citing the fact that private building interests and means of mortgage finance were simply incapable at the time of the Depression of doing the job themselves (Mayer, Wright and Mumford 93). Thus, home construction which had once been a private endeavor for the pursuit of profit was now, in the form of HOLC, FHA, and Fannie Mae, a government initiative in the attempt to resurrect the American economy. This notion of home building as an economic stimulus would remain a hallmark of American economic strategy.

The second motive of Roosevelt’s administration in encouraging homeownership was far more ideologically driven than the first: to build a “better” American society by creating better citizens via homeownership. This motive was outlined with clarity and enthusiasm in the 1930s by Henry E. Hoagland, who served on the Federal Home Loan Bank Board, was an emeritus professor of business finance at Ohio State, and often wrote on issues surrounding the New Deal Housing Agencies while he was still a steward of the federal government (Hoagland and Stone title page). When writing about the evolving role of government in the mortgage structure in 1936, Hoagland digresses from discussing lending practices, mortgage terms, and government agencies to the ideological importance of these government measures to American society. He calls the American home “the shrine about which center all of the members’ hopes and ambitions and achievements” (Hoagland 232). He goes on to assert,

“the government of the United States in its encouragement of home ownership is laying the foundation for good citizenship, for clean living, and for a higher type of civilization” (Hoagland 232). The fact that Hoagland, a representative of these government agencies who taught finance at the business school of Ohio State University, chose creating a “higher type of civilization” as justification for government encouragement of homeownership is highly telling. Clearly, there were ideological as well as economic goals attached to the government’s housing initiatives, goals based on presumptive logic at that. The notion that a person who owns his own home is somehow part of a “higher type of civilization,” one that apparently bars renters at the gate, may add a sense of elitism to the American dream, but it is not an idea upon which to base any part of a large-scale national homeownership initiative.

A related theory is that the liberal political force that created and administered the New Deal was utilizing homeownership as a tool to rebuild America in its own image (Bernstein 278). The Great Depression was catastrophic to the American psyche as well as to the American economy, and in its aftermath the New Dealers saw an opportunity to create an environment which would “restructure character and personality more appropriate to white, middle-class America” (Bernstein 278). Apparently, the most effective way to achieve this goal was by turning as many Americans as possible into home owners, a status which in past generations had been more exclusive to the wealthy and elite.

The third motive, and one that was especially important to Roosevelt in the historical context of the 1930s, was to utilize homeownership as a stabilizing measure to sap organized radicalism of its “potential constituency among the unorganized and discontented” (Bernstein 267). This motivation likely grew out of the historical evidence that times of economic hardship tend to breed radicalism, as people ideologically desert the economic system (such

as capitalism) that has failed to provide them with the means to live a decent life.¹⁶ In response to this possibility, Roosevelt acted by enabling stabilizing economic measures through the New Deal, such as HOLC, FHA, and Fannie Mae, that would hopefully curb Americans' desperation¹⁷ and discourage them from totally losing faith in the capitalist system.

Others also believed that being a homeowner would heighten a person's "sense of individual responsibility" to the society in a time of "stresses and strains upon the social order" (Husband 46). This motive stresses the upheaval of American society that occurred as a result of the economic hardships of the Great Depression, and Roosevelt's fear that if the government did not take drastic action to help homeowners and enact other stabilizing economic measures, then American society was at a great risk of radicalism and possible revolution. In another economically and socially tumultuous time for America, the post World War Two period, a similar concern was addressed by historian Charles Abrams: "Just as the security of home ownership is said to be the 'foundation' of our social system, so its insecurity poses a threat to the national stability" (Abrams 17). In this case, a lack of "national stability" would disable the nation's ability to pose a strong united front in times of war as well as incapable of maintaining national social stability in peacetime (he cites housing riots during the Civil War as further proof of the destabilizing effect of a lack of adequate housing) (Abrams 17). The common thread that interweaves the fears of these two eras is the belief that homeownership is not merely a strong foundation upon which to lay an economy, but also the underpinning of a socially stable American democratic society.

¹⁶ Such as the growth of Communism preceding the Russian Revolution in 1917-1918.

¹⁷ By either allowing Americans to remain in a home that they owned and risked losing or by providing the means to purchase decent housing.

The notion that homeownership and democracy are coexistent (and codependent) institutions was popularly espoused beyond the historical context of the New Deal and World War Two. A real estate finance text book from 1961, written by Henry Hoagland and Leo D. Stone, a lawyer, MBA, and professor of finance, states in its introduction:

“Ownership of homes and other real estate is a natural concomitant of political democracy. Individual freedom, private enterprise, and home ownership are parts of the same whole. Where one is lost, the other two are likely to disappear soon afterward” (2).

Other sources also speak of the “high public regard for home ownership in a democracy” (Husband 46).¹⁸ It is unfortunate that there has never been a public opinion poll of the 38.1 percent of Americans who did not own a home in 1960 (when Hoagland’s textbook was published) or the 33.8 percent of Americans who didn’t own a home in 2000, to enquire if their renter status resulted in feelings of deprivation of individual freedoms or exclusion from the democracy. Since none exist however, assumptions concerning the validity of this notion will have to rest on the fact that prior to 1950, when a majority of Americans were not homeowners, the American democracy did not tumble into anarchy, and individual freedoms and private enterprise endured.

The federal government had economic motives to encourage homeownership, based on the logic that home construction would stimulate the economy. It also had ideological aims for “improving” and refashioning the American people and assembling a buffer against radicalism. While some of these motives may seem more outlandish than others, together

¹⁸ Perhaps this idea has its historical roots in the ideology of one of the founding fathers of this democracy, Thomas Jefferson, and his vision of America as a nation of farmers who each own and work an individual plot of land.

they form the reasoning behind government encouragement of homeownership during the New Deal and beyond.

The True Effect of These Agencies on American Homeownership

The historical significance of HOLC, FHA, and FNMA is twofold. First, there is their role as the government's means of creating the culture of American homeownership in the 1930s, and their embodiment of various themes in this culture: increasing the amount of individual mortgage debt to make homeownership a reality for the widest swath of the American population, homeownership as both a social and economic stimulus, and moral hazard. The second assessment of the historical significance of these agencies is far less subjective: their actual quantitative effect on homeownership levels in the United States. Overall, HOLC, FHA, and FNMA caused little change in the mortgage market from their conception in the 1930s until the end of World War II. The 1925 peak of 937,000 new homes constructed across the United States (which dropped to an anemic 93,000 by 1933) was not surpassed, not even approached, until after the war (Green and Wachter 96). Another indicator, national homeownership rates, also did not recover during the period, falling from 47.8 percent in 1930 to 43.6 percent in 1940, with a recovery and rise in 1950 to 55 percent¹⁹ (U.S. Census Bureau). Thus, the New Deal trinity created to save and spur homeownership during the Great Depression did not increase either housing starts or homeownership rates by the end of World War II.

When examined individually, HOLC and FHA did produce some returns in the mid-1930s and early 1940s. As stated previously, the Home Owner's Loan Corporation purchased, reinstated, and converted one million mortgages in a period of three years, from

¹⁹ Rates fell as a result of foreclosures and the credit crunch.

1933 to 1936. According to the U.S. Census Bureau, the population of the United States in 1933 was approximately 125,000,000, with an average of four persons per household. If 45 percent of these families owned their own home in 1933 that equals 14,062,500 mortgages. Since HOLC saved 1,000,000 of these homes from foreclosure, that means that HOLC allowed approximately seven percent of American homeowners to keep homes that they may have lost otherwise through default, and to adopt more affordable mortgage terms.

While John Flynn was highly skeptical of the effect that the Federal Housing Administration had on increasing liquidity and enabling more Americans to acquire mortgages, FHA did account for 23 percent of single-family lending between 1935 and 1939 (Vandell 308). Considering that 1,410,000 homes were constructed during this entire period, this means that there were 324,300 homes made possible by the FHA after its extensive marketing campaigns and partnerships with realtors and builders. While these results may not seem impressive²⁰ they must be taken in a historical context. Given the severity of the Depression, FHA was fighting a steep uphill battle against a banking crisis and record unemployment. A full recovery of housing starts and homeownership rates wouldn't have been impressive; it would have been a miracle.

While the agencies' quantitative results during the 1930s and early 1940s may be lacking, the legacies of HOLC, FHA, and FNMA are integral components in the history of government encouragement of homeownership in the United States. These agencies represented the beginning of government intervention into the mortgage market with the express intent of keeping Americans in homes that they already owned and facilitating their ability to acquire mortgages to purchase new ones. They administered the modern mortgages

²⁰ Consider this figure (324,300 over a four to five year period) in comparison to 937,000 new homes constructed in 1925 alone.

that Roosevelt's administration had designed from scratch to make homes more affordable, but with LTV s that piled debt on homeowners and were inherently more risky. They marked the government's first creation of its own financial institution to prop up this system in the form of Fannie Mae. And finally, they set the precedent for the most dangerous characteristic of the government-administered culture of homeownership: moral hazard. While HOLC disbanded in 1936, FHA and Fannie Mae emerged as permanent fixtures in the world of mortgage finance, with evolving historical relevancy and tumultuous legacies which will be touched on again later in the thesis. Concurrently with the post-war rise in homeownership rates, the next phase of this history involves the government programs and agencies that emerged after World War Two.

A Continuing Culture of American Homeownership after World War Two

American economic history after the Second World War and prior to the 1970s was marked by several important developments concerning government encouragement of homeownership. While some of these developments, especially the chartering of additional government sponsored agencies such as the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Government National Mortgage Association (Ginnie Mae) were tied to the creation of the modern mortgage market during the New Deal by HOLC, FHA, and Fannie Mae, others owe their significance to an event that forever altered the history of homeownership in America: the return of 16 million G.I. s after World War Two. As they started new families and hastened the Baby Boom, these G.I. s benefited from groundbreaking legislation which provided them the means to purchase homes and also spurred a cultural redefinition of homeownership as an American right. This sense of entitlement has endured in the national mindset.

Throughout this period, the United States government changed hands between political parties and ideologies. Recessions came and went, wars were fought, and the nation underwent a cultural revolution. Yet one national mission remained constant: the creation of an economic and social culture of homeownership that would act as a permanent national stimulus. While the tools of the operation (the federal income tax code, the Servicemen's Readjustment Act of 1944, and the creation of Ginnie Mae and Freddie Mac) may seem diverse in economic method, their inherent purpose was uniform: to raise homeownership rates as high as possible. And in contrast to the desperate efforts of the New Deal-era agencies, these government measures actually worked. By 1950, a majority of Americans

owned their own homes. In order to understand the impact of these measures on the American culture of homeownership, an examination of the history of each is necessary.

The Servicemen's Readjustment Act of 1944 (The "G.I. Bill") and the Veteran's Administration Home Loan Guaranty Program

In 1944, as World War Two drew to a close in Europe and the Pacific and the Allies were poised for victory, the U.S. government was faced with a daunting domestic predicament in addition to the task of winning a world war: 16 million American service people would soon be returning home, without jobs and without any place to live (Jackson 233). A severe housing shortage had already become apparent as the war raged overseas. This shortage was the result of a combination of two factors, the first being a population boom spurred by the war. Marriage rates, which had been declining for a decade during the Depression, began to rise steeply in 1940 as war loomed on the horizon and couples faced imminent separation. Along with rising marriage rates came a sharp increase in the birth rate, 22 per 1,000 by 1943, the highest number that had been seen in two decades (Jackson 232). This baby boom continued as veterans returned home, resulting in millions of new American families. Along with this spike in population, however, was paired the anemic number of housing starts from the Depression years, which had bottomed out in 1943 when only 11,800 new homes were constructed per month. This figure equated to less than one new house for every town and city in the nation (Humes 92). The result of this equation was a drastic and wide reaching housing shortage when the war ended. In 1947, six million American families were "doubling up" in residences with friends or family, and others improvised on the American dream by purchasing converted trolley cars, ice boxes, and grain bins that were advertised as "homes" (Jackson 232). Despite the availability of these class

accommodations, Roosevelt's administration identified an immediate need for five million new homes after the war (Jackson 233) as well as a second chance to try its hand in the game of homeownership stimulation.

The U.S. Government responded to the housing shortage (as well as the danger of unemployment and other potential post-war domestic issues for returning veterans) with the Servicemen's Readjustment Act of 1944, which was signed into law by the President on June 22 of that year. Also commonly known as the "G.I. Bill of Rights" or simply the "G.I. Bill," the law provided resources for college education and vocational training, unemployment insurance, and under Title III of the Act: "loans for the purchase or construction of homes, farms, and business property" ("Servicemen's Readjustment Act of 1944" 291). Title III outlined the special mortgages available to the men and women who had served in the military between September 16, 1940 and the termination of the war. The terms and provisions of these mortgages included an interest rate maximum of four percent, advanced notice of foreclosure along with an additional opportunity to refinance, and zero interest payments for the first year of the loan. The Title III provision which had the greatest impact on the housing market, however, was the creation of the Veterans Administration (VA) Home Loan Guaranty Program.

The original form of the VA Home Loan Guaranty Program (known hereafter as the VA Program), as enacted in 1944, provided a loan guaranty limited to 50 percent of the mortgage (and not to exceed \$2,000), limited the life of the loan to a maximum of twenty years, set a maximum interest rate of four percent, and had to be utilized by individual veterans within two years of the termination of his service or within two years of the war (Department of Veterans Affairs 3). The logic behind this loan guaranty program is similar

to that of the FHA during the Great Depression. If the U.S. government insures (or “guarantees”) part of the mortgage loan in the case of default by the veteran, then mortgage lending institutions should have less hesitation in granting that veteran (who may not have sufficient credit to prove his financial reliability) a home loan.

However, it soon became evident that the \$2,000 maximum was not sufficient given rising real estate prices in the post-war years, and that the twenty-year maturity of the loan resulted in monthly payments that were too high for the average veteran to afford. The two-year limitation also underestimated the demand for such loans. Thus, in 1945 and following years, Congress made various changes to the VA program that gradually increased veterans’ accessibility to the loans and gave them additional years (up to ten) to take advantage of the program. The Housing Act of 1950 also provided for direct loans by the VA to veterans who couldn’t acquire a mortgage from a traditional lender. These adjustments transformed the VA Program from a piece of emergency legislation to address readjustment issues of the World War Two G.I. s into a “long term housing program for veterans”²¹ (Department of Veterans Affairs 4-5). The government had tapped a new, enthusiastic market for home loans composed of moderate income, young American families.

When Roosevelt signed the Servicemen’s Readjustment Act on June 22, 1944, he stated that the law “gives emphatic notice to the men and women in our armed forces that the American people do not intend to let them down” and that it would provide “the special benefits which are due to the members of our armed forces—for they ‘have been compelled to make greater economic sacrifice than the rest of us, and are entitled to definite action to help take care of their special problems”” (“Franklin Roosevelt’s Statement on Signing the

²¹ The VA Home Loan Guarantee Program still exists for American military veterans, and employs many of the same terms, provisions, and guarantees.

G.I. Bill” 1). Since housing provisions were a paramount part of this “definite action,” with this statement Roosevelt solidified the position of his administration that homeownership was part of the promise of American life: a right that veterans had earned with their military service to the country instead of a privilege to be enjoyed only by the wealthy or those who had financially planned for homeownership for years. But would this position, administered by the VA, result in significantly increased levels of homeownership in America, a goal that HOLC, FHA, and Fannie Mae had failed to achieve before and during the war?

The numbers speak for themselves. Single family housing starts spiked from 114,000 in 1944 (the year in which the G.I. Bill was signed into law), to 937,000 in 1946, a mere two years later. Starts continued to rise to 1,183,000 in 1948, and then to an all-time high of 1,692,000 in 1950 (Jackson 233) (Appendix B). By 1955, 4.3 million home loans had been granted under the program, with a total face value of \$33 billion (“Servicemen’s Readjustment Act (1944)” 1). During the decade after the war ended, nearly five million veterans bought homes with the help of the G.I. Bill benefits, and these residences accounted for almost half of all the new homes constructed during the period²² (Humes 99). These impressive numbers are reflected in national homeownership rates, which by 1950 had risen 11.4 percent to 55 percent from the 1940 low of 43.6 percent. By 1960, the national homeownership rate was 61.9 percent (Appendix A). For the first time in the nation’s history (and in a large part thanks to the G.I. Bill and the VA Home Loan Guaranty Program), a comfortable majority of Americans owned their own homes. After mixed results from the New Deal Housing Agency triad, which had created the modern mortgage and revolutionized

²² The VA Home Loan Guaranty Program has endured throughout the twentieth century and into the twenty first. Between 1944 and 2006, the VA has guaranteed over 18 million home loans to veterans, proving it to be a significant long term influence on homeownership rates (VA Legislative History 1).

the secondary mortgage market but had failed to return homeownership rates to Pre-Depression levels, FDR was now finally on his way to transforming America into a “nation of homeowners,” with all the economic, social, and political effects which his goal implied.

The legacy of the G.I. Bill and the VA Home Loan Guaranty Program is vastly significant to twentieth century American economic history. When the Servicemen’s Readjustment Act was passed in 1944, only one in six Americans lived in a neighborhood that could be classified as the “suburbs” (Humes 94). However, the government, along with a collection of clever construction entrepreneurs, saw enormous potential in the combined effects of a national housing shortage, millions of young veterans with new families in need of housing, and the easy credit available through the G.I. Bill (Humes 95). Here was the chance to reshape the average home owning experience into a cookie-cutter American dream within the reach of a majority of the population. The reality underlying this dream was the suburbs. As one historian asserted:

“The American suburban exodus of the 1950s did not simply spring into existence on its own: It is no exaggeration to say that the creation of suburbia and the resulting extension of home ownership to a majority of families in America was launched, underwritten, and paid for by the G.I. Bill” (Humes 90).

Construction companies such as that of Abraham Levitt and his sons recognized the huge market for moderately priced homes created by the government (with the easy credit of the G.I. Bill) and began to buy up farm fields and vacant land. Soon afterwards, construction of concrete and plywood homes (at 60 foot intervals) was buzzing along as fast as power tools and construction workers could saw, hammer, and nail (Jackson 234). Hundreds of new suburban communities sprung up across the nation, and young families clamored to exercise

their newly won purchasing power at local sales offices (with an urgency doubly fueled, perhaps, by fresh memories of trolley car and ice box accommodations).

The crowning achievement of this suburban phenomenon was Levittown, built by the Levitts in Hempstead, Long Island, New York beginning in 1946. At peak levels of production, the Levitts' crews were constructing more than 30 houses per day on old farm land which had stood vacant since the bleak Depression years (Jackson 234-235). When construction was completed, Levittown was the largest housing development ever constructed by a single builder, boasting more than 17,400 separate houses (Jackson 235). The Cape-Cod style homes were built as cheaply as possible and priced to sell to the average middle class American for \$7,990 (Jackson 236). The standard model featured a moderately sized living room with a picture window overlooking the backyard, a kitchen which overlooked the front yard (so mothers could keep an eye on their playing children while they washed the dishes), two bedrooms, and one bathroom. It took only one hour with a Levitt representative to complete the entire financing and titling transaction to purchase one of the homes (Jackson 236).

