

# White Picket Finance: The Remaking of the U.S. Mortgage Market, 1932-1960

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## Abstract

This paper tracks the history of government intervention in the U.S. mortgage market between 1932 and the 1960s, a period in which the system for housing finance underwent a fundamental transformation. Whereas prior to 1930 the government had little involvement in the mortgage market, by the 1960s it was a major player. These interventions were triggered in part by economic crises, particularly the Great Depression. Yet, as I argue in this paper, they were also motivated by a cultural understanding of homeownership as central to American identity and the rise of housing policy as a substitute for other forms of social assistance. Many of the instruments established during these years to direct the flow of credit toward housing would emerge as central features of the housing market that persist to the present day. These policies mark the beginning of the permanent subsidisation of residential mortgage credit. In addition, beyond introducing long-term debt instruments to the consumer, they fostered the depersonalisation of credit relations. In this way, I also show that some of the weaknesses that have contributed to current U.S. housing market woes found their inception in the policy responses to the Great Depression.

**Keywords:** mortgage finance, housing policy, GSEs, the regulatory state

**JEL Classification:** G18, G21, N22

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# 1 Introduction

Homeownership has been a perennial feature of the American Dream, and is often cited as a central element of American cultural identity. Indeed, U.S. homeownership rates rose considerably over the course of the twentieth century, leading to the creation of a ‘home owning democracy’ (Ferguson, 2008, 242). But what were the forces behind this rise in homeownership? Clearly, government intervention in the market for housing finance aimed at enhancing the supply of and access to mortgage credit played a significant role. Yet prior to the 1930s, the U.S. government had virtually no direct involvement in housing markets. It was not until the crisis years of the Great Depression that interventionist policy measures were undertaken in the market for residential mortgage finance. The 1930s was a watershed moment in the regulation of the housing sector, for government intervention led to a fundamental transformation in the mortgage credit system that continues to shape the market for housing finance to the present day. In various ways, the federal government is now a key player in mortgage markets – not least through its ownership of Fannie Mae and Freddie Mac, which were placed into conservatorship in 2008 (Pollock, 2010).

In this paper, I study the origins of government intervention in mortgage markets and the associated transformation of the mortgage finance system that this intervention induced. Specifically, I elucidate the individual policy measures that were implemented, explore the motivations for their implementation, and examine their effects. The paper focuses on the 1930s, the decade in which the government first began to directly intervene in mortgage lending. However, to offer a broader picture into the forces that drove government intervention, I will also briefly discuss the 1920s as well as post-WW2 developments up to the 1960s. The central question addressed in this paper is as follows: What forces led the U.S. system, in contrast to other advanced economies, toward an ever stronger subsidisation of homeownership? In answering this question, I hope to make a specific contribution to the economic history of government intervention in the mortgage market, as

well as illuminate an important chapter in the rise of the modern regulatory state.

The onset of the Great Depression, which was associated with extensive housing market distress, was the immediate cause of efforts to intervene in mortgage markets in the 1930s. The government introduced a wide range of new policy measures to direct the flow of credit toward housing. Among the measures introduced were mortgage default insurance, new terms for mortgage lending, and greater mortgage standardisation. The government also pioneered a secondary mortgage market for federally underwritten mortgages. The majority of these mechanisms emerged as central features of the post-war housing market and they continue to define the mortgage market to this day. In this way, the Great Depression led to the establishment of permanent system for the subsidisation of residential mortgages by the federal government. In the process, the government introduced the use of long-term debt to the American consumer, and fostered the depersonalisation of credit relations. In this way, it would appear that some of the weaknesses that have contributed to current U.S. housing market woes found their inception in government efforts to combat the Great Depression.

In this paper, I argue that the rise of various policy measures to intervene in mortgage markets was motivated by two factors aside from the immediate exigencies of the Great Depression. First, intervention in mortgage markets appears to have been motivated in part by the perception that homeownership was a fundamental aspect of American society and identity. Walt Whitman (1856), for example, famously expressed this cultural notion as follows: ‘(...) it is in some sense true that a man is not a whole and complete man unless he owns a house and the ground it stands on’ (Whitman, 1938, 607). Second, during the Great Depression, the government first became aware of the way in which cheap credit could be used to create real estate wealth for a broad section of the population. By the 1940s, the idea of employing the tool of easy credit to boost homeownership became an explicit element of housing policy. In this way, I argue that long-term government intervention in the mortgage market arose as a form of social assistance and

as a substitute for other assistance policies.

This paper is structured as follows. Section 1 sketches out general features of the mortgage market that evolved in the 1920s. Section 2 discusses the creation of Herbert Hoover’s Federal Home Loan Bank System, which established the government’s foothold in the mortgage market. Section 3 is devoted to the three main government interventions in the market for housing finance that were implemented as part of the New Deal: the Home Owners’ Loan Corporation, the Federal Housing Administration, and Fannie Mae. Section 4 then considers the main developments that took place in the post-war mortgage market. The final section concludes.

## 2 The Boom of the 1920s

The years preceding the Great Depression were a time of great economic prosperity and credit expansion that fostered a significant increase in household debt in general and mortgage debt in particular (Harriss, 1951). At the beginning of the twentieth century, the overall level of mortgage debt was approximately 13 per cent of GDP. After a brief decline during World War I, mortgage debt increased tremendously during the 1920s, more than doubling from 8 per cent of GDP in 1920 to 20 per cent of GDP in 1930 (see Figure 1).<sup>1</sup>

The rise in the volume of mortgage debt during the 1920s was associated with a nationwide real estate boom. Residential construction more than tripled between 1920 and the peak of the boom in 1925 (see Figure 2). However, the boom in real estate began to collapse well in advance of the Great Depression. Building starts began declining in 1926, falling to their 1920 level by 1931. Further declines were witnessed over the following two years.

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<sup>1</sup>The rising levels of mortgage debt were part of a general trend toward rising household indebtedness. Outstanding consumer debt had doubled as well, from 3.8 per cent of GDP in 1920 to 7.5 per cent of GDP in 1930 (Olney, 1999, Table 1).

<sup>2</sup>Source: Goldsmith (1955, Table R34), Grebler et al. (1956, Table N4), Board of Governors of the Federal Reserve System (2012).



Figure 1: U.S. Mortgage Debt, 1900-70 as Percentage of GDP.<sup>2</sup>

A similar development occurred for housing prices. Figure 3 shows two national house price indices, both of which peaked in the mid-1920s following a strong rise between 1920 and 1925.<sup>3</sup> (This rise has been estimated at 14 per cent by Grebler, Blank, and Winnick (Grebler et al., 1956) and 18 per cent by Shiller (Shiller, 2005).) Similar rises were witnessed in local markets (see Figure 4), where indices peak between 1924 and 1926, having increased between 19 per cent (Seattle) and 43 per cent (Manhattan).<sup>4</sup> This real estate boom was accompanied by a rise in the homeownership rate from 45.6 per cent in 1920 to 47.8 per cent in 1930.<sup>5</sup>

<sup>3</sup>Overall, there is no reliable national index for house prices during the 1920s and 1930s. The index provided by Grebler, Blank, and Winnick is based on a 1934 survey of owners in 22 cities (Grebler et al., 1956). These were asked to state the current value of their house as well as the initial purchase price they paid. The Shiller index used data from very different origins for the earlier period, including the data from Grebler Blank and Winnick. Both indices appear to have a strong downward bias for the 1920s (see also White (2009, 8)).

<sup>4</sup>For Florida, which is likely to have experienced the biggest boom and bust, no house price index is available for this period.

<sup>5</sup>The U.S. Census Bureau calculates homeownership rates by dividing the number of owner-occupied housing units by the number of occupied housing units. A house is considered to be owner-occupied if the owner lives in the house, regardless of whether the house is mortgaged or fully paid for (U.S. Census Bureau, 2011).

<sup>6</sup>Source: U.S. Census Bureau (1966, Table A2).

<sup>7</sup>Source: Grebler et al. (1956, Table C-1), Shiller (2005).

<sup>8</sup>Source: Cleveland: Grebler et al. (1956, Table C-2), Seattle: *ibid.*; Washington, D.C.: Fisher (1951), Manhattan: Nicholas and Scherbina (2011).

