Part One

The Federal Housing Administration

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The Modernization Loan Insurance Program

THE Federal Housing Administration was established as a new agency of the federal government when the President signed the National Housing Act on June 27, 1934. Title I of this Act provided the main outlines of the modernization loan insurance program, with which Part I of this study is exclusively concerned.[1] The reasons for the establishment of the modernization loan insurance plan are embodied in the memorandum submitted to the Senate Committee on Banking and Currency on May 16, 1934 by the National Emergency Council:[2]

(1) "A very substantial impetus to recovery and a sizeable relieving of the unemployment situation can be accomplished. . . . Such a program also leaves us with a lasting real benefit in the form of better homes. . . ."
(2) It will also "facilitate the flow of money from its present sources to the point of need without an excessive use of Government financing and the funneling of funds through

[1] Other parts of the National Housing Act called for the organization of a system of mutual insurance for mortgages (Title II) and for the establishment of national mortgage associations (Title III). In the first year or so of its existence the Federal Housing Administration concentrated its attention chiefly upon the modernization loan insurance plan, but in subsequent years its emphasis shifted in large measure to the mutual mortgage insurance provided for in Title II; more recently the first steps in the organization of national mortgage associations, as envisaged in Title III, have been taken. No further mention of operations under Titles II and III will be made in this study.
[2] Hearing before the Committee on Banking and Currency, U. S. Senate, 73rd Congress, 2nd Session, on S. 3603 (May 16, 1934) pp. 14-15.

the Federal Government and back out into the market. The approach is not only commendable from the standpoint of the National Budget but it is important from the standpoint of preserving and stimulating the private money market and private lending institutions so that they can more quickly assume the burden of normal financial operations."

(3) "The costs of this type of financing have in the past been excessive. To get these costs down and to control such financing the scheme . . . has been worked out. . . ."

A supplementary aim was expressed later by Federal Housing Administrator McDonald when he testified before a congressional committee that "the big thing in this has been to educate the banks to do this kind of business."[3]

THE MODERNIZATION LOAN INSURANCE PLAN

The chief provisions of the original modernization loan insurance plan, or the modernization credit plan as it is sometimes called in FHA publications, were set forth in Section 2 of Title I (Housing Renovation and Modernization) of the National Housing Act of 1934:[4]

(1) The Administrator was authorized to insure reliable financial institutions against losses on loans used to finance alterations, repairs and improvements upon real property.

(2) For each approved financial institution the insurance should not exceed 20 percent of the total amount of the loans advanced for such purpose.

(3) Individual insured loans could not exceed $2,000.

(4) The total liability of the administrator was limited to $200,000,000.

Several important administrative regulations implemented the plan. National banks, state banks, trust companies and

[3] Administrator Stewart G. McDonald, Hearing before a subcommittee of the U. S. Senate, 74th Congress, 2nd Session, on S. 4212 (March 16, 1936) p. 5.

[4] Public, No. 479, 73rd Congress, H. R. 9620. Title I and the most important amendments thereto are reproduced in Appendix A.

building and loan associations belonging to the Federal Home Loan Bank System were automatically approved, while finance companies, mortgage companies and other concerns had to be approved individually. Funds could not be used for the purchase and installation of movable equipment or machinery, but they could be applied to the improvement of unimproved real property. The $2,000 limit for individual loans was not to include the financing or time payment charge. Other regulations stipulated that the maturity of the loan must not exceed five years, that repayment be made in equal monthly instalments, that the entire time payment charge could not exceed 9.7 percent per annum true interest on the net proceeds of the loan, and that a borrower be a real property owner or the legal equivalent. Notes could be bought and sold among approved institutions. Minor exceptions to some of these regulations were permitted. Within this framework the insured institutions were free to follow their own lending policies. The government charged no premium for the insurance and left to the lenders almost complete responsibility for selecting sound credit risks.

This general plan was in effect from August 1934 until April 1937. Congress then permitted it to lapse, but revived it in February 1938.[5] In the period 1934-37, however, important changes were made in the law. The first of these were the amendments to the National Housing Act of May 28, 1935: (1) Loans or credits granted for the purchase and installation of detachable equipment and machinery were declared eligible for insurance. (2) Loans or credits of $2,000 to $50,000 were likewise insurable, provided the funds were

[5] The February 1938 amendments restored the plan with minor modifications. July 1939 regulations, in accordance with the June 1939 amendments, stipulated that the insured institution pay to FHA an insurance premium of ¾ of 1 percent of the net proceeds to borrower. Experience under the 1938 plan was too slight to warrant statistical analysis and in the present study it has been omitted from consideration.