This type of neighborhood, floor plan, and purchasing experience made it possible for a majority of Americans to own their own homes for the first time in the nation's history. As Paul Goldberger wrote in the *New York Times*:

“Levittown Houses were social creations more than architectural ones—they turned the detached, single-family house from a distant dream to a real possibility for thousands of middle-class American families” (Goldberger C1, C10).

Without the easy credit provided by the U.S. government through the G.I. Bill and the guarantees of the VA Program, neighborhoods such as Levittown would never have been

able to sprout like weeds on the American landscape. Thus, American Suburbia can be considered a visible legacy of the Servicemen's Readjustment Act.

The less tangible component of the G.I. Bill's legacy is its cementation of "the right to homeownership" in the national mindset, placing it on the pedestal of American birthrights along with life, liberty, and the pursuit of happiness. This was accomplished via Roosevelt's rhetoric on the matter and the provisions of the bill, which provided for accessibility to homeownership without wealth or savings. In contrast to this claim, the Department of Veteran's Affairs own legislative history of the VA Home Loan Guaranty Program asserts that "The VA programs are intended to benefit men and women because of their service to the country, and they are not designed to serve as instruments of attaining general economic or social objectives" (Department of Veterans Affairs 1). However, when Roosevelt signed the Act in 1944 he stated that the special provisions for homeownership were the "due" of the American military, implying that homeownership was an inherent American right that veterans shouldn't be denied simply because they had no credit or savings ("Franklin Roosevelt's Statement on Signing the G.I. Bill"). In fact, the United States government simply could have provided veterans with a cash bonus to help them get back on their feet and thank them for their service to the nation. However, it chose instead the symbolic gesture of making homeownership cheap, easy, and accessible, since this was the "due" and right of every deserving American. By extension the Act and the VA Program implied that, within reason, a lack of credit or savings should not rob a majority of Americans of their "right" to be homeowners. The Servicemen's Readjustment Act and the VA Home Loan Guaranty Program cemented the government's position, which was first established with HOLC, FHA, and Fannie Mae, that it would take almost any measure possible (aside from

handing out homes for free) to swell the number of American homeowners. An often overlooked supplement to this post-war swell was the homeownership subsidy of the Federal Income Tax Code.

The Federal Income Tax Code: A Subsidy for Homeownership

As homeownership levels swelled in the post-war years, a tax subsidy for homeowners which emerged from a technicality in the United States tax code drafted in 1913 was realized as a sizable economic incentive for homeownership (and a significant loss of tax revenue for the United States government). The language of the tax code excluded interest from the definition of “income,” and as a result, homeowners were able to deduct mortgage interest payments and local property taxes from their federal tax burden (Bratt 268). Few took notice of this technicality until veterans began returning from the war and buying up homes by the millions, raising homeownership rates to 55 percent in 1950, up from the anemic levels seen in the wake of the Great Depression (U.S. Census Bureau). While the U.S. government was undoubtedly ecstatic about skyrocketing homeownership rates, it was likely less enthusiastic about the significant chunk of taxable income that it was missing out on, a missed tax revenue opportunity that swelled with each veteran that moved into his new suburban home.

This technicality soon became a significant addition to the federal expenditure on housing (Bratt 264-265), but would the administrations of either Harry Truman (a Democrat) or Dwight D. Eisenhower (a Republican) amend the tax code to correct this loophole in the post-war years? Neither did, and mortgage interest payments are deductible from federal taxes still today. The U.S. government supports the deductibility as a subsidy for

homeownership, adding the federal income tax code to its arsenal of instruments intended to raise levels of homeownership in America. A report from the Congressional Budget Office concerning the housing finance system and federal policy states this intention outright:

“Several tax provisions provide incentives for individuals to become homeowners by reducing the after-tax cost of ownership. These provisions include: the deductibility of mortgage interest and property tax payments from taxable income” (Congressional Budget Office (Leigh) 24).

The report also openly recognizes the significant loss in tax revenue this represents for the government: “all these elements of the tax code cost the federal government sizable amounts of lost revenue annually” (Congressional Budget Office (Leigh) 24). For fiscal year 1983, when the report was released, the deductibility of mortgage interest payments resulted in \$25.1 billion in lost revenue. The deductibility of property tax payments from federal taxes represented \$8.8 billion in lost revenue for the federal government (Leigh 24).²³ In a nation which has historically suffered from a lack of sufficient healthcare for lower income citizens, a crumbling infrastructure, insufficiencies in public education, and a budget deficit, a voluntary \$35 billion “hit” in lost tax revenues is a significant testament to the federal government’s dedication to encouraging homeownership.

Historical motives of government aside, the homeownership tax subsidy should also be assessed on the basis of its fairness to all American tax payers over the course of the twentieth century and now in the twenty-first. More specifically, the historical impact of the homeownership subsidy on those Americans who, by necessity or preference, have chosen to rent instead of own a home should be examined with a critical eye. By definition, the

²³ Homeownership rates have increased roughly 2% from 1980 to 2000, meaning the revenue losses for the federal government because of the deductibility of mortgage interest payments and property taxes has also increased since these numbers were reported in 1983.

homeownership subsidy violates the principal of “horizontal equity,” or equal treatment of equals, because:

“homeowners with similar money incomes, family sizes, and consumption patterns to renters will generally incur lower income tax liabilities than renters even though the owner is actually better off in terms of total income and has a greater tax-paying capacity than the renter” (Merz 247).

This economics-speak can be illustrated in the historical context of two imaginary veterans starting their new lives after the war in 1950s America. Bob, the first veteran, marries Cindy and they have two kids, Bill and Sue. Bob manages an appliance store and makes \$25,000 a year (roughly the average American income in the 1950s). Bob and Cindy purchase a two-bedroom, single-family home with a big backyard for the kids to play in, and live the American dream happily ever after. Mike, the second veteran, marries Sally. They also have two kids (Jill and Lou). Mike is a car salesman and makes \$25,000 a year, just like Bob. In fact, Mike and Bob’s families, incomes, and lifestyles are similar in almost every way. Except, for whatever reason, Mike rents his two-bedroom, single-family home with the big backyard instead of owning it. Even though Bob is technically better off financially than Mike (since he holds the valuable asset of his house), Mike is paying more in taxes to the federal government. It is an “upside down subsidy” (Merz 248) since the most benefit is derived by Bob, who needs it less than Mike. The United States government has historically supported this inequitable subsidy for decades, sacrificing other areas of the federal budget and basic economic fairness in the interest of promoting homeownership.

The Government National Mortgage Association (Ginnie Mae) and the Mortgage Backed Security

More than two decades after the end of the Second World War, in 1968, the homeownership rate in America had finally leveled out since the post-war spike, hovering at 62.9 percent (U.S. Census Bureau). In this year, the U.S. government decided to convert Fannie Mae into a privately owned (yet still federally chartered) corporation to allow the institution to compete on a more even playing field with the private sector (without the unfair advantage of being a part of the federal government) (Henig 660). However, the government felt that certain functions and responsibilities of Fannie Mae (of paramount importance to the federal government because of their role in stimulating homeownership) still couldn't be carried out sufficiently by the private sector (Hearth 25). Thus, a new agency was established as a part of the U.S. Department of Housing and Urban Development (HUD). This new agency, The Government National Mortgage Association (commonly referred to as Ginnie Mae) was a government corporation: a federal agency with powers to operate within the private mortgage market, as Fannie Mae had done for the last thirty years.

The 1968 HUD (Housing and Urban Development) Act assigned Ginnie Mae two functions previously handled by Fannie Mae. The first was the special assistance function (SAF) (Hearth 25). This function concerned all the FHA mortgages, which as previously stated were not marketable to investors in the secondary mortgage market on their own because of their long term (often thirty year) commitment and the increased possibility of default because of their low and moderate income holders. Added to this load of unmarketable mortgages were those backed by the VA Home Loan Guaranty Program, which were an unattractive investment for similar reasons. So, to prop up this system which

rested on a foundation of undesirable mortgages, Ginnie Mae was assigned the role of purchasing them itself (Hearth 25-26). Ginnie Mae was also permitted to purchase any type of loan during periods of tight credit, with the hope that lending institutions would use the money they received from the agency to “churn out” additional home loans (Hearth 26). Thus, Ginnie Mae joined Fannie Mae as an institution that made FHA and VA mortgages possible by forging a secondary market.

The second function assigned to Ginnie Mae was Management and Liquidation (MLF). Like SAF, MLF was a function previously assigned to Fannie Mae since 1954. Ginnie Mae was now responsible for managing and liquidating the mortgages that the federal government had acquired between 1938 and 1967. Between 1968 and 1981, Ginnie Mae reduced the size of this portfolio from \$1.9 billion to \$141 million (Hearth 27).

The third function assigned to Ginnie Mae, separate from those inherited from Fannie Mae and perhaps the most significant to the modern mortgage finance system, was to guarantee timely payment of principal and interest on long-term securities which were backed by a pool of FHA, VA, and other special government program mortgages (Hearth 27). This investment product is still known today as a mortgage backed security, or MBS. Mortgage backed securities had existed prior to Ginnie Mae, but the agency’s guarantee changed the nature of the investment entirely. Previously, MBS s were known as “straight passthroughs:” investors received a return back on their investment only if the original loan borrower made his mortgage payments on time. (Congressional Budget Office (Leigh) 21). It is easy to understand then why only the boldest (or most masochistic) investor would want to purchase a straight passthrough MBS that came from Ginnie Mae—since the FHA and VA mortgages were more vulnerable to default, an investor was less likely to receive a return on

his investment. So, Ginnie Mae decided to guarantee payments from the MBS s it backed to the investors who purchased them—whether Joe Homeowner (with his FHA mortgage) made his mortgage payments or not (Congressional Budget Office (Leigh) 21). For obvious reasons, backed by the full faith and credit of the U.S. government (Congressional Budget Office (Leigh) 21), these Ginnie Mae MBS s proved quite popular (\$22.9 billion were issued in 1980 alone) (Hearth 27). Writing in *Banking* in 1970, John Kirk explained,

“It is hoped that the securities would provide a new source of capital for housing from investors who would be attracted to these government-guaranteed bonds but who are not interested in investing in mortgages directly” (Kirk 107).

Writing in *Mortgage Banker* magazine in 1977, W.A. Boileau echoed this sentiment: “many investors have been attracted to this security because it combines the best features of mortgages and government bonds: safety, yield marketability and cash flow” (Boileau 20).

Whether the popularity of the Ginnie Mae-guaranteed MBS s had a large hand in sparking the trend of mortgage backed security-tinkering by Wall Street in recent decades (which contributed to both the savings and loan crisis and the current financial crisis) is difficult to determine. However, the sheer popularity of this type of security must have sparked increased investment activity, guaranteed or otherwise. The MBS has now infiltrated almost every part of our financial system, with grave consequences that have become increasingly apparent in recent years. The fact that these MBS s were popularized by the government in an effort to make additional home mortgages available certainly adds to the bittersweet history of the American culture of homeownership.

The Federal Home Loan Mortgage Corporation (Freddie Mac)

The creation of Ginnie Mae and the privatization of Fannie Mae in 1968 were followed in 1970 by the chartering of the Federal Home Loan Mortgage Corporation (Freddie Mac). Freddie Mac was established under Title III of the Emergency Home Finance Act as a federally sponsored agency of the Federal Home Loan Bank Board with nonvoting private stock held by the Federal Home Loan Banks (Congressional Budget Office (Leigh) 23). The functions assigned to Freddie Mac consisted primarily of secondary market operations. Similar to Fannie Mae, the Corporation was authorized to purchase FHA, VA, and conventional mortgages (Hearth 28). Unlike Fannie Mae, however, since 1972 Freddie Mac has primarily purchased conventional loans.²⁴ From 1976 to 1983, the Corporation purchased only \$100 million worth of FHA and VA mortgages, as opposed to \$17 billion in conventional mortgages (Hearth 29).

Freddie Mac pooled together the mortgages it purchased and then sold pieces of this pool to other investors,²⁵ providing a majority of the Corporation's funds. The certificates Freddie Mac sold to its investors resembled Ginnie Mae's MBS s in that payments were guaranteed by Freddie Mac, but they were differentiated by a significant detail: the pool of mortgages that backed the certificates were usually composed of conventional loans, not FHA or VA loans (Hearth 29). Thus, Freddie Mac represented the U.S. government's transition from operating a secondary market in its own FHA and VA loans (Fannie Mae and later Ginnie Mae), to also acting as a broker of securities based on conventional loans originated in the private sector. Why would the government take this step, blurring the lines

²⁴ Non-FHA or VA mortgages.

²⁵ It is important to remember that the category "investors" doesn't just include individuals: these certificates (and MBS s) were sold to savings and loan associations, commercial banks, pension funds and insurance companies as well (Hearth 29).

of public and private mortgage finance even more so than it had already done with Fannie and Ginnie? By purchasing any and all types of mortgage loans, the government was trading mortgages for money with a lending institution. The underlying logic was that if the lending institution held more actual money in its vaults (instead of holding a bevy of mortgages in its portfolio), then the institution would lend this money out again as more and more mortgages. So the federal government was on a mission to utilize the secondary market not just to sustain its own instruments of mortgage origination, but to encourage the issuance of all types of home mortgages. If the New Deal was the era of the birth of the modern mortgage, then the 1960s and 1970s ushered in the era of the secondary mortgage market as the driving force behind the culture of American homeownership.

The Historical Implications of Fannie, Freddie, and Ginnie

Since they were chartered in 1938 and 1970, Fannie Mae and Freddie Mac have enjoyed a plethora of special treatment from the federal government, a common theme in the administration of the culture of homeownership. Both agencies are federally exempt from state and local corporate income taxes and are not required to register their securities with the Securities and Exchange Commission (SEC). They also enjoy a conditional line of credit comprised of \$2.25 billion from the Treasury Department, are exempt from most restrictive state business laws, and have lower capital requirements than their competitors in the private sector (Seiler 8).

To justify this special treatment, supporters of these government-sponsored agencies have historically offered four major policy goals in defense of their quasi-public, quasi-private status. The first is their pioneering of new investment products in the secondary

mortgage market such as the mortgage backed security. The second is the extension of homeownership that the agencies are supposed to foster through their secondary market activities. The third is the agencies' role in promoting the maintenance of open markets and liquidity (by purchasing mortgages from lenders resulting in more liquid "cash" in the lenders' reserves). The fourth policy goal in support of the agencies is the efficient manner in which they support mortgage markets, which is supposedly more efficient than depository institutions (Van Order 45).

The downside of the MBS (and securitization of mortgages in general) has already been discussed in relation to Ginnie Mae. Although the creation of such tools by the agencies back in the 1960s and 1970s has resulted in an increased flow of funds into the mortgage finance system, their use has also held a heavy price for our economy.

The second policy goal fits perfectly into the history of the government encouragement of homeownership in the United States. But have the government sponsored enterprises (GSE s) actually fostered the spread of homeownership to those who would be denied access otherwise (due to financial or credit constraints)? Some recent studies conducted for the Department of Housing and Urban Development suggest otherwise. Maps of the Chicago, Cleveland, and Akron metropolitan areas from the late 1990s display neighborhoods in which minorities comprise a majority of the population. Fannie Mae and Freddie Mac's market share of conventional mortgages in these neighborhoods is also displayed. What is clear is that as the percentage of minorities in a given census tract increases, the GSE s' market share decreases steadily (Appendix C). Studies on market share by borrower income display the same phenomenon (Appendix D) (Brown 153-162). If the government chartered these agencies to spread homeownership to the widest possible swath

of Americans despite race or income bracket, why have GSE s historically conducted the most business with those in the white, moderate to upper income bracket? Clearly, these agencies have lost track of their historical mission to increase the accessibility of homeownership for those who truly require the assistance. This study also illustrates the fundamental flaw of the government's mortgage system that has dogged it throughout its history: investing in FHA and VA mortgages simply isn't very good business. As a result, the government's own agencies stray from the purpose they were created to serve.

Income brackets and race aside, the means employed by Ginnie Mae, Freddie Mac, and Fannie Mae are of vast significance to the history of homeownership in America. Their primary weapon has been the creation of a secondary market for mortgages, VA and FHA-backed as well as conventional. While VA and FHA loans likely increase home buying opportunities for low and middle income Americans, it is necessary to question whether a mortgage finance system which can't sustain itself without the help of Fannie, Freddie, and Ginnie is really such a good idea for the American economy. Without the secondary market created by these agencies, there would be a lack of money to create additional mortgages, especially in lower income areas. But given the recent financial crisis's ties to mortgage backed securities and other securitized mortgage instruments, every American must consider the price to our economy of creating a nation of homeowners in this manner.

Part Two: The Savings and Loan Crisis

Introduction to the Savings and Loan Industry

So how can this homeownership culture, as established and administered by the federal government, lead to financial catastrophe? Many of the various agencies and programs of the culture have already revealed their fundamental economic weaknesses throughout their decades-long histories. The modern mortgage administered through the Home Owner's Loan Corporation and the Federal Housing Administration was unable to maintain a mortgage market on its own due to its undesirability as investment product. Therefore, the government created its own mortgage brokerage, Fannie Mae, in 1938 to artificially prop up the mortgage system it had created. After the jump in homeownership rates in the post-war period, when the number of these mortgages had risen substantially, Ginnie Mae began guaranteeing the mortgage backed security in 1968 to make it a marketable (and attractive) investment (again with the aim of pumping additional funds into the system). Freddie Mac encroached even further into the private mortgage market in 1970, purchasing and securitizing mortgages that had originated in the private sector in order to channel additional funds back into mortgage origination.

Other measures contributed heavily to the ideology that homeownership was an intrinsic American right, one that should be provided and protected with drastic legislative and structural measures if necessary. HOLC's chartered purpose to protect Americans from foreclosure during the Depression sent a message to homeowners and investors that American economic stability and national morale were dependent on a government that supported homeownership. The Servicemen's Readjustment Act (G.I. Bill) and the VA Home Loan Guaranty Program, enacted in the wake of World War Two, implied that homeownership was the due of deserving Americans despite their financial standing or

savings. The federal income tax subsidy for homeownership, in place since 1913, allowed home-owning Americans a financial advantage over their renter neighbors.

Together, these agencies, pieces of legislation, and tax code created the American culture of homeownership. This culture pervaded the American psyche and is an integral aspect of the American Dream, to the point where homeownership seems as inherently “American” as democracy or apple pie. Perhaps more sinisterly (for the fate of the economy, at least) this culture has pervaded the political landscape, leading presidential administrations and congresses which have spanned the political spectrum to almost constantly favor the spread of homeownership in America over economic rationality and pragmatism. As we have already seen, this agenda of economic stimulus, social perfection, and political stability has built the foundations of our mortgage market on an instrument that is dependent on artificial stimulation from the government to survive. It has also lead to an unwavering coddling of financial institutions that provide low-cost mortgage finance to lower and moderate income Americans. The special treatment of one type of mortgage lending institution in particular, the savings and loan or “thrift” industry,²⁶ has proven especially problematic in the twentieth century of American economic history.

