J. Finan. Intermediation 000 (2017) 1–17

Contents lists available at ScienceDirect

J. Finan. Intermediation

journal homepage: www.elsevier.com/locate/jfi

Economic crisis and the demise of a popular contractual form: Building & Loans in the 1930s[☆]

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ARTICLE INFO

Article history:
Received 7 August 2016
Revised 9 August 2017
Accepted 12 August 2017
Available online xxx

Keywords:
Mortgage
Great Depression
Savings and loan
Housing crisis

ABSTRACT

Before the 1930s Building and Loan Associations (B&Ls) were the leading residential mortgage leaders in the U.S. When severely distressed during the housing crisis of the 1930s, B&Ls frequently took years to liquidate. These delays in resolution resulted from the unique B&L contract that encouraged borrowing members to prolong dissolution and gave them shared control over the timing of liquidation. We estimate a hazard model of dissolution using a new dataset of New Jersey B&Ls and find that the probability of liquidation rose 37% when the share of non-borrowing members rose above two-thirds. The severe restriction on liquidity suffered by non-borrowers was instrumental to the rapid transition from the traditional B&L to the modern Savings & Loan industry during the 1930s housing crisis.

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1. Introduction

Severe disruptions in the housing market associated with the Great Recession of 2007 have prompted a broad re-evaluation of the nation's residential mortgage lending channels. A similar re-examination during the devastating housing crisis of the 1930s led to a fundamental restructuring of the contracts, intermediaries and market structures that were used to fund residential mortgages.[1] That transformation brought "federalization" in the form of an emergency mortgage refinancing program, a mortgage discount bank, a mortgage loan insurance program and a secondary mortgage market facility.[2] This paper examines the forces that shaped a less familiar element of change that was equally far-reaching—the transformation of the traditional Building & Loan sector into the modern Saving & Loan industry. By 1930 the B&L industry had become the nation's most important institutional source of home mortgage loans due to the success of its unique, equity-based contractual arrangement, through which saving and borrowing members shared local lending risk and organizational control. This mutual lending structure foundered badly during the 1930s housing crisis, however, and by the 1940s had been reduced to a small corner of the nation's financial landscape. We show in this paper that the modern S&L gained prominence during the housing crisis of the 1930s, while B&Ls became marginalized, because the latter lost favor among the saving public after it was shown to impose costly illiquidity on its non-borrowing members during the housing crisis.

The key contractual element of the pre-1930 B&L was the Share Accumulation Contract (SAC) that members used to purchase equity in the association in monthly installments. These investments offered non-borrowing members a disciplined savings plan that yielded attractive returns relative to the alternatives available at that time. The monthly contributions to SAC accounts by borrowing members, on the other hand, served as sinking funds with

☆ We are very grateful for the comments and suggestions from Charles Calomiris, Joshua Hausman, Kris Mitchener, Robert Margo, Dave Ribar, Jonathan Rose, Tiemen Woutersen and participants at sessions on the paper at the World Congress of Cliometrics in 2013 and the NBER-DAE Summer Institute in 2015. Fishback and Snowden acknowledge support from the National Science Foundation (Grant SES-1061927). Any opinions expressed here do not reflect the attitude of the National Science Foundation.

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[1] Housing starts in the U.S. peaked in in 1925 at 937,000, then fell to 509,000 in 1929 and to 93,000 in 1933. Meanwhile the nonfarm foreclosure rate quadrupled between 1926 and 1933 and remained at elevated levels until 1940. By the later date the real stock of home mortgage debt remained 15% below its 1932 peak. Data on housing starts and the stock of home mortgage debt was compiled from Snowden (2006), 4-481 to 4-482 and 4-526 to 4-527 and deflated by the CPI 1967 = 100. See Wheelock (2008) for foreclosure rates.

[2] The Federal Home Loan Bank System's discount facility was created in 1932, the Home Owner's Loan Corporation emergency refinancing program in 1933, the Federal Housing Administration's mortgage loan insurance program in 1934 and the Federal National Mortgage Association's secondary mortgage market facility in 1938.

http://dx.doi.org/10.1016/j.jfi.2017.08.003
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which they paid off their loans. Because all members invested in SAC contracts, B&Ls were mutually-owned intermediaries in which borrowers and non-borrowers shared the risks and rewards on their association's mortgage portfolio. For this reason, the SAC contracts were specifically designed both to fund and to repay long-term, illiquid loans. Within the earliest "terminating" associations popular in the 1830s, for example, non-borrowing members were required to remain in the association until the shares of all members had matured and all loans had been repaid. Innovations within the B&L industry over the next century provided greater liquidity for non-borrowers by embedding SAC contracts into a variety of "plans" that apportioned profits and losses as some members withdrew and others joined. Within these "serial" and "permanent plan" associations, members still had to provide 30-day written notification before withdrawing and then pay penalties for leaving the association "early." Withdrawal policies became even more liberal in the 1920s as a rapid expansion of B&Ls provided associations with steady inflows of new investments that permitted them to suspend withdrawal notifications and penalties.