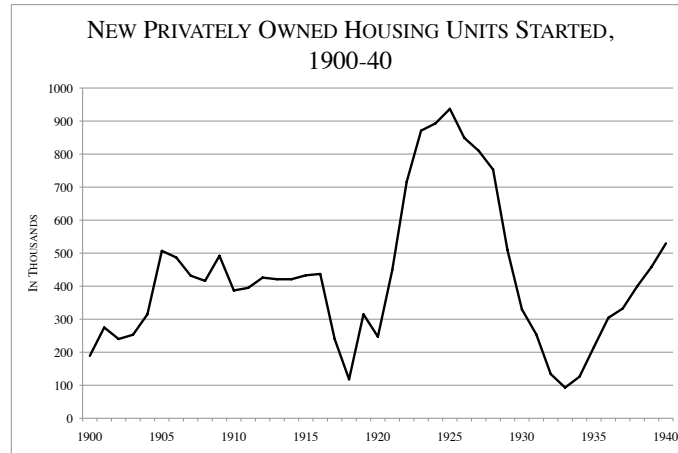


Figure 2: New Privately Owned Housing Units Started, 1900-40.<sup>6</sup>

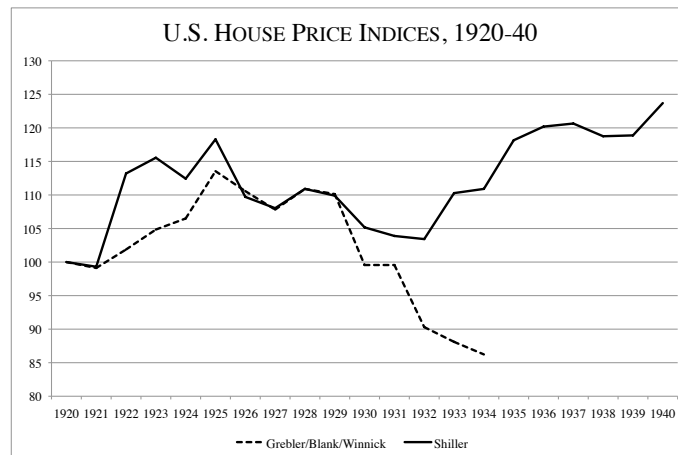


Figure 3: U.S. House Price Indices, 1920-40.<sup>7</sup>

Despite the availability of some data on the real estate boom that occurred in the mid-1920s, its causes have not yet been extensively analysed. To a certain extent, the boom might have been a post-WWI construction catch-up (Gjerstad and Smith, 2012). White identifies five factors that contributed to the 1920s boom in real estate (White, 2009). First, he argues that supervision over bank lending practices might have failed in certain boom regions. Second, during the 1920s, commercial and residential mortgages were securitised on an extensive scale for the first time. Two innovations in this regard appear to have made a significant contribution to the construction boom of



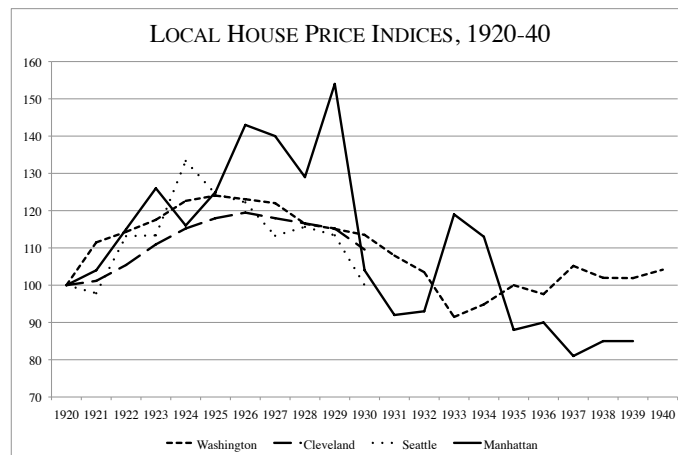


Figure 4: Local House Price Indices, 1920-40.<sup>8</sup>

the 1920s: (1) ‘certificates of participation’ that were granted against pools of loans issued and serviced by mortgage guarantee corporations; and (2) real estate bonds issued against pools of real estate loans or against individual high-value commercial mortgages (Snowden, 1995). Third, White argues that the substantial increase in mortgage finance was facilitated by a shift in the sources of mortgage lending: commercial banks, insurance companies, and building & loan associations (B&Ls) all expanded their market share. These changes were accompanied by a modest decline in lending standards, such as the lower down payments introduced by B&Ls, as well as by a moderate decline in mortgage rates. In addition, according to Morton, property appraisal standards might also have become more liberal, and the screening of loan applications less rigorous (Morton, 1956). Finally, White argues that a combination of two macroeconomic factors also contributed to the boom (White, 2009). First, monetary policy appears to have been too lax during the first half of the 1920s. Second, after the Federal Reserve was established in 1913, the volatility of interest rates declined substantially, lowering the stress on the financial system and reducing the likelihood of a panic (Miron, 1986). Yet this lower volatility might also have induced increased risk-taking, thus contributing to the 1920s boom (White, 2009, 15).

In the 1920s mortgages generally took the form of short-term debt rather

than of a long-term investment. The standard mortgage loan was a non-amortised balloon mortgage, often with a variable interest rate, a five-year maturity, and a loan-to-value- ratio (LTV) of about 20 per cent. Hence, borrowers had to roll over their mortgages every few years (Carliner, 1998, 304f.). This system favored lenders over borrowers, providing them with lower risk and more control compared to the modern mortgage, which features low down payments and longer maturity periods. However, borrowers did bear the risk of housing price fluctuations and interest rate volatility. Moreover, due to high down payments, many borrowers took out more than one mortgage on a single home. The market for second mortgages, however, was not well developed. In addition, compared to first mortgages, second mortgages were associated with substantially higher effective interest rates (Gries and Ford, 1932a). This pre-Depression system of mortgage lending placed borrowers in a state of ‘more or less permanent indebtedness’ (John Fahey as cited in Hyman (2011)). Yet because the 1920s were a period of optimism and prosperity, Americans felt confident that they could support their debt in the future without difficulties. When the boom years came to an end and the economy began to deteriorate, however, the burdens imposed on borrowers by the mortgage system became starkly apparent.

When the economic downturn started at the end of the 1920s, homeowners’ incomes decreased substantially and house prices declined, thus driving up the loan-to-value ratio (Green and Wachter, 2005; Hyman, 2011). The national indices (Figure 3) show that house prices declined by 24 per cent between 1929 and 1934 (as estimated by Grebler, Blank, and Winnick). The local indices, for which we have estimates for the early 1930s, point toward an even more pronounced fall in housing prices. In Manhattan, housing prices decreased by 62 per cent between 1929 and 1931, while in Washington, D.C., which was not considered part of the boom region, prices dropped by 24 per cent (see Figure 4, as well as White (2009, 9)). Many lenders, facing serious liquidity problems themselves, were not willing to refinance mortgages and withdrew their capital from the mortgage market. This caused a rapid drop in liquidity. As a result, many borrowers could neither repay

their mortgages nor refinance them, and eventually defaulted. Even though nonfarm foreclosures had already been rising continuously since the bust of the housing boom, foreclosures nearly doubled between 1929 and 1933 (see Figure 5).<sup>9</sup> By attempting to resell these foreclosed properties, financial institutions enhanced the downward pressure on the housing market (Weiss, 1989, 112). Alongside the troubles mortgaged homeowners were facing, the market for new housing also collapsed. In 1930–33, housing starts declined by approximately 70 per cent to some 93,000 starts per year (see Figure 2).

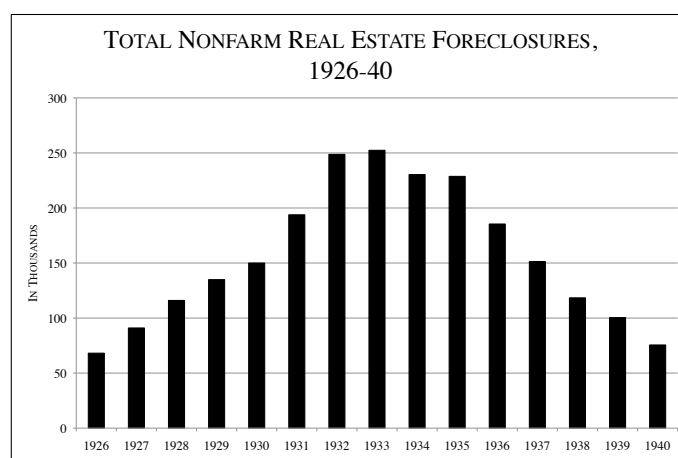


Figure 5: Total Nonfarm Real Estate Foreclosures, 1926-40.<sup>10</sup>

### 3 Housing Policy in the 1930s

In the early 1930s, the U.S. government began intervening in the housing market in response to the mounting troubles faced by this sector. Crises in the housing and mortgage markets created a range of problems for the en-

<sup>9</sup>Statistics on nonfarm foreclosures are only available beginning in 1926. Thus, there is no evidence whether the foreclosure rate was much higher in the late 1920s than it had been during the boom. Other accounts of foreclosure rates during the Great Depression point toward even greater distress. President Roosevelt, for example, stressed that while the annual average loss of urban homes to foreclosure was about 78,000 in normal times, foreclosures had more than tripled to over 273,000 in 1932. According to Roosevelt, in mid-1933, there were more than 1,000 foreclosures per day (Roosevelt, 1938a, 136).

