Debt Dilution in 1920s America: Lighting the Fuse of a Mortgage Crisis

An explanation of the Great Depression based on mortgage debt via the banking channel has been downplayed due to the conservatism of mortgage contracts at the time. For instance, loan-to-value ratios often did not exceed 50 per cent. As I show in a previous paper, the main problem with mortgages at the time was their intrinsic lack of liquidity. Nevertheless, using newly-discovered archival documents and a newly-compiled dataset from 1934, this paper uncovers a darker side of 1920s US mortgage lending: the so-called "second mortgage system." As borrowers often could not make a 50 percent down payment, a majority of them took on second mortgages at usurious rates. As theory predicts, debt dilution, even in the presence of seniority rules, can be highly detrimental to both junior and senior lenders. The probability of default on first mortgages was likely to increase, and commercial banks were more likely to foreclose. Through foreclosure they would still be able to retrieve 50 percent of the property value, but often after a protracted foreclosure process -- a great impediment to bank survival in case of a liquidity crisis. This paper is thus a timely reminder that second mortgages, or "piggyback loans" as they are called today, can be hazardous to lenders and borrowers alike. It provides further empirical evidence that debt dilution can be detrimental to credit.