The Myth of Home Ownership and Why Home Ownership Is Not Always a Good Thing

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Home ownership is viewed as key to achieving the "American Dream" and is now an essential element of the American cultural norm of what it means to be a success. The metastasizing mortgage crisis suggests, however, that our home ownership policies are out-dated, misguided, and largely ignore the actual market realities many potential homeowners now face. After briefly describing the current home ownership crisis, this Article argues that the United States should radically revise and restrict home ownership subsidies. Rather than encouraging universal home ownership, the Article argues that the government should replace existing home ownership subsidies with targeted subsidies that will help buyers make housing choices that are based on economics, not emotions.

INTRODUCTION

Home ownership is said to be a fundamental part of the American Dream because of the economic security it gives homeowners. The United States has long encouraged people to buy their own homes and has subsidized programs and activities that are designed to bridge the gap between renting and owning a home. Unfortunately, buying a house is no longer an option for many lower- and middle-income consumers; the purchase is often a high risk financial venture that has large, and frequently unarticulated, opportunity costs.

Buoyed by the irrational exuberance associated with home ownership, potential and existing homeowners are now guided by emotional and psychological—not economic—factors when they consider investing in a house. This irrational exuberance has resulted in one of the worst foreclosure crises since the Depression. Rather than question whether the American Dream of home ownership remains a goal worth pursuing, however, the current responses to the mortgage crisis are designed to help homeowners remain in their largely unaffordable homes. This Article argues that these and other U.S. home ownership policies are outdated, misguided, and virtually ignore the actual market realities most lower- and middle-income potential homeowners now face.

Part I of the Article discusses the rhetoric associated with the American Dream of home ownership and lists the benefits and subsidies the United States provides to encourage home ownership. Part II of the Article discusses how escalating housing prices and stagnating income has forced lower- and middle-income consumers to rely on nontraditional mortgage products in order to finance their mythical American Dream of home ownership. The U.S. government encouraged financial institutions to innovate these often risky products, and the secondary market's voracious demand for these products encouraged mortgage originators to approve loans that were not suitable

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for the individual homebuyers. Part III exposes the realities homeowners now face when they pursue home ownership and discusses the costs that home ownership poses on them and the external harm that the home ownership myth imposes on others. Part IV explains why borrowers, lenders, and changed economic conditions in the United States created a perfect storm that led to the current mortgage crisis, and Part V briefly discusses the responses to that crisis. The Article ends by critiquing the flaws inherent in the current responses to the housing crisis and arguing that existing homeowner subsidies should be replaced with targeted subsidies that encourage people to make rational and socially beneficial housing choices that are not based on any idealized notion of the importance of achieving the status of homeowner.

I. HISTORY OF THE AMERICAN DREAM

A. Rhetoric

Making the decision to purchase a house elevates the purchaser to a culturally significant status: that of a homeowner. Ever since President Abraham Lincoln signed the Homestead Act in 1862, subsequent U.S. Presidents—from Herbert Hoover, Lyndon Johnson, and Bill Clinton to George W. Bush—and legislators have stressed that the road to financial security and stability is best achieved by becoming a homeowner.[1] June has been designated as "National Home Ownership Month,"[2] and owning a home is viewed as a "basic American privilege" and is the cornerstone of the American Dream.[3] Unlike renters, homeowners are viewed as financially independent citizens who embody the "core American values of individual freedom, personal responsibility and self-reliance."[4]

Home ownership has been encouraged and subsidized by the government based on the economic benefits it is said to provide to individual homeowners and their families and also because of its positive externalities. Buying a home has been viewed as a

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1. *See* Tim Iglesias, *Our Pluralist Housing Ethics and the Struggle for Affordability*, 42 WAKE FOREST L. REV. 511, 511–14 (2007) (discussing the American obsession with and love of the concept of "home"); Donald A. Krueckeberg, *The Grapes of Rent: A History of Renting in a Country of Owners*, 10 HOUSING POL'Y DEBATE 9 (2002); Trina Williams, *The Homestead Act: A Major Asset-Building Policy in American History* 3 (Washington Univ. in St. Louis Ctr. for Soc. Dev., Working Paper No. 00-9, 2000).

2. *See Recognizing National Homeownership Month and the Importance of Homeownership in the United States*, H.R. Res. 477, 110th Cong. (2007) [hereinafter *National Homeownership Month*].

3. Press Release, The White House, National Homeownership Month, 2005 (May 25, 2005), http://www.whitehouse.gov/news/releases/2005/05/20050525-14.html [hereinafter Press Release]; *Preserving the American Dream: Predatory Lending Practices and Home Foreclosures: Hearing before the Subcomm. on Banking, Housing, and Urban Affairs*, 110th Cong. 10 (2007), *available at* http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=2053fdd2-9832-4731-802d-fa9c18772267 [hereinafter *Preserving the American Dream*] (statement of Harry H. Dinham on behalf of the National Association of Mortgage Brokers) ("No merchant, no government and no company should superimpose their own moral judgments on what is a basic American privilege of homeownership.").

4. Press Release, *supra* note 3; *National Homeownership Month*, *supra* note 2.

sound long-term investment device that gives the purchaser an asset that helps build wealth and gives the buyer property (the home) that can be used as collateral for a loan and could provide financial security for descendants.[5] Until the advent and increased use of home equity loans (that drain equity from homes), home ownership served as a forced savings plan for owners and, for most consumers, the bulk of their personal wealth consists of the equity they have in their homes.[6] Because housing prices for most homes have appreciated over time, home ownership has been financially beneficial for many individual consumers.[7]

Home ownership also is said to have a number of positive externalities. Although inconclusive,[8] studies find that home ownership has social, psychological, and emotional benefits for the individual homeowner's children and that raising children in owner-occupied housing is a more "wholesome, healthful, and happy" environment.[9] Some scholars also have found that the children of homeowners do better in school than the children of renters.[10]

Home ownership also can be good for neighboring property owners since homeowners have an incentive to protect their investment and, as a result, are more likely to invest in home repairs than renters.[11] Home ownership is also thought to

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5. *See* PRESIDENT GEORGE W. BUSH, A HOME OF YOUR OWN: EXPANDING OPPORTUNITIES FOR ALL AMERICANS (2002), *available at* http://www.whitehouse.gov/infocus/homeownership/homeownership-policy-book-whole.pdf [hereinafter EXPANDING OPPORTUNITIES] (naming the financial benefits of home ownership, including building families' wealth and equity and giving families borrowing power to finance important needs).

6. *See* ERIC BELSKY & JOEL PRAKKEN, HOUSING WEALTH EFFECTS: HOUSING'S IMPACT ON WEALTH ACCUMULATION, WEALTH DISTRIBUTION AND CONSUMER SPENDING 8 (2004), *available at* http://www.realtor.org/libweb.nsf/pages/fg302 (follow second hyperlink under "Wealth Effect" heading) (describing how home ownership is an attractive investment because of home price appreciation and because mortgage payments act as a forced savings plan).

7. George S. Masnick, *Home Ownership Trends and Racial Inequality in the United States in the 20th Century* 20–22 (Joint Ctr. for Hous. Studies of Harvard Univ., Working Paper No. 01-4, 2001), *available at* http://www.jchs.harvard.edu/publications/homeownership/masnick_w01-4.pdf; U.S. DEP'T HOUS. AND URBAN DEV., URBAN POLICY BRIEF NO. 2: HOMEOWNERSHIP AND ITS BENEFITS (1995), *available at* http://www.huduser.org/publications/txt/hdbrf2.txt [hereinafter HOMEOWNERSHIP AND ITS BENEFITS]; *see also* BELSKY & PRAKKEN, *supra* note 6, at 4−5 (finding that the growth of residential real estate wealth is historically faster and more stable than growth of corporate equities and stock wealth).

8. Krueckeberg, *supra* note 1, at 10 (discussing studies that find no social differences between renters and homeowners).

9. HOMEOWNERSHIP AND ITS BENEFITS, *supra* note 7, at 1.

10. Donald R. Haurin, Toby L. Parcel & Jean Haurin, *The Impact of Homeownership on Child Outcomes* 10 (Joint Ctr. for Hous. Studies of Harvard Univ., Working Paper No. LIHO-01.14 2001), *available at* http://www.jchs.harvard.edu/publications/homeownership/liho01-14.pdf.

11. Donald R. Haurin, Christopher E. Herbert & Stuart S. Rosenthal, *Homeownership Gaps Among Low-Income and Minority Households*, 9 CITYSCAPE: J. POL'Y DEV. & RES., No. 2, at 5 (2007); Press Release, *supra* note 3; *see also Subprime and Predatory Lending: New Regulatory Guidance, Current Market Conditions, and Effects on Regulated Financial Institutions: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on*

benefit the individual homeowner's community since homeowners tend to be concerned, involved citizens who are more likely to participate in local civic organizations, who will lobby for long-term or high quality community services (like building new highways and neighborhood schools), and who will help ensure neighborhoods remain safe.[12]

In addition to the benefits to individual homeowners and communities, home ownership has positive spillover effects that have macroeconomic benefits for the U.S. economy. The strength of the housing markets is often a bellwether for the general strength of the U.S. economy, and a weak housing market can create volatility across the spectrum of credit markets both in the United States and abroad.[13] Building and selling homes helps increase jobs and boosts the demand for goods and services.[14] In fact, for the last few years, consumer spending accounted for seventy percent of all economic activity in the United States.[15] Moreover, housing revenue, including actual home sales and home furnishing, has accounted for almost a quarter of the U.S. economy.[16] In addition, because the housing market often invigorates other economic activity, localities often encourage consumers to purchase houses in economically depressed communities.[17]

Financial Servs., 110th Cong. 394 (2007) [hereinafter *Subprime and Predatory Lending*] (statement of Harry H. Dinham on behalf of the National Association of Mortgage Brokers).

12. Clive Crook, *Housebound: Why Homeownership May Be Bad for America*, 300 ATLANTIC MONTHLY 21 (2007); Press Release, *supra* note 3; *National Homeownership Month*, *supra* note 2; *Subprime and Predatory Lending*, *supra* note 11, at 69 (statement of Sheila C. Bair on behalf of the Federal Deposit Insurance Corporation).

13. Crook, *supra* note 12, at 21. For example, the housing meltdown appears to have harmed colleges—especially those who rely heavily on tuition—because of the credit squeeze caused by the subprime meltdown. Similarly, college students are finding it harder to finance their education because of the number of lenders who have withdrawn from student loan programs. Paul Basken & Goldie Blumenstyk, *The Housing Market's Credit Crisis Raises Worries in Higher Education*, CHRON. HIGHER EDUC. (Wash., D.C.), Dec. 14, 2007, at 17; Jonathan D. Glater, *Government Seeks to Buy Loans Made to Students*, N.Y. TIMES, Apr. 23, 2008, at A11.

14. Press Release, *supra* note 3.

15. Peter S. Goodman, *Homeowners Feel the Pinch of Lost Equity*, N.Y. TIMES, Nov. 8, 2007, at A1. FANNIE MAE, THE GROWING DEMAND FOR HOUSING: 2002 FANNIE MAE NATIONAL HOUSING SURVEY (2002), http://www.fanniemae.com/global/pdf/media/survey/survey2002.pdf. Because higher home prices increase household wealth, housing price appreciation stimulates consumer spending. *See also* David Leonhardt, *Debt and Spending May Slow as Housing Falters, Fed Suggests*, N.Y. TIMES, Aug. 20, 2007, at C3; Governor Frederic S. Mishkin, Speech at the Forecaster's Club of New York: Enterprise Risk Management and Mortgage Lending (Jan. 17, 2007), http://www.federalreserve.gov/newsevents/speech/Mishkin20070117a.htm.

16. Courtney Schlisserman & Joe Richter, *U.S. Metropolitan Home Values Drop Most in Six Years*, BLOOMBERG.COM, June 26, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=aDPbZ0uuxP6E&refer=home; *see also* BELSKY & PRAKKEN, *supra* note 6, at 4 (noting that in recent years, housing consumption and related expenditures have accounted for nearly one quarter of the gross domestic product; over the past fifty years, housing has accounted for between one fifth and one quarter of the gross domestic product).

17. Iglesias, *supra* note 1, at 521−23; HOMEOWNERSHIP AND ITS BENEFITS, *supra* note 7.

B. Encouraging Home Ownership

1. Federal Policies

Because of what has been characterized as a "deeply rooted and almost universally held belief that home ownership provides important advantages that merit continued public support," the United States has long encouraged, supported, and subsidized home ownership.[18] Even before the recent mortgage crisis forced the government to increase its involvement in the housing market, the United States had an active role in the housing market and helped facilitate the transition from renting to home ownership.