<sup>10</sup>Source: Snowden (2006c, Dc1255).

tire economy. First, during the Great Depression, losses on foreclosed loans contributed to the failure of thousands of banks and building & loan associations, making real estate finance a highly visible candidate for government intervention (Acharya et al., 2011). The failure of financial institutions, as Bernanke has highlighted, disrupted credit channels and reduced not only the flow of mortgage lending, but also that of bank lending in general (Bernanke, 1983). Second, as the housing industry has many linkages to other parts of the economy, housing industry woes had damaging spillover effects (Hyman, 2011). Third, as argued by Mishkin, the deterioration of household balance sheets appears to have been a significant driver of declining aggregate demand during the Great Depression (Mishkin, 1973).<sup>11</sup>

Policymakers in the 1930s were undoubtedly aware that distress in the housing market had implications for the performance of the larger economy. However, the question remains as to why the U.S. government concentrated so markedly on addressing problems in this sector during the Great Depression. The value of residential construction in 1929 amounted to only 3.5 per cent of GDP (after having fallen from about 6 per cent in 1925; see Figure 6). Moreover, even though the mortgage indebtedness of households had risen considerably during the 1920s (see Figure 1), these levels (20 per cent of GDP in 1930) appear moderate compared to mortgage debt levels at the eve of the recent financial crisis, which reached 75 per cent of GDP in 2007. Finally, examining lenders' shares in nonfarm mortgage debt as a percentage of GDP, none of the institutions that were involved in the mortgage market on the eve of the Great Depression were too big to fail (see Figure 7).

Overall, these data, as well as the research cited above, suggest that even though the housing sector was an important sector in terms of general economic performance at the end of the 1930s, other factors might also have played a role in driving government intervention in housing. Indeed, in the first major intervention in the U.S. mortgage market during the 1930s –

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<sup>11</sup>This has also been argued for the recent financial crisis by, among others, Mian, Rao, and Sufi (2011).

<sup>12</sup>Source: Snowden (2006d, Dc256).

<sup>14</sup>Source: Snowden (2006a, Dc913-921).

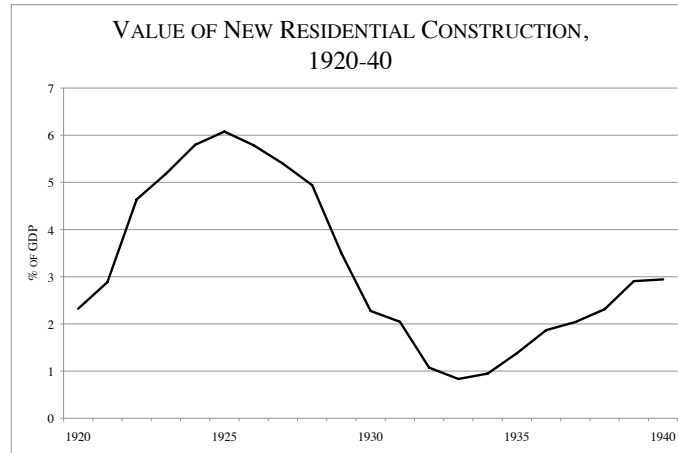


Figure 6: Value of New Residential Construction, 1920-40.<sup>12</sup>

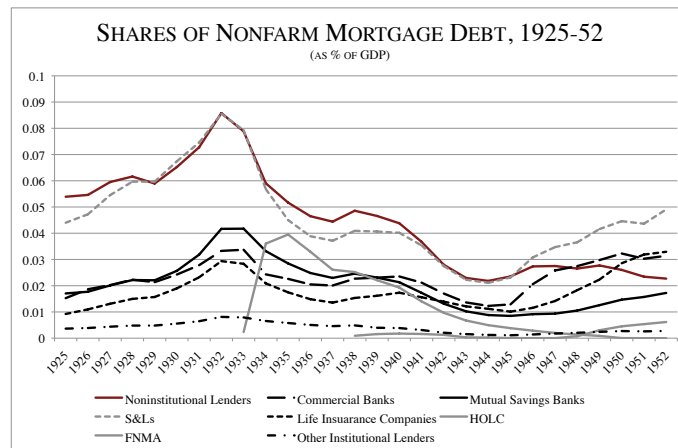


Figure 7: Shares of Nonfarm Mortgage Debt as a Percentage of GDP, 1925-52.<sup>14</sup>

namely, the creation of the Federal Home Loan Bank System (FHLB system) – we can already identify an effort to promote homeownership in general rather than merely provide immediate help to homeowners and stabilise the troubled housing market. This indicates that broader considerations were playing a role in the government’s actions. In 1931, President Hoover convened a ‘Conference on Homebuilding and Homeownership’ to discuss the challenges in the housing market. In the final reports, the conference stressed the ‘substantial increase in homeownership in many of our cities’ as a significant achievement of the past decade (Gries and Ford, 1932a, vii),

particularly because of its salutary effects in promoting ‘good citizenship and strengthening family ties’ (Gries and Ford, 1932a, 1). According to the logic underlying this rhetoric, a reversal of this trend would have negative social effects, and not just economic ones. In recognition of structural as well as institutional weaknesses in the U.S. mortgage system, the conference avowed that the government had a special role in addressing these deficiencies and stimulating homeownership. Indeed, in his address at the conference, Hoover said that even though the purpose of the conference was to discuss practical questions relating to the current situation, ‘behind it all every one of you here is impelled by the high ideal and aspiration that each family may pass their days in the home which [sic] they own’ (Hoover, 1931). In his speech, Hoover also discussed the cultural meaning of homeownership, stating that there was a basic need to protect homeownership in times of crisis:

‘There is a wide distinction between homes and mere housing. Those immortal ballads, Home, Sweet Home; My Old Kentucky Home; and the Little Gray Home in the West, were not written about tenements or apartments. They are the expressions of racial longing which find outlet in the living poetry and songs of our people. They were written about an individual abode, alive with the tender associations of childhood, the family life at the fireside, the free out of doors, the independence, the security, and the pride in possession of the family’s own home- the very seat of its being. That our people should live in their own homes is a sentiment deep in the heart of our race and of American life. [...] To own one’s own home is a physical expression of individualism, of enterprise, of independence, and of the freedom of spirit.’ (Hoover, 1931)

Since the onset of the Great Depression, it had been clear to the Hoover administration that mortgage finance was a crucial cog for protecting and expanding homeownership. According to Hoover, however, the mortgage market at the time was ‘the most backward system of our whole credit system’

(Hoover as cited in Barber (1989, 96)). In this regard, Hoover was referring particularly to the combination of low loan-to-value ratios for first mortgages and the high costs associated with second mortgages. Second mortgages were more expensive because these loans were often made by the individuals or businesses who had sold the home to the borrower – for example, previous owners or building-material suppliers (Snowden, 2010c). The Conference on Home Building and Home Ownership agreed with Hoover regarding these serious deficiencies, particularly in the market for second mortgages, stressing that ‘[t]here are good reasons to believe that the greatest hindrance to the sound development of home ownership is the lack of a well organised second mortgage service which can be offered at reasonable cost’ (Gries and Ford, 1932a, 9).

The Conference on Home Building and Home Ownership adopted two resolutions. The first supported Hoover’s plan to establish a system of home loan discount banks to provide a stable source of funding for residential mortgages and to reduce the cost of home financing. This measure was designed not only as a response to the crisis but also to have a ‘permanent value to the nation as a whole as a means of promoting home ownership in the future’ (Gries and Ford, 1932b).<sup>15</sup> The Federal Home Loan Bank Act of 1932 created the Federal Home Loan Bank System (FHLB system). Its member institutions could be any state chartered institution engaged in the mortgage business – predominantly building & loan associations, but also savings banks and insurance companies (Harriss, 1951, 8). As a creation of the government, the FHLB system could borrow funds at favourable rates on the capital market, and the twelve regional FHLBs could then pass along these funds to their member-owners (Colean, 1950, 93). This arrangement introduced a significant and enduring feature to the U.S. housing finance system: explicit or implicit borrowing in the name of the government to promote mortgage borrowing by households (Acharya et al., 2011, 15f.)

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<sup>15</sup>The idea to establish a federally-sponsored Home Loan Bank System that would parallel the Federal Farm Loan Bank System was suggested as early as 1920 by the Calder Committee. This committee, created by the Senate, had the task to investigate the housing shortage the U.S. faced after the end of World War I as well as to recommend legislation to address this issue (see Snowden (2010c)).