used for the purpose of improving other than single-family structures: "apartment or multiple family houses, hotels, offices, business or other commercial buildings, hospitals, orphanages, colleges, schools, or manufacturing or industrial plants." There followed a second set of amendments on April 3, 1936: (1) Loans of $2,000 or less could not be insured if the funds or credits were to be used for the purchase and installation of detachable machinery and equipment, and the additions, alterations or repairs had to be on improved real property. (2) The insurance protection on loans made from April 1, 1936 through March 31, 1937, when Title I was to expire, was to be reduced from 20 percent to 10 percent of the aggregate advance by the insured institution. (3) Borrowers could be either real property owners or lessees of "real property under a lease expiring not less than six months after the maturity of the loan or advance of credit."[6]

The legislative and administrative changes just mentioned affected the type of institution insured, the type of loan approved, the type of borrower receiving the funds, and ultimately the collection of the loans. These modifications of the original provisions are summarized in Table 2.

The plan was designed to function with a minimum of delay and red tape, and the procedure developed in August 1934 remained essentially unchanged. An approved financial institution, receiving a contract of insurance from FHA, could immediately proceed to extend credit in accordance with the regulations. Actually the credit was rarely transferred to the borrower in the form of cash. Instead the institution most commonly paid the amount borrowed directly

[6] Section 6 was added to Title I on April 17, 1936, to permit loans for the restoration of real property and equipment destroyed by floods and other catastrophes. It was repealed in 1938. During the period of its operation very few loans were made under its provisions and these have been largely disregarded in the present study. For the full text of Title I, see Appendix A.

TABLE 2

SUMMARY OF CHANGES, 1934–37, IN TITLE I OF THE NATIONAL HOUSING ACT

Legislation	*Purpose of Loan*	*Type of Borrower*	*Amount of Loan*	*Insurance Reserve*
Original Act and 1934 regulations	To improve real property, both improved and unimproved.	Real property owner or legal equivalent.	$2,000 or less.	20 percent
Amendments of May 28, 1935	To purchase detachable equipment as well as to improve real property.	No change.	Loans from $2,000 to $50,000 admitted (for improving other than single-family structures).	No change
Amendments of April 3, 1936	Loans of $2,000 or less only to improve improved real property. Loans in this class no longer permitted for purchase of equipment.	Real property owner, or holder of lease extending 6 months beyond maturity date of loan.	No change.	10 percent

to the building contractor or to the seller of equipment with whom the borrower dealt.

The borrower's procedure was equally simple. He merely filled out on a prescribed form a credit statement in which he described the uses to which the funds were to be put and supplied other pertinent data.[7] If his statement showed that the loan complied with the regulations, the bank could report the transaction to Washington and have its insurance reserve credited with 20 percent of the net advance (for loans made after April 1, 1936, 10 percent).

In case of default on instalment payments by the borrower the insured institution could file a claim for loss as early as 60 days but not later than 13 months after the last payment of an instalment. Claims could include the net unpaid amount of funds actually advanced, uncollected earned interest, uncollected late charges, uncollected court costs, attorney's fees and a handling fee.[8] Once the claim was paid the borrower became a debtor of the government, which then endeavored to collect the sum due. It was assumed that the lending institutions themselves would make strenuous efforts to recover from borrowers in order to prevent impairment of their insurance reserves with FHA.

It did not take long for the program to get under way. Rules and regulations were made available on August 10, 1934. Organization of the Washington staff and of the field staffs in all states was completed by August 15, 1934. Financial institutions and building materials and equipment firms were provided with information about the program by circular letters and by interviews. A better housing campaign, launched jointly by the National Emergency Council and

[7] After the plan had been in operation for some time a regulation was introduced requiring the borrower to sign an additional statement, before the amount borrowed was paid over to the contractor, to the effect that the improvements were satisfactory.

[8] See Chapter 4, footnote 9, for exact method of calculating claims as prescribed in the FHA regulations.

the Federal Housing Administration, undertook to acquaint the general public with the plan. This vast publicity enterprise continued well into 1935, embracing the cooperative efforts of thousands of volunteer local committees, advertising contributions by newspapers, magazines, broadcasters and motion picture theaters, and canvasses of housing conditions by Emergency Relief Administration workers.

Only the loans insured from August 1934 to April 1937 are considered in this study, since experience under the revived plan has been extremely limited. As is shown in Table 2, which summarizes the legislative changes in Title I of the National Housing Act, loans of $2,000-50,000, made exclusively for industrial and commercial purposes, were eligible for insurance after May 1935. These non-consumer loans are necessarily included in a number of the tabulations used in this study. They amounted, however, to only 1 percent of the number of loans insured and to 10 percent of the dollar volume, and therefore do not impair the consumer character of the general body of insured loans. Where isolation of the two classes—notes under $2,000 and notes over $2,000 —is possible, the latter are discussed incidentally for comparative purposes, while major attention is devoted to the smaller loans. Although not all of the loans of $2,000 or less were used for the improvement of single-family dwellings, which is here considered an indication of their consumer orientation, the tabulations which permit the separation of single-family and other than single-family loans of $2,000 or less show only small differences; hence it seems justifiable to regard the two classes as more or less homogeneous.