The Federal Housing Administration (FHA) was created during the Depression to help stimulate the housing market. The FHA encourages lenders to originate residential mortgages by insuring traditional long-term loans that meet certain underwriting standards and warranting to lenders who make these loans that they will be repaid in full even if the borrower defaults and the lender is forced to sell the house at a loss.[19] Congress also chartered Government-Sponsored Entities (GSEs) to help stabilize U.S. residential mortgage markets, ensure the efficiency and liquidity of the mortgage market, and generally expand opportunities for home ownership. Two GSEs, Fannie Mae (the Federal National Mortgage Association) and Freddie Mac (the Federal Home Loan Mortgage Corporation), are publicly traded corporations that purchase conventional mortgages from lenders then pool or bundle the mortgages and sell them to private investors.[20]

In addition to its role in buying and securitizing mortgages, the federal government routinely subsidizes initiatives that are designed to increase home ownership.[21] For example, the American Dream Downpayment Act provides down payment assistance to help families purchase a house, and the government has subsidized financial literacy courses.[22] Moreover, when housing became unaffordable for many lower- and middle-income renters, the George W. Bush administration encouraged the real estate and financial sector to increase product innovation to help renters (especially minorities) become homeowners and supported efforts to approve a zero down payment FHA loan program.[23] Finally, as a result of the current mortgage meltdown, the White House recently created a President's Advisory Council on Financial Literacy.[24]

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18. HOMEOWNERSHIP AND ITS BENEFITS, *supra* note 7.

19. *See* Adam Gordon, Note, *The Creation of Homeownership: How New Deal Changes in Banking Regulation Simultaneously Made Homeownership Accessible to Whites and Out of Reach for Blacks*, 115 YALE L.J. 186, 188−89 (2005) (describing the creation and functions of the FHA).

20. Federal Home Loan Mortgage Corporation Act, 12 U.S.C. § 1451 (2006); Eric Dash, *Fannie Mae's Offer to Help Ease Credit Squeeze is Rejected, as Critics Complain of Opportunism*, N.Y. TIMES, Aug. 11, 2007, at C1. For an overview of the role the FHA played historically in shaping the secondary mortgage market, see Christopher L. Peterson, *Predatory Structured Finance*, 28 CARDOZO L. REV. 2185, 2194−98 (2007).

21. Press Release, *supra* note 3. *See generally* EXPANDING OPPORTUNITIES, *supra* note 5 (detailing Bush agenda); The Budget for Fiscal Year 2007, Department of Housing and Urban Development, at 146−47 (discussing American Dream Downpayment Initiative, Neighborhood Reinvestment Corporation, HOME Investment Partnerships program).

22. EXPANDING OPPORTUNITIES, *supra* note 5, at 15.

23. "America's Homeownership Challenge" called on the real estate and financial sectors

2. Tax Benefits/Subsidies

While not an explicit tax benefit, homeowners are not taxed as landlords on the imputed value of the income they receive when they "rent" their homes from themselves. While this owner equivalent rental benefit may be hard to quantify, it is available to all homeowners. In contrast, the most significant tax benefits help only certain homeowners, primarily taxpayers in the highest income brackets who itemize their deductions on their tax returns.[25] Homeowners who itemize may deduct interest on mortgage loans, including home equity loans or lines of credit, up to a certain dollar amount on their first and second homes.[26] Homeowners who itemize their deductions can also deduct state and local real property taxes from ordinary income.[27]

However, since only thirty-six percent of all taxpayers itemized their deductions, only twenty-eight percent paid home mortgage interest to financial institutions in 2005, and most itemizers are higher income taxpayers,[28] these tax benefits are not evenly distributed among taxpayer homeowners. The tax benefits are significant: in 2005, the amount value of home mortgage interest paid deduction was $383,733,110, making this deduction one of the largest wealth transfers contained in the Internal Revenue Code.[29] Likewise, in 2005, the amount of the real estate taxes paid deduction was

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to find innovative ways to help increase minority home ownership. *Id.* at 4.

24. Press Release, President George W. Bush, Executive Order: Establishing the President's Advisory Council on Financial Literacy (Jan. 22, 2008), http://www.whitehouse.gov/news/releases/2008/01/20080122-1.html.

25. *See* Roberta F. Mann, *The (Not So) Little House on the Prairie: The Hidden Costs of the Home Mortgage Interest Deduction*, 32 ARIZ. ST. L.J. 1347, 1358–66 (2000) (analyzing how the tax deduction for home mortgages favors wealthy home owners and discriminates against minorities).

26. Internal Revenue Serv. Frequently Asked Questions: 3.6 Real Estate (Taxes, Mortgage Interest, Points, Other Property Expenses), http://www.irs.gov/faqs/faq3-6.html. This limitation currently is capped at $1.1 million: home owners may deduct up to $1 million of home acquisition debt and up to $100,000 of home equity debt. Internal Revenue Serv. Publication 936 (2007), Limits on Home Mortgage Interest Deduction, http://www.irs.gov/publications/p936/ar02.html#d0e1887.

27. Internal Revenue Serv. Tax Topics—Topic 503 Deductible Taxes, http://www.irs.gov/taxtopics/tc503.html.

28. *See* Internal Revenue Serv. Statistics of Income Division, Individual Income Tax Returns 2005, IRS Publication 1304, http://www.irs.gov/pub/irs-soi/05in13ms.xls; Internal Revenue Serv. Statistics of Income Division, Individual Income Tax Returns with Deductions 2005, IRS Publication 1304, http://www.irs.gov/pub/irs-soi/05in03id.xls [hereinafter IRS Publication 1304]. Taxpayers also paid mortgage interest to private individuals and also paid points on the real estate loans. *See* CONSUMERS UNION, RICH HOUSE, POOR HOUSE: THE TWO FACES OF HOME EQUITY LENDING 3 (1997), http://www.consumersunion.org/finance/home-tx2.htm (noting that, in Texas, only 18.2% of Texas filers overall take tax deductions and that only 3.4% of the lowest income filers deduct interest compared to 29% of all taxpayers nationally and 6.5% of the lowest income taxpayers nationally).

29. IRS Publication 1304, *supra* note 28. The lost tax revenue for employer-provided pension plans represents the largest tax benefit available for individuals. THOMAS L. HUNGERFORD, CONG. RESEARCH SERV., TAX EXPENDITURES: TRENDS AND CRITIQUES (2006). By way of contrast, 84,841,222 taxpayers (sixty-four percent) took the standard deduction, but the total value of that deduction was only $564,186,053. Thus, the housing interest deduction

$144,702,292, though this deduction was taken by only thirty-one percent of all taxpayers.[30]

Finally, the federal income tax capital gains deduction subsidizes home ownership. Taxpayers, even short-term homeowners and real estate speculators, who purchase homes can avoid paying capital gains taxes on up to $500,000 in profits they realize on the sale of the home because this deduction is available every two years.[31] In 2007, the estimated total cost to the federal budget for these federal tax benefits for homeowners was nearly $120 billion.[32]

3. Other Incentives

State and federal homestead exemption laws encourage and subsidize home ownership. Homeowners in most states, and all homeowners who file for bankruptcy, are allowed a homestead exemption that lets them keep at least a portion of the value of their home from creditors' collection attempts. Indeed, some states let debtors exempt the entire value of their home from all creditors except those who have a consensual security interest—typically the mortgage holder—in the home.[33]

Local land use policies and regulations also give homeowners certain cartel rights by letting them (but typically not renters) object to requests for zoning changes. This often lets homeowners ban certain types of housing uses (and, thus, certain types of housing dwellers) from entering into their neighborhoods.[34]

Finally, the government encourages low-income renters to become homeowners by allowing them to deposit a designated amount of funds in an Individual Development Account (IDA). IDAs encourage low-income individuals to set savings goals and accumulate assets by allowing them to deposit funds over a fixed period of time in an account that is then matched by other funds. While the matched money could originate from a foundation, individual, or other private source, matching funds typically come from a federal or state agency. Account holders can withdraw funds from the account for specific purposes, including home ownership, post-secondary education or training

($383,733,110) is proportionately more valuable to the thirty-six percent of taxpayers who take this deduction than the standard deduction is for the remaining taxpayers, since the value of the standard deduction that the majority of taxpayers take should, proportionately, be $599,582,984.

30. IRS Publication 1304, *supra* note 28.

31. *Id.*

32. STAFF OF THE JOINT COMMITTEE ON TAXATION, 110TH CONG., ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2007–2011, 27–28 (Joint Comm. Print 2007). The Committee estimates that, in 2007, the mortgage interest deduction will cost the federal budget $73.7 billion, property tax deductions will cost $16.8 billion, and the exclusion of capital gains on the sales of homes will cost $28.5 billion. *Id* at A1; Eduardo Porter & Vikas Bajaj, *Rising Trouble with Mortgages Clouds Dream of Owning Home*, N.Y. TIMES, Mar. 12, 2007, A1; *see also* Kenya Covington & Rodney Harrell, *From Renting to Homeownership: Using Tax Incentives to Encourage Homeownership Among Renters*, 44 HARV. J. ON LEGIS. 97, 105, tbl.1 (2007).

33. A. Mechele Dickerson, *Race Matters in Bankruptcy*, WASH. & LEE L. REV. 1725, 1736 (2004).

34. *See* Iglesias, *supra* note 1, at 540 (discussing "dark side" of focus on the home, including segregation, homelessness, and the Not in My Back Yard (NIMBY) syndrome).

(for the accountholder or the holder's child), retirement, and starting or expanding a small business.[35]

II. THE CURRENT AMERICAN DREAM: UNAFFORDABILITY AND MORTGAGE INNOVATION

Until foreclosure rates started to rise in 2006, many homeowners had experienced unprecedented home price appreciation.[36] Housing prices in the aggregate increased by more than fifty percent and, in some regions, housing prices increased annually by over ten percent.[37] Though housing price appreciation created vast sums of wealth for some homeowners, the gains have been unevenly distributed, and the gains for some created an unaffordability problem for others.[38]

To respond to the unaffordability problem, the U.S. government encouraged mortgage originators to diversify their loan products. The lending industry eagerly complied by creating, then extensively marketing, a wide array of nontraditional (also called "exotic" or "alternative") products.[39] These products sought to make housing affordable by allowing borrowers to buy a house with low (or no) down payments and low initial monthly payments. These products also made houses (even expensive ones) ostensibly affordable to people who might not have qualified for mortgages based on historical lending criteria, including those who had bad credit (i.e., subprime borrowers), who had no financial capital to make a down payment, or who were unable (or unwilling) to document their income and assets.[40] Affordability products also were

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35. Creola Johnson, *Welfare Reform and Asset Accumulation: First We Need a Bed and a Car*, 2000 WISC. L. REV. 1221, 1223–38 (2000); Susan A. Williams, *Individual Development Accounts in North Carolina*, 11 N.C. BANKING INST. 343 (2007).

36. Kevin D'Albert & Nicholas Rossetti, *2006 Global Structured Finance Outlook: Economic and Sector-by-Sector Analysis, Fitch Ratings*, FITCH RATINGS, Jan. 17, 2006; Karen Sibayan, *Home Sales Remain Robust All Around*, ASSET SECURITIZATION REP., Oct. 17, 2005.

37. ALLEN J. FISHBEIN & PATRICK WOODALL, CONSUMER FED'N OF AM., EXOTIC OR TOXIC? AN EXAMINATION OF THE NON-TRADITIONAL MORTGAGE MARKET FOR CONSUMERS AND LENDERS 28 (2006), *available at* http://www.consumerfed.org/pdfs/exotic_toxic_mortgage_report0506.pdf.

38. *See* Hang Nguyen, *Will Their Kids Ever Be Able to Buy a House?*, CHI. TRIB., Jan. 8, 2005, at 12 (describing how homeowners in Orange County, California benefit from the rise in home prices, but are concerned because their children can't afford homes in the same area).

39. The Mortgage Bankers Association defines "nontraditional mortgage products" as "financing options which have been developed to increase flexibility and affordability and otherwise meet the needs of homebuyers who have been purchasing homes in an environment where real estate prices have increased faster than borrowers' incomes." *Preserving the American Dream*, *supra* note 3, at 7 (statement of Douglas G. Duncan on behalf of the Mortgage Bankers Association).

