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It's a Wonderful Loan: A Short History of Building and Loan Associations

By David A. Price and John R. Walter

Prior to the advent of modern home mortgage markets in the United States, markets in which mortgage-backed securities and government-sponsored enterprises now play significant roles, prospective homebuyers had to rely on other mechanisms of home finance. For about a century, cooperative organizations known as building and loan associations, a concept imported from Britain, served millions of American savers and homebuyers.

From the 1830s until the Great Depression, a type of thrift institution known as building and loan associations made home loans more broadly accessible. The best-known example is a fictional one, Bailey Brothers Building and Loan, central to the 1946 film *It's a Wonderful Life*. The associations were based on notions of mutual self-help, that is, self-reliance combined with mutual aid.[1] Individuals held shares in the institutions and, in return, had borrowing privileges as well as the right to dividends. Broadly speaking, while operating plans varied, members committed to making regular payments into the association and took turns taking out mortgages with which to buy homes; the determination of the next borrower was often decided by an auction among the membership. At the peak of their numbers in 1927, some 12,804 of the associations were in operation with 11.3 million members — at a time when the entire U.S. population was only 119 million — and $7.2 billion in assets.[2] Building and loan associations were generally small and local, but a rival group of "national" building and loans was a significant force from the 1880s until the late 1890s.

Early Development and Diffusion

American building and loan associations had their roots in British building societies, which appear to have originated in Birmingham, England, in the 1770s or 1780s. At least a dozen of the societies were founded in Birmingham in the last quarter of the eighteenth century. These increased to sixty-nine societies by 1825 and then proliferated rapidly to 2,050 by 1851. In general, members bought shares and paid for them over time and received home loans on a rotating basis. When all the members had taken a turn, a society terminated.[3]

The British working class already had a longtime tradition of "friendly" societies, cooperatives of mutual self-help to which members would make regular payments and from which they could receive a loan in the event of certain hardships, such as fire, job loss, or sickness. Conceptually, it was perhaps a short distance from the friendly societies to the building societies. Britain in the nineteenth century also may have been fertile soil for building societies because ideas of mutual self-help were in the air more generally. Mutual

improvement societies, for example, were groups of working-class men who combined money to buy reading material that they shared and discussed.[4]

The conditions that apparently drove the application of these ideas to home buying were created by the Industrial Revolution. The rise of factory work meant, for many people, regular wages. Higher-skilled workers with relatively greater incomes might wish to purchase a home to avoid tenement-like conditions and to build equity through buying rather than renting. (In addition, homeownership brought with it the right to vote for one's representative in Parliament.) But those workers were stymied by conventional mortgage offerings of the time with their high down payments and short loan terms.[5] The British building society enabled some to overcome these obstacles.

The building society model appears to have been transmitted from Britain to the United States by British immigrants. The first building and loan association, Oxford Provident Building Association, was founded in Frankford, Pennsylvania, (now part of Philadelphia) in 1831 by two factory owners who were natives of England. The model spread across the Northeast and mid-Atlantic, with associations established in Connecticut, Maryland, New Jersey, and New York by 1850, along with additional associations in Pennsylvania. (Several associations also were established in Charleston, South Carolina, at least one of them founded by an English immigrant.) Associations were established in the majority of other states during the 1860s and 1870s. Illinois, California, and Texas leapfrogged other states outside the East Coast with associations established in 1851, 1865, and 1866, respectively, a pattern that may have been the result of westward migration of people who were familiar with the model.[6]

As in Britain, the growth of building and loan associations in the United States was likely aided by the factory system and the swelling of a wage-earning class — combined with a dearth of affordable home financing. Under the National Bank Act of 1864, national banks were not permitted to make loans secured by real estate. Mortgages from state-chartered commercial banks required large down payments, up to 60 percent of a home's value, and the loans were short-term (typically five years or less) and nonamortized. Mutual savings banks — which, notwithstanding the name, were not cooperatively owned — offered longer loan terms than commercial banks, but their mortgages still involved high down payments. Insurance companies, another source of mortgage finance in the nineteenth century, also required high down payments.[7]

Operating Plans

In the early decades of American building and loan associations, they closely followed the British societies' form of operation. This model came to be known as the "terminating plan" because an association's existence was required to end when all of its loans had been repaid, or more precisely, when the shares of stock that members purchased over time in connection with membership had matured.[8]

The plan of the Oxford Provident association offers an illustration of how the terminating plan worked, with that association's actual numbers.[9] The building and loan would be formed by a group of individuals (members), each of whom paid a membership fee of $5 at the time of formation. Each member also subscribed to a number of shares of stock — between one and five shares — with a predetermined maturity value or par value of $500. Then each member was required to pay in $3 per month per share until the amount paid in per share equaled the shares' maturity value. In general, no other members were allowed to join unless they paid, up front, an amount equal to that already paid in by the founding members. Once members' payments reached the maturity value of the shares, the association was terminated and members were repaid.