Driven blindly to keep afloat an industry whose founding purpose was to provide affordable home mortgages to working class Americans, over a period of six decades the federal government misguidedly drove the thrift industry into financial irrelevance and insolvency. One of the reasons that the history of the thrift industry in the twentieth century is so illustrative of the flaws of the culture of American homeownership is that the federal government managed to inadvertently doom savings and loans multiple times under the

²⁶ “Savings and loan,” “S&L” and “thrift” will be used interchangeably throughout the remainder of this thesis to refer to a savings and loan institution and also in reference to the industry.

auspice of aiding them. The government created the federal savings and loan as an inherently flawed financial institution, highly regulated to the point of financial strangulation. From the 1930s to 1980, most legislation enacted for the preservation and financial well being of the thrift industry was aimed at tightening financial regulation on the industry and limiting its activities. From 1980 until the collapse of the industry later in the decade, however, the federal government attempted to keep the industry afloat in a changing economic environment by throwing all types of financial and safety and soundness regulation to the wind. While both of these strategies did manage to keep the industry from complete collapse for a limited amount of time, they ignored the fundamental flaws of these institutions of mortgage finance. Instead of addressing issues of long term competitiveness and relevancy in the mortgage market, legislators “patched up” savings and loans industry problems before opening the flood gates of deregulation wide in the early 1980s. The result was one of the largest financial catastrophes in twentieth century economic history, a debacle that resulted in the failure of over 1,000 thrift institutions and hundreds of billions of dollars in losses that had to be absorbed by the government and the American taxpayer. Finally, the government would know the price tag of creating a politically powerful culture of homeownership.

The savings and loan crisis of the late 1980s is exemplary of how the administration of the culture of homeownership in America can lead to financial catastrophe. The thrift industry’s road to ruin began with the federalization of the industry during the New Deal and accelerated with the rapid and indiscriminate deregulation of the industry in the 1980s. So to revert back in history, we will trace the roots of the savings and loan crisis to the Great Depression.

The Origins of the Federal Savings and Loan (Thrift) Industry

Prior to Franklin D. Roosevelt's election to the presidency and his implementation of the New Deal, President Herbert Hoover also attempted to address the widespread economic suffering caused by the Great Depression. Not surprisingly, many of the efforts of his administration focused on housing finance as an instrument to stimulate and stabilize the economy. The culminating legislation of this mission was the Federal Home Loan Bank Act, which became law on July 22, 1932. This legislation created the Federal Home Loan Bank Board (FHLBB), a bi-partisan supervisory board of appointees chosen by the president (McDonough 669-670). The legislation also built from scratch a new system of low-cost mortgage lending meant to serve the average American. The hearts of this system were the hundreds of savings and loan institutions that dotted the country. Struggling financially like the rest of the banking sector during the Depression, these institutions were federalized by the Federal Home Loan Bank Act and transformed into member institutions of the FHLBB in return for government assistance. The second tier of the system was composed of twelve regional Federal Home Loan Banks which were opened to serve as secondary lenders to savings and loan institutions (in times of crisis, the savings and loan could borrow money from one of the FHLB s in order to continue operations). The third function of the FHLBB was to supervise the Federal Savings and Loan Insurance Corporation, or the FSLIC, which insured the accounts held by savings and loan institutions (similar to how the Federal Deposit Insurance Corporation insured the deposits of private banks)²⁷ (Balderston 418). The FSLIC and FDIC were measures taken to increase public confidence in the banking system and prevent "bank runs" that had plagued lending institutions during the Depression. Prior to

²⁷ In fact, the FHLBB was patterned on the Federal Reserve System, which oversees secondary lending to commercial banks and also supervises the Federal Deposit Insurance Corporation (FDIC), which insures accounts in said commercial banks (McDonough 670).

deposit insurance, rumors or fears of bank failures could cause members of the public to rush to their banks and remove deposits, resulting in the financial collapse of the bank. If your deposit in a savings and loan institution was insured by the FSLIC, however, you could rest assured that the federal government would pay back your money even if your individual institution lost all of its assets.

If FHA mortgages were the lifeblood of credit that pumped through the mortgage finance system and Fannie Mae was the life-support pump keeping the body alive, then the Federal Savings and Loan Associations were the heart of the government's mission to provide affordable and accessible housing finance. Born into their modern form by the same legislation that chartered the Home Owner's Loan Corporation in 1933 (McDonough 681), the federal savings and loan associations took the form of a "state-created industry" with the government-mandated function to "supply affordable home mortgages for moderate-income working-class families" (Glasberg and Skidmore 75). The 1933 Home Owners Loan Act defined federal savings and loan associations as "local mutual thrift institutions in which people may invest their funds" ("Home Owner's Loan Act of 1933" Section 5(a)). Later rules from the FHLBB for chartering S&L s further expanded on the objectives required of one of these federal associations:

"The objects of the association are to promote thrift by providing a convenient and safe method for people to save and invest money and to provide for the sound and economic financing of homes..." ("Rules and Regulations for the Federal Savings and Loan System" 9).

The creation of the federal savings and loan system was essentially the first time in American economic history that a home-financing institution was established with the principle purpose

of “accepting investments to be loaned to persons desiring to finance homes,” instead of treating this function as “merely incidental to some other function or functions regarded as of primary importance” (Arber 326). These institutions were differentiated from standard commercial banks,²⁸ another institution at which the public could open savings accounts or take out loans, in that they were beholden to the Federal Home Loan Bank Board. S&L s were also characterized by their community-centric nature: a neighborhood S&L was operated primarily by local people and local capital and its home-financing operations were restricted to the local area (often within fifty miles of the institution’s location) (McDonough 681-682).

In order to become a member of the FHLBB and enjoy the financial stability inherent in its supervision and support from the federal government, savings and loan associations were required to meet certain criteria, criteria that eventually defined their purpose and role in the culture of American homeownership. The two primary criteria were first that the institution originate home mortgage loans that could be judged by the FHLBB as “sound long term loans warranted by its time deposits (“Federal Home Loan Bank Act of 1932” Section 4(a)). Stressing the goal of providing affordable home-financing accessible to a majority of the public, the Board also vowed to reject applicants whose “lending terms and charges it regarded as extortionate” (McDonough 671).

Becoming a member of the FHLBB in the 1930s meant transitioning from state-chartered status to federal status. In the desolate financial landscape of the Great Depression, member-status in the FHLBB held benefits that likely had many thrift operators wringing their hands in anticipation after a long period of economic uncertainty. In addition to accessibility to federal funds from the twelve Federal Home Loan Banks, member

²⁸ Contemporary examples of “commercial banks” include PNC and Commerce Bank.
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associations were granted exemption from present or future federal, state and local taxation of their income, capital and surplus (McDonough 682). The drive to recruit S&L s into FHLBB membership began three weeks after the legislation that created the system became law, and within a few short months over 200 state-chartered institutions had either been accepted or had applied for FHLBB membership (McDonough 683). By June of 1934, only two years later, the total membership stood at 2,501 (around 19 percent of all savings and loan institutions in the United States) (McDonough 673-674). This is an impressive figure and quick pace given the amount of government bureaucracy that was likely inherent in the FHLBB's application system (or any new federal government operation). A *New York Times* article from June of 1934 quoted the Board as saying "In view of the voluntary nature of membership in the system, its growth since the regional banks opened is believed to be without precedent in the history of central banking institutions here or abroad..." (qtd. in McDonough 674). Membership numbers continued to swell, and the result was a nationwide, federalized savings and loan industry.

But why did the government target the thrift industry for resurrection from the financial cesspool of the Great Depression? Why create the Federal Home Loan Bank System with the thrift industry as the centerpiece? The fact was that the savings and loan industry: small-time, community-based, and provider of low-cost housing finance to the average American, was the exemplary lending institution for the government's goal of spreading homeownership. Unfortunately, as a result of the Depression, this industry in its state-chartered form (along with the rest of the banking system) was hurtling towards an economic black hole. One economic journalist, writing in 1934, bemoaned that many financial institutions had withdrawn from mortgage finance altogether (McDonough 683).

Another contemporary journalist noted: “many state institutions engaged in home financing had...lost their prestige and no longer enjoyed that confidence which is absolutely essential to the continuance and success of any financial institution” (Arber 326). The government likely saw this gap as a golden opportunity to remodel the thrift industry into a standardized, government-protected machine with the sole purpose of churning out affordable home mortgages. After all, after becoming member institutions of the FHLBB in order to “save themselves from extinction” (Arber 326), savings and loans didn’t have any choice but to conform to this ordained purpose. The always breathlessly enthusiastic (at least when it came to matters of mortgage finance) Henry Hoagland championed the chartering of federal savings and loan associations as a new “national bank of the home-financing field” and “an attempt to develop a model thrift and home-financing institution” (Hoagland “Government and the Changing Mortgage Structure” 231). Another hailed the federalization of the savings and loans as “of great and as yet unmeasured importance in the saving and revival of the home-financing structure in this nation” (Arber 326).

The drastic change embodied by this government action was highlighted when the constitutionality of the federal savings and loan associations was challenged in the 1930s. A majority of the Supreme Court supported the constitutionality of the system, and offered the following majority opinion:

“To our mind the preservation of home owners and the promotion of a sound system of home mortgages is none the less national in scope than the provisions for the unemployed and the aged. Its scope, as affecting the welfare of the nation as a whole, is of equal importance” (qtd. in Arber 326).

Legitimized by the Supreme Court, the federal savings and loan institutions could now serve as the government's tailor-made and favored institution of low-cost mortgage finance during the Great Depression and beyond.

From the 1930s until the 1970s, the thrift industry grew tremendously and enjoyed sustained prosperity in the nurturing hands of the federal government. Policy decisions supported and subsidized its home-finance role: interest rate controls, deposit insurance, freedom from taxation, and limits on entry and competition from outside the federal savings and loan system insulated the industry (Redburn 436). Unsurprisingly given their federal life preserver, from 1934 to 1979 hardly any savings and loan institutions failed at all despite natural economic cycles of boom and bust. There was even a period of fourteen years when not a single savings and loan institution failed (Cebula 620). Beginning in 1980, however, savings and loans began to fail by the hundreds, reversing a four-decade long history of success. Here, within the federally restrictive throes of the successful years and in the free-wheeling decade of spiraling decline, lies the story of how a political-economic strategy can lead to financial catastrophe.

1932-1989: “Over-Regulation” and “Under-Regulation” of the Savings and Loan Industry: Creating a Lending Institution for the Culture of Homeownership

1932-1980: “Over-Regulation”

Just because very few savings and loan institutions failed between 1934 and 1979 doesn't mean that trouble wasn't brewing on the American economic horizon. The federal government spent these four decades setting the thrift industry up for an epic financial failure by restricting the industry to a singular purpose: to provide home mortgages to the average American. The American government offered the industry the benefits of membership in the FHLBB: the line of credit from Federal Home Loan Banks, FSLIC insurance which would attract wary Depression-era depositors, tax breaks, and a general federal helping hand. But in return, the industry had to conform to the “over-regulation” that preserved it as an example of what the government believed that small-time mortgage lending “should be.” The creation of this group of specialized housing lenders, which were restricted to housing loans but in return were “protected and coddled” reflected a strain of twentieth century political thinking that was embodied in the political culture of homeownership (White, The S&L Debacle 56). As industry expert Lawrence J. White explained: “policymakers believed that a specialized set of institutions with an earmarked financing stream was necessary for the provision of low-cost housing finance” (White, The S&L Debacle 56-57). In their effort to spread homeownership, however, the political forces that created the federal savings and loan associations must have been blinded by ideological and economic goals. Because lurking in the shadows of this mission were economic and financial realities, and vulnerabilities in the industry sprung directly from its government-mandated purpose.

Prior to 1980, federal savings and loan institutions were highly regulated by the federal government and the FHLBB in order to maintain their singular purpose of providing mortgage loans and also, it appears, to uphold their small-time, local community image as the lending bank of the American everyman. They were, in fact, among the most highly regulated firms in the country (Barth, Trimbath, and Yago 183). Firstly, they were forbidden to issue home loans more than 50 miles from their home office. This was meant to protect thrifts from competition from other savings and loan institutions outside of their geographic area (Barth et al. 183). In 1971 the geographic limit on lending was extended to a 100 mile radius but the restriction still effectively limited “too vigorous” competition between S&L s, a trend which was widely believed to be one of the causes of the banking crisis during the 1930s (White, The S&L Debacle 59). The geographic limitation also grew out of the traditional history and accepted stereotype of what a savings and loan institution “should be.” In the 19th century, building and loan associations (an antiquated name for a savings and loan) and comparable building societies in England were founded on the ideology of “neighbors banding together to help each other acquire houses”²⁹ (Balderston 420). Whether this community-centric definition of a savings and loan institution or the desire to restrict competition was the driving force behind the geographic limit, the regulation did less to help preserve the system than it did to set it up for financial vulnerability. Limiting loan-making to a 50 or 100 mile radius prevented savings and loan institutions from diversifying their risk on a geographic basis. For example, metropolitan areas in the state of California are often separated by significant mileage. A savings and loan which operated in this state would then be tied to the economic health and vitality of only one or two metropolitan markets

²⁹ Since members of the neighborhood would deposit their savings into a savings and loan institution and the institution would then loan this money back to members of the neighborhood as home mortgages.

(Balderston 424).³⁰ This regulation, meant to preserve savings and loans as the government's model institution of mortgage finance, only exposed the industry to additional risk from a lack of geographic diversification.

A second restriction that built vulnerability into the structure of savings and loan institutions was their confinement by law to real estate lending with only minimal exceptions (Balderston 423). This regulation forbade S&Ls from originating different types of loans that commercial banks were permitted to have as part of their financial portfolios, such as commercial real estate loans (for the building of commercial properties such as malls and office buildings) or loans to businesses (Barth et al. 183). This regulation was meant to limit competition between the commercial banking system and the savings and loan industry (Barth et al. 183), but was also undoubtedly intended by the government to keep the thrift industry from straying too far from its intended purpose of originating home loans. So while the geographic regulation had prevented savings and loans from diversifying risk outside of a limited region, the real estate lending regulation prevented the industry from diversifying its risk outside of home-lending. Thus, over four decades, the over-regulated savings and loan industry was forced to place all of its eggs into a single financial basket: local home mortgages. This led to the inherent, damning flaw of the savings and loan system that set the industry on a path towards insolvency: borrowing short and lending long.

Since the thrift industry was largely restricted to originating home mortgages, a majority of any given savings and loan's assets³¹ were composed of long-term (usually 30

³⁰ To place the risk of geographic limits into a modern example, imagine that a savings and loan was operating in a town in Michigan. This town and the surrounding 50-mile radius are composed primarily of those who depend on the automobile industry for work. Crisis in the automobile industry leads to layoffs and economic hardship in the entire area. Since the savings and loan was only permitted to make loans in this one area, it is now highly vulnerable to the mortgage defaults and the lower levels of saving that will inevitably occur. It was unable to diversify its risk geographically by making loans in different regions of the state.

year), fixed-interest-rate mortgage loans. In order to gather the funds to be able to originate these loans, thrifts accepted deposits from average Americans to which they paid interest. These deposits were short-term liabilities—the depositor could withdraw his money from the savings and loan whenever he wanted (White, The S&L Debacle 61). The profit that a savings and loan earned, out of which it paid salaries to its employees and covered other general expenses, came from the “spread” between the interest rates—the difference between the interest it “raked in” from mortgage payments and the interest it had to pay out to its depositors. For example, in the beginning of the 1980s, the average savings and loan earned nine percent interest on the home mortgages it had lent out, and paid its depositors seven percent interest on deposits. So, for every \$100 the S&L lent out as home mortgages, it received \$2 in income to cover its costs (Barth et al. 183). After decades of originating long-term, fixed-rate mortgages that had made homeownership accessible to the average American, the ledgers of S&Ls across the nation were weighted down with these assets, their interest slowly trickling in at rates of six or seven percent (Glasberg and Skidmore 76). The vice president of the Mortgage Bankers Association of America referred to these mortgages as an “albatross around the necks” of thrifts and all other institutions and agencies of mortgage finance (Riedy 15). The historical irony of this moniker is evident: the mortgage instrument the government had engineered to make homeownership affordable was suffocating the lending institution which had been designed to originate it.

The toxic and potentially dangerous combination of “lending long” in fixed-rate mortgages and “borrowing short” in deposits upon which it paid market interest rates should have been obvious and avoidable for the federal government. If interest rates rose sharply,

³¹ An asset is any item from which value is derived. Outstanding mortgage loans represent an S&L’s assets because the institution derives value from the interest paid on the loan.

for whatever reason, then the savings and loan would be forced to pay a higher interest rate to its depositors than it was collecting from the fixed-rate mortgages which it had lent out at lower interest rates in previous years. This would result in insolvency, or insufficient assets to cover debts (bankruptcy). If the savings and loan tried to avoid this insolvency by not raising the interest rate it paid to its depositors, then the depositors would withdraw their money in favor of investments that would pay the market rate (White, The S&L Debacle 61). And midway through the 1960s, this is exactly what happened. The nation's escalating involvement in the Vietnam War caused interest rates to begin a steady climb between 1964 and 1966, from 3.53 percent in January of 1964 to 5.01 percent in December of 1966. Although these interest rates weren't yet above the rate the thrifts were collecting from mortgage loans, institutions began to feel a financial squeeze as their spread shrank smaller and smaller (White, The S&L Debacle 62).

The industry pressured Congress for legislative assistance with this issue, which promised to only grow worse if interest rates continued to rise. Instead of addressing this quagmire as the challenging task that it was, a fundamental structural issue which grew out of the very regulation and mission to which the government had restricted thrifts, Congress responded in 1966 with legislation that placed a "patch" on the issue. This legislation, the Interest Rate Control Act, was the equivalent to giving a Band-Aid to a dying man. The Act for the first time placed ceilings on the interest rates that thrifts could pay to their depositors. These ceilings had already existed for commercial banks under "Regulation Q" since 1933. The Interest Rate Control Act gave the Federal Home Loan Bank Board the power to set ceilings on interest rates, in hopes of avoiding the issue of declining spreads as interest rates rose (White, The S&L Debacle 62-63). The "Q" of Regulation Q was derived from the "Q"

differential between thrifts and commercial banks—an interest rate ceiling differential meant to offset the disadvantage faced by thrifts because they were not permitted to offer their depositors as wide a range of financial services (like checking accounts and car loans) as commercial banks could (White, The S&L Debacle 63). The differential was one “Q” quarter of one percent in favor of thrifts, allowing savings and loans to offer a slightly higher return on savings than commercial banks (Glasberg and Skidmore 76).

The Regulation Q patch worked moderately well for the rest of the 1960s and most of the 1970s to keep the savings and loan industry afloat, primarily because the small-time depositors at most thrifts had few other options for investing their moderate savings which offered comparable levels of safety (FSLIC insurance), liquidity (they could remove their savings from the institution whenever they desired), and convenience (the thrift was often located in their local community)³² (White, The S&L Debacle 64). In the late 1970s however, as inflation raged in the United States and drove interest rates ever higher, depositors began to desert their neighborhood S&L s in droves in favor of other investment opportunities that sprouted out of the inflation-era economy. One example were the investment products being offered by non-depository corporations like Merrill Lynch and Sears which paid interest at market rates (rates which were now, in the late 1970s, higher than the ceiling rate at savings and loan institutions). Money market funds also entered the American financial landscape, luring away the funds of small depositors that had once belonged to the passbook savings accounts of the thrift industry. This shift away from simple, interest-bearing savings accounts at an institution like a savings and loan into other investment tools like corporate paper and mutual funds represented a growing sophistication

³² Commercial banks offered a comparable experience, but recall that they were subject to interest rate ceilings under Regulation Q as well, offering them little advantage in attracting depositors over savings and loan institutions (White, The S&L Debacle 64).

of the American investor spurred by the tumultuous economic climate of the inflation-ridden 1970s (Glasberg and Skidmore 76). Unfortunately for savings and loan institutions, this was a trend that promised to leave the thrift industry in the dust.