40. In general, prime loans are offered to borrowers who have strong credit histories. Borrowers with weak or limited credit histories or who have high debt ratios generally are forced into the higher cost, subprime market because they are viewed as posing a higher risk of default. *Subprime and Predatory Lending*, *supra* note 11, at 71 (statement of Sheila C. Bair on behalf of the Federal Deposit Insurance Corporation); *id.*, at 123 (statement of JoAnn M. Johnson on behalf of the National Credit Union Administration). Borrowers who had uneven cash flow, worked on commission, were self-employed, anticipated a significant income increase, received significant lump sum payments or bonuses, or moved frequently historically

marketed to existing homeowners who wanted to remove equity from their homes to pay off existing debts, to make major consumer purchases or home improvements, or to pay for large anticipated expenses like medical procedures or college tuition.[41]

A. Attributes of Affordability Products

Despite the array of nontraditional mortgage products, most share common features, namely, flexible interest rates and low initial loan payments. In general, FHA and other conventional loans calculate a borrower's monthly payment based on principal and a fixed rate of interest.[42] In contrast, most nontraditional mortgages have adjustable rates (ARM) that start low then adjust on specific dates in the future. Once the rate "resets," the low initial monthly payments increase based on the new, higher "fully-indexed" rate.[43]

Some ARM products have a "balloon" feature that permits borrowers to make small payments for a specified period, but then make the entire loan balance due at the end of that period.[44] Others let borrowers defer principal payments early in the loan term by letting them pay interest only (IO) for a set time period.[45] Borrowers with uncertain income who would not have qualified for a traditional mortgage because of the likelihood that they would be unable to make payments during a low income (or high interest rate) period were offered products that let them skip a specified number of payments each year or let them choose the amount of their monthly payments (payment option loans).[46] In effect, these products permitted the borrower to "make" a

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would have a hard time obtaining mortgage loans but could be approved for a nontraditional loan product. FISHBEIN & WOODALL, *supra* note 37, at 5. For example, a third year law student who had no income, but who had a job offer from a large private law firm, would be an ideal candidate for an alternative mortgage product. *See* INTEREST-ONLY MORTGAGE, *infra* note 45.

41. *Improving Credit Card Consumer Protection: Recent Industry and Regulatory Initiatives: Hearing before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Services.*, 110th Cong. 88 (2007) (statement of Sheila C. Bair on behalf of the Federal Deposit Insurance Corporation) (discussing use of cash-out refinancing proceeds to pay off credit card debt); CHRISTIAN E. WELLER, CTR. FOR AM. PROGRESS, DROWNING IN DEBT: AMERICA'S MIDDLE CLASS FALLS DEEPER IN DEBT AS INCOME GROWTH SLOWS AND COSTS CLIMB 3 (2006).

42. *See* Federal Housing Administration, Common Questions About an FHA Loan, http://portal.hud.gov/portal/page?_pageid=33,717077&_dad=portal&_schema=PORTAL (comparing FHA and conventional loans).

43. Mortgage originators calculate the interest rate for an ARM by referring to a published index rate then adding a few percentage points ("the margin") to that rate. The adjusted rate, generally referred to as the "fully-indexed" rate, for an ARM is the margin plus the index rate. BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, CONSUMER HANDBOOK ON ADJUSTABLE-RATE MORTGAGES 8–9 (2006) [hereinafter BOARD OF GOVERNORS].

44. The flip side of a balloon payment is a product marketed as an extended maturity mortgage loan that has terms for longer than thirty years.

45. After the initial period, monthly payments "reset" and borrowers are required to pay down (amortize) the mortgage at a faster rate. BD. OF GOVERNORS OF THE FED. RESERVE SYS., INTEREST-ONLY MORTGAGE PAYMENTS AND PAYMENT-OPTION ARMS—ARE THEY FOR YOU? 2 (2006) [hereinafter INTEREST-ONLY MORTGAGE]. IO loans comprised almost one-third of total mortgage originations in 2004 and 2005 and were especially prevalent in high real estate markets.

46. Typically, borrowers could miss up to two payments annually (or a total of ten over the

loan payment each month even though the payment amount might be zero or significantly below the amount necessary to amortize the loan and, thus, reduce the principal loan balance.[47]

One of the most popular new nontraditional loan products was the hybrid ARM, a loan that started as a thirty-year fixed rate mortgage with a short-term introductory interest rate ("teaser" rate).[48] At the end of that period (typically two or three years), the fixed rate on these loans (typically called "2/28s" and "3/27s" because of the length of the teaser rate period) converted to an ARM, and the interest rate then periodically reset over the term of the loan.[49] Once the rates reset, the borrower's monthly payment would be recalculated and increase[50] based on the interest rate in effect when the loan rate reset.[51] Monthly payments for hybrid ARMs and other nontraditional loan products could increase dramatically after the reset, which is why these products were, in effect, exploding balloon loans. These products could (and ultimately did) have catastrophic consequences for borrowers who suffered a "payment shock"[52] and could not afford the new, higher monthly payments.[53]

Historically, nontraditional products (including IO loans) were designed for higher-income prime borrowers who had low loan-to-value (LTV) ratios (i.e., the ratio

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loan term). Payment option loan amounts can include: a fully amortizing payment similar to a conventional fifteen or thirty year fixed loan; interest plus *some* principal; interest-only; or, an amount that is less than IO payment. *Id.* at 3. Option ARMs have been compared to an exploding neutron bomb: when they come due, they kill all the people, but leave the houses standing. *See* Mara Der Hovanesian, *Nightmare Mortgages: They Promise the American Dream: A Home of Your Own—with Ultra-Low Rates and Payments Anyone Can Afford*, BUSINESSWEEK, Sept. 11, 2006. The mortgage crisis has caused at least one major lender to stop offering these mortgages. *Wachovia Quits Offering Risky Loan Option*, CNN.COM, June 30, 2008, http://money.cnn.com/2008/06/30/real_estate/wachovia_mortgages.ap/index.htm.

47. A borrower who chooses a payment amount that is lower than the fully-indexed accrual interest rate and that does not cover the accrued interest will have a loan that negatively amortizes because the required payment does not cover interest and, as a result, causes the principal balance of the loan to increase. INTEREST-ONLY MORTGAGE, *supra* note 45, at 3. Option ARMs generally require borrowers to make a specified minimum payment if the loan negatively amortizes beyond a pre-determined limit. *Id.* at 4; *Preserving the American Dream*, *supra* note 3, at 8 (statement of Douglas G. Duncan on behalf of the Mortgage Bankers Association).

48. Until recently, hybrid ARMs dominated the ARM market. FISHBEIN & WOODALL, *supra* note 37, at 10; John C. Dugan, Comptroller of the Currency, Nat'l Foundation for Credit Counseling (Washington, D.C.), Apr. 24, 2007, at 2, *available at* http://www.occ.treas.gov/ftp/release/2007-44a.pdf.

49. FISHBEIN & WOODALL, *supra* note 37, at 10.

50. While all ARMs adjust upward, not all of them adjust downward. *See* BOARD OF GOVERNORS, *supra* note 43.

51. *Id*. at 6.

52. The lending industry also refers to a payment shock as "reset sensitivity." *See* CHRISTOPHER L. CAGAN, FIRST AM. REAL ESTATE SOLUTIONS, MORTGAGE PAYMENT RESET: THE RUMOR AND THE REALITY 20 (2006), *available at* http://www.loanperformance.com/infocenter/whitepaper/FARES_resets_whitepaper_021406.pdf.

53. *See Subprime and Predatory Lending*, *supra* note 11, at 70 (statement of Sheila C. Bair on behalf of the Federal Deposit Insurance Corporation); Les Christie, *Subprime Bailouts: How They Work*, CNNMONEY.COM, Apr. 24, 2007, http://money.cnn.com/2007/04/24/real_estate/bailout_plans_how_they_work/index.htm.

between the principal loan balance and the current value of the property) and who could afford to repay the loan even at the higher interest rate.[54] These products were initially marketed as financial management tools—not as affordability products—that gave high-income buyers lower monthly payments so they could manage their cash flow and capitalize on other investments.[55] Hybrid ARMs and other nontraditional products also were deemed to be appropriate only for homeowners who had steady income but a spotty credit record. Both the borrower and the lender assumed that, with time, the borrower's credit score would improve and she could refinance into a more favorable fixed subprime loan, or even into a prime product.[56]

B. Relaxed Lending Requirements

In addition to offering loans with features that made monthly payments more affordable, mortgage originators gradually relaxed traditional lending procedures and requirements to make it easier to approve housing loans. In effect, the lenders allowed borrowers to achieve the American Dream without having to sacrifice anything to achieve that dream.

For example, though mortgages traditionally had fifteen- or thirty-year terms, some lenders started to offer extended maturity mortgage loans for terms up to forty or fifty years.[57] Mortgage originators also stopped demanding that borrowers specify their income and assets[58] and instead approved no documentation or low documentation (commonly referred to as "no doc," "lo doc," or "liar") loans.[59] Rather than require

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54. *Preserving the American Dream*, *supra* note 3, at 7 (statement of Douglas G. Duncan on behalf of the Mortgage Bankers Association); *see also Structured Finance Option ARM Risks and Criteria*, FITCH RATINGS, Oct. 4, 2006, at 1−2 (noting suitability of option ARMs for borrowers who have solid credit histories and low LTV ratios). A relatively new product, called Mortgage Plus, was recently introduced but only offered to prime borrowers with solid credit scores. This product lets the borrower convert their mortgage from an ARM to a fixed rate yet avoid the costs associated with a traditional refinancing. With an interest rate higher than comparable fixed rate mortgages, the product does not have a negative amortization option, is marketed only to people who can repay the loan at its fully indexed level, and lets homeowners tap into their equity only if the LTV ratio is less than ninety percent. *See* Les Christie, *Mortgages That Put You in Charge*, CNNMONEY.COM, Apr., 26, 2007, http://money.cnn.com/2007/04/26/real_estate/flexible_mortgages/index.htm.

55. INTEREST-ONLY MORTGAGE, *supra* note 45, at 7; *see also* FISHBEIN & WOODALL, *supra* note 37, at 4.

56. *The Mortgage Lending Market: An Insiders' Guide to Legislation and Litigation*, BANKING L. J., Nov.–Dec., 2007, at 867, 872.

57. D'Albert & Rossetti, *supra* note 36; Gretchen Morgenson, *Home Loans: A Nightmare Grows Darker*, N.Y. TIMES, Apr. 8, 2007, at C1; Holden Lewis, *50-Year Mortgage Debuts in California*, BANKRATE.COM, Apr. 27, 2008, http://www.bankrate.com/brm/news/mortgages/20060427a2.asp. These loans produce a product that looks substantially similar to a long-term monthly rental payment. As noted earlier, the flip side of these extended maturity mortgage loans is the "balloon payment."

58. Waiving this requirement might be justified for high income workers (who might prefer not to disclose their income, but can afford the monthly payments) and self-employed or seasonal workers (who might have high income, but are unable to verify that income).

59. *Frenzy of Risky Mortgages Leaves Path of Destruction*, REUTERS, May 8, 2007; *see also Preserving the American Dream*, *supra* note 3 (statement of Jean Constantine-Davis on

potential borrowers to verify their income and wealth, mortgage originators used reduced or minimal standards to verify the borrower's income and assets, often relying on the credit scoring devices used to approve credit cards.[60]

Mortgage originators also reduced the amount of money they demanded that potential buyers invest in their homes in the form of a down payment. Historically, only renters with at least some financial capital could become a landowner.[61] The FHA would not make loans that exceeded eighty percent of the value of the home and most lenders encouraged homeowners to make at least a twenty percent down payment in order to qualify for a loan. Those who did not were forced to purchase private mortgage insurance (PMI), although that requirement would be waived for wealthy borrowers who had the funds to make the down payment but chose to make other investments using those funds.[62]

Given the current U.S. savings rate (which has been less than one percent or has been negative for the last several years), many renters lacked funds to make a down payment.[63] To help these cash-strapped borrowers buy a home, lenders began to offer

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behalf of the AARP Foundation) (describing perils to consumers of "stated income" loans). Variations of stated income loans are no income, no asset (NINA) loans. With these loans, the borrower is not required to disclose income or assets. *See No Doc Home Loans*, http://www.bestnodocloans.com/content/nina_loan.htm; http://www.loanshoppers.net/no-doc.htm. These loans would be approved based on the borrower's employment, credit history, the property value, and the down payment (if any). Another variation, a NINANE (no income, no asset, no employment) loan, did not require the borrower to disclose income, assets, *or* employment. *See* Wisconsinmortgageservices.com, http://www.wisconsinmortgageservices.com/nina_loan_748.htm; Mortgage Professor's WebSite, What Are Mortgage Documentation Requirements, http://www.mtgprofessor.com/A%20-%20Qualifying/what_are_documentation_requirements.htm.

