

# How to Create Low-Income Homeownership Through Local Mutual Associations

by Alex J. Pollock

Several years ago, a lot of politicians and theorists tried and failed to create a meaning for the phrase, "community development bank."

We suggest the problems they encountered can be successfully addressed by the rediscovery and re-implementation of a very old financial idea: *mutuality*. This was historically considered inseparable from local voluntary associations, which reflected the community ideals of cooperation, self-help, savings and homeownership.

Mutual savings and loan associations, true to these principles as originally conceived, experienced many decades of success. Although their operations have changed from the historical design, there are still over 700 mutual savings associations in the United States, most of them, consistent with their historical roots, small and local organizations. Mutual institutions represent 45% of all thrift charters, but only 11% of thrift industry assets.

In the original concept, there were eight key characteristics, which made the mutual as-

Alex J. Pollock is President and Chief Executive Officer of the Federal Home Loan Bank of Chicago, U.S.

sociation a successful social structure for building homeownership in lower-income communities. Taken together, these points are an excellent outline of a coherent design for promoting low-income, minority and immigrant home ownership today.

These were:

- First: It was an *association*, not a stock corporation, whose purpose was not maximum profits, but the mutual financial progress of its members. It was considered part of a "movement" for individual and social improvement, as "a great character-building and community-building business," a "noble institution for self-help," and "practical idealism," by contemporary supporters. Appendix A contains excerpts from the classic text on mutual building and loans describing how these institutions viewed themselves.
- Second: It was a *local organization*, often started as a neighborhood club, and focused on the neighborhood or town. It was, as one historian put it, "generally patronized by persons in what we now call low-income categories." The members of the association were not financially well-off, but wanted to improve. Appendix B is a list of the member institutions in the City of Chicago of the Federal Home Loan

Bank of Chicago in 1933. Simply reviewing their names makes clear their community, local character.

- Third: It was *to gather and care for the savings of the local community*, and to promote "thrift, self-denial, temperance, simple living, success and independence," as one writer expressed the goals. The federal associations were especially to be organized in communities which lacked a local thrift institution.
- Fourth: Its *credits were to be sound*, always based on first liens on property geographically close to the association and thus known to its management and board. It was to be a self-sustaining economic organization. An interesting retrospective confirmation of the theory comes from an Office of Thrift Supervision research report, which concluded that during the 1980s, mutual institutions were significantly less risky than those in stock form.
- Fifth: It was *a commitment of the local community to help itself*. Funds invested in the association were equity or "shares," not debt and not deposits. In the U.S. context, this is a surprising notion now, since savings in today's thrift institutions are deposits, i.e. liabilities. But

in the original concept, savings shares were equity investment in the credit-worthiness of local people, known to each other. Although the idea subsequently became obfuscated and then lost, the historical thinkers about mutuality were very clear on this point. As a classic text explained, "Instead of paying the profit to a group of people who have contributed only a small amount of capital stock, the building and loan association pays all the profits to its members. Each member is part owner of the business, assuming an ownership risk. In building and loan associations, the risk is negligible, it is true, but no emphasis on this fact should be allowed to cloud the issue. The building and loan member is an owner of the business."

- Sixth: Its *management was local*. As a 1930s commentator wrote, "Local capital must take stock and local people must operate the association." Training and development of local management was a key requirement in the 1930s and would be again today.
- Seventh: *It could be helped by the federal government investing on a matching basis* by the purchase of preferred shares in an amount up to the investment raised locally. These shares had to be retired beginning five years later. Such matching preferred investments were made in significant amounts, a total of \$225 million (equal to about \$3 billion today) with overall success. After deducting the losses which inevitably occurred in some cases, in total the Treasury recovered its entire principal plus a yield of 3%.
- Eighth: It was *exempt from federal taxes*.

That this design worked is amply demonstrated by history. The notorious class of savings and loans of the 1980s, which made the very term suspicious, bore no relation to

the successful social design of preceding decades. To return to the original concept, we need to return to something very like the *original Home Owners' Loan Act of 1933*.

This Act created the charter of federal savings and loan associations. The key provisions of the Act as it was in 1933 and might be again in 2002 follow. One change needed is to correct for the depreciation of the currency. Since one 1933 dollar is equal to about 13 current dollars, the amounts specified in the Act should be multiplied by 13.