The laws and “over-regulation” that created and governed thrifts from 1934 to 1979 had structured the industry “so that thrifts could neither compete effectively with commercial banks nor ‘roll with the punches’ that economic shifts created” (Glasberg and Skidmore 76). The political belief that a highly-regulated lending institution in a local neighborhood setting was necessary for perpetuating the culture of American homeownership had built an industry that was highly rigid, undiversified, and vulnerable to natural economic fluctuations like the rise in interest rates that occurred in the 1960s and 1970s. Throughout the 1970s, the FHLBB, which recognized the industry’s inherent flaws, made various recommendations to Congress. Paramount among these recommendations was that thrifts be allowed to offer Adjustable Rate Mortgages (ARM s). This type of mortgage had an interest rate that was not fixed, but instead varied with an index keyed to other interest rates in the overall economy (White, The S&L Debacle 65). Originating ARM s instead of “albatrosses” (the thirty-year, fixed-rate mortgage) would allow a savings and loan’s income to rise as interest rates rose, eliminating the squeezes that had plagued the industry in the 1960s (White, The S&L Debacle 65). Unsurprisingly, Congress strongly opposed this transition and made clear that it intended for the industry to stick with the mortgage instrument that the federal government had created more than four decades prior. While Congressional justification for this lack of adjustment to financial realities was the fear that institutions would arbitrarily raise interest rates (financially victimizing locked-in borrowers), legislative path dependence seems a more likely analysis. Congress had only to look across the pond at Great Britain for proof that

adjustable rate mortgages were effective and not predatory, as that nation's building societies (the British equivalent of savings and loan institutions) had been originating ARM s since the 19th century (White, The S&L Debacle 65). But for over forty years, the United States government had promoted homeownership with the reassuring, stable, yet financially unattractive (to investors or the lending institutions entrusted to originate it) thirty-year fixed-rate mortgage. Congress made clear to the FHLBB that it would rather patch up the leaky damn of the thrift industry with Regulation Q than make the structural repairs that the industry desperately needed.

With the advent of new and more lucrative avenues of investment in the late 1970s, the savings and loan industry was retreating into economic obsolescence as 1980 approached. But would the federal government, which created the Federal Savings and Loan Associations in 1933 as its model institution of mortgage finance, allow the industry to die a natural free-market death? Would it assist the industry by allowing it to adjust its products and services into instruments better suited to the modern financial climate? The legacy of the government encouragement of homeownership quickly reveals the answer: of course not!

1980-1989: "Under-Regulation"

-or-

"Deregulate, Baby, Deregulate!"

The early 1980s was not a lucrative time to be a savings and loan institution in America. In 1980, the Federal Savings and Loan Insurance Corporation insured approximately 4,000 federally and state-chartered savings and loan institutions which held assets of \$604 billion ("The Savings and Loan Crisis and Its Relationship to Banking" 168).

As prescribed by the federal government decades prior, a majority of these assets were held in traditional mortgages. As the interest rate rise that began during the Vietnam War raged on into a third decade, savings and loans, still plagued by their toxic asset/liability combination of mortgages and small deposits sunk further into the red. The net income of the savings and loan industry, which had totaled \$781 million in 1980, plummeted to *negative \$4.6 billion* and *negative \$4.1 billion* in 1981 and 1982. The number of savings and loans which had been deemed insolvent, or unable to pay debts due to insufficient assets, grew from 43 in 1980 to 415 by 1982 (“The Savings and Loan Crisis and Its Relationship to Banking” 168). From 1980 to 1983, 118 savings and loan institutions which held \$43 billion in assets failed (Appendix E), compared to only 143 savings and loan failures representing \$4.5 billion in assets in the last *45 years*. In the first three years of the decade, the Federal Savings and Loan Insurance Corporation, fulfilling its duty of repaying the federally-insured depositors of failed thrifts, was responsible for \$3.5 billion. For the 45 years prior to 1980, resolving the accounts of failed thrifts had cost the FSLIC only \$306 million (“The Savings and Loan Crisis and Its Relationship to Banking” 168). It didn’t take an economist to realize that the thrift industry was dying an increasingly quick-paced death, and that its funeral was costing the FSLIC an escalating amount of money.

The path that the resolution of this crisis would follow was determined by the exceptional political-economic climate of the United States in the 1980s. The dramatic legislative action taken by Congress to keep the gasping thrift industry alive, pushed for by the President and thrift industry lobbying groups alike, represented one of the most significant shifts in political-economic strategy in the history of the United States: complete and widespread deregulation of savings and loan institutions. Despite this shift, the inherent

flaw of government involvement in the thrift industry still existed: problematic policy decisions which placed the preservation of an institution of homeownership over economic reality. There was still a galloping horse dragging the thrift industry towards a cliff of financial collapse, as there had been since its structure on a shaky asset/liability mismatch in 1932. In the early 1980s, however, this was a horse of a different color. It was galloping a whole lot faster. And Ronald Reagan was holding the reins.

The Reagan administration's genial relationship with American business and banking began with his campaign for President in 1980. Promising corporate tax cuts and monopolizing on nation disapproval of President Carter's handling of the economy, Reagan secured the support of American business. On October 30th of 1980, only days before the election, a Gallup poll in the *Wall Street Journal* found that a large majority of CEOs believed that Reagan was better equipped and able than Carter to handle the economy (Vogel 240). As a result, corporate political action committees (PAC s) launched a full scale financial effort to not only elect Reagan and support conservative Republican congressional candidates, but also to unseat Democratic incumbents and engineer a new Congress with a much kinder eye for the business lobby. One third of all corporate PAC campaign contribution money went to support conservative Republican candidates who were challenging incumbent Democratic liberals. Republican incumbents received 20 times as much money from the business lobby than their Democratic challengers. And PAC s contributed millions to Reagan's individual campaign for president (Vogel 240-241). This remarkably united corporate effort paid off: Reagan was elected and the partisan composition of Congress changed substantially. Republicans gained control of the Senate for the first time since 1955 and also gained 34 seats in the House of Representatives (Vogel

242). This push to victory would not be forgotten by Reagan in the eight years he served as President, and a new era of cozy political-corporate relations ensued.

Many media outlets recognized the significance of the end of the tempestuous relationship between business and the federal government represented by Ronald Reagan's election. Prior to 1980, the relationship between political forces and business entities, especially depository institutions such as banks and thrifts, had often been one of deep distrust, resulting in extensive regulatory limitations on their business activities³³ (White 25). In July of 1981, however, the *New York Times* reported that the administration had "quietly set about accomplishing a sweeping reversal of policy and practice in the way the government deals with business" (Raines A1).

A hallmark of this reversal of policy concerned the regulation of business. Reagan focused more on the issue of government regulation of business during his campaign than any previous presidential candidate ever had (Vogel 246). He announced to his friends in the corporate world that he planned to "turn you loose again to do the things that I know you can do so well" (qtd. in Vogel 246). And shortly after the Reagan administration took office, Budget Director David Stockman placed much of the blame for the stagnant economy on the "regulatory burden" and suggested that "a major 'regulatory ventilation' will do as much to boost business confidence as tax and fiscal measures" (qtd. in Vogel 247). Clearly, Reagan was relying on the deregulation of business to jumpstart a faltering economy in the early years of the 1980s and was attempting to make a clean break with the policies of the Carter and Ford administrations, which had both focused on reforming (but maintaining) business regulation. He made deregulation one of the four hallmarks of his plan to spur economic recovery along with tax cuts, spending cuts, and a stable monetary policy (Vogel 247). E.

³³ As was evident in the section on "over-regulation" of the savings and loan industry from 1932 to 1980.
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Pendleton James, the White House personnel director during Reagan's first term, explained how the strategy of deregulation began with the appointment of new officials who shared Reagan's desire to "turn business loose:"

"The common thread [between the newly hired officials] is one of less regulation on business enterprises...we are following President Reagan's policies and that is why the people we are appointing are so different from Jimmy Carter's appointees. It's a whole new ballgame" (qtd. in Raines A8).

These new regulatory officials often embodied the concept of "conflict of interest:" many of them were "former employees or financial beneficiaries of the concerns whose activities they are supposed to police" (Raines A8) or those who, like the new chair of the Council of Economic Advisors Murray Weidenbaum, shared Reagan's vehement anti-regulation views (Vogel 248).

Coupled with these appointments of regulators whose regulatory philosophy was decidedly "anti-regulation" were sharp reductions in the size and budget of federal regulatory agencies. The budgets of these regulatory agencies, forty two in all, had grown fourfold between 1970 and 1980, but had decreased nine percent by 1982, only the second year the administration was in office. The number of individuals employed at these agencies had fallen by eight percent by 1982 (Vogel 248-249). Not only did these agencies now have less clout to legally enforce regulation, but the Reagan administration also created an "appeals court" with a name that indicated the direction of many of its rulings: the "Task Force on Regulatory Relief." Corporations were encouraged by the administration to bring unfavorable decisions or penalties received from regulatory agencies to the task force's attention, at which time they would be reassessed (and often reversed). One CEO who spoke

to *U.S. News and World Report* in the fall of 1981 (not even a year after the Reagan administration had been in office) likely summed up the feelings of the entire American business and banking sector when he said: “I told a friend recently, ‘I almost feel like I’ve died and gone to heaven.’” (qtd. in Vogel 251).

The agencies most severely targeted by these budget cuts were the economic regulatory bodies (Vogel 248). This included the Federal Home Loan Bank Board, the regulatory and supervisory body of the Federal Savings and Loan Associations, which was strongly encouraged to reduce its examination staff in the first half of the 1980s (“The Savings and Loan Crisis and Its Relationship to Banking” 177). The regulatory agencies of the thrift industry were particularly vulnerable to the hatchet borne down on regulation by the Reagan administration because the FHLBB and the FSLIC had historically enjoyed less political independence than the Federal Reserve System or the Federal Deposit Insurance Corporation (FDIC). In the early years of the Reagan Administration, when thrifts were failing by the hundreds due to rising interest rates and the “borrowing short and lending long” mismatch, responsibility for managing the crisis lay with the Cabinet Council on Economic Affairs, chaired by Treasury Secretary Donald Regan. This council was composed of senior officials from the Office of Management and Budget (the White House office responsible for the President’s annual budget proposals) and senior White House officials. Unsurprisingly given its members, the Cabinet Council on Economic Affairs hand-crafted policies of deregulation for the industry’s regulatory bodies and also opposed any government spending to solve the major structural problems of the industry (“The Savings and Loan Crisis and Its Relationship to Banking” 177).

It is significant to note that the federal banking and thrift agencies, including the FHLBB, were pushed to reduce examination staff and downsize despite the fact that these agencies were funded by the institutions they regulated (via fees and premiums paid by each federally chartered savings and loan institution) and not by the American taxpayer (“The Savings and Loan Crisis and Its Relationship to Banking” 177). This fact indicates that the Reagan administration was pursuing an active policy of deregulation not just in concert with cutting the tax expenditure or the federal budget. Lax regulation was being pursued as the new default relationship between the federal government, American business, and the regulatory agencies meant to act as the connecting fiber between the two. However, a distinction must be made between the new, generally deregulatory environment of American business and the legislative actions taken to deregulate the savings and loan industry. Savings and loans were not just swept up in this climate of deregulation in the Reagan era, simply following the direction of other banking and business entities by default. The thrift industry was a targeted part of deregulation, and its case is exceptional because of the aggressiveness with which deregulation was pursued by the Reagan administration, Congress, and the lobbying interest of the industry itself as a solution to increasingly insolvency. The dramatic allowances made to the thrift industry by Congress during the early 1980s and the resulting ruinous “under-regulation” stand out even in the climate of deregulation that engulfed the 1980s. Even in the historical context of cozy government-business relations, the thrift industry was distinctively accommodated by the President and Congress in the 1980s because of its “special” status as an institution of mortgage finance. The following history of reckless thrift industry deregulation is a prime historical example of how the culture of homeownership can lead to financial catastrophe.

To preface the deregulatory acts of Congress in the early 1980s, it should be noted that the thrift industry itself played an active hand in its own deregulation. Prior to Reagan's administration taking office in 1981, powerful, well-organized political action committees (PAC s) and thrift industry lobbying groups began flexing their political muscles in Washington to push legislation and measures through Congress that would benefit savings and loans and those who operated them. The 1970s witnessed a dramatic increase in the political activity of business (Vogel 287). The Federal Election Campaign Act (FECA) of 1971 and amendments to the Act in 1974 and 1976 loosened regulations which controlled political contributions by individuals, corporations, and unions. The result was a surge in the formation of PAC s. From December of 1974 to July of 1983, the number of non-party affiliated PAC s climbed from 608 to 3,461, with a noteworthy growth rate of 20 percent or higher in the 1970s. These PAC s were sponsored by various interests including corporations, labor unions, trade groups, non-stock corporations, and various others (Johnson 289-290), and as their numbers grew so did their contributions to political candidates and their influence on voting patterns (Johnson 289).

Not to be left out of this golden opportunity to influence the political process in its favor (since apparently its special government treatment in the form of tax exemptions and FSLIC insurance were not sufficient), the savings and loan industry mobilized its own bevy of PAC s. These PAC s were sponsored by savings and loan related organizations such as trade associations as well as individual lending institutions. In the congressional elections of 1978, 46 thrift industry PAC s made contributions to winning House of Representatives candidates which totaled \$236,535 (Johnson 290). Wielding titles like "Participation in the Political Process Committee-Federal Savings Association PAC," "Good Government

Committee of 1st Federal Savings of Miami,” and “Community Organized for Legislative Action,” (Johnson 293) these thrift industry PAC s tried their hand at influencing voting patterns on various real estate legislation in the 1978 to 1980 congressional term. Although their influence during this period seems to have been minimal and less effective than other PAC s,³⁴ likely because of inexperience in the PAC process, the growth of thrift industry-related PAC s in the 1970s was significant to the culture of homeownership. The savings and loan industry crafted by the government as a model community-based home-lending institution had finally grown a pair of its own political legs. The fact that the PAC s even existed was indicative that savings and loans now had the industry-wide size, power, and organization to attempt to influence the government that had commanded it since the 1930s. When savings and loan institutions applied for membership in the Federal Home Loan Bank Board, the government had utilized its leverage to restrict savings and loans to the purpose of increasing accessibility to affordable mortgage finance. But for what purpose would the thrift industry use any political sway it might garner, via PAC s or lobbying, over the federal government? This influence would not be used to further the economic or ideological goals of spreading homeownership, but for the benefit of the industry itself and its operators. This outcome is exemplified by the most puissant of the savings and loan lobbying groups, the U.S. League of Savings and Loans.

In the 1980s, the U.S. League of Savings and Loans, also known as the U.S. League of Savings Institutions, or simply just “the League” was one of the most powerful lobbying groups in Washington (Calavita, Pontell, and Tillman, Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 90). The League was generous and strategic with its

³⁴ Other homeownership related PAC s achieved better results at influencing legislation, namely, real estate PAC s and homebuilder PAC s (Johnson 298).

campaign donations, and had various Congressmen in its pockets whom it would wine and dine around Washington on a regular basis (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 90-91). As the *Wall Street Journal* described in 1989, “When the League talked, Congress listened, and so did the White House and the Bank Board” (Jackson and Thomas A1). The success of the League in influencing legislation and regulation related to the thrift industry is evident in the strong reactions of those in the U.S. government who dealt with the lobbying group in the 1980s. The chair of the FHLBB at the time, Edwin Gray, explained the power of the League to the *Wall Street Journal*:

“When it came to thrift matters in the U.S. Congress, the U.S. League and many of its affiliates were the *de facto* government...What the league wanted, it got. What it did not want from Congress, it got killed” (Jackson and Thomas A1).

Senior member of the House Banking Committee, Congressman Gonzalez, told a congressional hearing on General Oversight and Investigation in 1987: “I have seen committee after committee do everything the industry has asked us to do. Everything the industry has wanted the Congress has rolled over and given it to them...” (qtd. in Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 90). The League was so persistent that Speaker of the House Jim Wright, cornered by a League lobbyist who pressed for additional legislation after Wright had just facilitated the passing of another industry-friendly bill, lost his patience, yelling: “*Listen! My back got tired of carrying all you people*” (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 212-213).

So what did the U.S. League of Savings and Loans accomplish by wielding this great power? Did it secure legislation to increase the affordability of mortgages for the “common

Americans” that its member institutions were supposed to serve back in their communities? Did it push for a reasonable deregulatory solution for the thrift industry asset/liability mismatch so it could continue its government-mandated mission of spreading homeownership across different geographic regions and income brackets? What soon became very clear in the 1980s was that the government had essentially “created a monster:” its “model lending institution” was now capable of lobbying solely for the benefits of the industry itself and not the American homeowner. The League’s primary lobbying goals in the 1980s were to deflect regulatory scrutiny, under-fund regulatory agencies, and postpone the closure of insolvent and fraud-ridden savings and loans (Calavita, Tillman, and Pontell “The Savings and Loan Debacle, Financial Crime, and the State” 33). Incredibly, the League also had a hand in the writing of the thrift industry supervisory laws, which allowed it to become highly involved in its own supervision. Many of these allowances by the government, which in hindsight seem incredibly unscrupulous (and later proved to be just that) stemmed from the industry’s historically favored image and protected status with lawmakers as an institution of mortgage finance (“The Savings and Loan Crisis and Its Relationship to Banking” 172). However, it would be difficult to disprove the fact that many of these allowances were likely the result of generous campaign contributions by the League to select legislators. Apparently, as much as these individuals venerated a sound institution of mortgage finance as the basis of a strong economy and society, they revered cash in their campaign troves more highly.

Paired with the deregulatory pressure from the industry was the belief of the Reagan administration, which took office on January 20, 1981, and the Carter administration before it, that the cause of the industry’s difficulties was its limitation to fixed-interest rate

mortgages (White, The S&L Debacle 72). Thus, deregulation was the only way to cure the current woes of the thrift industry caused by high interest rates and inability to attract deposits lured away by commercial banks and other investment products such as money market funds. Carter's administration sought to reform the regulation of the thrift industry by focusing on interest rate ceilings, and Congress finally allowed thrifts to offer adjustable rate mortgages (ARM s) beginning in 1979 (White, The S&L Debacle 72). When Reagan's administration took power, Treasury Secretary Donald Regan formulated four central policies intended to curb the wave of savings and loan failures. First, the administration would cure inflation, which would bring down the high interest rates that were plaguing the industry. Interest rates would also be deregulated to allow thrifts to attract depositors by offering a competitive interest rate. Third, the administration was reluctant to offer any money for a "bailout" of the institutions, so all assistance would have to come from deregulatory allowances. The final policy recommendation was that real deregulatory legislation was vital in order for thrifts to compete in the modern economic climate (Lowy 20). These deregulatory policy initiatives were meant to save the "model" lending institution of the culture of homeownership, which had not only become largely obsolete (and inherently unable to adjust to modern economic conditions) but also politically self-serving. Two pieces of legislation were the fruits of this initiative: the Depository Institutions Deregulation and Monetary Control Act of 1980 and the Garn-St. Germain Act of 1982.