60. Because those scoring devices have never been used to verify income (and, indeed, do not consider income at all), lenders protected themselves from the increased risk of default by charging borrowers higher interest rates for these loans. *See* Kenneth R. Harney, *The Lowdown on Low-Doc Loans*, WASH. POST, Nov. 25, 2006, at F01 (describing how lo-doc and no-doc loans work). Of course, using credit scores to approve liar loans increases the risk that borrowers cannot afford to repay the loans and likely will default because those scores are not designed to predict whether a borrower will face a payment shock and be unable to make payments on a ARM mortgage loan after the interest rate resets, nor can they anticipate whether economic conditions will permit the borrower to refinance the ARM loan to a more affordable product.

61. William E. Nelson & Norman R. Williams, *Suburbanization and Market Failure: An Analysis of Government Policies Promoting Suburban Growth and Ethnic Assimilation*, 27 FORDHAM URB. L.J. 197, 226−31 (1999) (tracing the history of government intervention in the housing markets to expand home ownership by loosening financial requirements); Williams, *supra* note 1, at 4.

62. FISHBEIN & WOODALL, *supra* note 37, at 12.

63. Since 2006, the United States has had a negative savings rate, that is, Americans save less than they spend on goods or services. *See* News Release: Personal Income and Outlays, Bureau of Economic Analysis, United States Department of Commerce, Personal Income and Outlays: Sept. 2007 (Nov. 1, 2007), *available at* http://www.bea.gov/newsreleases/national/pi/2006/pi1106.htm; News Release, Bureau of Economic Analysis, United States Department of Commerce, Personal Income and Outlays: Nov. 2006 (Dec. 22, 2006), *available at*

nontraditional products that required no down payment and that had high loan-to-value (LTV) ratios that let borrowers take out a loan (or loans) equal to the sale price of their home.[64]

While the median down payment on a home purchase historically had been twenty percent, until the recent mortgage crisis, the median down payment had dropped to nine percent and almost thirty percent of all buyers made no down payment.[65] Increasingly, both prime and subprime borrowers were allowed to avoid buying PMI, yet purchase a home with zero down, by taking out a first mortgage (typically for eighty percent of the value of the home) and then a simultaneous second mortgage (or line of credit) for the remainder, a loan system commonly referred to as "piggyback" loans.[66] High LTV, or piggyback loans, are functionally similar to negatively amortizing payment option loans. That is, in a piggyback loan transaction, each time the borrower draws on the home equity loan or line of credit, the loan balance increases—just as it would increase for a payment option loan when the borrower made a monthly payment that did not cover total accrued interest.[67]

C. Risk-Layering

Relaxed lending requirements and certain features associated with nontraditional loans made it likely that borrowers would be unable to make loan payments once interest rates increased. This risk increased if mortgage originators engaged in certain "risk-layering" practices. In general, risk-layering occurs when a mortgage originator combines different features of nontraditional loans in one product.[68] For example, a mortgage originator who qualified a borrower for a thirty-year subprime ARM that had

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http://www.bea.gov/newsreleases/national/pi/2007/pi0907.htm. The negative U.S. savings rate has made the United States increasingly dependent on non-U.S. funds. Indeed, just as the United States routinely imports goods (because we are no longer a manufacturing economy) the United States also is forced to import savings from other countries just to finance domestic business investments. Martin Feldstein, *The Return of Saving*, 85 FOREIGN AFF. 89 (2006).

64. *See Calculated Risk: Assessing Non-Traditional Mortgage Products: Hearing Before the Subcomm. on Housing and Transportation and the Subcomm. on Economic Policy of the S. Comm. on Banking, Housing, and Urban Affairs*, 109th Cong. (2006), *available at* http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=f70279b0-1372-4075-a740-9a1aeb7bdc3e [hereinafter *Calculated Risk*] (statement of William A. Simpson on behalf of the Mortgage Insurance Companies of America); FISHBEIN & WOODALL, *supra* note 37, at 12.

65. John Leland, *Facing Default, Some Walk Out on New Homes*, N.Y. TIMES, Feb. 29, 2008, at A1.

66. Borrowers often put no money down, though some borrowed eighty percent with a traditional mortgage, ten percent as a second loan, and put ten percent down, which is why these loans often are called 80-10-10 loans. Robert A. Avery, Kenneth P. Brevoort & Glenn B. Canner, *Higher-Priced Home Lending and the 2005 HMDA Data*, 92 FED. RES. BULL. A123, at A135 (2006); FISHBEIN & WOODALL, *supra* note 37, at 3.

67. *See Subprime and Predatory Lending*, *supra* note 11, at 78–79 (statement of Sheila C. Bair on behalf of the Federal Deposit Insurance Corporation); FISHBEIN & WOODALL, *supra* note 37, at 3.

68. *The Role of the Secondary Market in Subprime Lending: Hearing before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Servs.*, 110th Cong. 105 (2007) [hereinafter *The Role of the Secondary Market*] (statement of Warren Kornfeld on behalf of Moody's Investors Service).

a low teaser rate (that increased in two years) based on the product's initial (not fully indexed) interest rate; approved the loan based on the borrower's representation of his income or assets (i.e., a no-documentation loan);[69] and required no down payment, while allowing the borrower to take out a high LTV first mortgage with a piggyback loan, increased the risk that the borrower would face a payment shock and default.[70] Similarly, a mortgage originator who qualified a borrower for a payment option ARM that let the borrower make low initial payments and defer accrued interest payments increased the risk that the loan would negatively amortize, even if the borrower made some mortgage payments. If the loan negatively amortizes, the borrower will not build equity in the house and will risk losing any accumulated equity if housing prices decline and she sells the house for less than the principal balance of the loan.[71]

The borrower might accept the risks associated with the loan transaction by assuming that she will be able to refinance the loan to a lower interest rate product and, thus, will never be forced to make monthly payments at the higher reset rate. This was a widely held assumption during the frenzied house appreciation period at the beginning of this decade. In fact, no one involved in the transaction ever believed these borrowers would actually pay the loan at the reset interest rate, and everyone knew the borrower could not afford the monthly payments at the fully-indexed rate. Everyone involved in the transaction (mortgage brokers, underwriters, borrowers) assumed that the borrower would refinance the loan before the rates reset. This was a low-risk assumption, but only if interest rates were low and housing prices were appreciating.[72] However, the borrower would be at an increased risk of default if he suffered a payment shock at the reset; he had no equity in the home (perhaps because the loan negatively amortized); he could not sell the home because housing prices were stagnant (or house price appreciation increased at a slower rate than the loan balance); or interest rates were dropping (and, thus, he could not refinance the loan).

D. Prevalence of Affordability Products

Nontraditional mortgage product originations increased dramatically during the last several years. In 2005, approximately thirty-four percent of all home buyers who

69. Consumer advocates argue that some lenders and mortgage brokers use these loans to avoid having to alter or otherwise fabricate income or asset information on the loan application. *See Preserving the American Dream*, *supra* note 3 (statement of Jean Constantine-Davis on behalf of the AARP Foundation).

70. Industry experts agree that loans with very low teaser rates increase the risk that the borrower will face a payment shock. *See* CAGAN, *supra* note 52, at 25.

71. For example, more than twenty percent of the ARMs made starting in 2004 that had low initial interest rates have negative equity. ***Id.*** at 22.

72. Even with this assumption, refinancing a loan to get a more affordable product could potentially harm the homeowner because a loan refinance reduces the borrower's equity in the home due to the transaction costs for a new loan. Loan refinancings are especially likely to strip equity if the borrower made no down payment when he bought the home. Borrowers who put no money down on their homes and then refinance to get a lower interest rate virtually ensure that they will have no equity in their homes even if they make monthly payments during the first few years of the loan. *See Calculated Risk*, *supra* note 64, at 11–12 (testimony of Michael D. Calhoun, President of Center for Responsible Lending).

bought a home used some type of nontraditional product,[73] and that number increased to thirty-eight percent in 2006.[74] The years 2004 and 2005 are particularly significant because the interest rates on many hybrid ARM loans made in those years reset between 2006 and 2008, which is one reason foreclosures started to skyrocket in 2006.[75]

ARM products dominated the nontraditional mortgage market before the housing meltdown and are found in virtually all nontraditional subprime loans.[76] For example, in 2005, ARMs accounted for about seventy percent of subprime loans and, despite the increased costs associated with subprime loans,[77] were found in eighty percent of subprime loans when the mortgage meltdown started.[78] Moreover, the subprime portion of total mortgage loan originations jumped from 5.4% in 2001 to 7.9% in 2003,

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73. Kelly Gullo, *Nearly One in Five Recent Homebuyers Purchased a Home That Exceeded Their Price Range*, WALL ST. J. ONLINE, Sept. 16, 2005, www.harrisinteractive.com/news/newsletters/WSJfinance/HI_WSJ_PersFinPoll_2005_vol1_iss03.pdf.

74. Jennifer Cummings, *More U.S. Adults Than Last Year Say They Utilize Creative or Payment Option Mortgages to Finance the Purchase of Their Homes*, WALL ST. J. ONLINE, Oct. 12, 2006, http://www.harrisinteractive.com/news/newsletters/WSJfinance/HI_WSJ_PersFinPoll_2006_vol2_iss08.pdf.

75. Potentially $650 billion in U.S. mortgages—or eight percent of total outstanding mortgage loans—are due to reset between 2006 and 2008. John W. Schoen, *The Mortgage Mess: Fraud, Abusive Lending Crushes Dreams For Millions of Home Owners*, MSNBC.COM, Apr. 10, 2007, http://www.msnbc.msn.com/id/17929461/. Approximately two million ARMs will reset to a higher rate in 2007 and 2008. *Major Lenders Move to Offer Subprime Help: Freddie Mac*, *Washington Mutual Will Help Refinance Billions in Mortgages*, MSNBC.COM, Apr. 18, 2007, http://www.msnbc.msn.com/id/18184371/. While these resets contributed to the increased foreclosure rates, a leading bond rating agency concluded that mortgages that were originated in 2006 are performing even worse than loans originated between 2002 and 2005, and that more borrowers are delinquent on 2006 loans than earlier loans. *The Role of the Secondary Market*, *supra* note 68, at 109 (statement of Warren Kornfeld on behalf of Moody's Investors Service); *see also* Edmund L. Andrews, *Accord Seen on Revising Loan Rules*, N.Y. TIMES, Sept. 21, 2007, at C1 (stating that the percentage of subprime loans which are seriously delinquent in 2007 is triple that of 2005).

76. *See Subprime and Predatory Lending*, *supra* note 11, at 75 (statement of Sheila C. Bair on behalf of the Federal Deposit Insurance Corporation); *Id.* at 348 (statement of Allen J. Fishbein on behalf of the Consumer Federation of America).

77. Costs associated with predatory mortgage lending of subprime loans include prepayment penalties, which are imposed when a borrower makes a whole or partial payment on the loan earlier than scheduled. In addition, subprime borrowers often pay a yield spread premium, which simply rewards the broker for placing the borrowers in higher cost and interest loans. *Id.* (statement of Allen J. Fishbein on behalf of the Consumer Federation of America).