The FHLB system emerged as a permanent institution in home financing and had a significant influence on the housing market during the 1930s. Indeed, the Federal Home Loan Bank Board (FHLBB) supervised most Depression-era housing programmes (e.g. Courtemanche and Snowden (2010, 2)). Together with the National Housing Act of 1934, which established a deposit insurance system for thrifts with the creation of the Federal Savings and Loan Insurance Corporation (FSLIC), the FHLB system fundamentally changed the thrift industry and eventually led to the later rise of the savings & loan (S&L) industry.<sup>16</sup> However, as a general emergency measure, the FHLB Act only had a limited impact, since it was restricted to the B&Ls that joined the FHLB System (Snowden, 2010c, 12). This restriction also limited the FHLB system's long-term effects, as it could not function as a universal mortgage bank. Policymaking in finance is often influenced by lobbying and interest groups. The design of the FHLB system is an excellent example of how special interests can shape policy, as the Hoover administration closely cooperated with the United States Building & Loan League (USBLL) in drafting the system. As a result of this cooperation, the discount model established by the FHLB Act focused on the lending standards and procedures of building & loan associations. Consequently, the FHLB system was unable to function as a universal home-loan bank that incorporated all sorts of mortgage lenders such as commercial banks, savings banks, insurance companies, and mortgage companies. In 1941, only 1 per cent of the member institutions were savings banks and life insurance companies. The remaining members were all S&Ls (Snowden, 2010c, 11f.). In general, prior the 1930s, the federal government was not lobbied by interest groups of builders, lenders, and realtors concerning housing issues, since there were only very few

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<sup>16</sup>Snowden provides an encompassing analysis of this fundamental change in the industry. With the major changes in the thrift industry and many B&Ls frozen and in liquidation during the 1930s, industry leaders fashioned the modern S&L industry. In this process, many of the old B&Ls that were operating when the FHLB was established were left behind. About 3,300 of initially about 10,600 B&Ls joined the FHLB system. These 3,300 together with about 600 newly chartered Federal S&Ls Associations became the modern S&L industry (Snowden, 2003, 192ff.). In fact, the FHLB System would remain an important player in the mortgage market until the 1980s (Courtemanche and Snowden, 2010).



policy measures in this field. However, beginning in the 1930s, organisations such as the National Association of Real Estate Boards, the National Retail Lumber Dealers Association, and the previously mentioned USBLL tried to ensure that government intervention took into account the economic interests of the private sector. During this decade, these organisations were generally sceptical toward government subsidy of private borrowers and lenders, and were clearly opposed to public housing (Howard, 1997, 97f.).

Despite the creation of FHLB system, residential construction continued to fall, experiencing a dramatic 95 per cent drop between 1928 and 1933. In 1933, the mortgage market was effectively dead. And so was the housing industry (Jackson, 1985, 193). Consequently, the New Deal policymakers under President Roosevelt were naturally obliged to focus on housing, and began to undertake even greater intervention in the mortgage market. In doing so, they rhetorically identified homeownership as an essential component of American society. Indeed, there was a strong bipartisan consensus regarding the issue of homeownership at that time.

## 4 The New Deal for Housing Finance

Shortly after he took office, Roosevelt turned to the troubles homeowners and mortgage lenders were facing. From the very start, he framed his policy measures in terms of a larger effort to promote homeownership. In his request to Congress of 13 April 1933, titled ‘Asking for Legislation to Save Small Home Mortgages from Foreclosure’ (which would pave the way for the Home Owners’ Loan Corporation), he stressed that his concern was not only to immediately help homeowners, but also to protect and promote homeownership in general:

‘Implicit in the legislation which I am suggesting to you is a declaration of national policy. This policy is that the broad interests of the Nation require that special safeguards should be thrown around home ownership as a guarantee of social and economic

stability, and that to protect home owners from inequitable enforced liquidation in a time of general distress is a proper concern of government.’(Roosevelt, 1938a)

However, the Homeowners’ Loan Corporation (HOLC), which was established in June of 1933 to arrest the free fall of the housing market, was first of all ‘in every sense of the word an “emergency” institution’ (Bodfish, 1935, 404). To fulfil its mission, it was to serve both as a ‘bad bank’ for mortgage credit and as a loan modification programme (Snowden, 2010b). As a bad bank, the HOLC purchased more than three billion dollars worth of shaky or defaulted mortgages issued on one- to four-family properties by private lenders, exchanging its bonds for the lender’s claim on the loan.<sup>17</sup> By removing these poorly performing assets from the lenders’ balance sheets, the HOLC saved many of these institutions from failure (Weiss, 1989, 113).<sup>18</sup> The HOLC then restructured these loans into fixed-rate, fully amortising mortgages with a 15-year maturity at 5 per cent interest.<sup>19</sup> As this longer maturity extended the mortgage over multiple business cycles, it stabilised the supply of mortgage money and changed the way periodic recessions would interact with mortgage refinancing (Fishback et al., 2010, 7).

In addition to restructuring mortgages, the HOLC offered principle reduction in the event debt exceeded 80 per cent of the HOLC appraisal of the property (Rose, 2011, 1079). Overall, borrowers benefitted from the HOLC’s lenient mortgage terms. Nevertheless, Rose argues that the HOLC was in

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<sup>17</sup>The U.S. government guaranteed the interest on the HOLC bonds and after April 1934 also the principal of the bond. Moreover, the bonds were exempt from income and property taxes both at the state and federal levels. Initially, these bonds offered 4 per cent interest as well as a maximum maturity of 18 years. However, later, there were also issuances at lower interest and shorter maturities. Some mortgages were also paid for with cash (see Rose (2011, 1079)).

<sup>18</sup>The HOLC accepted applications from June 1933 to November 1934 and from May 1935 to June 1935. In 1936, the HOLC’s active lending programme ended. The HOLC was liquidated in 1951. By taking over these loans, the HOLC also took over the lending institution’s unsound loan choices. By 1940, 17 per cent of the loans ended in foreclosure. As a result, the agency was left with properties that were not liquidated until after World War II (see Rose (2011, 1078), Harriss (1951, 6)).

<sup>19</sup>However, the absence of a prepayment penalty allowed borrowers to repay their mortgages before the loan matured (Fishback et al., 2010, 8).

many ways a lenders' programme, since most of the necessary adjustments were left to the borrowers.<sup>20</sup>

The HOLC succeeded in curtailing the deflationary forces that had been driving the mortgage crisis, as well as in restoring liquidity (Jackson, 1985, 196).<sup>21</sup> Until its liquidation in 1951, the HOLC refinanced about 40 per cent of all qualifying property and about a fifth of U.S. owner-occupied non-farm homes.<sup>22</sup> Figure 8 shows the sudden and substantial impact of the HOLC during the mortgage crisis of the 1930s. As a result, the shares of the S&Ls in particular, as well as of non-institutional mortgage lenders, decreased. Yet the impact of the agency was limited by its lack of funds, since it did not have a self-sustaining stream of income (Hyman, 2011, 50).<sup>23</sup> The cost of this policy tool remains difficult to estimate. The initial capitalisation of the HOLC was \$200 million. The agency had been authorised to issue up to \$2 billion worth of bonds. This upper limit was later increased to \$4.74 billion. Since the interest and principal on these bonds were explicitly guaranteed, the HOLC generated considerable liabilities for the government during the time of its operation (see Wheelock (2008, 141), Courtemanche and Snowden (2010, 2)). However, once the last loan had been repaid in 1951 and the HOLC had fully sold off its holdings of foreclosed property, losses on the programme were moderate. Fishback, Flores-Lagunes, Horrace, Kantor, and Treber estimate the losses created by the HOLC programme until its

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<sup>20</sup>The HOLC's ability to make principal reduction available for borrowers depended on the voluntary cooperation of borrowers, making the refinance process often difficult. As a consequence, HOLC appraisals were relatively high to increase lenders' participation. This in turn resulted in rather high payments to lenders, constraining the agency's ability to seek principal reduction for borrowers. According to Rose, this suggests that the government, by designing the HOLC in the way it did, underestimated the importance that households debt relief has for economic recovery (Rose, 2011, 1074ff.).

<sup>21</sup>Fishback et al. as well as Courtemanche and Snowden conclude that HOLC lending increased both median home values as well as homeownership rates in local markets. However, Courtemanche and Snowden also stress that since the HOLC focused on refinancing rather than on making new loans, it failed to revive construction activity (see Fishback et al. (2010); Courtemanche and Snowden (2010)).

<sup>22</sup>Harriss provides an encompassing study of the HOLC's procedures, operations, and organisational structure (see Harriss (1951)).

<sup>23</sup>The HOLC funded its loans through its operating income and by issuing its own bonds. However, the agency was only authorised to issue bonds worth \$2 billion; this limit was later increased to \$4.74 billion (Wheelock, 2008, 141ff.).

liquidation at approximately \$100 million (Fishback et al., 2010, 8).

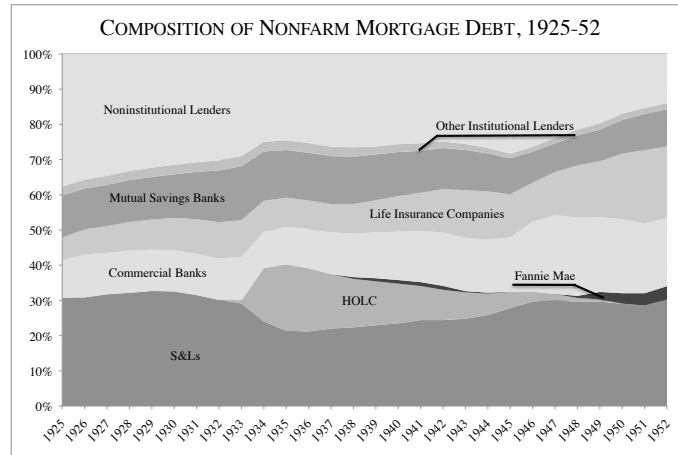


Figure 8: Composition of Nonfarm Mortgage Debt, 1925-52.<sup>24</sup>

Even though the HOLC was designed as a temporary programme, it left a significant and lasting imprint on the U.S. mortgage market by demonstrating the feasibility of long-term, self-amortising mortgages (Rajan, 2010, 32). The modern American mortgage is still based on the innovations introduced by the HOLC.