The Depository Institutions Deregulation and Monetary Control Act (or DIDMCA) was signed into law by President Carter on March 31, 1980. While this law addressed different types of financial institutions and contained a laundry list of new deregulatory provisions, it effected savings and loans most of all. Much of the deregulation that DIDMCA

enacted for the thrift industry, although it was intended to allow savings and loans to compete financially, was actually the first nudge towards the risky financial activity and moral hazard that would be the death blow to the industry later in the decade. So what were these deregulatory provisions? First, DIDMCA lowered the net worth requirement for individual thrifts to three percent (down from five percent in previous years) and loosened the accounting principles according to which this net worth requirement could be satisfied (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 91). Since net worth is defined as an institution's assets minus its liabilities, this essentially meant that an individual savings and loan institution was now required to hold less money in its reserves for the amount of money it lent out. This change was paired with more liberal accounting standards so savings and loans could count different types of investments and loan instruments towards their asset or liability columns. This soon led to individual institutions reporting net worth amounts that were highly overstated (in real terms, the net worth of a savings and loan using these accounting standards might have been less than three percent) (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 91). While this lower net worth standard allowed a savings and loan to place more money in investments outside of the institution and hold less in its vaults in the hope that this would result in increased profit, lowering net worth or capital requirements equated to "thinning the capital 'cushion'" and exposed S&Ls to a higher risk of failure (Cebula 623).

DIDMCA also expanded the asset and liability offerings of savings and loans, allowing them to peddle new types of financial services and originate different types of loans. For instance, thrifts could now offer NOW (Negotiable Order of Withdraw) accounts, in which the customer was allowed to write drafts against money held on deposit. They were

also permitted to offer other modern services to their depositors that are taken for granted at basically any depository institution today, such as automatic transfer services from savings to checking accounts and credit cards (Federal Reserve Bank of Boston 6-7).

On the asset, or lending side of the balance sheet, the Act permitted savings and loans to branch out beyond the small-time fixed-rate mortgage loans that they had been largely restricted to since the 1930s. The institutions could now invest up to 20 percent of their assets in consumer loans, commercial paper, and corporate debt securities (Federal Reserve Bank of Boston 6), as well as make various new types of mortgage loans (Lowy 19). An S&L could also now invest the funds that it held (which recall, consisted of people's savings deposits) in shares of "open-ended investment companies" such as money market funds, and count these owned shares towards its net worth requirement (Federal Reserve Bank of Boston 7). DIDMCA also removed the geographic restriction that had limited the S&Ls to mortgage lending within a 50 and later 100 mile radius. Now, an individual savings and loan could essentially offer mortgages anywhere. The Act also changed the loan-to-value ratio limit on S&L mortgage lending to 90 percent (Federal Reserve Bank of Boston 7), rendering the mortgages they originated more affordable but inherently more risky.³⁵

Another dramatic financial freedom granted to the thrift industry by DIDMCA was Title II, which provided for a six-year phase out of all interest rate ceilings for savings and loan deposits. Since 1966, Regulation Q had limited the interest rates that thrift institutions could offer their depositors to a ceiling set by the government. But this "patch" didn't help savings and loans in a competitive marketplace, and sharp interest rate spikes in late 1979 and again in early 1980 only hastened the retreat of the S&Ls' depositors to accounts in

³⁵ Recall from the discussion of HOLC and FHA in Chapter 1 that the higher the LTV ratio of a mortgage, the more vulnerable the borrower is to default.

other institutions that offered market interest rates (Gilbert 30). Finally realizing that Regulation Q wasn't a solution to the industry's woes, Congress took the exact opposite approach and made the elimination of deposit interest rates ceilings one of the hallmarks of the DIDMCA legislation. In a period of 14 years, the measure that had been touted by Congress as the solution to S&L failures had now become the leading scapegoat for the industry's inability to survive financially.

A Depository Institutions Deregulation Committee (DIDC) consisting of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve, the Chairmen of the FDIC, FHLBB and the National Credit Union Administration was established to oversee the phase-out of interest rate ceilings to be accomplished by a gradual increase in ceilings leading up to a complete elimination of the practice (Federal Reserve Bank of Boston 4). Treasury Secretary Don Regan who headed DIDC and oversaw much of the phase-out, fervently pursued the final goal of elimination of interest rate ceilings with an "almost religious belief in free competition" (Lowy 22). Thus, savings and loans could now offer market rates of interest to their depositors, allowing them to compete with other deposit-collecting institutions for America's savings. The executive vice president of the Mortgage Banker's Association of America declared with an almost-religious fervor (which he may have caught from Regan): "The born-again thrift...will operate nationwide, both seeking and investing its funds at highly competitive capital market rates" (Riedy 17). Hallelujah! However, commensurate with the total removal of interest rate regulation, a savings and loan could now theoretically offer any interest rate it wanted to depositors, even one above the market rate.

The final aspect of the DIDMCA legislation that was highly significant to the thrift industry's deregulation was the increase of the Federal Savings and Loan Insurance Corporation deposit insurance ceiling from \$40,000 to \$100,000 (Federal Reserve Bank of Boston 7). This meant that a deposit of up to \$100,000 for each individual with a savings account at a savings and loan institution was now insured by the federal government in the event that the institution that held his or her account failed. This represented a significant increase in the monetary value of federally insured deposits, and concurrently, the government's obligation to thrift depositors in the event of an institutional failure. However, the action was never the subject of hearings; it was never debated by Congress; and it was not in the bill that was passed by either the House or the Senate. Instead, this measure which increased the government's liability to the depositors of an industry already teetering on total insolvency with billions of dollars at stake, was slipped into the Act at the last minute by a few powerful members of Congress during a conference meant to resolve differences between the House and Senate versions of the bill (Lowy 19).³⁶ The reason for the covert nature of this action is obvious. Even a federal government dedicated to special treatment of the thrift industry as an instrument of homeownership probably wouldn't have approved of such a ludicrous measure. At the same time that the government was setting the thrift industry loose to engage in much riskier types of business ventures and investments, it was also increasing its own responsibility for those ventures if an S&L's gambles didn't pay off and federally-insured funds were lost. Besides the government's individual responsibility, couldn't the increase in FSLIC insurance entice S&L operators to take more financial risks with their funds, given the fact that its depositors were fully backed by the federal

³⁶ This covert action seems to be a common theme in the history of the FSLIC. A report on the creation of the Federal Home Loan Bank System from 1934 implies that the FSLIC itself was slipped into the legislation that created it "just before adjournment" of Congress (McDonough 683).

government? Thus, with the DIDMCA legislation of 1980, a storm of new investment activity and moral hazard in the thrift industry began to brew. More deregulatory legislation under the Reagan administration in 1982 only quickened the pace towards collapse.

The Garn-St Germain Act was signed by President Reagan in late 1982 after the new set of financial activities and deregulation afforded to the thrift industry by DIDMCA failed to curb losses caused by high interest rates (White, The S&L Debacle 72). In the eyes of the Reagan administration and Congress in the early 1980s, the cure for an already deregulated industry that was still failing despite being enabled to “compete in the free market” was to provide thrifts with additional deregulation. This legislation took steps to both speed up and intensify many of the deregulatory provisions of DIDMCA. First, it accelerated the phase-out of interest rate ceilings, an action which Don Regan pursued like a fox in an interest-rate-ceiling hen house. It also moved the thrift industry even further away from its original mission of providing home loans by further expanding its investment powers. An S&L could now increase the amount of its assets held in non-mortgage investments such as consumer loans (which could now represent 30 percent of a thrift’s assets), commercial, corporate, and business loans. Garn-St. Germain also allowed an S&L to utilize up to a whopping 40 percent of its assets to invest in real estate. It could even engage in 100 percent financing, which required zero down payment from a borrower. Reagan called the Garn-St. Germain Act “The Emancipation Proclamation for America’s saving institutions” and stated fatefully upon signing the bill, “I think we’ve hit a home run” (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 11-12).

Even before the reckless deregulation of the Garn-St. Germain Act proved to be disastrous for the thrift industry, the bill was tainted by corruption in the form of thrift

industry-Congressional conflict of interest. The Act's primary sponsor and namesake, Congressman Fernand St. Germain of Rhode Island, was a devoted patsy of the U.S. League of Savings and Loans. Congressman St. Germain was the Chair of the House Banking Committee in the early 1980s, and had earlier been a voice for "greater uniformity in statutes and regulations" in banking, especially in cases of insider fraud (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 11-12). However, by 1982 St. Germain was being wined and dined on a regular basis by the appropriately nicknamed James "Snake" Freeman, one of the League's main lobbyists (Calavita et al. "The Savings and Loan Debacle, Financial Crime, and the State"33). After dining out regularly on the League's expense account and palling around with League insiders, St. Germain was suddenly taken with a strong penchant for savings and loan deregulation. He spearheaded the Garn-St. Germain Bill in 1982, but it wasn't until 1987 that his more-than-cozy relationship with the U.S. League of Savings and Loans was investigated by the Justice Department. Not surprisingly, prosecutors found "substantial evidence of serious and sustained misconduct," but the matter was dropped by the House Ethics Committee when St. Germain lost reelection in November of 1988. After the League was caught red handed in corruption, Fred Webber, the League's new president in 1989, told the *Wall Street Journal* that the League's relationship with St. Germain was "downright stupid" and that "Never, ever should a trade group ever get that close to a key member of Congress financially...I can tell you, it will never happen on my watch" (Jackson and Thomas A18). These assurances in 1989 could not change the fact that the Garn-St. Germain Act had become law in 1982, and soon became the means with which the industry would drive itself into the ground and drag its federally-insured deposits with it. For his part, as of the late nineties Fernand St. Germain

was enjoying a lucrative career as a thrift industry lobbyist (Calavita et al. “The Savings and Loan Debacle, Financial Crime, and the State” 33).

Recall also that this rampant deregulation of the thrift industry was paired with extensive budget cuts and pressure to downsize for the regulatory agencies whose job it was to monitor these savings and loans. Thus, in 1982 the thrift industry was poised for a “predictable explosion of moral hazard”: lower net worth standards (more money for S&L operators to “play” with), a widely expanded menu of investment activities in which to use this money, expanded FSLIC insurance to protect against any possible depositor losses, and far fewer field supervisors and bank examiners to monitor S&L activity (Glasberg and Skidmore 78). Between 1982 when the Garn-St. Germain Act was passed and 1984, the examination and supervision staff of the FHLBB was reduced from 1,379 to 1,337 (White, The S&L Debacle 88). While this decrease of 42 staff members may seem negligible, it is important to remember that the economic deregulation that had occurred necessitated a significant rise in safety and soundness regulation (such as tighter scrutiny, higher net worth standards to provide a thicker “cushion” against risk, and the use of risk-based FSLIC insurance premiums (White, The S&L Debacle 75)) and certainly not a reduction of even one field supervisor or bank examiner. With their staff reduced, examinations of FSLIC-insured thrifts by the FHLBB fell from 3,210 in 1980 to only 2,347 in 1984 (White, The S&L Debacle 89). The FHLBB, its budget and staff vulnerable to the whims of White House agencies, was simply not equipped to function in a complex new web of savings and loan activities (“The Savings and Loan Crisis and Its Relationship to Banking” 170).

1980-1989: Crisis and Crash in the Savings and Loan Industry

1980-1985: How “Over-Regulation” and “Under-Regulation” Lead to the Collapse of the Industry

From the Great Depression until 1980, the federal administration of the culture of homeownership drove the thrift industry towards financial insolvency: “over-regulation” limited savings and loan institutions to a toxic combination of borrowing short and lending long. When interest rates began to rise in the 1960s, this asset/liability mismatch of short-term deposits and long-term fixed-rate mortgages ate away at savings and loan profits until many institutions were sorely “in the red.” Geographic restrictions and strict limitations on types of investment and service offerings also hindered thrifts’ efforts to compete against other avenues of investment in the modern economy. All of this regulation was enforced by the federal government in order to preserve the thrift industry as a model of an exemplary mortgage-finance institution meant to foster homeownership by offering affordable home loans to average Americans nationwide. However, this federal strategy for the savings and loan industry didn’t mesh with financial realities.

In the late 1970s and early 1980s, the federal government intervened again to try and preserve this faltering institution which had been a traditional bastion of American homeownership. However, these efforts took a drastically different policy and legislative direction. From 1980 until 1989, “under-regulation” would define the government’s efforts to preserve its model institution of mortgage finance. Once again however, this strategy ignored financial realities in its drive for widespread homeownership in America. The President and the Congress deregulated savings and loans economically while simultaneously

reducing regulatory scrutiny. What were the fruits of the early 1980s deregulatory fervor? While there were multiple ingredients that composed the recipe for disaster for the thrift industry, some stand out as particularly damaging to its financial solvency: poor lending and investment decisions and risky investment activity, the moral hazard inherent in the raising of the FSLIC deposit insurance ceiling, and fraud on the part of thrift managers. Despite the fault of savings and loans for engaging in these activities, keep in mind that the federal government facilitated many of these mistakes by prioritizing the culture of homeownership over practical regulatory policy.

New Categories of Loans and Investments

After the Depository Institutions Deregulation and Monetary Control Act and the Garn-St. Germain Act became law in 1980 and 1982, the thrift industry began to grow and change its financial portfolio at a feverish pace. Recall that the abolishment of Regulation Q removed the interest rate ceiling that determined the maximum interest rate savings and loans could offer depositors. Many savings and loan institutions took this deregulatory measure and ran with it, offering to pay above-market interest rates in order to lure depositors back from new lucrative investment opportunities such as money market funds (“The Savings and Loan Crisis and Its Relationship to Banking” 178). Many Americans found this offer attractive, and why not? After all not every type of depository institution was willing to offer an above-market rate (primarily because this practice ate away at an institution’s spread), and federal deposit insurance meant their money was secure. Deposits began to flow into the vaults of savings and loan institutions nationwide and total S&L assets increased from \$686 billion to \$1,068 billion (56 percent) between the end of 1982 and the end of 1985. In 1983

and 1984 alone, the industry garnered \$120 billion in new deposits (Appendix E) (“The Savings and Loan Crisis and Its Relationship to Banking” 178).

It doesn’t take an economic genius to realize that this practice of paying depositors above-market interest rates was a “catch-22” for the savings and loan industry. While it meant that Americans would be eager to deposit their money in a thrift institution as opposed to a commercial bank or other investment vehicle, the institution was sometimes sharply reducing its “spread,”³⁷ or profit with which it covered all of its business expenses. This practice made the financial standing of these institutions wobbly to say the least. The rapid growth in the industry’s assets also began to raise eyebrows. Not the eyebrows of regulators or a watchful federal government however, but those of entrepreneurs who recognized the profit potential in an industry allowed to run wild with the federally-insured savings of millions of Americans and the nurturing support of the federal government.

A sundry variety of entrepreneurs sought to enter the savings and loan industry in the early and mid-1980s. They recognized that an institution which was allowed such a wide variety of investment activity without corresponding regulatory scrutiny held the potential for enormous profits. This lure didn’t just extend to entrepreneurs in banking or finance, either. Everyone from dentists (who obviously had little financial experience) to real estate developers (who represented an inherent conflict of interest because of thrift institutions’ newly won ability to offer commercial real estate loans) clamored for entry into the industry, by either acquiring an existing institution or starting a new one. Between 1980 and 1986, charters were issued for nearly 500 new savings and loans nationwide (Appendix F) (“The Savings and Loan Crisis and Its Relationship to Banking” 179).

³⁷ The spread is the difference between the interest that a lending institution collects from the money it loans out and the interest it pays its depositors.

These new savings and loan operators were a far cry from the George Baileys of the thrift industry of yesteryear. Just as the deregulatory legislation of 1980 and 1982 had sidetracked savings and loan institutions from their founding purpose of providing affordable home loans in local communities, many of these entrepreneurs seemed far less interested in acting as noble stewards of the culture of homeownership than they did in “free-wheeling” with the institutions’ funds and personally profiting from financial gambles. One of the most disastrous of these gambles was real estate lending and speculation.

Part of the reason for the industry transition away from traditional home mortgage lending was the belief (and likely a justified belief, at that) that given the financial difficulties of the industry during previous decades, there was simply no profitable business to be done in single-family mortgage lending. The manager of Beverly Hills Savings & Loan (an institution which would eventually fail primarily because of poor real estate investments), Dennis Fitzpatrick, stated: “We could not survive if we continued to do business in the traditional fashion” (qtd. in Lowy 62). Thus, many savings and loans, most notably those in the West and Southwest, decided to transition from single-family mortgage lending to construction lending for commercial real estate properties. What many savings and loan operators failed to realize, however, was that construction loans for properties such as condominiums, office buildings, shopping centers, and hotels were entirely different in nature and expertise than the industry’s traditional specialty (Lowy 64). However, in the mid 1980s, construction lending gave the false impression of being the salvation from insolvency and obsolescence that the industry had been waiting for. There was a construction boom fueled by a recovered economy enjoying a bull market and tax provisions that favored real estate speculation enacted in 1981 (Lowy 72). Commercial mortgage loans, which only a

few years before had been a largely forbidden lending activity for savings and loans, represented 6.4 percent of the industry's total assets by the end of 1982 and 9.2 percent by 1985 (Appendix G)(White, The S&L Debacle 102).

Unsurprisingly, the lack of experience in real estate and desire for quick profit which characterized the management of many savings and loan institutions lead some operators to embroil their S&L s in real estate lending and investment that was highly risky and many times just plain bad business. Too often, S&L s made poor business decisions without understanding all of the intricacies of the real estate market. A prime example of this type of “bad business” was the acquisition, development, and construction, or ADC loan. ADC loans were made to a real estate developer by an S&L to purchase a plot of land, develop it (which included grading the land and constructing roads and sewers), and construct buildings. After 1982, these types of loans were commonly made by S&L s in Texas and California with no cash down payment required and a *100 percent* loan-to-value ratio. Other costs and fees related to construction (which were usually paid by the developer) were also “rolled into” the loan, as was an “interest reserve:” loan interest payments for two years or more were included in the loan itself. Along with these terms, which required zero money down from the developer, were the risks inherent in any ADC loan, considered one of the riskiest investments a financial institution could make. There were construction risks (represented by everything from weather conditions to engineering glitches), market risks (if real estate prices were to fall), as well as the risk of fraud if the integrity of the developer (the borrower) was misjudged (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 39). These loans, originated by savings and loan institutions without any commercial real estate lending experience prior to 1980, represented a direct

investment which would be risky even for a lending institution with years of experience lending to real estate developers. If the development of the condominium, hotel, or mall succeeded the S&L would earn a share of the profits. If the project failed, the S&L would absorb the entire loss (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 39).

Added to this risk were the sobering facts of the financial playing field already in place in the 1980s, which put thrifts at an automatic competitive disadvantage. Commercial banks already had relationships with the most reputable and reliable real estate developers, leaving thrifts to skim for potential borrowers among the worst possible loan candidates—developers who would pay the high interest and fees charged by an S&L ADC loan because no one else would lend to them (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 40). A New York mortgage broker expressed amazement to the *Wall Street Journal* in 1985 over his meeting with Beverly Hills Savings and Loan's executives concerning their New York-area loans: "It was amazing to me...They were doing high risk deals in parts of Manhattan where no local lenders would go. They got into deals where there was no hope of coming out. I told them they were making a terrible mistake" (qtd. in Guenther and Zweig 1). Making matters worse, these loans were often poorly underwritten and the projects they funded not sufficiently examined by the S&L institution lending the (federally-insured) funds (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 41). By 1985, the *Los Angeles Times* had already identified ADC loans as "the most troublesome" of the thrift industry's real estate activities, calling them "ill-conceived and sloppily put together" (Furlong C2). Originating these highly risky ADC loans for ill-reputed developers wasn't just a gamble—it was institutional masochism.