78. D'Albert & Rossetti, *supra* note 36, at 12. From 2003 to 2005, nontraditional mortgage product originations increased from less than ten percent of residential mortgages to over thirty percent of all mortgages. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-06-1112T, ALTERNATIVE MORTGAGE PRODUCTS: IMPACT ON DEFAULTS REMAINS UNCLEAR, BUT DISCLOSURE OF RISKS TO BORROWERS COULD BE IMPROVED 6 (2006); *see also Subprime and Predatory Lending*, *supra* note 11, at 348 (statement of Allen J. Fishbein on behalf of the Consumer Federation of America); *Calculated Risk*, *supra* note 64 (statement of William A. Simpson on behalf of the Mortgage Insurance Companies of America); JOINT CTR. FOR HOUSING STUDIES OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING: 2007, at 16 (2007), *available at* http://www.jchs.harvard.edu/publications/markets/son2007/son2007.pdf.

to over 20 % in 2006,[79] and estimates before the mortgage meltdown were that the percentage of subprime loan originations relative to all loan originations ranged from ten percent to fifteen percent (lenders' estimate) to twenty-five percent (consumer advocate estimate).[80] Even after the percentage of traditional ARMs relative to fixed-rate loans started to decrease in late 2005, the market for nontraditional ARMs (including IO and payment option loans) had meteoric growth, largely because of increasing interest rates and housing price appreciation.[81]

Virtually no subprime borrowers were allowed to avoid a down-payment by taking out piggyback loans in 1999. By 2006, however, approximately thirty-three percent of subprime borrowers (and over twenty percent of all buyers) had piggyback loans.[82] Similarly, while only twenty-five percent of subprime loans were no or lo doc loans in 2002, fifty percent of subprime loans failed to document the borrower's income by 2006.[83]

E. Securitization and Affordability Products

Lenders were willing to relax their standards and increase the number of nontraditional loans they issued partly because of the intense competition for borrowers in the first part of this decade who increasingly found it difficult to buy a home in certain housing markets.[84] But mortgage originators increased the volume of their nontraditional loan approvals primarily because of the enormous profitability of these high-yield loans in the secondary mortgage market.[85] Though the process to

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79. *See Subprime and Predatory Lending*, *supra* note 11, at 69 (statement of Sheila C. Bair on behalf of the Federal Deposit Insurance Corporation). Other reports indicate that the number of subprime loans increased more than 6.5 times between 2001 and 2006. *Preserving the American Dream*, *supra* note 3, at 5 (statement of Douglas G. Duncan on behalf of the Mortgage Bankers Association). Subprime originations in 1994 totaled $35 billion but increased to $665 billion in 2005. *Possible Responses to Rising Mortgage Foreclosures: Hearing before the H. Comm. on Financial Servs.*, 110th Cong. 161 (2007) [hereinafter *Possible Responses*] (statement of George P. Miller on behalf of the American Securitization Forum and the Securities Industry and Financial Markets Association).

80. *Preserving the American Dream*, *supra* note 3, at 5 (statement of Douglas G. Duncan on behalf of the Mortgage Bankers Association); *Calculated Risk*, *supra* note 64, at 2 (statement of Michael D. Calhoun on behalf of the Center for Responsible Lending); Editorial, *Mortgage Insecurities*, N.Y. TIMES, Feb. 22, 2007, at A22; Jonathan R. Laing, *Coming Home to Roost*, BARRON'S, Feb. 13, 2006, at 26.

81. JOINT CTR. FOR HOUSING STUDIES OF HARVARD UNIV., *supra* note 78, at 16–17.

82. *Subprime and Predatory Lending*, *supra* note 11, at 351 (statement of Allen J. Fishbein on behalf of the Consumer Federation of America); Avery et al., *supra* note 66, at A137.

83. *Subprime and Predatory Lending*, *supra* note 11, at 350 (statement of Allen J. Fishbein on behalf of the Consumer Federation of America).

84. *See* JOINT CTR. FOR HOUSING STUDIES OF HARVARD UNIV., *supra* note 78, at 16–17; FISHBEIN & WOODALL, *supra* note 37, at 15.

85. *Preserving the American Dream*, *supra* note 3, at 2 (statement of Martin Eakes on behalf of the Center for Responsible Lending and Center for Community Self-Help); *see also Foreclosure, Predatory Mortgage and Payday Lending in America's Cities: Hearing before the H. Comm. on Oversight and Government Reform* 110th Cong. 53–54 (2007) [hereinafter *Foreclosure, Predatory and Payday Lending*] (statement of Josh Nassar on behalf of the Center for Responsible Lending); Vikas Bajaj & Christine Haughney, *Tremors at the Door—More*

securitize loans is somewhat complex, in general, loan originators sell individual mortgage loans to an entity that then creates a trust and sells the right to receive monthly payments on the pooled mortgage loans to the trust. The trust, in turn, issues and sells mortgage-backed (also called asset-backed) securities (MBS) to investors and promises to pay investors using the income stream from borrowers' monthly loan payments.[86]

At least until the mortgage meltdown, Freddie Mac was one of the largest purchasers of conventional mortgage loans in the secondary market and one of the largest guarantors of home mortgages in the country, and it provided liquidity to the mortgage market by reselling the loans it purchased in the form of MBS.[87] Until the recent crisis, Fannie Mae was the largest mortgage financier in the country,[88] while another GSE, Ginnie Mae (the Government National Mortgage Association) guarantees securitized mortgages insured by the FHA or the Department of Veterans Affairs (VA).[89]

The active participation by GSEs in the securitization industry provided liquidity and gave mortgage originators an incentive to quickly sell the loans they originated on the secondary market and use the sale proceeds to make new loans. Most subprime mortgage loans are securitized, some even before the first loan payment is due, then sold primarily to large institutional investors, including hedge funds, and to conservative investors like insurance companies, pension funds, and university endowments.[90] Of the 21.5 million high-cost mortgage loans that were originated or

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People with Weak Credit Are Defaulting on Mortgages, N.Y. TIMES, Jan. 26, 2007, at C1.

86. The cash flows from the loans are then layered into "tranches," that is, investor classes, and parties purchase specified interests in the loan payments (i.e., right to principal or interest repayment in a particular year of the loan). *Subprime Mortgage Market Turmoil: Examining the Role of Securitization: Hearing before the Subcomm. on Securities, Insurance, and Investment of the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2007), *available at* http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=a14998f7-0b7d-4deb-8e2b-ce11fa95d79f [hereinafter *Subprime Mortgage Market Turmoil*] (statement of Gyan Sinha on behalf of Bear, Stearns & Co. Inc.); *Possible Responses*, *supra* note 79, at 158 (statement of George P. Miller on behalf of the American Securitization Forum and the Securities Industry and Financial Markets Association).

87. Avery et al., *supra* note 66, at A139–41.

88. Historically, GSEs have been limited in the amount of mortgages they can purchase. Fannie Mae, The Industry, http://www.fanniemae.com/index.jhtml (follow "About Fannie Mae" hyperlink; then follow "The Industry" hyperlink). *See generally* Irwin M. Stelzer, *Why They Call It the Dismal Science: Everything You Need To Know About the Mortgage Crisis in Three Economics Buzzwords*, WKLY. STANDARD, Nov. 26, 2007, at 26 (discussing externalities associated with refusing to permit GSEs to expand their lending activities).

89. Ginnie Mae, About Ginnie Mae, http://www.ginniemae.gov/about/about.asp?Section=About.

90. *See Subprime Mortgage Market Turmoil*, *supra* note 86 (statement of David Sherr on behalf of Lehman Brothers, Inc.); *Id.* at 9 (testimony of Warren Kornfeld on behalf of Moody's Investors Service); *Subprime and Predatory Lending*, *supra* note 11, at 395 (statement of Harry H. Dinham on behalf of the National Association of Mortgage Brokers). Hedge funds tend to invest in more speculative tranches while pension funds tend to invest in less risky, higher-rated tranches. Ironically, while conservative investors were not willing to buy individual mortgage loans, they happily invested in MBSs because of the perception that these loans were high yield but low risk.

purchased in 2005, seventy percent were sold in the secondary market.[91] Over the last decade, the MBS market grew considerably, and in 2006, the outstanding debt in the MBS market ($6.5 trillion) was larger than the debt for U.S. Treasury securities ($4.3 trillion) or corporate debt ($5.4 trillion).[92]

The almost insatiable appetite for profitable, high-yield securities helped generate a robust market for securitized mortgage loans, even though many of the underlying mortgages were high-risk subprime loans.[93] To satisfy investor demand, lenders and underwriters relaxed lending practices and underwriting standards which then caused them to inaccurately assess (or, to simply ignore) the borrowers' ability to repay the underlying loans after payments reset.[94] The financial institutions viewed these loans and securitized products as relatively safe bets, given rapidly appreciating housing prices.[95] Moreover, mortgage originators assumed that they faced little risk of carrying delinquent loans on their books since they quickly sold the loans and shifted the cost of future defaults to the investor/purchaser of the loan.[96]

By securitizing residential mortgage loans and guaranteeing MBS created by Wall Street investment houses, the GSEs (and other entities that securitize mortgages) provided mortgage originators with a continuous flow of funds that they then used to enter into new nontraditional mortgage contracts. Without these entities—especially the GSEs—the mortgage market as it currently exists would cease to function. And, but for the increased demand for MBS, the mortgage crisis would never have occurred.

III. THE HOMEOWNER'S REALITY

The oft-stated benefits of home ownership are largely inconsistent with recent trends that indicate that, for many, attempting to become a homeowner is a painfully short and ultimately unwise investment. Loans that were developed and actively marketed to lower- and middle-income borrowers to help them achieve their home ownership dream have placed them at a risk of losing both their housing investment and any reasonable chance to permanently change their social status from renter to homeowner.

Because people are irrationally (but predictably) optimistic in planning for the future, they have wholeheartedly accepted the myths associated with home ownership and seem genuinely stunned when they learn that they have homes that are of no value

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91. Avery et al., *supra* note 66, at A139.

92. *Possible Responses*, *supra* note 79, at 165 (statement of George P. Miller on behalf of the American Securitization Forum and the Securities Industry and Financial Markets Association).

93. *Id.* at 159–60.

94. *See Subprime and Predatory Lending*, *supra* note 11, at 80 (statement of Sheila C. Bair on behalf of the Federal Deposit Insurance Corporation); Bajaj & Haughney, *supra* note 85; Justin Lahart, *Ahead of the Tape*, WALL ST. J., Feb. 20, 2007, at C1.

95. FISHBEIN & WOODALL, *supra* note 37, at 14; Lahart, *supra* note 94.

96. *See* Kathleen C. Engel & Patricia A. McCoy, *Turning a Blind Eye: Wall Street Finance of Predatory Lending*, 75 FORDHAM L. REV. 2039, 2048–50 (2007) (discussing "lemons" problem and how securitization lets lenders shift the risk of default onto the investor); *see also* Bajaj & Haughney, *supra* note 85; Vikas Bajaj & Ron Nixon, *Minority Buyers Especially Hurt As Interest Rates Adjust Higher*, N.Y. TIMES, Dec. 6, 2006, at C1; *Lawmakers Debate Necessity of Lending Reforms*, MSNBC.COM, May 8, 2007, http://www.msnbc.msn.com/id/18560483/.

to them (because they lack equity) or that they have equity in their homes but they cannot sell them and recoup their costs.

A. Housing Affordability

The increased availability of products with "affordability" features created a vicious cycle. While additional financing may have helped fuel housing sales and may have allowed some buyers to purchase homes, it encouraged people who could never afford to buy a home to engage in extreme means to buy one to avoid missing out on the supra-normal price appreciation. Because of the affordability features of the loan products, almost all potential homebuyers could suddenly buy a house. This increased the pool of potential buyers, and with more potential buyers, sellers could then demand more for their homes, which caused housing prices to go even higher. This meant, of course, that cash-strapped homebuyers needed to borrow even more to buy these now higher-priced homes.

Because of housing price appreciation, many lower- and middle-income homeowners simply cannot afford to buy homes unless they accept risky, complex mortgage products that force them to gamble that the return on their investment (i.e., the price appreciation) will be large enough to 'cover' the high cost of their investments (i.e., significantly higher future interest). Though the federal government and other entities that evaluate housing affordability have concluded that households should spend no more than thirty percent of their gross income on housing costs, recent estimates indicate that half of all renters, and more than a third of all mortgage holders, spent at least thirty percent of the income on housing costs.[97] For subprime borrowers, the number was higher: in 2007, they spent approximately thirty-seven percent of their after-tax income on mortgage payments, insurance, and property taxes.[98]

B. Rising Rates and Credit Tightening

Once housing price appreciation stalled, and interest rates on ARMs reset or rose, some homeowners defaulted as soon as (and sometimes even before) their rates reset and then found that they could not refinance the loan product or sell their homes.[99] Loan defaults and foreclosures have now hit record levels. The delinquency rates for ARMs have been especially high, and default rates increased by 141% in 2006 over 2005 rates.[100] This is not surprising, since monthly mortgage payments for hybrid mortgages increased dramatically, sometimes doubling, when the interest rates reset.[101]

Foreclosure rates in 2007 were seventy-five percent higher than 2006 rates, and the foreclosure filing rate for April 2008 represented a sixty-five percent increase from

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97. John Leland, *Housing Costs Consumed More of Paycheck in 2006*, N.Y. TIMES, Sept. 12, 2007, at A14; U.S. Dept. of Housing and Urban Development, Affordable Housing, http://www.hud. gov/offices /cpd /affordablehousing/index.cfm.