As the government did not intend to stay in the business of holding mortgages permanently, options were also assessed on how to make mortgages marketable. The idea was that with the help of a re-designed mortgage instrument, private financing would both expand homeownership and revitalise the economy under the guidance of federal policy (Hyman, 2011, 53). In May 1934, President Roosevelt thus proposed the creation of the Federal Housing Administration (FHA) and its insurance programme.<sup>25</sup> The programme was designed to help life insurance companies, mutual savings banks, and commercial banks to engage in the mortgage market by offering insurance on

<sup>24</sup>Source: Snowden (2006a, Dc913-921).

<sup>25</sup>The Housing Act created two different loan programmes that the FHA had to oversee: loans for ‘Housing Modernization’ (Title I), and loans for building new houses (‘Mutual Mortgage Insurance’, Title II). The Act therefore offered insurance to private lenders on qualifying loans not only for the construction of new houses, but also for the purchase, repair, expansion, and alteration of existing ones (see Hyman (2011, 55); Snowden (2010c, 17); Colean (1950, 97)).

qualifying mortgages (see Snowden (2010c, 17); Wheelock (2008, 144)).<sup>26</sup>

The FHA initiated two major changes in the housing market. First, it adopted terms for mortgage-insurance qualification similar to those successfully introduced by the HOLC: a maximum LTV of 80 per cent, a 5 per cent cap on mortgage rates, and full amortisation over a 20-year maturity (Babcock, 1939, 1f.). This inaugurated the widespread use of this ‘credit trio’ (Haar, 1960, 57). These terms were a clear departure from traditional mortgage lending conditions, and marked the beginning of what would later be perceived as the modern mortgage. The high elasticity of demand in relation to mortgage terms, particularly to the size of the down payment and monthly payment requirements, made the introduction of the credit trio a crucial factor in the subsequent evolution of the housing market (Haar, 1960, 8). As a result of this first major action undertaken by the FHA, New Deal policymakers leveraged the possibilities of deferred payment, enabling American homebuyers to take out larger mortgages (see Hyman (2012)). Due to this new mortgage system structure, homeownership became possible for millions of households who would have been barred from a loan under pre-existing terms (Snowden, 2010c, 15).

Second, the FHA established construction guidelines for new homes built under the programme. These guidelines helped market participants to better evaluate the quality of a house and enabled investors to better assess the value of a particular mortgage, thus reducing transaction costs (see e.g. Hyman (2011, 63ff.)). As a result of this standardisation process, mortgages could be sold nationwide like commodities rather than being loans designed for the needs and requirements of both lenders and borrowers in local markets. Standardisation was therefore an important precondition for establishing a liquid and national secondary mortgage market (Hyman, 2011, 53ff.). As an emergency measure, the FHA also fulfilled its purpose. Between 1936 and 1940 it financed about 350,000 new homes, thus contributing to a revival in

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<sup>26</sup>Qualifying mortgages were amortising loans featuring a maximum LTV of 80 per cent, a five per cent cap on mortgage rates, and a maturity period of 20 years. Subsequently, the maturity was lengthened to 25 or 30 years (see Jackson (1985, 204f.)).

real estate construction (see Figure 2 and Figure 6, Hyman (2011, 53ff.)).

Mortgage insurance was not a completely new idea. Insurance companies had been active in this area prior to 1930. However, mortgage insurers were often insufficiently capitalised and eventually failed (e.g. Green and Wachter (2005, 95); Babcock (1939, 1)). The FHA insurance programme addressed this weakness, protecting mortgage lenders from default. If a borrower defaulted on his mortgage, the FHA covered the remaining balance of the loan (Schwartz, 2006, 49ff). Lenders thus only had to bear the interest rate risk associated with holding a mortgage, as they financed fixed-rate long-term mortgages with short-term deposits. Moreover, lenders were relieved of a large part of the costs of default and foreclosure. By introducing mortgage default insurance, the FHA thus fostered an increase in the funds available for home purchase and construction. Furthermore, high-interest second mortgages became less prevalent due to the high loan-to-value ratio of FHA-insured loans. As a result of the changes instituted by the FHA in the mortgage market, homeownership often became less expensive than renting (Schwartz, 2006, 50). Another important aspect of the FHA programme was that it would not be paid for by the government. Instead, it was to be self-sustaining (Quigley, 2006, 283). The FHA funded its insurance program by charging a fixed premium on unpaid loan balances. These revenues were deposited into Treasury bills and managed as a mutual insurance fund. In the event of default, the insurance payment would be disbursed as bonds that could only be collected after three years. As losses would lead the banks' capital to be tied up without earning interest, this discouraged unsound lending practices (see Quigley (2006, 283); Hyman (2011, 53ff.)).

Again, this programme was motivated not only by short-term concerns related to the economic downturn, but also by the long-term idea of promoting homeownership. According to Federal Housing Administrator James Moffet, the chief objectives of the programme were 'the establishment of special safeguards around home ownership and the creation of a nation-wide, uniform system through which the ownership of homes may be easier of accomplishment' (Moffett, 18 November 1943). Roosevelt too stressed that widening

access to homeownership by ‘lowering the cost of homes to the great mass of our people is worthy of our best efforts’ (Roosevelt in a letter to Moffet, as cited in Hyman (2012)). He further argued that this programme would ‘(...) produce tangible, useful wealth in a form for which there is great social and economic need’ (Roosevelt, 1938b). These quotes indicate that during the Great Depression, the government was already becoming aware of the potential associated with using low-cost mortgage credit to produce wealth in the form of real estate for a broad share of the population.

In addition to mortgage default insurance provided by the FHA, the 1934 Housing Act established another long-lasting institution: the Federal Savings and Loan Insurance Corporation (FSLIC), which offered federal deposit insurance to S&Ls for saving account balances up to \$5000 (Wheelock, 2008, 140). The FSLIC also influenced the flow of credit into housing. As the government guaranteed the deposit liabilities of S&Ls, they could borrow at low interest rates from depositors and also offer low interest rates on mortgage loans. This again reduced the cost of homeownership.<sup>27</sup>

Finally, the 1934 National Housing Act also aimed to create a liquid and national secondary mortgage market that would enable institutions and investors to invest in mortgages without having to originate them. Moreover, by selling mortgages, the mortgage-originating institutions could use freed-up capital to issue additional loans. The overall supply of mortgage funds would thus be increased (Bradford, 1979, 316). An additional benefit of a secondary mortgage market was the enhancement of lender confidence, since lenders might hesitate to acquire FHA mortgages if they could not be resold (Haar, 1960, 77). The Act therefore provided for the creation of private but federally chartered national mortgage associations (NMAs) which were to engage in trading qualifying first mortgages (Wheelock, 2008, 144f). In promoting a secondary mortgage market, the federal government hoped that life insurance companies, commercial banks, and mutual savings banks would

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<sup>27</sup>However, the Federal Savings and Loan Insurance Corporation (FSLIC) did not differentiate between institutions that engaged in high-risk activities and those that did, nor did it distinguish between financially sound institutions and those near collapse. The resulting moral hazard encouraged thrifts to engage in risky business (Grossman, 2010, 270ff.).

all invest surplus funds in mortgages (Bradford, 1979, 316). In addition, it was hoped that this market would allow funds to flow from financially liquid or capital rich areas to illiquid or capital scarce areas (Haar, 1960, 77). However, despite the standardisation of mortgages by the FHA, no private mortgage associations were established after the Act was passed, mainly due to the many restrictions that were imposed on NMA operations.<sup>28</sup> In 1938, President Roosevelt therefore set up a quasi-governmental corporation, the Federal National Mortgage Association (FNMA), which quickly gained the nickname Fannie Mae (Klaman, 1961, 218).

