# Book Review

# Borrow: The American Way of Debt

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Author: **Louis Hyman**
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Not every attempt to share academic research with a broader general audience has been accomplished with the finesse, style, and humor with which *Borrow: The American Way of Debt* has been written. The Harvard educated Louis Hyman, currently an Assistant Professor at Cornell University's School of Industrial and Labor Relations, has mastered the ability to make economic history personal and compelling. Filled with almost 400 unobtrusive endnotes, Hyman's research is accessible to the general reader, useful for undergraduate introductions to 20th century consumer history, and profitable for the more advanced reader to consult.

In the Introduction, *Everything Old is New Again*, we meet a hypothetical young couple just starting their life together. Short on savings and without adequate income to meet traditional mortgage payments, Dick and Jane eagerly sign up for a 4-year, interest only mortgage with a balloon payment – a balloon payment that was due in 1932. The parallel with today's economy is intended to startle the reader, and it does. Thus begins Hyman's story of how the American way of debt shifted dramatically from the 19th century's moral condemnation to contemporary dependency.

Chapter 1, *When Personal Debt Was Really Business Debt* (2000 B.C. - A.D. 1920), sketches the history of government, commercial, and personal debt prior to the advent of automobile purchases in the 1920s. Hyman argues persuasively that government and commercial debts from medieval times until the 19th century were restricted to productive investment on "assets producing profits" (p. 19). Personal or consumer indebtedness was unknown, considered virtually immoral, and ultimately constrained by religious bans on usury. Most of the chapter deals with the history of debt in America. Hyman details the dependence of 19th century farmers on middlemen who connected western farms with eastern financial markets or southern "factors" who did the same for southern plantations. Western middlemen provided storage for agricultural harvests and ultimate delivery to urban markets while southern factors provided a purely financial facilitation, linking New York and European bankers to the cotton harvests. The urban immigrant experience in the late 19th century depended on co-ethnic microfinance, loan sharking, or installment lending from "Borax" houses for durable consumer goods. Like contemporary rent-to-own retail outlets, Borax houses overcharged for durable goods, linked payment to customer paychecks, and profited more from repossession and resale than from paid-in-full contracts.

Although Hyman does not mention the contemporary alternative financial services sector in this chapter, the stories of exorbitant credit costs and resulting financial ruin read as if they were written by contemporary consumer financial protection advocates. Nonprofit alternatives to loan sharks, called remedial loan societies, offered financial advice and interest rates less than state usury limits, but were unsustainable financially. Consumer financial protection in the 1920s meant opposition to state usury laws that limited consumer access to cash loans. Modestly successful, relaxation of usury limits opened the way to installment loans.

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Chapter 2, *Everybody Paid Cash for the Model T* (1908 - 1929), states that the production-oriented populism of Henry Ford was unable to withstand the credit-driven marketing of General Motors. Ford had sold one million cars for cash between 1908 and 1915, but in 1927 alone, the General Motors Acceptance Corporation (GMAC) financed the purchase of over one million cars. The low prices and production efficiencies pursued by Henry Ford were no match for the readily available credit and market segmentation created by the General Motors sales teams. GMAC invented neither consumer installment purchasing nor corporate bonds, but GMAC did marry the two to explode family ownership of automobiles.

Then came the crash of 1929. In Chapter 3, *Fannie Mae Can Save America*, Hyman focuses on the role that mortgage securities played in the housing bubble of the 1920s and the foreclosure crisis that ensued. The securitization particulars are substantially simpler than the collateralized debt obligations of today, yet the story is familiar. Interest-only mortgage loans with balloon payoffs were converted into participation certificates that operated like government or corporate bonds, but without any capital security or secondary resale market. Accordingly, participation certificates relied upon a stable or inflating housing market as well as upon a rising supply of investors willing to capitalize mortgage loans. When prices began to fall, capital was no longer available, and the housing market crashed. The half million new home starts in 1925 fell to 22,000 in 1934 while foreclosures rose to more than a thousand per day by 1933.