98. John Leland, *supra* note 97; Porter & Bajaj, *supra* note 32.

99. Dan Levy, *Foreclosures Doubled in September as Loan Rates Rise*, BLOOMBERG.COM, Oct. 11, 2007, http://www.bloomberg.com/apps/news?pid=newsazrchive&sid=aWHIgddHc.zk.

100. *Calculated Risk*, *supra* note 64, at 11 (statement of Allen J. Fishbein on behalf of Consumer Federation of America and National Consumer Law Center).

101. Telis Demos, *Leading Indicators*, FORTUNE, Sept. 17, 2007, at 30.

April 2007 rates. Industry experts project that the higher mortgage default and foreclosure rates will continue throughout 2008 and possibly into 2009.[102] Foreclosure filings on subprime mortgages, especially ARMs, are especially high and have steadily increased for the last five years.[103] Reports indicate that more than forty percent of the most recent foreclosures were ARMs made to subprime borrowers.[104] Subprime loan foreclosures now account for over sixty percent of total foreclosure filings even though they accounted for less than twenty-five percent of loan originations and were only thirteen percent of all outstanding mortgages.[105]

When loan deficiency rates started to increase, loans were underwritten using stricter guidelines, and bond rating agencies downgraded mortgage securities. This credit tightening then had a ripple effect in the housing sector because, once it became harder for potential home buyers to refinance loans or to borrow money to buy homes, the pool of available homebuyers shrank. This then increased the supply of homes on the market, which then caused home prices to drop even more.[106] Increased foreclosure rates have caused housing prices to stagnate and decline and have also slowed home sales. A weak real estate market combined with the often high transaction costs and potential fees associated with loan refinances have made it harder for all homeowners—even those with high incomes—to tap into their home equity or refinance their homes to reduce their monthly payments and avoid foreclosure.[107]

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102. *Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress?: Hearing before the Subcomm. on Commercial and Administrative Law of the H. Comm. on Judiciary*, 110th Cong. 2 (2007), *available at* http://judiciary.house.gov/hearings/hear_103007_2.html [hereinafter *Straightening Out, Part II*] (statement of Mark Zandi on behalf of Moody's Economy.com); Damian Paletta, Study Warns of Decline in Value of Homes, WALL ST. J., Nov. 27, 2007; Levy, *supra* note 99.

103. Levy, *supra* note 99; *see Nationwide Foreclosures Jumped 75% in 2007*, CREDIT & COLLECTIONS WORLD, http://www.creditcollectionsworld.com/article.html?id=20080129S4FTCWQT.

104. Levy, *supra* note 99. Subprime loans have higher defaults than prime loans, and ARMs have higher default rates and are at a significantly greater risk of foreclosure than fixed rate mortgages. Loans with high LTV rates have greater defaults than those with low LTV.

105. *Subprime and Predatory Lending*, *supra* note 11, at 292 (statement of Michael D. Calhoun on behalf of the Center for Responsible Lending).

106. Bob Tedeschi, *Ripples From the Subprime Storm*, N.Y. TIMES, Mar. 25, 2007, § 11, at 13.

107. *Subprime and Predatory Lending*, *supra* note 11, at 85 (statement of Sheila C. Bair on behalf of the Federal Deposit Insurance Corporation); *Calculated Risk*, *supra* note 64, at 348–49 (statement of Allen J. Fishbein on behalf of the Consumer Federation of America); THE FEDERAL RESERVE BOARD, CONSUMER HANDBOOK ON ADJUSTABLE-RATE MORTGAGES 24 (2006) (discussing prepayment penalties); Levy, *supra* note 99. Some reports suggest that housing prices have not dropped this steeply since the Great Depression. Bob Ivry & Brian Louis, *U.S. Home Construction Bust May Last Until 2011*, BLOOMBERG.COM, May 29, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=aKQoeHb1MraI&refer=home. Not even the wealthiest communities in the country have avoided the wave of foreclosures. Christine Haughney, *Pain of Foreclosures Spreads to the Affluent*, N.Y. TIMES, Apr. 25, 2008, at C1; *see* JOHN RAO, NAT'L CONSUMER LAW CTR., HENRY J. SOMMER, NAT'L ASSOC. OF CONSUMER BANKR. ATTORNEYS, TRAVIS PLUNKETT, CONSUMER FED'N OF AM., ELLEN HARNICK & ERIC STEIN, CTR. FOR RESPONSIBLE LENDING, JOINT MEMORANDUM FOR PROPOSED BANKRUPTCY LAW REFORM: SOLUTIONS TO PRESERVE HOMEOWNERSHIP (2007), *available at*

C. Prospect for Long-Term Home Ownership

Despite the rhetoric associated with the American Dream, most nontraditional ARM products do not encourage long-term home ownership, and instead, are best suited for borrowers who intend to remain in the home for only a short period of time and either "flip" the home and sell it when the price rises, trade up to a more expensive house, or remain in the home and refinance the loan to a more affordable product.[108] Likewise, the $500,000 capital gains tax exclusion gives homeowners an incentive to treat a housing purchase as a business investment and does not encourage them to invest long-term in their communities. Moreover, while financial innovation appears to have increased the amount of overall household debt, it does not appear to have increased the number of long-term homeowners.[109]

Recent data confirm that a significant percentage of subprime loans were not used to make home ownership a reality, but instead were used by existing homeowners to refinance existing high-rate mortgage loans or as home equity loans.[110] Specifically, between 1998 and 2006, only 1.4 million of 15.1 million subprime loans were made to first-time home buyers.[111] Given the higher foreclosure rates for subprime loans, it is perhaps not surprising that net new home ownership does not appear to have increased despite attempts to make housing more affordable. In fact, recent data indicate that notwithstanding the government's "homeownership challenge" to the financial community, there has been a net loss of home ownership.[112]

Losing an investment in a home can have a long-term detrimental effect on the homeowner and may make it prohibitively expensive for them to purchase a home in the future. Data show that homeowners who lose their homes—for any reason—may be unable to re-enter the home buying market for a decade because of the effect the foreclosures have on the borrowers' credit rating and also because of the time it takes for the homeowners to generate additional savings to replenish the money they lost in the investment in their homes.[113]

Encouraging consumers to purchase houses they might be forced to sell in the short-term, subsidizing their decision to purchase a house with the goal of making a short-term profit, or allowing homeowners to extract money from their houses arguably is consistent with the view of home ownership as a way to build wealth. However, treating a housing purchase purely as a real estate investment is not consistent with the cultural significance attached to home ownership as a way to ensure a stable home in which to rear children, to stabilize communities, or to encourage neighbors to be

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http://www.consumerfed.org/pdfs/Bankruptcy_Law_Reform_Memo041207.pdf [hereinafter JOINT MEMORANDUM].

108. *The Role of the Secondary Market*, *supra* note 68, at 106 (statement of Warren Kornfeld on behalf of Moody's Investors Service) (discussing "flippers" who rely on rising home prices to trade out of a new home or repay an otherwise unaffordable mortgage).

109. Karen E. Dynan & Donald L. Kohn, *The Rise in U.S. Indebtedness: Causes and Consequences* 18 (Fed. Reserve Bd., Working Paper No. 37, 2007).

110. *Subprime and Predatory Lending*, *supra* note 11, at 300 (reporting data that revealed that only eleven percent of subprime loans went to first-time buyers).

111. CENTER FOR RESPONSIBLE LENDING, SUBPRIME LENDING: A NET DRAIN ON HOMEOWNERSHIP 2 (2007).

112. *Id.*

113. FISHBEIN & WOODALL, *supra* note 37, at 20; Editorial, *Losing Homes and Neighborhoods*, N.Y. TIMES, Apr. 10, 2007, at A20.

invested in local schools and community services. Indeed, encouraging consumers to borrow money to purchase a home they can afford only if the value of the house increases is a version of market speculation that is not substantially different from the strategy margin traders or hedge funds use when making investing decisions.[114]

D. Opportunity Costs

In addition to the actual costs that the mythical American Dream imposes on existing and potential homeowners, there are significant opportunity costs associated with the American Dream. Homebuyers who purchase a house in order to achieve homeowner status restrict their ability to use those funds to make other investments. For example, homeowners who struggle to buy a house or to keep their over-priced houses in order to avoid being ejected from the ranks of homeowners often deplete retirement funds[115] and often find themselves forced to reduce spending on other consumer items, even critical ones like health insurance.[116] In the process, they increase the likelihood that their homes will not be as valuable, since stretching to buy the house often leaves them little money to spend on routine home maintenance.

Investing in a house may also prevent the homeowner from investing (or making a larger investment) in their or their dependents' pre-school, secondary, or college education. An investment in education is not subject to the vagaries of the housing market, and more importantly, will not restrict the consumer's mobility. That is, when low- and middle-income renters and homeowners use scarce investment funds to invest in the housing market, they are prevented from using those funds to invest in education, which generally is not subject to wild market fluctuations and also can enhance the renters' long-term prospects for economic stability. Moreover, the drive to achieve homeowner status reduces actual homeowners' incentive to weigh the long-term benefits of renting a home in a school district that has higher quality schools for their children against attempting to buy an unaffordable home in a district whose schools might be of a lower quality.

E. Negative Externalities

Borrowers' defaults on their subprime mortgages created a ripple effect in the financial sector. Increased defaults caused rating agencies to downgrade subprime mortgage securities, forced lenders to severely restrict the amount of funds they lent to companies who made, or invested in, subprime loans, and also caused lenders to restrict the credit available to businesses who were credit-worthy and did not invest in mortgage-backed securities.[117] These events combined to create a loss of confidence in

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114. For a description of margin trading, see Investing with Borrowed Funds: No "Margin" for Error, Financial Industry Regulatory Authority, http://www.finra.org/InvestorInformation/InvestorAlerts/MarginandBorrowing/InvestingwithBorrowedFundsNoMarginforError/index.htm.

115. *Cf.* David Bauerlein, *Florida Senator Sponsors Bill to Let Homeowners Tap 401(k)s to Pay Mortgages*, FLA. TIMES-UNION, Nov. 24, 2007.

116. *See* Cara Baruzzi, *Time Bomb*, NEW HAVEN REG., Dec. 10, 2006 (describing how higher mortgage payments will force homeowners to reduce consumer spending).

117. Stelzer, *supra* note 88.

the financial sector that ultimately made investors unwilling to purchase debt offerings involving subprime loans. This devastated the market for mortgage securitizations and created an unfavorable feedback loop that seized up virtually all credit markets for both potential prime and subprime borrowers.[118]

This liquidity restriction has now led to the collapse of several mortgage lenders and hedge funds that invested in those lenders; has harmed large institutional non-financial investors, like pension funds and university endowments;[119] has caused old-fashioned runs on banks;[120] and has led to the firing of the CEOs of Citigroup and Merrill Lynch.[121] And, the U.S. government has now been forced to bail out Fannie Mae and Freddie Mac because of the losses these GSEs have suffered due to the mortgage meltdown.[122] While it was not a surprise when those involved with mortgage lending were harmed during the meltdown, the general restriction of credit and the multibillion dollar losses banks have suffered because of their real estate activities are harming businesses who did not invest in MBSs and who have solid credit and profitable business lines. Such businesses are now often denied loans or are forced to wait longer and pay higher interest rates for those loans.[123]

Just as home ownership has positive externalities, increased mortgage loan defaults and foreclosure rates have significant negative externalities. The glut of houses on the market combined with the depressed sale prices of foreclosed properties and a sharp curtailment of credit has decreased the demand for all houses and has forced homeowners who do not have risky mortgages and who are not in default on those mortgages to watch their homes drop in value because of neighboring foreclosed and vacant homes.

Studies have found that foreclosures lower the price of nearby homes by at least one percent, and also give people an incentive to vandalize the empty home, steal copper, and use the homes for illegal drug-related purposes.[124] Foreclosed properties also

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118. *Possible Responses*, *supra* note 79, at 158 (statement of George P. Miller on behalf of the American Securitization Forum and the Securities Industry and Financial Markets Association); Jeannine Aversa, *Fed Worries About Upcoming Credit Market*, ST. LOUIS POST-DISPATCH, Jan. 2, 2008, at C2; Vikas Bajaj, *Top Lender Sees Mortgage Woes for 'Good' Risks,* N.Y. TIMES, July 25, 2007, at A1.

119. *See* Jeff Benjamin, *More Problems Ahead from the Credit Crisis; Subprime Woes May Spread to Bonds Backed by Higher-Quality Mortgages*, INVESTMENT NEWS, Nov. 5, 2007, at 2; Julie Creswell & Vikas Bajaj, *$3.2 Billion Move by Bear Stearns to Rescue Fund*, N.Y. TIMES, June 23, 2007, at A1; Editorial, *Pensions and the Mortgage Mess*, N.Y. TIMES, Aug. 7, 2007, at A18 (quoting Federal Reserve Chairman Bernanke's concern about risks that mortgage-related securities pose to pension funds).