So why would any S&L operator in his right financial mind allow his institution to originate this kind of loan? By tricks of accounting, these types of commercial real estate projects funded by ADC loans appeared like unprecedented income on paper, resulting in huge salaries and bonuses for the thrift management and juicy dividends for managers and stockholders (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 41). Sunrise Savings and Loan Association of Florida, for example, used ADC loans as a mainstay of their investment activities. Sunrise was started after deregulation and grew to \$1.7 billion in assets in less than five years (Brannigan 15). The pursuit of thrift income in this manner, however, was incredibly short sighted in relation to the financial health of the institution and to real estate market conditions. The real estate development projects were pursued by S&L s in the early 1980s under the assumption of a continuing rise in real estate values, meaning that even if prices simply leveled off the viability of the project would suffer along with the S&L's balance sheet (White, The S&L Debacle 110). During the flurry of construction lending that occurred between 1982 and 1985, the amount of outstanding construction loans originated by the savings and loan industry rose from \$29 billion to \$102 billion (Lowy 73).

However, the poor decision to focus on ADC lending came back quickly to bite the thrift industry. A majority of the \$102 billion was never paid back, and the losses were fully absorbed by the thrifts that had made the masochistic loans (Lowy 73). Sunrise Savings & Loan, an institution which owed its lighting-quick growth to real estate development, was already in financial trouble by April of 1985 and was investigated by regulators for its "lax lending practices" and accounting treatment of its ADC portfolio (Brannigan 15). Why were ADC s such an epic failure? By the time thrifts started originating these loans, there was

already a glut in the Southwestern commercial real estate market and high vacancy rates as a result of economic contraction and over-building (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 41). This contraction in the Southwest was largely caused by a downward drift in crude oil prices beginning in 1981 and a sharp fall in prices in 1986. S&L s' real estate development projects had been pursued under the assumption that crude oil prices would climb higher and higher, enriching those in the oil business and fueling demand for office buildings, hotels and other developments (White, "The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century" 22). And recall that because of direct financing, if anything went wrong with the project (like the realization that nobody was going to rent the property after it was built), the borrower could simply walk away and allow the S&L to foreclose and suffer the losses, and many did just that (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 41). So, the results of the ADC-fueled S&L commercial building boom were empty office buildings, condominiums, and other properties which dotted the Southwestern landscape like monuments to poor lending decisions and lost S&L funds. These abandoned properties were known as "see throughs"—since the buildings didn't have any tenants, you could look in one window and see directly out the other side (Guenther and Zweig 1). Turns out the properties were as empty as thrift industry business acumen.

Along with the fall in crude oil prices, savings and loans' real estate boondoggles were also botched by a surprising antagonist—the federal government. The Tax Reform Act of 1986 reversed many of the tax provisions that had attracted newly deregulated thrifts to real estate ventures (Cebula 623). While the reforms lowered overall tax rates, they eliminated tax loopholes and other advantaged positions such as shorter depreciation periods

and the ability to deduct losses on “passive investments” which had increased the relative profitability of real estate investment. Some of these new provisions were applied to real estate projects already underway as well as future projects, which was a death sentence for S&L-funded projects undertaken with the intent of exploiting these loopholes. Real estate values fell, and savings and loans directly invested in real estate development projects suffered (White, The S&L Debacle 109).

Besides real estate development, there were a variety of other new loan and investment categories with which deregulated savings and loans could gamble with federally-insured funds. One notable example is thrift investment in “junk bonds,” or debt securities that a ratings agency (such as Standard & Poor’s) has given a low rating. For whatever reason, a junk bond has a higher risk of default than a government issued bond and therefore pays out a higher interest rate to its investors (to compensate them for taking this risk) (Lowy 155). These junk bonds gained enormous popularity in the 1980s under the stewardship of banker Michael Milken at investment house Drexel Burnham Lambert, and while only six S&L s invested over ten percent of their assets in junk bonds, four of these thrifts, Lincoln, CenTrust, Imperial, and Columbia, were included in the most expensive failures to the federal government after the crisis came to a head (Lowy 155). For Columbia Savings and Loan Association of Beverly Hills, sales of junk bonds contributed to 18 percent of profits in 1985. The thrift boasted assets of \$6.1 billion at the time, six times the amount of its assets in 1982. For his part, the chief executive officer of Columbia, Thomas Spiegel, predicted in an interview with the *New York Times*: “I doubt you will see any failures...due to corporate loans [another term for junk bonds]” (Hayes D2).

Similar to how S&L operators had seen potential for huge profits in ADC lending, some used their new regulatory freedom to invest in junk bonds despite the inherent risk of this investment (risks that most commercial banks were unwilling to take) (Lowy 158). And again, much of the reason that the S&L s invested in junk bonds related to a lack of expertise in the field: most operators were unequipped to evaluate the detailed information that described the specifics of the bond. Many also made the mistake of trusting junk bond salesmen who packaged the product attractively and also employed large expense accounts to wine and dine thrift operators (Lowy 158). One of these thrifts, Lincoln Savings and Loan of California, leant a whole new meaning to the traditional thrift mission of “serving the community” with its junk bond activities. Between 1987 and 1988 alone, Lincoln Savings and Loan sold \$230 million worth of junk bonds to 23,000 investors, many of them elderly and under the false impression that the bonds, sold by a federally-insured institution, were backed by the federal government. One description of this practice calls into question whether this particular savings and loan was taking advantage of the trust of depositors who remembered the thrift in its previous life as a stable, secure lending institution of the community:

““When a customer came in to renew a large certificate of deposit, he would be told he could earn more by investing in American Continental Corp.’s junk bonds. When he asked if his money would be safe, he was told that American Continental Corp. was as strong as its subsidiary Lincoln Savings, which was a federally insured institution. The subtleties of that reply were lost on many of the investors”” (qtd. in Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 27).

After American Continental Corporation, a real estate company which owned Lincoln Savings and Loan, went bankrupt; these 23,000 trusting S&L patrons lost the entirety of their investments (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 27). Not only had thrifts shifted their focus away from their founding purpose of providing home mortgages, but their poor investment decisions and questionable offerings were now hurting the communities they were founded to serve.

After deregulation thrifts also became more heavily embroiled in the secondary mortgage market. A bastion of the culture of homeownership that was born with Fannie Mae in the 1930s, the relevance of the secondary mortgage market grew with Freddie Mac and Ginnie Mae's popularization of the mortgage backed security in the late 1960s and early 1970s. If the secondary market for mortgages and the use of mortgage backed securities (MBS s) was problematic in theory from the 1930s to 1980 (because of the notion of artificially "propping up" the mortgage market by purchasing, pooling, and reselling mortgages),³⁸ the thrift industry's participation in this market for the pursuit of income and profit proved problematic on a much more tangible level. The potential for financial complication caused by the secondary mortgage market would finally rear its ugly head.

Wall Street investment banks spent much of the 1980s devising ways to cater secondary mortgage market products to deregulated savings and loans. Many even opened new departments of mortgage finance for this purpose (Lowy 165). Firms had identified savings and loans soon after their deregulation as a prime target for their secondary mortgage market operations. S&L s had millions of mortgages on their books that they were willing to sell in order to raise capital (remember, in the early 1980s the industry was still suffering

³⁸ See Chapters 1 and 2 for additional discussion of Fannie Mae, Ginnie Mae and Freddie Mac's roles in creating and maintaining the secondary mortgage market.

financially after years of high interest rates), and were also eager to use their new deregulatory freedom to purchase vast amounts of MBS s and other secondary mortgage market products (Lowy 165). Bankers wooed S&L managers using “slick presentations with graphs, charts, and tables and the trappings of the great Wall Street firms,” prompting many to purchase all kinds of securities with S&L funds, enact complex hedging schemes to manage their assets and liabilities, and generally “complicate” the business of running a savings and loan institution (Lowy 165-166). Understanding the workings of a thrift institution had likely been confusing already for the dentist-turned-S&L manager set. But in the mid 1980s, these S&L operators chose to involve their institutions in the intricate workings of the secondary mortgage market, the complexities of which many couldn’t even begin to understand. And just as other attempts at new types of lending and investment activities had failed to pay off for deregulated savings and loans, these new products furnished by Wall Street firms proved much more damaging to thrifts’ finances than profitable. The primary reason for substantial losses from these products was that some, like collateralized mortgage obligations (CMO s),³⁹ didn’t pay reliable enough dividends to justify the millions of dollars S&L s spent to purchase them (Lowy 167-268).

Another core problem was that selling S&L-held mortgages to the secondary market was driving mortgage interest rates down. When the practice of jettisoning old, low-interest paying mortgages into the secondary market began, even the *New York Times* championed the practice as a way for the thrift industry to “stave off bankruptcy” (Berg 14). The head of mortgage-related activities at Drexel Burnham Lambert (a key player in secondary mortgage

³⁹ A collateralized mortgage obligation (CMO) is similar to a mortgage backed security (MBS) in that a pool of mortgages exists at its core. However, interests in this pool of mortgages are sold to investors (and they are paid dividends) in “short,” “medium,” and “long” series. The “long interest” is paid last, and if cash flow is slower than expected, this investor might not get paid at all. This was the circumstance that many S&L s which had invested in CMO s faced (Lowy 168).

market finance) legitimized the practice as a necessity, saying: ““For some, selling off mortgages was an absolute imperative”” (qtd. in Berg 14). However trouble soon brewed as competition in the secondary mortgage market between the thrift industry, Wall Street, and the GSE s (Fannie Mae, Ginnie Mae, and Freddie Mac)⁴⁰ caused mortgage interest rates to fall as each undercut the other (Lowy 166). At the same time, the lifting of Regulation Q had driven deposit interest rates up. So, the S&L s were financially squeezed again because of the same old problem they had battled for decades: a spread that was sharply reduced due to paying too much interest to depositors and not raking in enough interest from mortgage loans (Lowy 166). According to an economist at the Office of Management and Budget in 1991, MBS s offered by the government mortgage agencies also had a competitive edge over those offered by savings and loans:

“...this alternative system of mortgage backed securities guaranteed either by government agencies or government-sponsored enterprises proved more efficient at collecting funds and managing risks for investors than the traditional savings and loan model. Thus, the profits of the average thrift were squeezed almost to the vanishing point” (Redburn 437).

Deregulation, meant to save the thrift industry by allowing it to diversify and compete in the free market, hadn't fixed savings and loans' fundamental problems at all—it just altered the economic reasons why interest rates rose and fell. If the historical irony of this quagmire wasn't enough, the federal mortgage agencies (bastions of the culture of homeownership) were dashing the efforts of the thrift industry (the chosen lending institution of the culture of

⁴⁰ The government agencies had an advantage over private entities in the secondary mortgage market because of their low operating costs and government backing.

homeownership) to earn income in the secondary mortgage market. It was as if the homeownership culture was tearing itself apart.

ADC loans, real estate development, direct investment, junk bonds, and secondary mortgage market activities are exemplary of the new types of loans and investments that the savings and loan industry engaged in after deregulation was completed by the Garn-St. Germain Act in 1982. The “emancipation” of S&L’s financial activities, as Reagan had called the deregulation, resulted in immediate and rapid growth of the industry between 1983 and 1984 (18.6 percent annual asset growth and 19.9 percent annual asset growth, respectively). These double-digit growth rates were more than twice what they had been in previous years, and thrifts in certain “sunbelt” states such as Texas (where much of the real estate development activity was concentrated), boasted growth rates of up to 38 percent (Appendix H) (White, The S&L Debacle 100). However, rapid expansion in the early 1980s didn’t mean salvation from insolvency or preservation of the model institution of mortgage finance. Besides the fact that such rapid growth in any industry is often indicative of mismanagement and organizational problems (it’s simply not “natural,” economically speaking), a majority of the growth that occurred in the 1980s can be attributed to these new categories of loans and investments, not home mortgages (White, The S&L Debacle 102). The truth was, after 1982 many thrifts made the conscious decision to shift their emphasis away from affordable mortgage lending and towards risky investments like ADC s and CMO s (Glasberg and Skidmore 77). The investment portfolio of the typical savings and loan institution in the 1980s would have been unrecognizable to the George Bailey-esque S&L operator of only a few decades prior. By 1986, four years after deregulation, only *56 percent* of total S&L assets nationwide were in mortgage loans (mortgage loans had represented 78

percent of assets in 1981, and even higher percentages in previous years) (Appendix I) (“The Savings and Loan Crisis and Its Relationship to Banking” 179). The federal government’s model institution of mortgage finance, its community thrift resurrected from the throes of the Great Depression to provide John and Jane American with an affordable mortgage, the industry that it had regulated with an iron fist and then aggressively deregulated to preserve—was now primarily concerned with casinos, fast food franchises, ski resorts, windmill farms, malls, condominiums, junk bonds, and mortgage backed securities (“The Savings and Loan Crisis and Its Relationship to Banking” 180). Clearly, the deregulatory actions taken by the federal government to preserve the savings and loan industry as the culture of homeownership’s model lending institution had inadvertently distracted it from that very mission. But new types of loans and investments weren’t the only government allowance that drove the thrift industry into the ground. FSLIC insurance also played a vital role.

Federal Savings and Loan Insurance Corporation (FSLIC) Deposit Insurance

In 1980, the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) raised the Federal Savings and Loan Insurance Corporation (FSLIC) deposit insurance ceiling from \$40,000 to \$100,000.⁴¹ This meant that the federal government had increased their liability to thrift depositors while simultaneously freeing the industry to employ its federally-insured deposits in risky loans and investments. The problem with this federal guarantee, meant to ensure depositors that their funds were safe within a savings and loan institution, was that it was a dangerous catalyst for moral hazard.

The FSLIC insurance ceiling per account was \$5,000 until 1949 and then increased incrementally throughout the years until 1980 when it jumped to \$100,000 (Cebula 621). To

⁴¹ See Chapter 3 for additional information on the DIDMCA legislation.

understand how the risk for moral hazard was inherent in this provision of the DIDMCA legislation, recall that in 1980 hundreds of thrifts around the country were teetering on the verge of insolvency due to their asset/liability mismatch and an outflow of deposits. Because of the safety net of extensive FSLIC insurance, thrifts desperate for profits were encouraged to take greater risks with their funds (think direct investment, CMOs, and other dicey investments) in the hope of a greater rate of return. After all, if a gamble didn't pay off (i.e. if the developer walked out on a condominium project directly financed by an S&L or if a CMO paid zero dividends), the individual savings and loan institution wasn't liable for depositor losses—the FSLIC was (Cebula 621). One economist described this phenomenon as the thrifts “gambling for financial resurrection using the FSLIC's money and little if any of their own” (Cebula 621). It was as if you had walked into a casino in 1980 which represented the world of finance and real estate ventures. You're then handed a chunk of cash by a man in an FSLIC sweatshirt surrounded by a faceless crowd. He says: “Take this and try to win as much money as you can. It's theirs [pointing to the crowd], but if you lose it all, don't worry, I'll pay them back. Oh, and whatever profit you make is yours to keep.” The offer was simply too good for many desperate savings and loan institutions to pass up in the early 1980s. They chose the riskiest financial gambles that would pay the highest dividends if they were successful. Unfortunately, most of them weren't.

In addition to the incentive for a savings and loan to “go for broke” under the assumption that the FSLIC absorbed the risk that its activities posed to depositors (Glasberg and Skidmore 77), deposit insurance also removed any incentive that depositors had to monitor the institution that was frittering away their money by financing poorly planned real estate development deals and by purchasing worthless securities (Redburn 439). After all,

depositors' money was backed by the federal government, and this guarantee provided a security net that made the high interest rates offered by deregulated savings and loans irresistible. If the FSLIC insurance guarantee hadn't existed (or if only a portion of the accounts were insured), depositors would likely have "voted with their dollars" against risky financial gambles by removing their funds if they expected that a thrift was poorly managed or would soon lose money (Redburn 439). In this manner, the depositors themselves would have acted as regulators of the thrift industry.

However, regulation of any sort was out of vogue in the 1980s. There would be hardly any regulation for savings and loans, only a safety net of FSLIC insurance that allowed them to gamble with their depositors' funds without taking on hardly any of the risk. Empirical studies conducted on the industry's health in the 1980s have found that savings and loan failures were an increasing function of the federal deposit insurance ceiling per account (Redburn 625). The higher the FSLIC deposit insurance ceiling, the more financial risks thrifts took. The more risks they took, the more federally-insured deposits they lost and the further many sank into insolvency as the decade ambled onward. The "special treatment" afforded to the savings and loan industry by its friends in Congress, who slipped the FSLIC deposit insurance provision into DIDMCA at the eleventh hour, provided the incentive for moral hazard that contributed to the failure of many thrifts.

Fraud

At some thrift institutions, excessive risk taking and poor business decisions were not the only factors dragging the S&L into solvency. Others were damaged financially by fraud and criminal wrongdoing by their operators and those whom they did business with. A good portion of the secondary literature that examines the savings and loan crisis and much of the

media coverage at the time focused on this criminal activity, creating media “villains” out of such S&L operators as Charles Keating of Lincoln Savings and Loan in California. The fraud committed in the historical context of the crisis, however, has more to do with the foolishness of the federal government for slashing FHLBB regulatory staff and less about the administration of the culture of homeownership. The impact of the fraud on the financial health of thrift institutions and its role in their downfall is also debated, with some estimates placing the percentage of losses due to criminal wrongdoing as low as ten percent (Calavita et al. “The Savings and Loan Debacle, Financial Crime, and the State” 20). These abuses included the deliberately poor underwriting of loans (which could allow a risky construction project to go forward), loans to inappropriate individuals such as the managers themselves, their relatives, and other businesses which they owned, and loans which exceeded maximum allowed amounts. Some thrifts also deliberately overvalued properties to justify larger loans or to artificially inflate their assets to meet net worth requirements. There was also excessive spending of S&L funds which went far beyond normal business expenses: fancy new corporate headquarters, inflated executive salaries, lavish parties, and the wining and dining of clients (White, The S&L Debacle 115-117).

There were various other creative ways in which certain thrift operators managed to “rip off” their own institutions, and it’s not very surprising that some fraud did occur given the Reagan-ordered staff and budgetary cut-backs for the thrift industry’s regulatory agencies and the influx of new S&L operators in the early 1980s, many of whom were intent on taking advantage of the newly deregulated and under-scrutinized industry. These circumstances were so facilitative to fraud and criminal activity on the part of thrift owners that a House Committee on Government Operations, assigned the task of examining thrift fraud in the

1980s, concluded: “The best way to rob a bank is to own one” (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis title page).