The FNMA had an initial capitalisation of \$10 million and was permitted to buy or sell FHA-insured mortgages. Fannie Mae began operations in May 1938 but had little impact before the 1950s, not only because it was restricted to acquiring federally insured mortgages and had a maximum lending capacity of \$220 million, but also because of the dislocations of World War Two. Figure 8 shows that the FNMA's overall presence in the market was therefore more symbolic than substantial in nature.<sup>29</sup> However, Fannie Mae's willingness to purchase FHA-insured loans encouraged lenders to originate such mortgages. To fund its purchases, the agency was authorised to sell bonds. The federal government did not explicitly guarantee these bonds, but investors quickly assumed an implicit government guarantee (Frame and White, 2004). This perceived implicit guarantee on debt issued by Fannie Mae would persist beyond its reorganisation into a government-sponsored enterprise in the late 1960s, and remained a key factor in its future devel-

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<sup>28</sup>NMAs were regulated directly by the FHA administrator; they would be able to conduct business all over the country, but their operations would be restricted to the purchase and sale of first mortgages and they were forbidden from investing money in anything other than first mortgages. Moreover, all NMA borrowing was subject to the approval of the FHA administrator (Hyman, 2011, 67f.). Also, a subsequent series of liberalizing amendments did not encourage the creation of a single private national mortgage association (see Klaman (1961, 218), see also Haar (1960, 79f)).

<sup>29</sup>In 1952, the FNMA held 3.8 per cent of all nonfarm mortgages. Until the FNMA gained authority to also purchase VA-guaranteed loans in 1948, its share of mortgage debt hovered around or below 1 per cent (see Figure 8). 1939 was the FNMA's peak year in the pre-war period. In this year the FNMA purchased or made commitments to purchase mortgages worth about \$100 million. Moreover, in the early years of its operation, the FNMA did not sell the mortgages it had bought. Beginning in 1943, it started to divest due to an increasing demand for mortgage paper (Haar, 1960, 85f.).



opment. Overall, by establishing Fannie Mae, the government pioneered the secondary mortgage market for federally insured mortgages.

Even though Fannie Mae was not a private mortgage association, as initially intended in the 1934 Housing Act, it fostered a national private network for federally insured loans. Local mortgage companies could lend to homeowners on the basis of FHA standards and subsequently resell the mortgage to Fannie Mae. Insurance companies, commercial banks, and other institutions took advantage of the introduced national standards to invest in mortgages across the country, since these mortgages also seemed to be safer investments than local conventional mortgages that were not federally insured. As a result, the share of mortgages held by large institutions rose from 60 per cent in 1925 to 80 per cent in 1952 (see Figure 8, see also Hyman (2011, 68f.)). Within this structure, which would be further strengthened during subsequent years, depository institutions emerged as the dominant institutions in the mortgage market.

The creation of a secondary mortgage market inaugurated another major change in mortgage finance. As originating institutions sold their mortgages to other investors, homeowners suddenly owed a large amount of money to anonymous institutional investors. Likewise, the ultimate lender of a mortgage did not know the borrower. By contrast, at the turn of the last century, prospective homeowners seeking to obtain a mortgage could solicit either a local savings bank, a non-institutional investor, or a building & loan association, in which the borrower had to become a member. Thus, even though the methods of financing could become complex due to the widespread need to finance homeownership with more than one mortgage, there was an individual assessment of the borrower's soundness by the lender, as well as a clearly defined obligation for the borrower to repay a specific lender. The depersonalisation of credit that started in the 1930s was thus a significant departure from the previous structure of mortgage lending. Augmented by the rise of securitisation, this trend would be strengthened throughout subsequent decades, reaching its peak in the early years of the twenty-first century (Calder, 1999, 65ff.).

## 5 The Post-War Mortgage Market

Despite the end of the Great Depression – and, by extension, the need to actively stabilise the housing market – the government continued to intervene in the mortgage market via the structures and instruments it had established during the crisis. Policymakers continued to emphasise the ideological meaning of homeownership for creating a better and stronger society – as can be seen, for example, in Roosevelt’s assertion in 1942 that ‘a nation of home owners, of people who own a real share in their land, is unconquerable’ (Roosevelt, as cited in No Author (17 November 1942)). Indeed, this ideological dimension of homeownership would continue to exert an influence over the remainder of the twentieth century.

The success of housing market interventions during the Great Depression had made policymakers aware of the potential for using housing policy as a macroeconomic steering mechanism. As part of ongoing efforts to promote homeownership, the federal mortgage insurance system and FHA were supplemented in 1944 by the loan programme of the Veterans Administration (VA). Established under the Servicemen’s Readjustment Act, better known as G.I. Bill, this programme helped veterans to return to civilian life after serving in World War Two.<sup>30</sup> The programme was closely modelled after the FHA programme. It provided a federal guarantee for up to 60 per cent of the face value of a mortgage. The VA also contributed to a relaxation of mortgage terms, since it facilitated an even higher LTV (and hence lower down payment) as well as longer repayment periods than the FHA. While FHA-insured loans could have a maximum LTV of 80 per cent, VA-guaranteed loans had a median down payment of only 9 per cent. A significant share of VA loans even featured LTVs of 100 per cent and more (Fetter, 2011, 7).<sup>31</sup>

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<sup>30</sup>The Servicemen’s Readjustment Act, better known as the G.I. Bill, provided various benefits to veterans and replaced the traditional veteran’s bonus, which had been an award of land or cash. These benefits included federally guaranteed housing, business or farm loans; a stipend for further education; unemployment compensation as well as health care at no cost (Frydl, 2009, 1f.).

<sup>31</sup>According to Fetter, in each census year between 1950 and 1970, between one-fifth and one-third of VA loans featured LTVs of 100 per cent or more (Fetter, 2011, 7).

Consequently, homebuyers needed less equity. Even though the programme was initially designed to only last a few years, it was extended several times to support veterans of later wars, and ultimately emerged as a long-term housing programme. According to Skocpol, about one-fifth of post-war mortgages for single family homes featured lower interest rates due to the subsidies and guarantees provided by the VA under the Servicemen's Readjustment Act and successor legislation (Skocpol, 1995, 98). Fetter argues that the G.I. Bill increased aggregate homeownership rates by shifting the purchase of a home to an earlier life stage (Fetter, 2011). He thus estimates that the VA programme can explain roughly 25 per cent of the increase in homeownership rates that was witnessed among cohorts affected by the programme (homeownership rates for these cohorts rose from 13 to 41 per cent). He concludes that in the absence of veterans' housing benefits, the overall homeownership rate for men aged 18 and above would have been 1.9 percentage points lower in 1960. Overall, the VA loan programme was thus a significant driver of the boom in residential construction that took off in the late 1940s (Jackson, 1985, 204). In addition to mortgage insurance, beginning in 1950, the Veterans Administration also provided direct lending in areas where private lending was viewed as scarce. Nevertheless, direct lending by the VA was small in comparison to the size of other programmes: as of January 1958, the total value of loans extended under this programme amounted to just \$678,000 (Haar, 1960, 44ff.).

With the Servicemen's Readjustment Act of 1944, the concept of extending homeownership to 'under-served' segments of the population using cheap credit entered federal housing policy for the first time. Indeed, we find that the strategy of intervening in the mortgage market as an element of, or substitute for, social policy would be further expanded during the following decades. By the end of the century, the promotion of homeownership among households previously denied credit had become a general trend. Important features of this development that accelerated at the end of the 1990s were the GSEs' affordable housing goals, as well as the emergence and growth of the subprime mortgage market. As a result of the introduction of the FHA

insurance programme and the VA loan guarantee programme, the mortgage market was effectively split into a market for federally insured mortgages and a market for non-federally insured, and thus conventional, mortgages.

Overall, during the post-war period, the terms on conventional mortgages also became more relaxed. The S&L industry, for example, started offering mortgages with conditions comparable to federally insured mortgages, including maturity periods of between 20 and 25 years and lower down payments (Ewalt, 1962, 288). But life insurance companies and commercial banks also eased terms on residential mortgages, as can be seen in Table 9. Soon after World War Two, most mortgages featured a down payment of about 30 per cent, an interest rate of 4 to 5 per cent, as well as maturities of 15 to 20 years. According to Aaron and Ewalt, the change in mortgage terms offered by the private sector was a reaction to government initiatives during the Great Depression to make home mortgages a safer investment. Furthermore, in practical terms, both the FHA and VA programmes had proved that more liberal mortgage terms did not accelerate default rates (see Figure 10 and Figure 11, as well as Aaron (1972, 74ff.) and Ewalt (1962, 288)). Thus, overall, the federal mortgage insurance offered by the FHA and the VA had redefined what was considered to be a sound as well as a standard mortgage.

LIFE INSURANCE COMPANIES			SAVINGS & LOAN ASSOCIATIONS			COMMERCIAL BANKS			
Average Loan to Value Ratio (%)	Average Interest Rate (%)	Average Contract Length (Years)	Average Loan to Value Ratio (%)	Average Interest Rate (%)	Average Contract Length (Years)	Average Loan to Value Ratio (%)	Average Interest Rate (%)	Average Contract Length (Years)	
1920	46	6.1	6	59	7	11.3	48	6.2	2.9
1925	49	5.9	6	60	6.9	10.9	50	6.1	3.1
1930	53	6	7.5	59	6.9	10.8	50	6.2	3.6
1935	53	5.5	13	60	6.2	11.9	60	5.6	9.8
1940	73	4.6	19.9	68	5.7	14.6	72	4.7	16
1945	76	4.4	20.1	73	5.1	14.3	61	4.5	9.3
1947	69	4	19.5	74	4.7	15.2	69	4.4	14.8

Figure 9: Terms on 1-4 Family Mortgages, Life Insurance Companies, Savings & Loan Associations, and Commercial Banks, Selected Years 1920-42.<sup>33</sup>

<sup>33</sup>Source: Saulnier (1950, 132-134), Morton (1956, 173-175).