120. Paul Krugman, *It's a Miserable Life*, N.Y. TIMES, Aug. 20, 2007, at A19; Julia Werdigier, *Nervous Customers Withdraw Billions from Troubled Lender*, N.Y. TIMES, Sept. 18, 2007, at C3.

121. Jenny Anderson & Vikas Bajaj, *Wary of Risk, Bankers Sold Shaky Mortgage Debt,* N.Y. TIMES, Dec. 6, 2007, at A1; Stelzer, *supra* note 88, at 4 (discussing demise of Merrill Lynch's Stanley O'Neal and Citigroup's Charles Prince).

122. Binyamin Appelbaum, *Mortgage Giants' Rescue Imperils Some Banks*, WASH. POST, Sept. 9, 2008, at A1.

123. *See* Peter S. Goodman, *Worried Banks Sharply Reduce Business Loans*, N.Y. TIMES, July 28, 2008, at A1.

124. Les Christie, *The Ugly Face of Foreclosure*, CNNMONEY.COM, May 7, 2007,

reduce the value of nearby homes because appraisers include foreclosure sales as comparable neighborhood sales when determining the value of all homes, even though foreclosed properties often are sold for only a fraction of their original loan value. The stigma and economic effects (and also the appearance) of foreclosed properties in close proximity thus harms owners of neighboring properties who are trying to sell their homes, refinance higher rate loans, or obtain new financing even though they have acted responsibly and borrowed wisely and they do not have risky subprime loans.[125] This, in turn, can create a cycle of negative disinvestment.[126]

Rising mortgage foreclosures also harm municipalities. Cities are often forced to increase police protection in areas with vacant homes to protect the homes from vandalism, to prevent criminal activities from taking place in the homes, or to investigate suspected arson committed by homeowners who cannot afford their mortgage payments.[127] A downturn in the real estate market also harms cities because it decreases municipal revenue (for example, the issuance of fewer building permits), results in lower property tax revenues from vacant houses, lowers revenue generated by property assessments, and imposes additional costs associated with maintaining the appearance of vacant properties.[128] These lower tax revenues then affect the ability of cities to adequately fund schools or provide other vital governmental services, which in turn may cause cities to increase taxes to make up the shortfall.[129]

Of course, when cities attempt to increase property taxes to make up for lost property tax revenue, homeowners seek lower assessments and taxes to reflect the decrease in their property values that the mortgage foreclosures may have caused.[130]

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http://money.cnn.com/2007/05/02/real_estate/face_of_foreclosure/index.htm; *Losing Homes and Neighborhoods*, *supra* note 113.

125. *Calculated Risk*, *supra* note 64, at 10 (statement of William A. Simpson on behalf of the Mortgage Insurance Companies of America); Stelzer, *supra* note 88 (discussing externalities caused by mortgage crisis and the presence of homes with uncut grass); Ian Urbina, *Foreclosures Prompt Cities to Make Plea for U.S. Aid*, N.Y. TIMES, Jan. 24, 2008, at A15.

126. *See* Press Release, U.S. Office of the Comptroller of the Currency, Comptroller Dugan Expresses Concern over Subprime Mortgage Foreclosures; Receives "Making-the-Difference" Award from Credit Counseling Foundation (Apr. 24, 2007), http://www.occ.treas.gov/ftp/release/2007-44.htm.

127. *See* Stelzer, *supra* note 88 (discussing how homes are stripped of sinks and aluminum siding during the eviction process); Jon Birger, *Will Foreclosures Spark an Arson Boom?*, CNNMONEY.COM, Jan. 10, 2008, http://money.cnn.com/2008/01/09/news/economy/birger_arson.fortune/index.htm?postvers. *See generally* Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 HOUSING STUD. 851 (2006).

128. *See* Urbina, *supra* note 125 (discussing costs to board up properties, cut grass, demolish abandoned structures, collect trash, and protect from vandals). Cities also may find it more difficult to borrow cheaply because of the decreased value of the collateral for loans (i.e., the assessed value of their property base). Monica Davey, *Housing Downturn Takes Big Toll on Cities' Revenue*, N.Y. TIMES, Oct. 18, 2007, at A20.

129. For example, Chicago's Mayer Daley recently requested a fifteen percent increase in property taxes and another city official called for increases in sales, gasoline, and parking taxes to compensate for the lost revenue caused by flattening property assessments and rising mortgage foreclosures. Davey, *supra* note 128.

130. Jennifer Steinhauer, *Taxes Reassessed in Housing Slump as Prices Decline*, N.Y. TIMES, Dec. 23, 2007, at A1 (discussing homeowners' requests for a downward tax assessment in declining housing markets).

Indeed, the recent crisis has forced many local government leaders to make downward reassessments in property values even though doing so further depresses tax revenue.[131] Some cities have sought to stem their losses by lending money to homeowners who are facing foreclosure, though these programs have been opposed by taxpayers who believe that this rewards irresponsible behavior.[132]

Finally, the mortgage meltdown also harms tenants. When landlords default on their mortgages and have their properties sold in foreclosure, renters are frequently evicted—and often on short notice—if the new seller (often the lender) intends to resell the property. Thus, even though they may have made timely rental payments to their landlords and may not even know that the owner is in default, renters are often victimized by the landlord's problem.[133]

IV. ASSESSING THE BLAME FOR THE CURRENT CRISIS

There is sharp disagreement between the lending community and consumer advocates over who is responsible for the current mortgage crisis. As the following sections show, several factors have combined to create a perfect storm for the current housing crisis.

A. Economic Factors

Certain aspects of the U.S. economy, unrelated to the terms of the mortgage products, can be blamed for the increase in delinquency and foreclosure rates.[134] The U.S. economy is no longer one that depends primarily on the manufacture of goods. Instead, the U.S. economy has shifted from a manufacturing to a financial services economy, often referred to as the "financialization of the American economy."[135] Thus, instead of making things, Americans increasingly make money by moving money around. Much of this money movement involves moving money from the financial services industry to consumers in the form of consumer debt.

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131. Nelson D. Schwartz, *Can the Mortgage Crisis Swallow a Town?*, N.Y. TIMES, Sept. 2, 2007, § 3, at 1.

132. William Yardley, *Foreclosure Aid Rising Locally, As Is Dissent*, N.Y. TIMES, Feb. 26, 2008, at A1.

133. *Mortgage Lending Discrimination: Field Hearing Before the Comm. on Financial Services*, 110th Cong. 52 (2007) (statement of Lynn E. Browne on behalf of the Federal Reserve Bank of Boston); John Leland, *As Owners Feel Mortgage Pain, So Do Renters*, N.Y. TIMES, Nov. 18, 2007, at 11.

134. *Preserving the American Dream*, *supra* note 3, at 14–15 (statement of Douglas G. Duncan on behalf of the Mortgage Bankers Association) (citing unemployment, illness/death, and marital difficulties as factors that caused increased delinquency rates); *Calculated Risk*, *supra* note 64, at 5 (statement of Robert D. Broeksmit on behalf of Mortgage Bankers Association) (stating that unemployment was historically the chief cause of borrower delinquency); Editorial, *The American Dream in Reverse*, N.Y. TIMES, Oct. 8, 2007, at A18.

135. Greta R. Krippner, *The Financialization of the American Economy*, 3 SOCIO-ECON.REV. 173 (2005).

B. Borrower Conduct

Lenders and some government officials blame borrowers for buying homes they simply could not afford.[136] Especially during the earlier stages of the current housing crisis, many people and groups (including the Bush administration) opposed relief for homeowners whom they contended borrowed recklessly in order to live in a "McMansion."[137] While not all borrowers acted irresponsibly, a combination of fraudulent behavior, lack of financial sophistication, and unrealistic expectations about the housing market and the U.S. economy clearly helped create the mortgage crisis.

1. Fraud

Some borrowers appear to have engaged in outright fraud. Indeed, recent reports suggest that some borrowers intentionally inflated their incomes on liar loans,[138] rented or borrowed the credit scores of more creditworthy borrowers, paid to be added to the credit cards of people with good credit histories, or bought fake payroll stubs.[139]

2. Naiveté and Behavioral Tendencies

While not all borrowing was irrational or irresponsible, lack of financial sophistication, informational disparities, and certain behavioral biases may help explain why so many borrowers bought homes they could not afford, often accepting risky nontraditional mortgage products they did not understand.

Some homeowners, especially first-time homeowners, appear to have been naive and unsophisticated. Many buyers remain convinced to buy a home, even with no money for a down payment and concerns about affording the monthly mortgage

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136. *See The American Dream in Reverse*, *supra* note 134; Patrice Hill, *Blame Abounds for Housing Bust*, WASH. TIMES, Dec. 26, 2007, at A1.

137. Jessica Holzer, *Major Bailout Is Unlikely on Sub-Prime Mortgages*, THE HILL (Wash. D.C.), Sept. 4, 2007, at 13 (reporting quote of President Bush, "It's not the government's job to bail out speculators, or those who made the decision to buy a home they knew they could never afford"); Kathleen Pender, *Why We Shouldn't Be Bailing Out Subprime Lenders or Borrowers*, S.F. CHRON., Apr. 22, 2007, at D1 (arguing against government bailouts of borrowers and lenders).

138. Gretchen Morgenson, *Crisis Looms in Mortgages*, N.Y. TIMES, Mar. 11, 2007, § 1, at 11. (reporting that liar loans were forty percent of the subprime mortgage issuance in 2006). Members of the mortgage industry suggest that some borrowers took out a mortgage to buy a home with the intent only of living in the home rent-free until they are evicted. *See* Justin Lahart, *After Subprime: Lax Lending Lurks Elsewhere*, WALL ST. J., Feb. 20, 2007, at C1. Of course, the increased practice of approving low documentation subprime loans increases the likelihood of buyer misrepresentation.

139. Julie Creswell, *Fake Pay Stubs Online, and Other Mortgage Fraud*, N.Y. TIMES, June 16, 2007, at A1; *see The Role of the Secondary Market*, *supra* note 68, at 131 (statement of Larry B. Litton, Jr., on behalf of Litton Loan Servicing LP) (stating that defaults were the result of lax underwriting standards, improper documentation, or borrower fraud); *see also* Merle Sharick, Jennifer Butts, Michelle Donahue, Nick Larson & D. James Croft, MORTGAGE ASSET RESEARCH INSTITUTE, LLC, NINTH PERIODIC MORTGAGE FRAUD CASE REPORT TO MORTGAGE BANKERS ASSOCIATION 11 (2007).

payments. Despite these concerns, nine out of ten buyers still believe that purchasing a home is a good financial decision.[140] Borrowers seemed to characterize the housing purchase as essentially a long-term rental with the risk of foreclosure being nothing more than a renter's risk of eviction.[141] Once the housing market stalled and interest rates increased, many homeowners genuinely seemed shocked to learn that it would be difficult to sell their homes and that, given their lack of equity, refinancing would not be an option.[142]

Some borrowers also accepted high-cost loans without realizing that other less expensive lending options might be available.[143] Borrowers without college degrees, lower income borrowers, and minority borrowers seemed especially likely to accept loan products they did not understand and seemed least likely to be informed (by mortgage brokers) of other borrowing options.[144] Borrowers also did not seem to be aware of the additional costs associated with home ownership, like setting aside money for routine maintenance,[145] or did not realize the true "affordability" of their loans because the loans did not escrow for taxes or property insurance.[146]

Data show that many borrowers accepted loan products they simply did not understand. Theoretically, they should have been able to protect themselves from harmful loan products by shopping for a mortgage product available in the marketplace

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140. *See* Press Release, Nat'l Ass'n of Realtors, NAR Survey Shows Americans Believe Buying a Home Still a Good Financial Decision (Nov. 14, 2007), *available at* http://www.realtor.org/press_room/news_releases/2007/nar_survey_shows_americans_believe (reporting that despite recent turbulence in the housing markets and concerns over having enough money for a down payment, nearly nine out of ten respondents believe buying a home is a good financial decision).

141. Ironically, these homeowners often viewed their "home" as a debt and many are electing to abandon their houses and cede them to lenders in foreclosure. Leland, *supra* note 65.

