Although HOLC was popular and generally successful, it was only intended to be an emergency measure and did not finance purchases. As a longer-term measure, Congress passed the National Housing Act in 1934. With an ultimate goal of reducing unemployment in the construction industry, the Act was designed to encourage mortgage lending and to make purchase-money credit available again. It has been called a “blueprint for a national mortgage market.”

One major component of the Act was creation of the Federal Housing Administration (FHA). The FHA was created to insure mortgages made by private lenders against default. While there had been a number of private insurers operating during the 1920s, they had all failed during the Depression. Insurance premiums charged to borrowers were pooled in the FHA’s insurance fund. The economic theory behind the FHA was to get capital moving again by eliminating the risk in mortgage lending. Unlike other New Deal programs, the FHA was innovative because it used mostly private capital rather than government funding. Before the advent of the FHA, residential mortgages had been considered too risky an investment for responsible banks. So, even though there was significant demand from potential home buyers and plenty of capital available, the banks refused to lend.

By fully insuring banks against defaults, FHA loans offered banks a guaranteed profit. This guarantee convinced banks, which certainly needed the business, to begin lending. In doing so, the FHA’s insurance program broke the credit logjam that had been holding back the nation’s building industry.

At inception, FHA insurance consisted of two programs, under Titles I and II of the National Housing Act. Title I insured home improvement loans for up to 20% of losses on the lender’s entire Title I portfolio. Before the program was launched, only 1% of banks were willing to make this type of loan. By six months later, 71% were doing so.

Title II insured home purchase loans for new and existing homes. In order to qualify for FHA insurance, however, the transaction had to meet certain guidelines. These guidelines permanently influenced the terms of mortgage lending and the shape of homeownership. The FHA initially insured only loans having a twenty-year amortization (later raised to twenty-five, then thirty years) and a maximum interest rate of approximately 5%. The loan principal could be as much as 80% of the property value, requiring a much smaller down payment than in the past. The required down payment was later reduced to 3%.

The predictability and affordability of FHA-insured loans encouraged banks to resume lending with less risk, enabled them to lend to more potential buyers, reduced the demand for large down payments, and brought more lenders into the market. These changes made homeownership more accessible. Importantly for lenders, as well as borrowers, these changes also reduced the risk of foreclosure by making payments more affordable and by reducing the exposure to changing interest rates that came when a borrower needed to refinance a short-term loan.

The creation of the FHA also led to an early example of widespread credit deregulation. Until the 1930s mortgage lending was highly regulated at the state and federal level in the name of safety and soundness. Laws and regulations mandated lower loan-to-value ratios and shorter loan terms than permitted by the FHA. As a result, loans meeting the FHA’s standards were unavailable or illegal. This problem led the FHA to lobby Congress and state legislatures for exemptions from bank safety-and-soundness rules. With promises that the insurance offered by the FHA would protect banks and account holders from the increased risk associated with FHA lending, Congress and every state gave the FHA exemptions that would not be available to non-FHA loans until the 1970s.

Footnotes


43 Louis Hyman, Debtor Nation: The History of America in Red Ink 53 (2011) (attributing to Federal Reserve economist Winfield Riefler the economic theory behind the FHA mortgage instrument).


48 [48] Id. at 54.

49 [49] Id. at 53–54 (quoting Fed. Hous. Admin., Architects, Contractors, Building Supply and Other Merchants 4 (1934)).


51 [51] Id. at 376.

52 [52] Id.


59 [59] See generally id. at 194–207.

60 [60] Id. at 195.

61 [61] Id. at 196, 198.

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