From Hyman's perspective, the economic problems of the Great Depression were not rooted in unemployment, but in the declining access to credit. Consumption declined while the installment loans of the 1920s were repaid. Stopgap measures like the federally-backed Home Owners' Loan Corporation were able to refinance enough mortgages to stabilize home prices, but not to stimulate new construction. Investors would not invest, and deficit public spending was unacceptable. The solution came from the mind of James Moffett in the form of the Federal Housing Administration (FHA). The FHA created a national mortgage marketplace for long-term, amortized mortgage loans for the homebuyer and a nearly risk-free place for lenders to invest by creating insurance pools for investors, home construction minimum standards for buyers, government guarantees, and a secondary marketplace to sell mortgage loans – the Federal National Mortgage Association (Fannie Mae). Balloon payments and participation certificates disappeared. In 1934 - 1935, its first year, FHA stimulated over $350 million of new mortgage investment and created 750,000 jobs.

Installment loans for cars and durable goods had become a means of promoting sales and rewarding affluent customers as early as the 1920s, but in Chapter 4, *How I Learned to Stop Worrying and to Love the Debt* (1945 - 1960), these privileges were extended to the suburban middle class. In 1938, Bloomingdale's started the permanent budget account, a form of in-store revolving credit on which customers paid interest – the credit card had been born. The synchronicity of FHA fueled suburban development, the consolidation of retail specialty shops into massive department stores, and the stability of post-war middle class incomes, resulted in an explosion of retail credit. At 1.5% per month, credit departments became modestly profitable and credit approval standards relaxed. Third party debt collectors freed the department store credit departments from the conflict between promoting sales and collecting debts. Now the only limit on consumer credit was the retailers' access to capitalization.

The decade of the 1960s described in Chapter 5, *Discounted Goods and Distributed Credit* (1959 - 1970), was a decade of turmoil in retailing as well as in politics. The highly structured middle class household budget of the 1950s, committed to mortgage, auto loans, and other consumer credit, gave rise to consumer embrace of alternatives to the centralized department stores. Specialty stores had more variety; discount stores like K-Mart, Target, and Wal-Mart had better prices. Neither had the capital to sustain expansion, to maintain inventory, and to offer customers credit. For a brief time, General Electric Credit Corporation (GECC) was able to satisfy the demand for consumer credit for both discount and specialty stores by expanding its traditional corporate bond funded installment loans for durable goods into the revolving, store-branded credit card. Sears Roebuck Acceptance Corporation mimicked GECC for the middle and working classes, but everyone wanted what only the affluent enjoyed – a bank credit card.

During the next decade, described in Chapter 6, *Bringing Good Things to Life* (1970 - 1985), the bank credit card began to gain some momentum. There were three challenges to overcome. First, customers had to want the cards. Demand was constrained until the late 1960s because few stores accepted them. Secondly, the banks had to generate enough volume to lower transaction costs through economies of scale. The BankAmericard network went nationwide in 1966 with 2.5 times as much borrowed as in 1965,

and faced competition by another California-based network of banks that offered Master Charge by the end of the decade. Thirdly, a national bank card had to deal with the complexities associated with state usury laws. The *Marquette* decision in 1973 erased state sovereignty over interest rates. The stage was now set for ever-expanding levels of competition. Banks across the country invested capital in credit cards. Giants like GE Capital and then Citibank joined the fray. Most continued to try and limit cardholders to the affluent, but when the high interest rates of the late 1970s began to fall, Citibank especially kept the bank card rates high in order to lend to riskier borrowers, a portent of things to come.

Chapter 7, *If Only the Gnomes Had Known* (1968 - 1986), refers to the "omniscient associates" (p. 180) who purchased mortgage-backed securities from Freddie Mac in the secondary market. The urban riots of the late 1960s, which in Hyman's view were the product of FHA inner city redlining, suburbanization, and the exorbitant credit costs associated with the alternative financial services available in the ghetto, led to mortgage reform. These reforms included the fraud-infused and short-lived Section 235 mortgage program for low-income home ownership in the urban core, financed exclusively by Fannie Mae bundles of mortgage-backed securities. Section 235 did not survive, but securitization did.