While the association was operating, members could pledge their stock and thereby take out home mortgage loans equal to as much as the matured value of all their shares of stock (though at the time of the loan, the member might have paid in much less than this amount). For example, if a member had subscribed to five shares, each with a maturity value of $500, the member could borrow as much as $2,500. (The borrower pledged his or her stock when taking out a mortgage, then continued paying for the stock on an

installment plan until the stock was paid for, which had the effect of canceling the loan.) In the rotation of home loans, members who wished to receive the next loan bid against one another; the bidding determined the premium that the winner would pay to secure the upcoming place in the rotation. Most commonly, the amount of the premium would be deducted from the loan when it was disbursed.[10]

The relative simplicity of the terminating plan made it an attractive framework for the associations during the first decades of the movement. A difficulty of the terminating plan, however, is that it was burdensome for members to join once an association was underway; as noted, all shares were issued at the same time, so members who joined later were required to pay a lump sum to cover the payments they had missed. (In modern terms, a terminating plan was "closed-end" in the sense that it generally issued shares only at its inception.) Moreover, the automatic termination of an association was perceived by some as wasteful given the efforts involved in organizing it and its potential usefulness if it were to continue.[11]

The 1850s saw the emergence of a variation on the terminating plan that partially addressed these shortcomings. An association organized under the "serial plan" issued multiple series of shares over its lifespan. In effect, a serial-plan association was like a collection of terminating-plan groups, each with its own onset and termination dates, under one organizational umbrella. New series were commonly offered quarterly or semiannually. Thus, someone who had not been a member at the association's birth could join when the association later issued a new series of shares without the obstacle of making a large back payment. Because the association was periodically adding member-borrowers to its rolls, there was no need to require someone to take an unwanted loan. Finally, the association as a whole had no defined termination date.[12]

A third form of organization, the permanent plan, arose in the 1870s. It did away with the concept of series of shares and instead issued shares to each member that were independent of the shares of other members; consequently, members could join and leave whenever they chose.[13] As noted by Heather A. Haveman of the University of California, Berkeley and Hayagreeva Rao of Stanford University, the structural evolution from the terminating plan to the serial and then permanent plans enabled building and loans to serve a sometimes transient home-buying population with less burdensome, more flexible arrangements.[14]

With the further increase in U.S. urbanization in the 1880s, thousands of local building and loan associations were founded. Associations spread into every state during this decade (except Oklahoma, which saw its first building and loan in 1890). By 1893, according to a survey taken by the U.S. Commissioner of Labor, there were 5,598 local associations with a total of 1,349,437 members and $473.1 million in assets. The same survey indicated that the associations were attracting many members from the working class; among the associations that reported their members' occupations, over 59 percent of members were "laborers and factory workers," "housewives and housekeepers," or "artisans and mechanics."[15]

While the serial, permanent, and terminating plans continued to dominate, a new form of organization emerged during this period. The Dayton plan, first used in Dayton, Ohio, in the early or mid-1880s, permitted some members to participate as savers with no obligation to borrow. This new model somewhat reduced the centrality of mutual self-help in those institutions.[16] In addition, the Dayton plan allowed borrowers to determine their own payment amounts, with higher payments reducing their total interest, a feature that partially anticipated the structure of a typical modern mortgage allowing early prepayment without penalty.

The National Associations: A Cul-de-Sac

Beginning in the mid-1880s, national building and loan associations emerged. Unlike the local associations, the national associations operated across city and state lines by opening branches. The term "national" referred to the broader scale of the associations rather than any federal-level regulation or charter. The term was somewhat of a misnomer since

the associations could not operate on a truly nationwide basis; some large states adopted laws effectively barring "foreign" — that is, out-of-state — associations from doing business within their borders by requiring them to put up prohibitively high bonds with the state.[17] (Some banks during this period operated in multiple states, but it was a rarity.[18]) From their starting point of two institutions in Minneapolis, the national associations had grown to some 240 by 1893, with at least one in every state.[19]