Despite the sordid and compelling history of savings and loan insider fraud in the 1980s, criminal activity was not a primary cause of the crisis. As economist Lawrence White observed:

“The bulk of the insolvent thrifts’ problems, however, did not stem from such fraudulent or criminal activities. These thrifts largely failed because of an amalgam of deliberately high-risk strategies, poor business judgments, foolish strategies, excessive optimism, and sloppy and careless underwriting, compounded by deteriorating real estate markets” (White, The S&L Debacle 117).

Fraud was not the anchor that dragged down the savings and loan industry in the late 1980s. The industry sank into insolvency, eventually costing the federal government billions of dollars, because efforts to preserve a “model lending institution” for the culture of homeownership had doomed the industry from the start. First, from the 1930s to 1980 the federal government restricted the industry to its ordained purpose of providing affordable home mortgages. Then in 1980, after years of struggling to survive in a changing economic climate, the federal government pulled the blanket of regulation out from underneath thrifts, allowing them to careen towards a black hole of poor investments and bad business. The federal government had handed its model lending institution a shovel and stood by in the 1980s as it dug its own grave.

1986-1989: Thrifts Fail and the Federal Government (Eventually) Cleans Up the Mess

-or-

What is the Price Tag on the Culture of Homeownership?

From 1983 to 1985, the two years immediately following the DIDMCA and Garn-St. Germain deregulatory legislation, many thrifts nationwide took excessive risks with their federally-insured funds, made poor business decisions, and sometimes even engaged in outright fraud. The inevitable conclusion of this two-year “free-for-all,” especially as real estate values fell precipitously and other investments failed to deliver the profits that slick Wall Street pitches had promised, was widespread bankruptcy and failure of savings and loan institutions. Between 1986 and 1988, almost 10 percent of the nation’s savings and loan institutions were disposed of by the FSLIC for reasons of insolvency, a percentage representing hundreds of thrifts nationwide (Appendix J) (White, The S&L Debacle 108). While the number of insolvent thrifts disposed of by the FSLIC jumped in 1988 (up approximately 5.5 percent from the year before), this does not mean that more thrifts were failing in 1988, or even in 1986 when the wave of failures appears to have begun. There was a significant lag in the closure of failing thrift institutions, some of which had been insolvent or teetering on the verge of insolvency since they had embarked on their deregulated investment activities in 1983. Some of this lag can be contributed to poorly-chosen accounting standards which were slow to recognize changes in the value of thrifts’ assets (or deliberate numbers “fudging” by thrift owners to give the appearance of solvency) (White, The S&L Debacle 112). However, much of the blame for this delay in the closing of insolvent thrifts, which resulted in a significantly increased cost to the federal government when the mess was finally resolved, lies with the political culture of homeownership.

Because of their special status as mortgage lenders, the federal government allowed thrifts to flounder on throughout the eighties despite the fact that many of these institutions had lost sight of their original purpose. Congress deliberately shielded many of these institutions from closure and dragged its feet when it came time to stem the tide of thrift failures and close those which were already insolvent. The longer that Congress impeded the efforts of those who recognized the severity of the crisis and allowed financially unhealthy thrifts to continue their operations, the more money these institutions lost. And ironically, since much of this squandered money belonged to thrift depositors, the federal government (as the steward of the FSLIC) was liable to repay it, all *billions* of dollars worth. In 1988, the resolution of the savings and loan crisis would finally force the federal government to pay the price of administering the culture of homeownership at the expense of financial reality and reason. And it was going to be steep.

The thwarted efforts of Edwin Gray, the chair of the Federal Home Loan Bank Board from March of 1983 to 1987, to contain and resolve the crisis illustrates the political power of the culture of homeownership in the context of the savings and loan crisis. Some time in the mid-1980s, Gray was said to have had an epiphany concerning the mounting severity of the crisis after watching a homemade videotape that displayed miles of abandoned condominiums which had been directly financed with the insured deposits of Empire Savings and Loan in Dallas, Texas. Gray and his staff at the FHLBB urgently set about attempting to regulate and contain thrifts that were running rampant with FSLIC-insured deposits, but encountered nothing but resistance from thrift industry lobbyists, the White House, and Congress (Calavita et al. "The Savings and Loan Debacle, Financial Crime, and the State" 34).

Even Speaker of the House Jim Wright called Gray repeatedly on behalf of Texas thrifts who contributed to his campaign fund, imploring the FHLBB chief regulator to halt his attempts at “aggressive” thrift regulation (apparently to Wright, thwarting corrupt real estate development deals that wasted FSLIC-insured funds was too “aggressive” a measure) (Calavita et al. “The Savings and Loan Debacle, Financial Crime, and the State” 33). In a statement filled with irony given the precarious financial situation of risk-taking thrifts, Wright told Gray: ““This kind of high-handed and arbitrary attitude [on the part of regulators] can only create fear, mistrust, and a climate of great instability”” (qtd. in Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 104).

The relationship between Wright and Gray appears to have been particularly tempestuous, especially concerning the head of regulatory affairs at the Federal Home Loan Bank of Dallas, Joe Selby. In 1988, when Wright was under investigation by the House Ethics Committee for his active role in shielding Texas S&L s from closure and punishment, Ed Gray told the *Wall Street Journal* that Wright had harassed him repeatedly to fire Selby: “He said, ‘They (Texas savings and loan operators) were calling you and this Mr. Joe Selby the Gestapo... Isn’t there anything you can do to get rid of Selby?’” (qtd. in Jackson and Yang 38). The fact that Texas thrifts were protesting reasonable levels of scrutiny by the FHLBB was a stark display of how entitled the industry felt to regulatory freedom by 1986: when Selby had arrived in Texas, some thrifts hadn’t been examined in as long as three years (Jackson and Yang 38). When Gray refused to balk to Wright’s demands, the House Speaker’s accusations against Selby turned increasingly vindictive. In another phone call to Gray, Jim Wright unleashed a ridiculous diatribe concerning the Dallas regulator. Gray told the *New York Times* in 1989:

“He said that he understood that Selby was a homosexual. And he understood from people that he believed...Selby had established a ring of homosexual lawyers, and in order for people to deal with the [bank board personnel] they would have to deal with this ring...He said to me, ‘Isn’t there anything you can do to get rid of Selby?’”

(Lewis A27).

These deplorable words, from a senior ranking member of Congress, typify the intensity with which some politicians were prepared to protect the ability of savings and loans to “free-wheel” with federally-insured deposits. They also characterize the barrage of harassment that regulatory staff, including Gray and Selby, faced for simply doing their jobs in the deregulated 1980s.

Ed Gray’s knock-down, drag-out fight against the thrift industry and its supporters in Washington was likely not expected. A former thrift executive and close friend of Ronald Reagan, Gray had been recommended by the powerful U.S. League of Savings and Loans as its choice to lead the FHLBB (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 94-95). However, when the stark economic reality of the thrift industry’s deregulated free-for-all became too tangible for Gray to ignore (as it should have been for every regulator and government official); his efforts to contain the crisis by enacting sensible (and reasonable) regulatory measures rendered him a pariah in the political culture of homeownership. Treasury Secretary Don Regan mockingly labeled him “the Great Reregulator” and had his former company, Merrill Lynch, submit reports to the press that purposely smeared Gray’s professional reputation (Calavita et al. Big Money Crime: Fraud and Politics in the Savings and Loan Crisis 95). Although Gray held strong to his mission (one investigative reporter described him as a prize fighter who took repeated blows but

“never fell to canvas” (qtd. in Calavita et al. “The Savings and Loan Debacle, Financial Crime, and the State” 34)), he was no match for the combined forces of Washington, which favored special treatment for the industry as an institution of mortgage finance (and a generous contributor of campaign funds). He was replaced as FHLBB chair in 1987 by a more “agreeable” director, many of his re-regulatory efforts unrealized. Selby, too, left the FHLBB in 1988, explaining to the *Dallas Morning News* with probable sarcasm: “I had a sense that perhaps I was not wanted” (qtd. in Jackson and Yang 38). The head of the FHLBB and his staff road-blocked, strong-armed, and publicly smeared, thrifts had almost total freedom to fritter away FSLIC-insured funds.

In addition to obstructing the efforts of regulators like Ed Gray and Joe Selby, Congress also dragged its feet when it came time to pass legislation to resolve the crisis of hundreds of insolvent thrifts which continued to hemorrhage FSLIC-insured deposits. By early 1985, the FHLBB realized that closing the growing number of insolvent thrifts would soon overwhelm the ability of the FSLIC to pay back depositors. The FSLIC was a self-sustaining institution, and its reserves were composed of small interest premiums paid by the individual lending institutions. In that year, 71 insolvent thrifts needed to be closed on the basis of the most forgiving accounting standards (there were additional thrifts which stricter standards would have determined insolvent). Closing these thrifts and paying their depositors would have cost the FSLIC \$15 billion.⁴² In 1985, the FSLIC held reserves of only \$5.6 billion (White, The S&L Debacle 135-136). As the number of insolvent thrifts grew, this already severe problem promised to only grow worse (Appendix K). In late 1985 the FHLBB requested that the FSLIC be permitted to borrow billions of dollars from the U.S.

⁴² The FSLIC also had the option of placing insolvent thrifts with an “acquirer” who would recapitalize the institution and take on the responsibility of the depositors. Between 1986 and 1988 close to 250 thrifts were placed with acquirers (Appendix K) (White, The S&L Debacle 150).

Treasury in the form of thirty-year bonds that the insurance fund would pay back over time (White, The S&L Debacle 137). With these funds, the FSLIC could address the pressing problem of closing insolvent thrifts before their losses mounted.

The legislation to enact this plan was presented to Congress in April of 1986 and shockingly was not treated with any sense of urgency or timeliness. Some politicians felt the issue was not a “crisis” or simply didn’t understand the problem, others were reluctant to lend money to the FSLIC because it was supposed to be a self-sustaining institution funded by insurance premiums (even though this was clearly an exceptional circumstance), and others probably had dinner plans with the U.S. League after the day’s sessions were over (White, The S&L Debacle 138). Jim Wright, loyal friend of the Texas thrift industry, placed a hold on further progress of the bill for months, according to the FHLBB (Lewis A27). When the legislation was finally considered; it was bogged down by disagreement between the House and Senate. Congress adjourned in October of 1986 without passing any legislation to provide additional funds to the FSLIC, and by the end of the year thrift insolvencies had reached 255, representing \$68.2 billion in lost assets. The General Accounting Office (the Congressional auditing agency) declared the Federal Savings and Loan Insurance Corporation insolvent by the end of the year (White, The S&L Debacle 139).

In the summer of 1987, Congress finally passed legislation that addressed the issue of thrift insolvencies: the Competitive Equality Banking Act. The legislation only authorized the FSLIC to borrow \$10.825 billion with a limit of only \$3.75 billion to be borrowed in any 12-month period, along with a “forbearance” provision that forbade the FHLBB from closing near-insolvent thrifts with miniscule net worth ratios (White, The S&L Debacle 139-140). Considering that the FSLIC needed to close 255 thrifts worth \$68.2 billion by the end of

1986, this legislation wasn't just a joke. It was a slap in the face to anyone who had a stake in federal deposit insurance. By this time, the price tag for closing insolvent thrifts had grown so enormous that the federal government was no longer the only stakeholder. By extension, the American taxpayer would have to pay part of the bill. By 1987, the favored relationship between the thrift industry and Congress had grown completely irrational and painfully expensive.

By 1988 hundreds more thrifts, their investments failing, had sunk into insolvency (or had finally been revealed to be insolvent) and required disposal by the FSLIC. When the Bush administration took office in January of 1989, the multi-billion dollar problem of insolvent thrifts and a bankrupt FSLIC was finally too pressing to ignore. The administration reached the painful conclusion that the problem had grown too expensive to solve without taxpayer funds (White, "The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century" 24). The resulting legislation, The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), dramatically and fundamentally altered the regulation and operations of the thrift industry for the second time in a decade. First, the FHLBB (and by extension, the FSLIC) were abolished. Their functions were replaced by the Federal Deposit Insurance Corporation (FDIC) (which absorbed the FSLIC's deposit insurance function), the newly created Office of Thrift Supervision (OTS) to regulate the industry, and the Resolution Trust Corporation (RTC), which was created to dispose of the hundreds of insolvent thrifts (White, "The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century." 24). FIRREA granted the Resolution Trust Corporation \$40 billion to close insolvent institutions and repay federally-insured depositors (Brumbaugh and Galley 96). In a shrewd reversal of the deregulatory legislation of the early 1980s (and in

unofficial recognition that reckless deregulation had been a grave policy mistake for the industry), FIRREA heavily restricted nonresidential and commercial real estate lending (which had financed all of those empty condominiums and office buildings) and required thrifts to hold at least 70 percent of their assets in home mortgages and similar housing-related loans (Brumbaugh and Galley 96). Thrifts were also forbidden to hold junk bonds, and capital requirements were raised to levels commensurate with commercial banks (to provide thrifts with a thicker financial “cushion”). In an additional measure, the remaining healthy savings and loans were directly taxed with higher deposit insurance premiums and indirectly taxed through the Federal Home Loan Banks to assist in covering the costs of the cleanup (White, “The Savings and Loan Debacle: A Perspective From the Early Twenty-First Century” 24).

This final measure, which essentially “punished” solvent thrifts for the sins of the toxic portion of the industry, indicates that the honeymoon between the federal government and its “model lending institution” had come to a bitter end in 1989. Much of Congress and the White House resented what they believed to be a “bailout” of the thrift industry (White, The S&L Debacle 163)—having to write a “blank check” to cover the losses of its poor business decisions and bad investments (Glasberg and Skidmore 80). Therefore, they levied “harsh” legislation and punishment on the entire industry. But not every member of Congress felt the entire industry deserved punishment. Chairman of the House Banking Subcommittee on Financial Institutions, Frank Annunzio, stated in a proposed amendment to FIRREA:

“This is very similar to those World War II movies where the German Gestapo commander enters a small French town and announces that 400 men will be shot

because a German truck was blown up the night before... That is the current approach under the legislation” (Nash D5).

Apparently to Congressman Annunzio, even as the industry was poised to cost taxpayers billions of dollars for its follies, its regulators could still be equated to the Nazi secret police (recall that House Speaker Wright was also fond of calling S&L regulators “The Gestapo”). Despite this articulate objection, the legislation moved forward in Congress. The result was a deep rift and resentment within an industry that only months before had been a united political powerhouse with the ability to “derail legislation or change it in its favor” (Nash D1). Now healthy thrifts, resentful of higher insurance premiums and interest costs, urged Congress to “bear down hard on the industry and weed out the weak” (Nash D1). Clearly, FIRREA not only provided the funds to close insolvent thrifts. It also broke the back of the politically united, powerful thrift industry of the 1980s.

Despite resentment from Congress and portions of the industry, resolving the thrift crisis was not a “bailout”—the government bore responsibility for repaying thrift depositors because thrifts were federally insured since the 1930s. Political pouting over the need to “bail out” savings and loans was also in blatant denial of the fact that the government had essentially facilitated the crisis through reckless deregulation. FDIC Chairman William Seidman made clear that the government’s hands were tied to resolving the crisis:

“Whatever the loss is, and unless the Government wants to raise questions about its guarantee to depositors, which I am sure they don’t and no one does, then they are going to have to pay the bill, whatever it is and whatever interest rates are” (qtd. in Glasberg and Skidmore 80).

Incredibly, when it appealed to Congress during the FIRREA hearings for federal and taxpayer funds, the savings and loan industry had the audacity to evoke the now-tainted culture of homeownership as reasoning that it should be saved from extinction. S&L s:

“portrayed themselves as the champions of the working class, providing them with the means to attain the American dream through low-cost mortgages. The thrifts maintained that because of their unique role in the industry, Congress had no choice but to bail them out” (Glasberg and Skidmore 80).

The president of the Kentucky Savings and Loan Institutions told Congress:

“The bottom line question...is whether you cripple the savings and loans in Kentucky so much that they cannot perform their historic housing finance function for our citizens. That would be a terrible loss to our communities” (qtd. in Glasberg and Skidmore 80).

Given that the industry as a whole had suffered prior to 1980 because of an outflow of depositors who no longer desired its services and that it had purposely shifted away from mortgage lending in the deregulated 1980s, this reasoning was far from historically sound. Congress granted the industry funds, but for once, this legislative assistance was not special treatment meant to coddle the model lending institution. It was the obligation of a government whose hands were tied to FSLIC-insured deposits.

What was the price tag of the FIRREA legislation’s resolution of the savings and loan crisis? Some sources estimate the cost to American taxpayers at as much as \$500 billion over 30 years (Calavita et al. “The Savings and Loan Debacle, Financial Crime, and the State” 19). In 1991, the Congressional Budget Office estimated the cost of the crisis at \$215 billion, but this figure only included the direct monetary cost to the government of paying

back insured depositors (Manchester and McKibbin 579). While the exact cost to the American tax payer is difficult to determine, suffice it to say that each American in the 1990s and beyond did pay the price for the follies of the savings and loan industry in the 1980s, behavior that had been facilitated by the federal government.

“Over-regulation” and “under-regulation” had preserved the savings and loan as the model lending institution of the culture of American homeownership from the 1930s to the 1980s. But the resolution of the savings and loan crisis in 1989 proved that there was a much higher price to white picket fences than the average American, or even the federal government, had originally thought.

Conclusion

The roots of the savings and loan crisis of the 1980s, in which more than a thousand thrift institutions failed and billions of dollars of federally-insured funds were lost, are deeply entrenched in the political-economic culture of homeownership.

The federal government contributed to thrift failures directly through a long history of policy and legislation that began in the 1930s and was aimed first at preserving the thrift industry as a model lending institution of the community. Faced with the loss of this model when interest rates rose in the 1960s and 1970s, the federal government took drastic steps beginning in 1980 to jolt the industry back to life. This financial deregulation, not accompanied by an appropriate corresponding increase in regulatory scrutiny, resulted in an industry embroiled by moral hazard. Left unattended to financially gamble with the federally-insured savings of its depositors, the industry lost billions. As the crisis mounted, Congress, out of respect for the “special status” of the industry as a traditional mortgage provider (and under the influence of the industry’s powerful lobbying group), refused to stem the tide of thrift losses.

“Over-regulation” from 1932 to 1980 and “Under-regulation” from 1980 to 1989 were both as intentional and calculated on the part of the federal government as they were destined to doom the industry to financial failure. The preservation of the model lending institution was a more salient goal to the government than the improvement of the actual economic vitality of the industry in question. These direct federal actions concerning the savings and loan industry already allow one to draw conclusions on the effect of the homeownership culture on the economic history of the United States. But the more subtle historical legacy of the culture also came into play during the crisis.

Clearly, there was irony in the fact that the government's hand crafted thirty-year fixed-rate mortgage was an "albatross around the neck" of the thrift industry. It's also ironic that the secondary mortgage market and competition from the federal mortgage agencies damaged thrifts' finances. But what should not be forgotten is that the underlying political-economic homeownership culture actively drove federal administration of the savings and loan industry for sixty years. This culture embraced the ideal of an American nation of homeowners, an "unconquerable" nation in Roosevelt's mind. A nation that would rescue homeowners from foreclosure, allowing them to hold on to their vestige of stable civilization when economic times were tough. A nation in which even the most modest American, despite his savings, could acquire a Levittown-style homestead with a white picket fence in exchange for thirty years of debt. A nation that would provide its home-owning citizens with an inequitable tax advantage over their renting neighbors. A nation that would guarantee its citizens' mortgages to encourage lenders to lend and would build a secondary market to pump funds through this system. A nation whose government would make a multi-billion dollar sacrifice to save an industry that they fantasized was still embodied by George Bailey but was actually helmed by Mr. Potter.