<sup>35</sup>Source: Snowden (2006c, Dc1261-1264).

<sup>37</sup>Source: Snowden (2006c, Dc1266-1269).

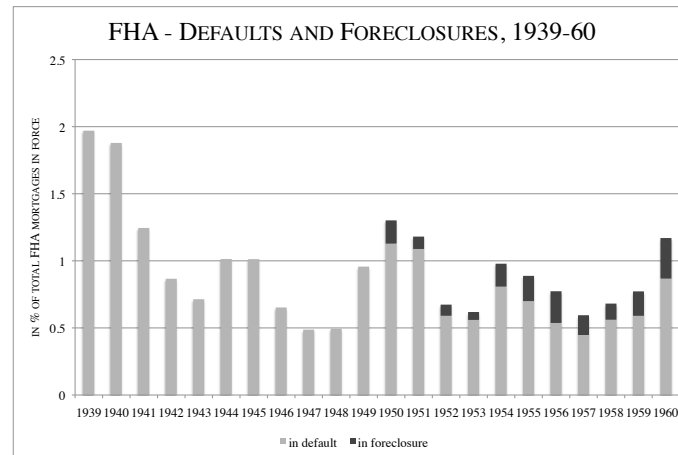


Figure 10: FHA – Defaults and Foreclosures (Single-Family Home Mortgage Programme), 1939-1960.<sup>35</sup>

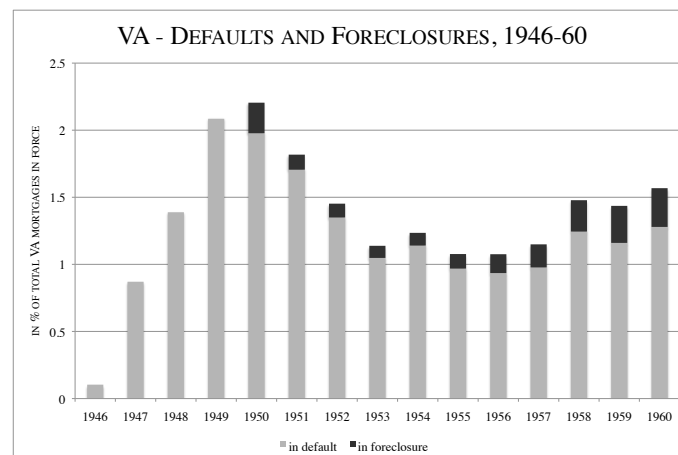


Figure 11: VA – Defaults and Foreclosure (Single-Family Home Mortgage Programme), 1946-1960.<sup>37</sup>

The distributional consequences of this general easing of mortgage terms were heatedly discussed in the immediate post-war period, particularly during the housing boom of the 1940s. As noted, many families that had not been able to take on mortgage debt and buy a house under pre-existing terms were now able to do so. Yet some economists argued that the benefits of eased mortgage terms were offset by rising home prices, as federally subsidised credit was heating up demand for housing, the supply of which was

considered fairly inelastic (Morton, 1956, 5). As a result, some families were being priced out of the market despite the eased mortgage terms (Eccles, 1947, 1464).

The new federal loan programmes provided by the FHA and VA played a significant role within the framework of the post-war mortgage system. As a result, a considerable share of the risk associated with mortgage debt was shifted from the private to the public sector. In 1956, Morton therefore argued that for lenders, investment analysis had become less concerned with judging the quality of individual mortgages than with trying to understand and correctly anticipate federal loan insurance and guarantee programmes (Morton, 1956, 5). Figure 12 provides a clear picture of the magnitude of this shift of risk to the public sector. The share of federally subsidised loans on total mortgage debt increased from about 10 per cent at the end of the 1930s to about 40 per cent in the 1950s. Figure 12 also shows the considerable growth of mortgage originations that can be ascribed to the VA and FHA programmes. In 1945, one year after the creation of the VA programme, about \$4.1 billion in FHA-insured loans and \$0.2 billion of VA-guaranteed mortgages were issued. By 1960, these amounts had increased to about \$26.7 billion for FHA-insured mortgages and \$29.7 billion for VA-insured mortgages. Snowden, however, argues that the level of subsidy provided by the government was even larger than Figure 11 suggests, since the conventional loan market in the post-war era was dominated by S&L industry, whose members were protected from default risk by the FSLIC (Snowden, 2010c, 19).

In the 1950s, however, private mortgage insurance also re-entered the mortgage market, particularly because FHA insurance had been consistently profitable. In 1957, the Mortgage Guarantee Insurance Corporation began offering the first private mortgage insurance, allowing lenders to originate loans with even lower down payments than those backed by the FHA (Green and Wachter, 2005, 97).

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<sup>38</sup>Source: Snowden (2006b, Dc934-949).

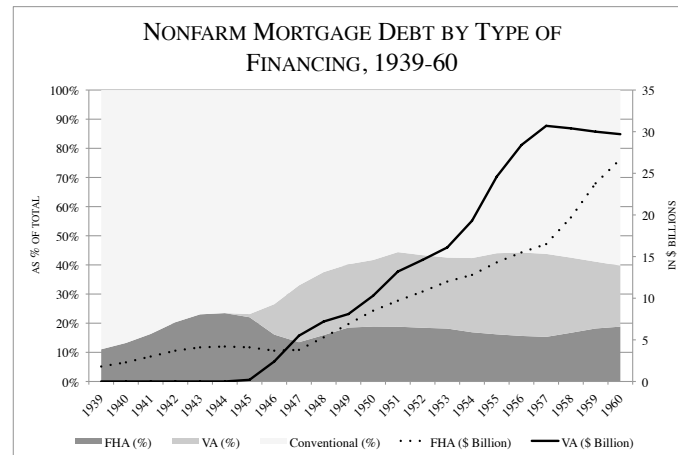


Figure 12: Nonfarm Mortgage Debt by Type of Financing, 1939-60.<sup>38</sup>

Accelerated by the federally underwritten mortgage programmes, the two decades after World War Two were marked by the rise of an increasingly nationwide mortgage market. This development was a major driver of growth in the secondary mortgage market (Klaman, 1961, 175). The federal government continued to intervene in the secondary mortgage market by constantly adjusting Fannie Mae's market involvement. In 1948, Fannie Mae was reorganised and authorised to purchase mortgages guaranteed by the VA. Subsequent legislation increased Fannie Mae's maximum lending capacity to \$3.65 billion. Several other changes alternately expanded and curbed its activities. The 1954 Housing Act re-chartered Fannie Mae and reorganised its operational structures, separating activities into three different functions: secondary market operations, special assistance functions, and management and liquidation functions (Haar, 1960, 104). Subsequent legislation expanded Fannie's special assistance activities for segments of the population that were unable to obtain mortgages under existing home-financing programmes (Haar, 1960, 107). In 1958, for example, the Emergency Housing Act provided additional funds for Fannie Mae to support these programmes. After the 1960-61 recession, the 1961 Housing Act again increased these funds (see Carliner (1998, 308f.), Aaron (1972, 94), Jones and Grebler (1961, 33ff.)). These special functions continued the trend of using intervention in the mortgage market as a form of social-assistance policy. While the prohibi-

tion on the purchase of conventional mortgages remained a major statutory restriction for Fannie Mae (Jones and Grebler, 1961, 33ff), the confirmation of its status as a government agency and its exemption from state and local income taxes provided it with a substantial and lasting competitive advantage over private financial firms (Klaman, 1961, 220). As a result of these changes, the share of nonfarm mortgage debt held by Fannie Mae increased (see Figure 8).

Apart from interventions focused on the mortgage market, tax policy also emerged as a significant element of homeownership subsidy. Most importantly, mortgage interest deduction (MID) was introduced as a major tax benefit after World War Two, enabling homeowners to deduct mortgage-interest payment from taxable income.<sup>39</sup> Even though interest payments were deductible under the modern federal income tax legislation introduced in 1913, the deduction had only had a slight effect on housing investment prior to the Second World War, since only individuals with very high incomes paid income tax.<sup>40</sup> During World War Two, the income tax was converted into a mass tax and tax rates were increased.<sup>41</sup> As a result, the tax benefits provided by the MID became sizeable. Furthermore, homeowners were also able to fully deduct property taxes on their principal residence from taxable income (Schwartz, 2006, 71). Due to the post-war surge in homeownership, the mortgage interest rate deduction became a major subsidy for middle- and upper-middle-income homeowners (Rosen and Rosen, 1980). In 1986, the Tax Reform Act ended many deductions, including the consumer interest deduction. Yet the mortgage interest deduction was retained, for it was, according to Senator Pryor, ‘one of the most sacred parts of the Tax Code’

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<sup>39</sup>Rosen and Rosen estimate that about one-quarter of the growth in the share of homeowners in the post-war period can be attributed to the favourable tax treatment of owner-occupied housing (Rosen and Rosen, 1980).