There were significant differences between local and national associations. While all of a member's payments into a local building and loan went into paying down his or her shares, payments into a national association went in part to an "expense fund" that served to boost the organizers' profits. The portion allocated to the expense fund varied from one association to another; a range of 5 percent to 7 percent appears to have been common. Local associations did, of course, spend a portion of their funds on operating expenses, but the amounts involved were only in the 1 percent to 2 percent range. Moreover, if a member of a national association failed to keep up his payments, he would forfeit the payments he had already made even if he had not yet taken a loan. (Additionally, as with any mortgage, those who had taken a loan were subject to foreclosure.) Countervailing these disadvantages, from the point of view of prospective members, were the high rates of return that the national associations advertised. The dividend yields they promised were several times those available from banks, local associations, or government bonds.[20]

The local associations responded to the new entrants in part by forming statewide trade groups that fought the nationals through public education — that is, vituperative criticism — and restrictive legislation. (In some states, trade groups for local building and loan associations were already in place before the emergence of the nationals.) These organizing efforts within the industry culminated in 1893 with the formation of a nationwide body of the state trade groups, the U.S. League of Local Building and Loan Associations; its first convention took place that year in Chicago in conjunction with the World's Columbian Exposition. In addition to opposing the national associations, the state groups and their national body promoted homeownership and the local associations.[21]

The groups representing the local associations held that the nationals were cooperatives in theory but proprietary for-profits in practice. A U.S. League publication argued, "The only object in organizing or carrying on the [national] association is to create and gobble up this expense fund. Their name should be changed."[22] Seymour Dexter, founder and first president of the U.S. League, told the league's second convention in 1894, "Whenever so fine a field of operations presents itself to the scheming and dishonest as the present system of the National Building and Loan Association, we may rest assured that the scheming and dishonest will enter it and pluck their victims until restrained by proper legal restrictions."[23]

Whatever the share of national associations with "scheming and dishonest" organizers, a weakness of their business model was the difficulty of assessing properties and monitoring real estate market conditions in branch areas. This difficulty reflected the informational disadvantage of a centralized lending operation; the information technology that eventually would help lenders overcome the disadvantages of distance in home mortgage lending was, of course, not yet in place. Consequently, in contrast with the local associations and their locally based operations, national associations ran a higher risk of lending on the basis of inflated appraisals or lending to poorly qualified borrowers.[24]

The downfall of the national associations was put in motion by a major real estate downturn associated with the Depression of 1893. In the first few years of the downturn, the assets of the nationals actually grew because their shares were perceived as low-risk investments, but they would come to be hard hit. While mortgage lenders in general suffered, national building and loans were particularly vulnerable on account of the lower average quality of their loans. In addition, as economic conditions reduced the number of new members, the national associations lost a source of new expense-fund contributions and other fees, which some institutions relied on to meet their obliga-

tions. The knockout blow for the national associations was the failure in 1897 of the largest of them, the Southern Building and Loan Association of Knoxville, Tennessee, an event that gravely damaged confidence in the remaining nationals; virtually all of those institutions ceased operation within a few years.[25]

Final Wave of Growth in the 1920s and Demise

During and after the collapse of the national building and loan associations, some people in the local building and loan movement expressed concern that the dubious record of the nationals would leave a long-term stigma on the local associations. An article in the official newsletter of the Building Association League of Illinois and Missouri, for example, noted in 1896 that in many "smaller cities and towns," hundreds of savers had trusted their money to a national association only to lose it all. "It will be years," the newsletter held, "before it will be possible to establish a genuine building and loan association in such a community, after the name of building association has been besmirched and prostituted, and brought into grave disrepute through the actions of the schemers who have run these bogus concerns."[26]

Although the membership and assets of local building and loans did remain essentially flat during the first few years of the 1900s, perhaps as a result of the stigma left by the failed national associations, they resumed their growth afterward: from about 1.5 million members and $571 million in assets in 1900 to about 2.2 million members and $932 million in assets in 1910. Even more rapid growth was still to come. By 1920, membership had more than doubled to nearly 5 million and assets had grown more than 150 percent to $2.5 billion. (The number of associations also rose, but less dramatically, reflecting an increase in the average institution size: from 5,356 in 1900 to 5,869 in 1910 and 8,633 in 1920.) In 1930, despite the financial crisis of the preceding year, membership was up to 12.3 million, and assets totaled $8.8 billion.[27]

Several developments fueled the growth of the local associations and their model of affordable mortgage lending during this period. One is that the locals became more promotion minded and more sophisticated about promotion. While hard data on their promotional efforts are scarce, it appears that the locals increasingly supplemented their primary means of acquiring new members — word of mouth — with the use of newspaper advertisements and window displays. This shift appears to have been partly the result of encouragement and guidance from the U.S. League but is also consistent with the increasing scale of the local associations, which could better support such efforts.[28]