The federal government intended for the fruits of this culture to be economic, social, and political stability. Rising homeownership rates would stimulate the economy and provide a rock of financial constancy to each home-owning American. Once king of his own castle, this American would somehow be transformed into a better person—a citizen of a higher type of civilization. And finally, this economy-boosting, socially-stable American would view his home, made possible by the federal government, as a shining vestige of the legitimacy of the American democracy and forsake all other political doctrines. At the

conclusion of a history of the American culture of homeownership, the glaring question must be asked—does history declare these goals “accomplished”?

Economically speaking, the administration of the culture of homeownership (which has inevitably stimulated economic growth because of high levels of home construction), has also been a catalyst for economic and financial instability. The thirty-year mortgage designed by the Home Owner’s Loan Corporation and the Federal Housing Administration conveniently plopped an increased number of Americans into their own homes. But it also locked them into long-term debt and high loan-to-value ratios that made them vulnerable to mortgage default. The secondary mortgage market created and maintained by Fannie Mae, Freddie Mac, and Ginnie Mae has purchased these mortgage instruments in order to pump funds back to lenders, increasing accessibility of mortgage money to the average American. However, the fact that the secondary mortgage market must exist to serve this purpose proves that the government-created mortgage finance system can’t stand on its own. Mortgage backed securities and other similar products, designed to spur interest and investment in the secondary market, have proven in recent years (and during the S&L crisis) to be unstable instruments vulnerable to economic fluctuations. The Servicemen’s Readjustment Act of 1944 and the VA Home Loan Guaranty Program, which made purchasing a home incredibly accessible to those with little or no savings, also implied to Americans that homeownership was their rightful due as patriotic citizens of the country. This implied entitlement, swelled by the other institutions of the culture and transmitted to the nation as a whole, has likely led some Americans to purchase homes when they were clearly better-suited financially to rent. The havoc that American sub-prime mortgage foreclosures unleashed on the international economy in the late 2000s is an all-to-tangible amalgamation of the culture’s risk to the

economy. And finally, if the preservation of the savings and loan industry was meant to maintain economic stability, why did it lead to financial collapse and a multi-billion dollar bill for the federal government and the American taxpayer?

Economics aside, the question of whether the culture of homeownership has created better citizens or if it has strengthened their devotion to democracy doesn't yield empirical evidence or clear-cut answers. Obviously, democracy has endured as the nation's political doctrine—as it did prior to 1950 when only a minority of Americans were homeowners. And in an even more obvious truth, there are millions of Americans nationwide who rent homes or apartments and are still “good people” (by the personal standards of this author, at least). If anything, financial havoc tied to the administration of the culture during the S&L crisis and in modern times has caused Americans a swelling amount of grief and personal *instability* in the form of foreclosed homes, lost jobs, and disappearing savings and investments.

Considering the scope and lengthy history of the culture of homeownership, it must also be determined whether these government initiatives were the direct cause of the continuous rise in American homeownership rates since the 1940s. Some scholars would assert that they were not, citing other factors for rising homeownership such as a climbing population, income levels, and desire for privacy, which are all isolated from government intervention (Chevan 250, 253). Sociologist Albert Chevan also claims that the peak year of prevalence for government-insured home mortgages occurred in the 1950s, which doesn't coincide with the peak year of homeownership in the context of his research, 1980. According to Chevan, this proves that the government program had only a small effect on the propensity to be a homeowner (259). Other studies suggest that Americans have switched from renting to owning homes for the simple reason that owning has become an increasingly

better value than renting over the years (as determined by return on equity) (Peiser and Brueggeman 415).

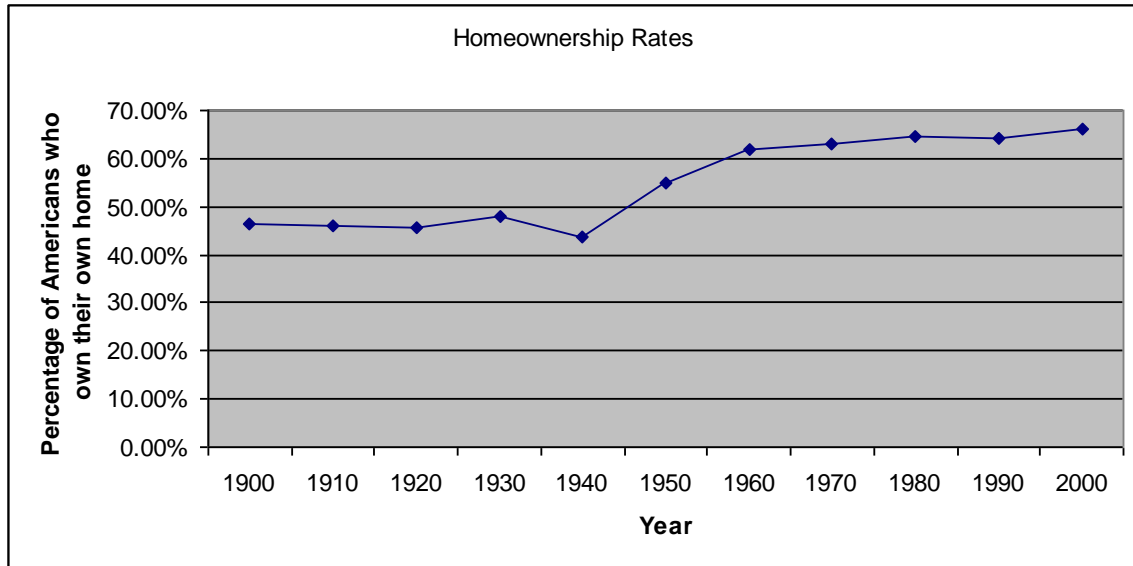
There is the possibility that some or all of these factors worked in concert with government initiatives to produce the steady and dramatic increases in American homeownership rates since 1940 (for example, if the means to attain an affordable home aren't available an increase in population can't result in rising levels of homeownership). It is also unlikely that the federal government would continuously support these initiatives over a 60 year period if its economic advisors determined that the legislation, agencies, and markets were having little to no effect on homeownership rates. The historical relevancy of these initiatives, however, doesn't lie in the exact number of mortgages originated as the result of the existence of FHA Insurance or because The Garn-St. Germain Act enabled a neighborhood thrift to remain in business. The historical legacy of these initiatives is their role as the building blocks of the culture of homeownership, the dominant ideology surrounding housing in America. And these initiatives have made economy-bending contributions to American history: the federal government completely reinvented the terms of the standard mortgage during the Great Depression. Fannie Mae, Ginnie Mae, and Freddie Mac did legitimize the secondary mortgage market. The G.I. Bill and the VA Program directly contributed to the creation of suburbia. And the deregulatory legislation of the early 1980s did hasten the downfall of an entire industry.

The economic vulnerabilities inherent in many of these initiatives have produced instances in which the federal government received much more than it bargained for. Instead of simply producing higher rates of homeownership, the culture also generated financial calamity. The most expensive manifestation of this risk was the savings and loan crisis of

the 1980s. The crisis stands as a prime historical example of how the political-economic culture of American homeownership can lead to financial catastrophe. Thus, Franklin D. Roosevelt wasn't entirely correct when he asserted that "a nation of home owners is unconquerable." This nation, or its economy at the very least, was and is conquerable—by the culture of homeownership itself.

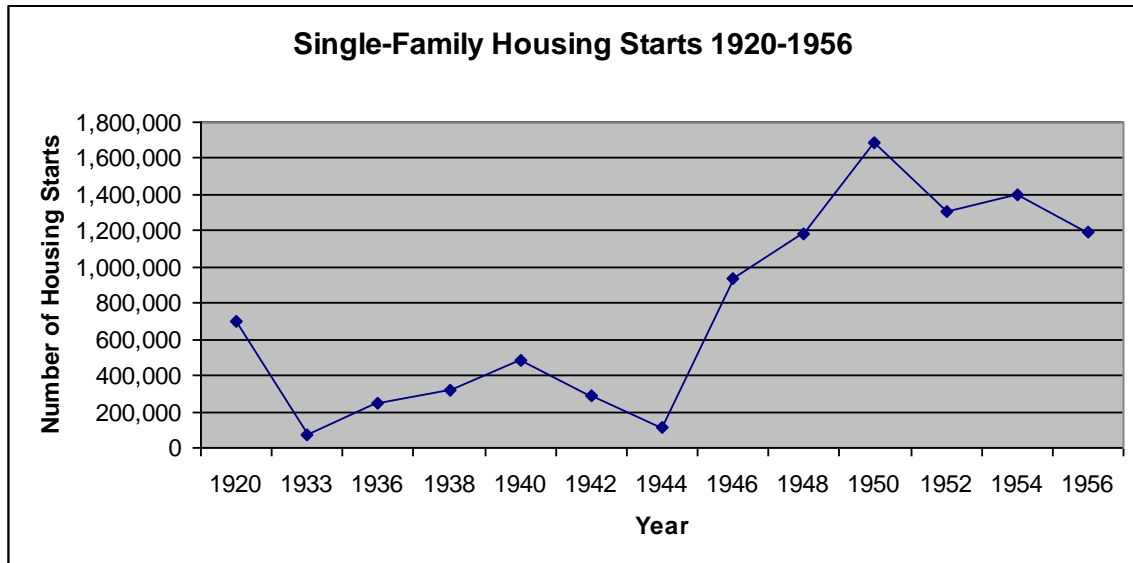
Appendix

Appendix A



Source: (U.S. Census Bureau)

Appendix B



Source: (Vandell 308) and (Jackson 233)

Appendix C

TABLE 9-1
GSE MARKET SHARE, BY CENSUS TRACT RACIAL CATEGORY,
CHICAGO PMSA, 1998

<i>Census Tract Minority Population (%)</i>	<i>Census Tracts</i>	<i>Loan Originations</i>	<i>GSE Purchases</i>	<i>GSE Market Share</i>
75 or more	472	23,616	7,860	33.28
50-75	141	12,546	6,846	54.57
30-50	182	20,194	12,825	63.51
20-30	146	24,887	16,971	68.19
10-20	267	66,815	47,842	71.60
Less than 10	550	167,043	125,446	75.10
Tracts with no population data	18			
Total tracts	1,776			

Source: (Brown 159)

Appendix D

TABLE 9-2
GSE MARKET SHARE, BY CENSUS TRACT INCOME CATEGORY,
CHICAGO PMSA, 1998

<i>Census Tract MFI as a Percentage of MSA MFI</i>	<i>Census Tracts</i>	<i>Loan Originations</i>	<i>GSE Purchases</i>	<i>GSE Market Share</i>
Less than 50	280	8,631	3,367	39.01
50-80	374	29,541	14,717	49.82
80-90	168	22,722	12,919	56.86
90-100	209	36,401	23,260	63.90
100-110	167	39,927	27,440	68.73
110-120	141	43,729	31,931	73.02
More than 120	409	133,944	103,858	77.54
Tracts with no income data	28			
Total tracts	1,776			

Source: (Brown 160)

* “MSA MFI” indicates lower income borrowers.

Appendix E

Selected Statistics, FSLIC-Insured Savings and Loans, 1980–1989 (\$Billions)

Year	Number of S&Ls	Total Assets	Net Income	Tangible Capital	Tangible Capital/ Total Assets	No. Insolvent S&Ls*	Assets in Insolvent S&Ls*	FSLIC Reserves
1980	3,993	\$ 604	\$ 0.8	\$32	5.3%	43	\$ 0.4	\$ 6.5
1981	3,751	640	-4.6	25	4.0	112	28.5	6.2
1982	3,287	686	-4.1	4	0.5	415	220.0	6.3
1983	3,146	814	1.9	4	0.4	515	284.6	6.4
1984	3,136	976	1.0	3	0.3	695	360.2	5.6
1985	3,246	1,068	3.7	8	0.8	705	358.3	4.6
1986	3,220	1,162	0.1	14	1.2	672	343.1	-6.3
1987	3,147	1,249	-7.8	9	0.7	672	353.8	-13.7
1988	2,949	1,349	-13.4	22	1.6	508	297.3	-75.0
1989	2,878	1,252	-17.6	10	0.8	516	290.8	NA

* Based on tangible-capital-to-assets ratio.

Source: (*The Savings and Loan Crisis and Its Relationship to Banking* 168)

Appendix F

Approvals of De Novo Thrifts to Receive Deposit Insurance from the FSLIC, 1980–1986^a

	Federally Chartered Institutions	State-Chartered Institutions	Total
1980	5	63	68
1981	4	21	25
1982	3	23	26
1983	11	36	47
1984	65	68	133
1985	43	45	88
1986	14	13	27

^a Excludes state-chartered thrifts that converted from state-sponsored insurance funds to the FSLIC.

Source: FHLBB data.

Source: (*White, The S&L Debacle* 106)

* “De Novo” indicates a newly-started thrift. The difference between “federally-chartered” and “state-chartered” institutions can be overlooked for the purposes of this thesis.

Appendix G

Holdings of "Nontraditional" Assets by FSLIC-Insured Thrifts, 1982 and 1985

	1982		1985		Increase in Amount, 1982-1985 (billions)
	Amount (billions)	Percentage of Total Assets	Amount (billions)	Percentage of Total Assets	
Commercial mortgage loans	\$43.9	6.4%	\$98.4	9.2%	\$54.5
Land loans	6.9	1.0	31.0	2.9	24.1
Commercial loans ^a	0.7	0.1	16.0	1.5	15.2
Consumer loans	19.2	2.8	43.9	4.1	24.7
Direct equity investments	8.2	1.2	26.8	2.5	18.6
Total	\$78.9	11.5%	\$216.1	20.2%	\$137.2

^a Includes "junk bonds."

Source: Barth, Bartholomew, and Labich (1989).

Source: (White, *The S&L Debacle 102*)

Appendix H

Annual Percentage Growth Rates of FSLIC-Insured Thrifts,^a 1980-1986

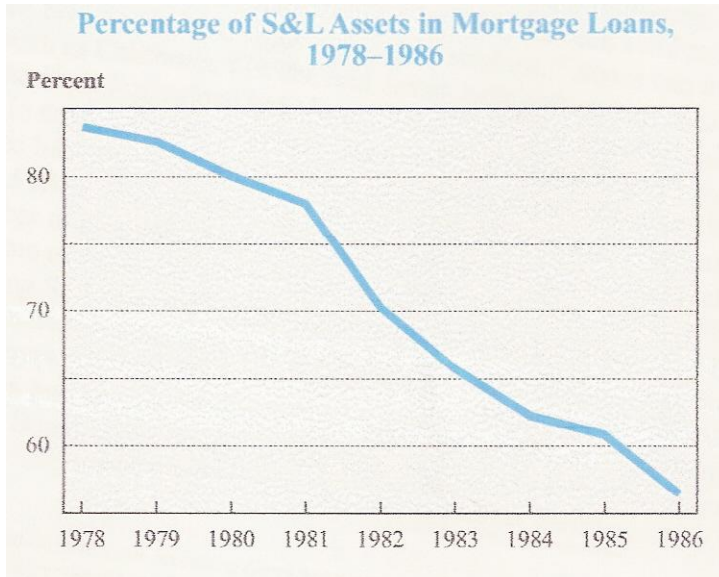
	1980	1981	1982	1983	1984	1985	1986
Total U.S.	7.2%	7.8%	7.3%	18.6%	19.9%	9.5%	8.7%
Arkansas	6.0	4.2	-2.3	42.9	24.7	6.2	-2.0
Arizona	13.5	9.4	23.5	18.3	46.7	23.8	15.3
California	10.1	8.2	18.3	28.0	29.6	8.8	13.1
Colorado	13.0	8.6	-9.2	9.9	24.7	6.8	12.1
Florida	11.8	10.5	9.6	17.1	20.7	7.6	2.2
Kansas	6.6	5.3	5.9	21.2	28.8	20.9	11.9
Louisiana	10.5	8.0	11.5	20.3	18.1	3.7	5.2
Oklahoma	11.7	10.4	9.8	16.5	13.6	5.4	1.9
Texas	11.9	9.7	13.2	33.3	38.0	18.4	5.5

^a Growth in assets, from previous year end.

Source: Barth, Bartholomew, and Bradley (1989).

Source: (White, *The S&L Debacle 100*)

Appendix I



Source: (*"The Savings and Loan Crisis and Its Relationship to Banking"* 179)

Appendix J

FDIC and FSLIC Disposals^a of Insolvent Banks and Thrifts, 1979–1988

	FDIC			FSLIC ^b		
	Number of Disposals	Disposals as a Percentage of All Insured Banks	Disposed Assets as a Percentage of All Bank Assets	Number of Disposals	Disposals as a Percentage of All Insured Thrifts	Disposed Assets as a Percentage of All Thrift Assets
1979	10	0.02%	0.01%	3	0.07%	0.10%
1980	10	0.07	0.01	11	0.28	0.23
1981	10	0.07	0.24	28	0.75	2.11
1982	42	0.29	0.53	63	1.91	2.52
1983	48	0.33	0.31	36	1.14	0.57
1984	79	0.54	0.13	22	0.70	0.52
1985	120	0.83	0.32	31	0.96	0.60
1986	138	0.97	0.24	46	1.43	1.07
1987	184	1.34	0.23	47	1.49	0.85
1988	200	1.47	1.04	205	6.95	7.45

^a Instances in which an insolvent bank or thrift was disposed of, either through liquidation or through placement with an acquirer.
^b For 1980 and after, only FSLIC-assisted acquisitions and liquidations are included; for 1979, supervisory cases are included as well.

Source: (White, *The S&L Debacle* 108)

*The data in relation to the thrift industry are in the "FSLIC"-headed columns.

Appendix K

The FSLIC's Liquidations and Placements with Acquirers of Insolvent Thrifts, 1980–1988

	Liquidations			Placements with Acquirers			Total		
	Number	Assets (billions)	Estimated Cost ^a (billions)	Number	Assets (billions)	Estimated Cost ^a (billions)	Number	Assets (billions)	Estimated Cost ^a (billions)
1980	0	\$0.0	\$0.0	11	\$1.5	\$0.2	11	\$1.5	\$0.2
1981	1	0.1	0.03	27	13.8	0.7	28	13.9	0.7
1982	1	0.04	0.003	62	17.6	0.8	63	17.7	0.8
1983	5	0.3	0.1	31	4.4	0.2	36	4.6	0.3
1984	9	1.5	0.6	13	3.6	0.2	22	5.1	0.7
1985	9	2.1	0.6	22	4.2	0.4	31	6.4	1.0
1986	10	0.6	0.3	36	11.9	2.8	46	12.5	3.1
1987	17	3.0	2.3	30	7.6	1.4	47	10.7	3.7
1988	26	3.0	2.8	179	97.7	27.1 ^b	205	100.7	29.9 ^b

^a Costs to the FSLIC on a present discounted value basis; neglects costs to the U.S. Treasury in the form of reduced tax collections.

^b Reduced tax collections by the U.S. Treasury were estimated to be an additional \$5.5 billion, on a present discounted value basis.

Sources: Barth, Bartholomew, and Bradley (1989); FHLBB data.

(Source: White, *The S&L Debacle* 150)

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