Here, in excerpts quoted from Section 5 of the original 1933 Act, is an attractive structure for local mutual thrift associations:

- a. The purpose is to provide local mutual thrift institutions in which people may invest their funds.
- b. Such associations shall raise their capital only in the form of payments on such shares as are authorized in their charter. No deposits shall be accepted and no certificates of indebtedness shall be issued.
- c. Such associations shall lend their funds only on the security of their shares or on the security of first liens upon homes or combination of homes and business property within fifty miles of their home office. Not more than \$20,000 shall be loaned on the security of a first lien upon any one such property.
- d. Power to provide for the reorganization, consolidation, merger, or liquidation of such associations, including the power to appoint a conservator or a receiver.
- e. No charter shall be granted except to persons of good character and responsibility, nor unless necessity exists for such an institution in the community to be served.

- f. Each such association shall become a member of the Federal Home Loan Bank of the district in which it is located<sup>1</sup>.
- g. The Secretary of the Treasury is authorized on behalf of the United States to subscribe for preferred shares in such associations which shall be preferred as to the assets of the association and which shall be entitled to a dividend, if earned, to the same extent as other shareholders. Subscription to the preferred shares of any one association shall not exceed \$100,000, and no such subscription shall be called for unless the funds are necessary for the encouragement of financing in the community to be served. The amount paid in by the Secretary of the Treasury shall at no time exceed the amount paid in by all other shareholders. To enable the Secretary of the Treasury to make such subscriptions when called there is hereby authorized to be appropriated, out of any money in the Treasury not otherwise appropriated, the sum of \$100,000,000. Each such association shall make provision for the retirement of its preferred shares held by the Secretary of the Treasury, and beginning at the expiration of five years from the time of the investment in such shares, the association shall set aside one-third of the receipts from its investing and borrowing shareholders to be used for the purpose of such retirement.
- h. Such associations, including their franchises, capital, reserves, and surplus, and their loans and income, shall be exempt from all taxation now or hereafter imposed by the United States.

When we adjust the amounts from 1933 to current dollars, we find that:

- The lending limit against any individual property is \$260,000.

- The matching preferred stock investment available from the Treasury is up to \$1.3 million per association.
- The initial appropriation for such matching investments is \$1.3 billion.

Note that this would result in enough appropriation for 1,000 associations.

A number of variations on the theme may need consideration. Home Loan Bank membership might be voluntary, not mandatory.

The tax exemption might phase out after assets reach a certain size. An appropriate regulatory design is required. It might make sense for this to be a project of the Office of Thrift Supervision, in a revival of its historical roots. Detailed issues can be settled when there is a coherent framework.

We suggest the basic framework is logically articulated in the original 1933 version of the Home Owners' Loan Act and is available to reenact, *mutatis mutandis*.

**NOTES**

<sup>1</sup> Regarding Federal Home Loan Banks, see Alex J. Pollock, "Simplicity vs. Complexity in the Evolution of Housing Finance Systems," *Housing Finance International*, Spring, 1994; "The Federal Home Loan Banks and Risk Distribution in American Housing Finance," *Housing Finance International*, September 2001.

**APPENDIX A**

**HOW THE LOCAL MUTUAL ASSOCIATIONS SAW THEMSELVES**

Elements of the Modern Building and Loan Associations

By Horace F. Clark, PhD. (Wisconsin)

*Horace F. Clark was an economist with the American Savings, Building and Loan Institute (Formerly with the Department of Economics, University of Wisconsin). Frank A. Chase, general manager, American Savings, Building and Loan Institute, also contributed to the text. The following is excerpted from a text-book prepared as a part of the educational program of the American Savings, Building and Loan Institute, published by The MacMillan Company, 1930. All rights reserved.*

**Buildings and Loan Association (1930)**

Building and loan associations started as neighborhood clubs. Neighbors wished to become homeowners and began contributing a certain sum monthly.

The joint purposes of thrift and homeownership are inseparable. The community ideals which are served by these associations are appreciated throughout the country.

A building and loan association is not a philanthropy, it is a straight business proposition in which a valuable service is rendered to the borrower and is paid for by him at a rate which produces a reasonable profit on the investment.

Thrift is by no means as trite a subject for discussion as some would have us believe. Thrift is a disciplinarian. It breeds virility. It strikes at sensuality, self-indulgence, flabbiness. It teaches heroism of self-denial, temperance, abstemiousness, and simple living. It is the way to success and independence. It makes for happy homes, contented communities, a prosperous nation. The value of homeownership for a large portion of the population is not to be denied.

The success of the building and loan association in promoting the two ideals is due primarily to the use of small periodic payments, or the so-called "principle of amortization." By reason of the installment plan, the bor-

rower is able to pay for his home out of his earnings.