Another development that boosted local associations during this time was the real estate boom in California and other western states, together with the embrace of building and loan associations there as a form of affordable housing finance. The assets of building and loans in the West grew at an average annual rate of 47.1 percent from 1920 to 1930 compared with 25.1 percent for the nation as a whole.[29]

Additionally, the 1920s saw a trend of developers and builders establishing, in effect, captive associations that they dominated to support the sale of their houses. While developers, builders, and brokers had long been involved in local building and loan associations, there is evidence that they went further during this period in co-opting the building and loan model, possibly boosting the numbers of building and loans.[30]

Recessions were frequent during this period, even before the Great Depression — eight recessions occurred from 1900 to 1928, or an average of one every three and a half years — but these downturns did not appear to interfere with the growth of building and loans. In general, building and loans tended to be more stable than banks during periods of market stress, such as the panic of 1907, because their savers were member-owners rather than creditors and because deposits at (that is, shares of) building and loans had longer maturities than bank deposits. While bank depositors could, by definition, demand the immediate return of demand deposits, not all building and loan plans allowed for withdrawal before prescribed maturity dates, and under those plans that did, the association had a significant period (commonly thirty or sixty days) to carry out a member's request. Thus, building and loans were not exposed to the extent that banks were to a risky

mismatch between long-term assets and short-term liabilities.[31] The withdrawal process is accurately represented in *It's a Wonderful Life*:

> TOM: I got two hundred and forty-two dollars in here, and two hundred and forty-two dollars isn't going to break anybody.
>
> GEORGE (handing him a slip): Okay, Tom. All right. Here you are. You sign this. You'll get your money in sixty days.
>
> TOM: Sixty days?
>
> GEORGE: Well, now that's what you agreed to when you bought your shares.

Following the crash of 1929 and the ensuing Great Depression, a large number of building and loans did close; the number of associations dropped from 12,342 in 1929 to 8,006 a decade later.[32] These closures did not result from depositor runs, but from other effects of the Depression on the banking sector. Because many building and loans required short-term lending from banks (given that their assets were mainly longer-term mortgages), the widespread extent of bank failures led to a short-term credit crunch for the associations. It is reasonable to assume, also, that the sharp drop in nominal real estate prices contributed to building and loan closures.[33] During the era in which local building and loans thrived, however, they played a significant role in extending homeownership through more affordable mortgage lending. ■

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Endnotes

1. This *Economic Brief* is excerpted from David A. Price and John R. Walter, "Private Efforts for Affordable Mortgage Lending before Fannie and Freddie," *Economic Quarterly*, Fourth Quarter 2016, vol. 102, no. 4, pp. 321–351. Source notes are set out in the original article.
2. Price and Walter, p. 329, note 37.
3. Price and Walter, p. 329, notes 39–42.
4. Price and Walter, pp. 329–330, notes 43–44.
5. Price and Walter, p. 330, note 45.
6. Price and Walter, p. 330, notes 46–49.
7. Price and Walter, pp. 330–331, notes 50–52. The provision of mortgage loans by insurance companies during this period is discussed in Price and Walter, pp. 339–341, 345.
8. Price and Walter, p. 331, note 53.
9. Price and Walter, p. 331, note 54.
10. Price and Walter, p. 332, notes 55–56.
11. Price and Walter, p. 332, note 57.
12. Price and Walter, p. 332, note 58.
13. Price and Walter, pp. 332–333, note 59.
14. Heather A. Haveman and Hayagreeva Rao, "Structuring a Theory of Moral Sentiments: Institutional and Organizational Coevolution in the Early Thrift Industry," *American Journal of Sociology*, May 1997, vol. 102, no. 6, pp. 1606–1651.
15. Price and Walter, pp. 333–334, notes 65–68.
16. Price and Walter, p. 334, note 69.
17. Price and Walter, p. 334, note 70.
18. David L. Mengle, "The Case for Interstate Branch Banking," *Economic Review*, November-December 1990, vol. 76, pp. 3–17.
19. Price and Walter, p. 334, note 71.
20. Price and Walter, p. 335, notes 73–76.
21. Price and Walter, pp. 335–336, notes 77–79.
22. Price and Walter, p. 336, note 80.
23. Price and Walter, p. 336, note 81.
24. Price and Walter, p. 336, note 82.
25. Price and Walter, pp. 336–337, notes 83–85.
26. Price and Walter, p. 337, note 86.
27. Price and Walter, p. 337, note 87.
28. Price and Walter, pp. 337–338, notes 88–89.
29. Price and Walter, p. 338, note 90.
30. Price and Walter, p. 338, note 91.
31. Price and Walter, pp. 338–339, notes 92–94.
32. Price and Walter, p. 339, note 95.
33. Price and Walter, p. 339, note 97.

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