<sup>40</sup>In 1913, interest payments were made deductible based on the idea that interest receipts were a product of business and investment income. However, Congress did not distinguish between interest arising from the production of taxable income and interest to generate returns from houses and consumer durables (Toder et al., 2010).

<sup>41</sup>According to Howard, in 1939 only 6 per cent of workers paid income tax. Due to the reduction in the personal exemption for individuals and families, in 1945 70 per cent of all workers paid income tax (Howard, 1997, 98).



(132 Cong. Rec. 14,824 (1986)). This statement belies the true history of the MID, however, which had grown in significance without particular advocacy. In fact, when the U.S. Housing and Home Financing Agency published a summary of all government housing programmes in 1950, the MID was not mentioned at all. According to Howard, most policymakers were long unaware of the MID, and once the MID finally gained broader visibility, options for legislative change were limited due to high political costs of opposing this tax benefit (Howard, 1997, 95).

The revenue losses associated with the MID subsidy are sizeable. Estimates of these revenue losses are only available for 1970 onward, indicating that the programme's influence was somewhat invisible for many decades. For the period from 1970 to 1975, MID tax expenditure,<sup>42</sup> calculated as the difference between tax liability under present law and tax liability in its absence, amounted to \$25.7 billion (Joint Committee on Taxation, 2011). During subsequent decades, the size of MID deductions increased further, compelling Howard to describe the MID in 1997 as 'by far the largest housing programme in the United States and one of the largest tax expenditures' (Howard, 1997, 95).

Overall, the MID and property-tax deductions decrease the cost of homeownership and reduce the price of homeownership relative to renting. However, it has been argued that the MID is not a cost-effective tool for increasing homeownership. First of all, families at the upper end of the income distribution generally benefit more from the MID and property-tax deduction than low-income families, since the value of the tax deductions increase with income and higher home values (see Poterba and Sinai (2008), Schwartz (2006, 73)). In addition, lower-income homeowners are less likely to seek the deduction in their federal tax returns.<sup>43</sup> Overall, the distribution of the property

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<sup>42</sup>Tax expenditures are "revenue losses attributable to provisions of the Federal tax laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability." Therefore, they include any reductions in income tax liabilities resulting from regulations providing tax benefits or special tax provisions (Joint Committee on Taxation, 2011)

<sup>43</sup>Poterba and Sinai find that about 98 per cent of homeowners with incomes more than \$125,000 itemise their tax deductions. In contrast, only 23 per cent of homeowners with

tax deduction mirrors the uneven distribution the MID (Schwartz, 2006, 76). A second reason as to why the MID is said to be ineffective in encouraging home ownership is its possible inducement of higher home prices, as the subsidy increases the purchasing power of home buyers. Bourassa and Yin examine these price effects, concluding that tax deductions actually reduce the homeownership rate for young households.<sup>44</sup>

Between 1930 and 1960, the federal government thus created a range of institutions and programmes that imbued it with wide ranging influence over the mortgage market. The structures that were introduced during this period significantly shaped the market for residential mortgages, and provided the basis for subsequent legislation. Depository financial institutions such as savings & loans formed the heart of this system. The overall system was well suited for expanding mortgage debt in the post-war era, and for fostering rising homeownership rates (Snowden, 2010a). Fuelled by an expansion of mortgage credit, the overall rate of homeownership between 1930 and 1960 increased significantly by about 13 percentage points. However, even if changes to the mortgage finance system played an important role in this process, the extent to which federal support and tax benefits were responsible for homeownership growth remains difficult to ascertain. Rising real incomes and savings rates as well as the baby boom also contributed to an increase in demand for housing (Fetter, 2011, 5ff.). By the late 1960s, troubles in the market for housing finance would reappear, mainly because the allocation of risk in this post-war system favoured borrowers over lenders (Snowden, 2010a).

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an income of less than \$40,000 itemise deductions (Poterba and Sinai, 2008, 84).

<sup>44</sup>Bourassa and Yin estimate that eliminating the deductibility would increase the homeownership for their sample of young urban households from 41.5 to 42.5 per cent (Bourassa and Ying, 2007).

## 6 Conclusion

This study discussed the origins of government intervention in the mortgage market, intervention that led to a major structural change in mortgage finance as well as to its vast post-war expansion. As this paper has argued, these developments were not solely a response to the Depression-era crisis in housing. Other factors also played a major role. This paper focused on two significant motivating factors: The notion of homeownership as central to American society and, beginning in 1940s, the use of easy access to mortgage credit as a substitute for other social-assistance policies.

Between 1932 and the 1960s, the government instituted various mechanisms to encourage the flow of credit into housing. First, through the Home Owners' Loan Corporation, the government temporarily acted as a mortgage lender. Second, various government backstops, including the FHA loan insurance, S&L deposit insurance, and the VA loan guarantee programme, reduced the cost of homeownership and broadened access to mortgage credit. Third, government intervention encouraged the introduction of new and uniform standards for mortgage lending. Fourth, the government created a secondary market for federally underwritten mortgages, which increased the liquidity of mortgage lenders and the distribution of capital for housing finance. Fifth and finally, with the mortgage interest deduction, the government provided sizeable tax benefits.

Most of these instruments represent indirect and off-budget support for mortgage lending rather than, say, direct subsidies for the construction of housing (Quigley, 2006, 1). Overall, these government activities had a marked influence on the behaviour of all three groups participating in the housing market: debtors, investors, and builders. These individual instruments effectively led to emergence of a permanent system for the subsidisation of residential mortgage credit (Snowden, 2010c). The FHA, the VA loan programme, as well as Fannie Mae are still with us today; the FHLB system and FSLIC, by contrast, were abolished in the 1980s. The long institutional history of these programmes underscores the far reaching effects of

Depression-era legislative action.

The introduction of longer maturities to the mortgage credit system represented the first introduction of long-term debt to the American consumer. Thus, we find that government intervention led to a fundamental change in the way Americans borrowed as well as the way mortgage credit was lent (Hyman, 2011, 72). Calder thus argues that ‘[t]he twenty- year mortgage [...] gave real substance to a phrase coined in the 1920s to describe what Americans were adopting in the credit revolution: “the debt way of life”’ (Calder, 1999, 281).<sup>45</sup> Even though these interventions fostered a strong increase in homeownership, for most Americans, this ‘ownership’ was associated with significant indebtedness.

An important consequence of the growth of a nationwide mortgage market and a secondary market for mortgage securities was the depersonalisation of credit. The government interventions in the mortgage market during the 1930s for the first time placed home mortgages in the hands of anonymous institutional investors. As Hyman notes: ‘Debtors gradually became accustomed to owing money in large amount to someone they had never met’ (Hyman, 2011, 72). This trend would accelerate throughout subsequent decades, facilitated by the rise of ever-more complex securitisation, and would lead to the transformation of the mortgage system along the lines of an originate-to-distribute model rather than an originate-to-hold one (Barth et al., 2009, 22ff.). An additional effect was that mortgage credit became more and more disconnected from the idea of being a loan secured by real estate as collateral. Indeed, in the first decade of the twenty-first century, mortgage-backed securities were perceived as being backed by the future economic performance of the U.S. rather than the creditworthiness of individual homeowners.

Overall, these interventions in the mortgage market during the 1930s were part of a general paradigm shift in economic policy from what Galbraith terms ‘classical orthodoxy’ (Galbraith, 1994, 42ff), which had emphasised *laissez-faire*, toward New Deal liberalism, which stressed the importance of

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<sup>45</sup>The term ‘credit revolution’ refers to the rise of consumptive credit based on the idea ‘buy now, pay later’ during the 1920s that fostered rising debt levels (Calder, 1999, 211f.).

a more active role of the government to maintain the economy on a stable growth path and attain greater income equality (Brinkley, 1995, 5ff.). New Deal liberalism would dominate U.S. economic policy until the 1970s, when neoliberalism emerged as the ruling paradigm. In this sense, even though the period discussed in this paper stands out for its pronounced focus on housing policy, government intervention in the economy was common during this time, which was a watershed moment in the rise of the modern regulatory state. What is striking, however, is that even in times of neoliberal deregulation, the federal government would continue to intervene so intensively in the mortgage market, providing ever greater subsidies.

From a broader perspective, this study examined one aspect of a general shift in the relationship between the state and the financial sector witnessed over the course the past century. As a result of the Great Depression, the government assumed an active role in stabilising the U.S. financial system. To control the risks that emerged from these new implicit as well as explicit guarantees, the government introduced tighter financial regulation. During the 1970s and 80s, financial deregulation and liberalisation considerably weakened this regulatory regime. However, the government would remain ‘the guarantor of last resort in times of crisis’ (Schularick, 2012, 4).

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