Savings accumulated in building and loan associations differ from those accumulated in savings banks. Instead of paying the profit to a group of people who have contributed only a small amount of capital stock, the building and loan association pays all the profits to its members. Each member is part owner of the business, assuming an ownership risk. In building and loan associations, the risk is negligible, it is true, but no emphasis on this fact should be allowed to cloud the issue. The building and loan member is an owner of the business. The dividend rate is obtained by dividing the net earnings by this total average investment. The profits are credited to each member's share when dividends are declared. Since it is only possible for an association to distribute the earnings actually received, it is sometimes necessary to vary the rate each year in accordance with income.

The cooperative and semi-philanthropic character of the association movement makes it imperative that both interest and dividend rates be equitable.

The cloaking of efforts to make large profits for a group of insiders under the guise of philanthropy cannot be too strongly condemned. No one should be permitted

to pervert the movement for his private advantage.

## APPENDIX B

### Member Institutions in the City of Chicago, Federal Home Loan Bank of Chicago—1933

Adams Building and Loan Association  
 Almira Building and Loan Association  
 Amerikan Building Loan and Homestead Association  
 Amity Building and Loan Association  
 Apollo Building and Loan Association  
 Archer Avenue Building and Loan Association  
 Austin Building and Loan Association  
 Avondale Building and Loan Association  
 Bell Savings Building and Loan Association  
 Belmont Building and Loan Association  
 Ben Franklin Building and Loan Association of Chicago  
 Ben Hur Building and Loan Association  
 Bohemia Building and Loan Association  
 Building and Loan Association Douglas Park  
 Building and Loan Association Silver Crown  
 Capitol Building and Loan Association  
 Casimir Pulaski Building and Loan Association  
 Central Building and Loan Association of Chicago  
 Chesterfield Savings and Loan Association  
 Commonwealth Edison Building Loan and Savings Association  
 Copernicus Building and Loan Association  
 D. K. L. Gedimino Building and Loan Association  
 Dornov Building and Loan Association  
 East Side Savings Building and Loan Association  
 Falcons Building and Loan Association  
 First Croatian Building and Loan Association  
 Fraternal Building and Loan Association  
 Gage Park Building Loan and Homestead Association  
 Good Shepherd Building and Loan Association

Haller Building and Loan Association  
 Holland Building and Loan Association  
 Homan Building and Loan Association  
 Hoyne Building Loan and Homestead Association  
 Irving Park Savings Building and Loan Association  
 Jefferson Park Building and Loan Association  
 Jugoslav Building and Loan Association  
 Kalifornie Building and Loan Association  
 Kedzie Building and Loan Association  
 Kosciuszko Building and Loan Association No. 3 of Chicago  
 J. 1. Kraszewski Building and Loan Association  
 Labe Building and Loan Association  
 Laramie Building and Loan Association  
 Lawn Building and Loan Association  
 Lawn Manor Building and Loan Association  
 Liberty Mutual Building and Loan Association  
 Lithuania Building Loan and Homestead Association  
 Mansfield Building and Loan Association  
 Marshall Building Loan and Homestead Association  
 Mickiewicz Building and Loan Association  
 Narodni Building and Loan Association  
 Netherlands Building and Loan Association  
 New City Building Loan and Homestead Association  
 Northwestern Bohemian Building and Loan Association  
 Northwestern Saving Building and Loan Association  
 Norwood Park Building and Loan Association  
 Novy Krok Building and Loan Association  
 Ondrej Hlynka Building and Loan Association  
 Parkside Building and Loan Association  
 Piast Building and Loan Association  
 Polonia Building and Loan Association

Prospect Building and Loan Association  
 Public Building and Loan Association  
 Pulaski Building Loan and Investment Association  
 Pulaski Loan and Building Association of the 6th Ward of Chicago, Illinois  
 Radnice Building and Loan Association  
 St. Paul Building and Loan Association  
 St. Wenceslaus Building and Loan Association  
 Simano Daukanto Building and Loan Association  
 Sixteenth Ward Building and Loan Association  
 Slovak Building and Loan Association  
 "Krivan"  
 Slovenian Home Building and Loan Association  
 A. J. Smith Home Building Association  
 South Chicago Building and Loan Association  
 Swedish Home Building Association  
 Talman Building and Loan Association  
 Uhland Building and Loan Association  
 Union Building and Loan Association  
 United Community Building and Loan Association  
 Vltava Building Loan and Homestead Association  
 "Vojta Naprstek" Building and Loan Association of Chicago, Illinois  
 Vytauto Building and Loan Association  
 Western Building and Loan Association of Chicago  
 Westmont Building and Loan Association  
 West Pullman Building and Loan Association  
 Zdar Building and Loan Association  
 Zeiena Hora Building Loan and Homestead Association  
 Zgoda Building and Loan Association  
 Zlata Hora Building and Loan Association