These relaxed withdrawal policies were quickly undone as the Depression and the housing crisis gained momentum in the early 1930s.[3] As repayments on outstanding loans and the flow of new members fell dramatically, B&Ls that were no longer able to accommodate withdrawal requests could, under their bylaws, postpone withdrawals indefinitely. Thousands of associations did so and became "frozen" associations that operated for years even though they attracted no new members, made no new loans and held large quantities of foreclosed real estate as they waited for mortgages that were still in good standing to be paid off (Snowden, 2003).[4] The crisis clarified to all B&L members that their SAC accounts were not deposits and left non-borrowing members with only three options. First, they could apply to withdraw their funds, but doing so could take years after B&Ls implemented rotation systems in which a set dollar amount of net earnings was paid each month to each withdrawing member until all their claims were satisfied (Kendall 1962, 76–7). Second, non-borrowers in larger cities also had the option of selling B&L shares in informal secondary markets that appeared during the 1930s—although withdrawal by means of a curb sale generated a deep discount relative to the book value of the shares (Rose 2014; Kendall, 1962).

In this paper, we focus on a third possible response. As owners of their B&L, non-borrowing members could press their frozen association to liquidate voluntarily and immediately. It is here that the contractual structure of the traditional B&L created a conflict between borrowing and non-borrowing members. Under the terms of the SAC loan contract, borrowing members who were in good standing had strong incentives to oppose liquidation of their B&L until their loans had been paid off. Non-borrowing members, on the other hand, generally favored more rapid resolution. B&L contracts, and the case law that interpreted them, favored the borrowers in this conflict. The voluntary liquidation of a B&L required the approval of two-thirds of the members—with each member in good standing having one vote. To see how this voting requirement influenced the timing of B&L liquidations, we have collected and digitized a new panel dataset with time-varying information on the membership and balance sheets of all (more than 1500) B&Ls that operated in New Jersey in the 1930s.[5] Estimates from a semi-parametric Cox survival model show that the probability of liquidation rose 37% when the share of non-borrowing members rose above the two-thirds required for voluntary dissolution. This translates into a typical delay of about one year in the exit of a failing B&L.

Delayed liquidation was a well-understood feature of the B&L landscape throughout the 1930s (Snowden, 2003). The New Jersey case illustrates why. Between 1930 and 1935, the real estate share of assets for New Jersey B&Ls rose from 4% to 24%, a level of distress that would have led to insolvency and liquidation in other types of real estate lenders. Yet, by 1935 only 41 of 1565 New Jersey B&Ls had closed. Another 90 associations exited between 1935 and 1938, but even by then most of the remaining 1434 B&Ls in operation were badly distressed with an average real estate share of assets above 40%. Between 1938 and 1940, 440 of these associations finally closed, followed by another 485 between 1940 and 1945. By the later date only 509 Building (or Savings) and Loan associations were operating in the state.[6] B&L liquidations in the 1930s took so long to complete that New Jersey, along with several other states, undertook special "Community Programs" as late as 1940 to rehabilitate the mortgage market in major "B&L cities."[7]

B&L contracts were intentionally designed to fund long-term residential investment. The bylaws of these associations, and the case law that interpreted them, preserved this function even under the severe distress of the 1930s by suspending withdrawals and delaying liquidation. The extra time provided borrowing members an opportunity to finish repaying their loans so that foreclosures were avoided, B&Ls dumped fewer foreclosed homes into weak housing markets, and downward pressure on local housing prices was relieved. These benefits came at substantial cost, however, to the non-borrowing B&L members who could not withdraw their assets at book value and had to wait to obtain the liquidation value of the assets. These delays forced non-borrowers to sacrifice liquidity and to hold for extended time periods ownership claims on portfolios of poorly performing loans and foreclosed real estate. The associated costs were large enough that non-borrowing savers quickly abandoned B&L investment and moved to a new "Savings & Loan" contract that provided, with the support of new federal regulatory structures, a more reliably liquid investment than the traditional B&L. The transition from B&L to S&L during the 1930s, therefore, offers an important example of how a contractually-delayed resolution mechanism generated institutional change during our last great mortgage crisis.

[3] During the 1930s foreclosures spiked because of a 30 percent decrease in per capita income, a 25% decrease in the nominal value of housing, and deflation that raised the real cost of repaying loans.

[4] Snowden (2003, 187–9) shows that the combined numbers of B&Ls and S&Ls fell from 12,342 to 8,318 between 1929 and 1939. Another 2,000 small associations exited the industry by 1944. The long duration of B&L curtailment is also reflected by the share of assets held in real estate which grew from 3 percent in 1929 to 20% in 1935 and remained at 12 percent as late as 1939.

[5] We focus on New Jersey because it is the only state where the regulator consistently reported the number of borrowing and non-borrowing members and balance sheet information for each B&L for each year in the 1930s.

[6] Information on the New Jersey B&Ls is from the sample we constructed from New Jersey state reports, and the number of New Jersey banks come from New Jersey fared better than the nation as a whole as the U.S. number of B&Ls and Savings and Loans declined 12.8% between 1930 and 1935 and the number of commercial banks declined 39% between 1930 and the trough in 1933 (U.S. Bureau of Census, 1975, series X834 and series X580). Nationwide, the number of B&Ls and Savings and Loans fell by 12.8 percent. In comparison, 27% of commercial banks and 15% of U.S. life insurance companies were eliminated nationwide between 1930 and 1933/34.The national figures are from the changes in the number of insurance companies and commercial banks come from series X834 and X580 from U.S. Bureau of the Census (1975).

[7] The community programs of the late 1930s are described in the *Eighth* (107–10, 1940) and *Ninth* (120–4, 1941) Annual *Reports* of the Federal Home Loan Bank Board. The cities that were affected were New Orleans, Altoona, Philadelphia, Chicago, Milwaukee, Newark and Patterson. These programs benefitted from the support provided by the newly-created Federal Savings & Loan Insurance Company,

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