INSTITUTIONS PARTICIPATING IN THE PLAN

Although 11,945 financial institutions had entered into contracts for insurance with FHA by the end of 1934, only 6,433, or slightly more than half of them, actually took advantage of the scheme by extending insured loans.[9] By far the vast majority of the financial institutions remained outside the program; only two-fifths of the commercial banks, about 15 percent of the industrial banking companies, less than 10 percent of the finance companies, and an even smaller percentage of the building and loan associations, savings banks and credit unions in the country as a whole participated in the plan.

Since almost any reputable financial institution could obtain a contract from FHA, the question arises as to why such a large proportion failed to accept the government's offer of free insurance. One explanation is to be found in the regulations governing the type of borrower and the kind of property to be improved.[10] The definition of property ownership, for example, rendered the plan almost useless for most credit unions, and the restriction upon the use to which the loan could be put had a similar effect upon sales finance companies, especially those specializing in automobile financing. Moreover, since ordinarily the only security for the loans was to be the economic capacity of the borrower as represented by his income, many savings banks and building and loan associations, which customarily require real estate mortgage security, may have considered that the risk involved in such character loans would be too great and that the regulations as to proof of property ownership would introduce unnecessary complications. Even if eligible institutions remained undaunted by these restrictions, a large number, particularly the personal finance companies and the industrial banking companies, may have decided that the 9.7 percent maximum annual rate of interest permitted for insured loans was too low, despite the added protection they might otherwise have enjoyed from the insurance.

[9] The only available tabulation of institutions approved is that for December 31, 1934, published in the *First Annual Report of the Federal Housing Administration,* 1934, p. 9.

[10] See Table 2 above.

A number of other considerations, more difficult to appraise, may well have caused some institutions to abstain from participating in the scheme. It seems likely that many feared that the fairly specific requirements regarding the loan and the borrower would prove to be a nuisance, if not actually a threat to customer goodwill. It is possible, too, that a few balked at participation because FHA was a government enterprise. Others may have anticipated that the expense involved in the drafting of reports and the extra bookkeeping would not be counterbalanced by the money return. Finally, government credit insurance was new to American money-lenders, and some of them may have been suspicious of the plan simply because the service was being given away.

Let us return now to the 6,433 institutions which did insure loans with the Federal Housing Administration during the period under discussion, for it is with them, with the notes they insured and with their experience in collecting the loans that this study is chiefly concerned.[11] As Table 3 shows, 90 percent of the lending institutions were commercial banks, almost evenly divided between national banks on the one hand and state banks and trust companies on the other. These outlets provided 70 percent of the dollar volume of loans. Finance companies, frequently subsidiaries of building materials concerns, comprised only 2 percent of

[11] By December 31, 1934, 3,997 had reported loans; by December 31, 1935, 6,082; by December 31, 1936, 6,399; and by March 31, 1937, 6,433. Of the 6,433 institutions which made insured loans up to April 1, 1937, 6,289 came in under the 20 percent reserve provision; 4,010 of them continued to use the insurance under the 10 percent reserve prevailing from April 1936 to April 1937 and an additional 144 joined the plan in that year. At first glance it might seem that the decline in actively insured institutions was conditioned by the reduction of the reserve. However, since few institutions used up their insurance even under the 10 percent reserve, it is more likely that a large proportion of those which dropped out found that they were not making enough eligible loans to warrant continuation of the insurance. The insured notes were a negligible part of the business of most of the institutions on FHA rolls.

TABLE 3

NUMBER AND PERCENTAGE DISTRIBUTION OF INSTITUTIONS INSURING NOTES WITH FHA, 1934–37, PERCENTAGE DISTRIBUTION OF NUMBER AND AMOUNT OF NOTES INSURED, AVERAGE VOLUME OF NOTES INSURED PER INSTITUTION AND AVERAGE NOTE, BY TYPE OF INSTITUTION[a]

Type of Institution	*Insured Institutions*		*Percentage Distribution of Notes Insured*		*Average Volume of Notes Insured Per Institution*	*Average Note*
	Number	Percentage Distribution	Number	Amount		
Commercial banks	*5,808*	*90.3*	*67.1*	*70.5*	*$ 68,022*	*$407*
National banks	2,794	43.4	42.7	43.9	88,065	398
State banks and trust companies	3,014	46.9	24.4	26.6	49,442	423
Other lending institutions	*625*	*9.7*	*32.9*	*29.5*	*264,622*	*345*
Finance companies	149	2.3	25.3	22.1	829,888	337
Industrial banking companies	77	1.2	6.3	5.7	421,770	354
Building and loan associations	296	4.6	.5	.8	14,898	533
Savings banks	62	1.0	.7	.7	66,395	400
Credit unions	28	.4	.1	.1	14,576	521
Others	13	.2	(.01)	.1	24,968	594
ALL GROUPS	6,433	100.0	100.0	100.0	$ 87,122	$386