Freddie Mac, chartered in 1970, soon duplicated the securitization patterns of Fannie Mae for conventional loans. Mortgage-backed securities became a means of sustaining the housing market, delaying the insolvency of the savings and loan industry during a time of high short-term interest rates, and keeping these mortgages off of the federal books. By 1983, Freddie Mac, with assistance from Wall Street brokerages, had invented a new form of mortgage security, the collateralized mortgage obligation (CMO). Thirty-year mortgages were converted into "short-, medium-, and long-term investments – all with a range of risks and returns" (p. 209). These security tranches created a faux diversification of risk that, in the mind of investors, was more secure than any single individual mortgage could possibly be. New sources of capital flowed into mortgage financing through CMOs, especially pension funds and international investors, creating a demand for mortgage investments that outstripped consumer demand for home purchases. The consequences are now well known. The thrift industry could not compete and folded. Capital flooded into new securitized tranches. Lenders, no longer concerned with the potential loss of investment associated with bad debt, became producers of increasingly risky loans.

Chapter 8, *The House of Credit Cards*, describes how it took less than three years for Ohio-based Banc One to apply the CMO securitization methodology to credit cards. By 1991, 65 percent of American households had a credit card. By 1996, 45 percent of credit card debts in America were securitized. "The demand for securities outstripped the supply. Investor demand, rather than lender supply, began to drive the market" (p. 230). Riskier borrowers led to increased defaults, but the losses fell on investors who had been compensated for the risk. Lenders were safe. Markets were created for bad credit card debt purchased at a fraction of face value and home equity loans to consolidate credit card debt. By the late 1990s, the escalating demand for securities produced subprime, balloon, adjustable rate, interest-only, and even documentation-free mortgages. Although several magnitudes more complex than the 1920s, securitization relied fundamentally on the same two unstable legs – rising home values and stable incomes. When subprime home loan borrowers defaulted in 2006, a crash was inevitable.

In his Conclusion, *Turning the Magic of Borrowing into the Reality of Prosperity*, Hyman proposes a solution to security speculation by creating an FHA-like Bureau of Business Security to coordinate the securitization of business loans. He proposes a carrot rather than stick approach to moving capital back into production and away from consumption. He believes that the common accounting standards utilized by small businesses and the development of a federal appraising mechanism similar to FHA housing appraisals will provide sufficient incentive for small businesses to open their records in order to tap into the funds securitization makes possible. He does not address the costs of compliance, protection mechanisms against financial malfeasance, or the challenges associated with foreclosure on bad small business loans.

Readers of the *Journal of Financial Counseling and Planning* may find much to reflect on in *Borrow.* As Hyman asserts, unregulated capitalism is extremely efficient in funneling corporate profits to capital, and the owners of capital will always seek opportunities to invest. However, there is a qualitative difference between investments in productive assets and investments in financial securities. When General Electric can make a higher rate of return by underwriting in-store credit cards over operating manufacturing plants, GE stockholders become

speculators rather than job creators. As Hyman so clearly documents, financial speculation does increase access to credit, but it also generates artificial value bubbles that create opportunities for financial malfeasance on a massive scale. Financial counseling and planning efforts must become more adept at educating consumers about bubble detection and avoidance.

Hyman errs in at least two conclusions. First, he neglects the role that taxation plays in stimulating the move of capital from production to financial securities. The absence of financial transaction costs and the modest tax rate on capital gains may alone be sufficient to explain investor reluctance to fund production. Reverse the tax rates, and capital flows will follow. Secondly, Hyman underappreciates the shift in the meaning of risk that has accompanied the history he chronicles. When personal debt was hard to obtain, the lender was at risk in the event of default. There may have been some moral decrement implied for the defaulter, but only the lender lost money. Today, securitization has redefined risk. As the Troubled Asset Relief Program and the extensive financial bailout provided by the Federal Reserve demonstrated, there is no risk of default to investors for capitalizing weak loans. Only American taxpayers incur the moral hazards associated with securitization.