[a] Based on 1,450,503 notes for $560,458,230 insured August 1934 to April 1937.

the lenders, but furnished 22 percent of the total dollar volume. Industrial banking companies constituted only 1 percent of the lending institutions and yet accounted for 6 percent of the total volume of notes insured, while building and loan associations made up nearly 5 percent of the institutions insured but less than 1 percent of the total dollar volume. A few savings banks, both stock and mutual, and a still smaller group of credit unions, mortgage companies, insurance companies and production credit associations provided the remaining 1.6 percent of the number of institutions and 1 percent of the dollar volume.[12]

Also in Table 3 are shown some striking variations among the different types of lending institutions with regard to the average amount each institution loaned under the insurance scheme. Thus although the average total amount loaned by all institutions was $87,122 per institution, the average for finance companies per unit was $829,888 and for industrial banking companies $421,770. The building and loan associations and the credit unions, on the other hand, provided the smallest averages per institution. The leading position of the participating finance companies in this respect is to be attributed to the fact that a large part of their loans conformed to FHA specifications. Industrial banking companies, which had a relatively large volume, were already in operation as agencies of consumer credit and a goodly portion of their business was eligible for FHA insurance, especially from June 1935 to March 1936 when movable equipment was included in the FHA list. The small average for building and loan associations reflects their reliance on real estate mortgage loans. The average volume per bank for national banks, although small compared with that for

[12] The relatively large financial institutions made more extensive use of the insurance than the relatively small; the 3,997 institutions reporting loans insured by December 31, 1934 represented nearly three-fourths of the commercial banking assets in the United States but only about one-fourth of the number of banks.

finance companies, was almost twice as great as the average for state banks and trust companies. This divergence may be explained by the fact that larger banks in the highly industrialized sections of the country, where the modernization loans were concentrated, are usually national banks.

As Table 4 indicates, the dollar volume of notes insured was by no means equally distributed among the different institutions. Of the grand total of 6,433 lending institutions, as small a number as 596 (9.4 percent) accounted for 84 percent and as few as 64 of the latter (1 percent of the total number of institutions participating) furnished 60 percent of the total dollar volume of notes insured. The average volume per institution for the 64 institutions with the largest volume was over $5,000,000, while the average for the institutions in the smallest volume group—those with less than $100,000—was not quite $16,000.[13]

Some general reasons for the volume concentration may be offered. Many of the 596 institutions had exceptionally large resources; many were located in populous regions or where population was growing rapidly; some had a number of branches; a few were particularly well prepared to take advantage of the FHA insurance subsidy; some, seeking new sources of income, were disposed to make substantial investments in insured loans.

Thus far we have described the modernization loan program, outlined its provisions and summarized the major features of the institutions which took advantage of them. The following chapter deals with the principal characteristics of the loans extended by the insured institutions, and Chapter 4 analyzes claims paid by FHA to insured institutions.

[13] The percentage distribution of the dollar volume of notes insured among the 596 large-volume lending institutions, by type, is as follows: 283 national banks, 43 percent; 208 state banks (including trust companies and a few savings banks), 22 percent; 61 finance companies, 26 percent; and 44 "others," 9 percent.

TABLE 4

NUMBER AND PERCENTAGE DISTRIBUTION OF INSTITUTIONS INSURING NOTES WITH FHA, 1934–37, PERCENTAGE DISTRIBUTION OF NUMBER AND AMOUNT OF NOTES INSURED, AVERAGE VOLUME OF NOTES INSURED PER INSTITUTION AND AVERAGE NOTE, BY VOLUME OF NOTES INSURED PER INSTITUTION[a]

Volume of Notes Insured Per Institution[b]	*Insured Institutions*		*Percentage Distribution of Notes Insured*		*Average Volume of Notes Insured Per Institution*	*Average Note*
	Number	Percentage Distribution	Number	Amount		
Under $100,000	*5,837*	*90.6*	*15.8*	*16.4*	$ *15,772*	*$399*
100,000 and over	*596*	*9.4*	*84.2*	*83.6*	*786,146*	*384*
100,000–500,000	475	7.5	16.1	16.9	198,924	407
500,000–1,000,000	57	.9	6.6	6.9	678,115	408
1,000,000 and over	64	1.0	61.5	59.8	5,240,649	375
ALL GROUPS	6,433	100.0	100.0	100.0	$ 87,145	$386

[a] Based on 1,450,503 notes for $560,458,230 insured August 1934 to April 1937.
[b] Each level includes the lower figure and excludes the higher.