142. *Subprime and Predatory Lending*, *supra* note 11, at 396–97 (statement of Harry H. Dinham on behalf of the National Association of Mortgage Brokers) (speculating on the cause of the increase); Vikas Bajaj & Julie Creswell, *Home Lenders Hit by Higher Default Rates*, N.Y. TIMES, Feb. 22, 2007, at C1; FISHBEIN & WOODALL, *supra* note 37, at 2, 6, 11. Consumers, in general, suffer from an overconfidence bias that leads them to believe that they will not overuse credit and that, if they do, they will somehow find money to repay their debts. Oren Bar-Gill, *Bundling and Consumer Misperception*, 73 U. CHI. L. REV. 33, 45 (2006); Oren Bar-Gill, *Seduction by Plastic*, 98 NW. U. L. REV. 1373, 1395–1401 (2004).

143. *See Subprime and Predatory Lending*, *supra* note 11, at 76 (statement of Sheila C. Bair on behalf of the Federal Deposit Insurance Corporation); *id.* at 351 (statement of Allen Fishbein on behalf of the Consumer Federation of America); BRIAN BUCKS & KAREN PENCE, DO HOMEOWNERS KNOW THEIR HOUSE VALUES AND MORTGAGE TERMS (2006), *available at* http://www.federalreserve.gov/Pubs/feds/2006/200603/200603pap.pdf; FANNIE MAE, THE GROWING DEMAND FOR HOUSING: 2002 FANNIE MAE NATIONAL HOUSING SURVEY (2002), *available at* http://www.fanniemae.com/global/pdf/media/survey/survey2002.pdf.

144. BUCKS & PENCE, *supra* note 143, at 22.

145. *See* Stephen Gandel, Amanda Gengler & Paul Keegan, *For Sale: Scenes from a Bubble*, MONEY, May 2007, at 114; Schoen, *supra* note 75.

146. *The Role of the Secondary Market*, *supra* note 68, at 133 (statement of Larry B. Litton, Jr. on behalf of Litton Loan Servicing LP) (recommending that subprime borrowers establish an escrow account to pay taxes and insurance); *Foreclosure, Predatory and Payday Lending*, *supra* note 85, at 40 (statement of Josh Nassar on behalf of the Center for Responsible Lending) (discussing failure of subprime lenders to escrow for taxes and insurance).

and then making an informed decision to select the product that best suits their needs. Their ability to shop around and compare products was affected, however, by the complexity of many of the features of nontraditional loan products, because of the sheer number of products that borrowers would need to compare, and because individual borrowers infrequently take out mortgages and typically have little experience with mortgage shopping.[147] As a result, borrowers seemed confused by mortgage products, and "information overload" appears to have caused some borrowers to acquiesce and accept nontraditional loan products that had terms they simply did not understand.[148] One group, higher income borrowers, did appear to have had much better knowledge of the risks associated with certain ARM products (including interest rate changes) and, as a result, seem to have made better mortgage choices.[149]

Another reason borrowers appear to have made irrational mortgage decisions based on limited information involves timing. Much of the pricing information is disclosed toward the end of the loan process. It is hard for most potential borrowers to gather additional information at that time to determine whether the loan product actually suits their needs. Consumers have a natural incentive to accept a loan with unfavorable terms they learn of at the end of the process because of their desire to complete the process and buy their home, or to get the proceeds of the home equity loan to pay off other debts or make other purchases. Because they decide to purchase a home well before they receive full pricing information, they are willing to accept unfavorable loan terms even if they understand that those terms may make the loan unaffordable.[150]

Even assuming borrowers receive the information early in the process and have the time and ability to sift through that information, they have a tendency to choose products with immediate gain and future risk because they cannot accurately gauge the likelihood that those future risks will ever occur. That is, borrowers overestimate the likelihood that they will be able to make future loan payments, that housing prices will continue to appreciate, or that interest rates will not rise. Given their preference for immediate gain, they are more likely to complete a mortgage transaction that promises lower initial payments (immediate gain) but has significantly higher future risks (like defaulting on the loan and losing the home because of future interest rate increases)

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147. *Subprime and Predatory Lending, supra* note 11, at 351 (statement of Allen Fishbein on behalf of the Consumer Federation of America); *see also id.* at 68 (statement of Sheila C. Bair on behalf of the Federal Deposit Insurance Corporation); BUCKS & PENCE, *supra* note 143, at 15–25.

148. REN S. ESSENE & WILLIAM APGAR, JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., UNDERSTANDING MORTGAGE MARKET BEHAVIOR: CREATING GOOD MORTGAGE OPTIONS FOR ALL AMERICANS 11 (2007). *See generally* Elizabeth Renuart & Diane E. Thompson, *The Truth, The Whole Truth, and Nothing but the Truth: Fulfilling the Promise of Truth in Lending*, 25 YALE J. ON REG. 181, 215–16 (discussing problems consumers have when weighing multiple credit options).

149. BUCKS & PENCE, *supra* note 143, at 20–21.

150. CONSUMERS UNION SWRO, CONSUMERS UNION, HOME EQUITY REFORM FOR TEXAS 2 (2002) (discussing couple who paid unexpected origination fee because they needed the loan proceeds to pay other creditors); *see also* Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1283 (2002) (describing how predatory lenders market their services to low- and moderate-income borrowers).

rather than accepting a mortgage product that has higher immediate costs (like higher initial payments or a down-payment requirement) but lower future risks (like being a long-term homeowner).[151] Of course, while borrowers may have been unaware that certain behavioral traits may make them more likely to accept a loan product they don't understand, or to make them overestimate the likelihood that they would be able to repay their mortgage loans, lenders do not suffer from the same behavioral tendencies and, in fact, lenders study and exploit consumer biases.[152]

3. The National Bank of Home

For years, borrowers have made economic decisions that are authorized by U.S. housing policies, but are not entirely consistent with the justification for those policies—that subsidizing the home ownership dream promotes long-term ownership. These decisions have led homeowners to engage in economic transactions that largely depersonalize the "home" and treat it as if it were an automated teller machine.

When interest rates began to decline in 2001, home ownership stopped functioning as a forced savings device. Homeowners started to refinance their existing mortgage loans in record numbers and to cash out their equity.[153] Indeed, mortgage lenders routinely contacted their borrowers to encourage them to remove equity from their homes.[154] Mortgage refinancings often represented more than half of all mortgage originations, and mortgage originators willingly increased the availability of traditional and nontraditional refinance loans.[155]

Homeowners were willing to extract equity from their homes and place their shelter at risk in order to buy durables like cars and swimming pools and to pay off higher interest loans, often credit card debt.[156] This is not, of course, totally irrational. Taking

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151. ESSENE & APGAR, *supra* note 148, at 11–12, 18, 20; *see also* Patricia A. McCoy, *A Behavioral Analysis of Predatory Lending*, 38 AKRON L. REV. 725, 729–33 (2005) (explaining how predatory lenders emphasize borrower's immediate financial crisis and downplay the future threat of foreclosure); Schwartz, *supra* note 131 (discussing homeowner who focused only on the monthly payment, not the interest rate); BUCKS & PENCE, *supra* note 143, at 2 (noting that borrowers underestimate the amount by which their interest rates can increase).

152. Bar-Gill, *Seduction by Plastic*, *supra* note 142, at 1401–07; Max H. Bazerman, *Consumer Research for Consumers*, J. CONSUMER RES. 499, 502 (2001); Lauren E. Willis, *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending: Price*, 65 MD. L. REV. 707, 809 (2006) (discussing lender marketing practices designed to target vulnerable borrowers who are more likely to accept expensive loans).

153. Kenneth R. Harney, *Refinancing Homeowners Cut Back on Cashing Out*, WASH. POST, Nov. 8, 2003, at F1.

154. Countrywide Financial sent "complimentary loan reviews" to its customers one year after they obtained their mortgages to encourage these borrowers to remove equity from their homes. Gretchen Morgenson, *Illinois Suit Set Against Countrywide*, N.Y. TIMES, June 25, 2008, at C1.

155. *Subprime and Predatory Lending*, *supra* note 11, at 187–88 (statement of Emory W. Rushton on behalf of the Office of the Comptroller of the Currency); FANNIE MAE, *supra* note 143, at 2.

156. FANNIE MAE, *supra* note 143, at 2; Alan Greenspan & James Kennedy, *Sources and Uses of Equity Extracted from Homes* 8–11 (Fed. Reserve Bd., Working Paper No. 2007-20, 2007).

out a lower interest (and tax deductible) home equity loan is a sound financial management tool for a household that is not liquidity constrained.[157] But, taking on additional mortgage debt to pay off consumer debt makes sense only if you can afford to repay the home equity loan, if you think you can sell the home and get some return of equity, or if you intend to remain in the home long enough to pay off the mortgages and build up additional equity. It is also a benefit if you happen to be a homeowner who itemizes deductions and thus can deduct the interest on the mortgage, thereby reducing the cost of the debt.

In addition to not using their homes as forced savings devices, the increasing value of their homes caused homeowners to significantly increase their consumer debt. Though many made no down payment, had no equity in their homes, and often had a loan balance that was negatively amortizing, skyrocketing house-price appreciation made homeowners think that their expensive homes meant they were wealthy and, thus, could spend more.[158] That borrowers who accepted subprime ARMs during this decade felt house-rich is especially ironic because they were most likely to be house-poor. That is, though this varies depending on the amount of the owners' down payment, the benefits of owning versus renting typically do not appear until approximately 3.5 years into the loan term because of the high transaction costs (estimated at over two percent of the home's value) associated with purchasing a home.[159]

In addition to increasing their consumer spending generally because of their belief that they are wealthy, homeowners decreased their rate of saving. Though much of this lack of saving resulted from a conscious decision by retiring baby boomers to spend down their retirement income,[160] even younger homeowners stopped contributing to retirement accounts and many even withdrew funds from their retirement accounts to increase their spending or, in some instances, to try to prevent their homes from being sold in foreclosure.[161]

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157. CAGAN, *supra* note 52, at 3 (suggesting that homeowners reasonably extracted equity from their homes to pay for college tuition, purchase consumer durables, or pay higher interest non-tax deductible obligations, like credit card debt); *cf.* Greenspan & Kennedy, *supra* note 156, at 5 (discussing use of home equity to maintain wealth by investing in other types of assets).

158. Greenspan & Kennedy, *supra* note 156, at 3–5.

159. Costs include origination fee, discount points, title insurance, survey fee, attorneys' fees, and taxes (mortgage, recording, and transfer). *Id.* at 30–31. Costs for refinance loans and home equity loans (HEL) are estimated to be lower, at approximately 1.25% of the total loan amount for refinance loans and less than 0.5% for HELs. *Id.* at 32.

160. Feldstein, *supra* note 63, at 88−89. *See generally* Martha M. Hamilton, *Could the Market Fall Down and Go Boom?*, WASH. POST, Feb. 4, 2007, at F3.

161. *See* KAREN E. DYNAN & DONALD L. KOHN, FED. RESERVE BD., THE RISE IN U.S. HOUSEHOLD INDEBTEDNESS: CAUSES AND CONSEQUENCES 6–7, 28–29 (2007) (discussing why consumers may not behave rationally when increasing their mortgage debt).

C. Lender Conduct

1. Fraud

Housing advocates and consumer advocacy groups typically place most of the blame for the foreclosure crisis on the "mortgage industrial complex," which includes mortgage originators, lenders (especially subprime), and underwriters.[162] Many have suggested that the lending community engaged in fraudulent conduct and this conduct caused the current housing crisis. Some initially assumed that most of the fraudulent conduct, including mortgage originator and foreclosure rescue operator fraud, involved small independent brokers or companies.[163] Some large financial institutions likely avoided engaging in mortgage fraud because of a desire to preserve the value of their good reputation. Lawsuits filed as a result of the mortgage crisis suggest, however, that both small and large mortgage lenders participated in fraudulent activities (including falsifying loan documents and tax returns and misrepresenting or intentionally inflating borrowers' incomes) to allow unqualified borrowers to secure loans.[164]

2. Riskiness of Nontraditional Loans and Risk Layering

Products that were never designed to be marketed to lower- and middle-income borrowers increasingly were offered to these borrowers—even if they were high credit risks.[165] Consumer advocates argue that the lending community relaxed its lending standards and issued inherently risky loans to subprime borrowers and that these risks virtually ensured that borrowers would remain in their homes only until the reset, only if housing prices continued to increase, and only if interest rates remained low.[166]

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162. *Preserving the American Dream*, *supra* note 3, at 2 (statement of Martin Eakes on behalf of the Center for Responsible Lending and Center for Community Self-Help) ("Subprime lenders have virtually <u>guaranteed</u> rampant foreclosures by approving risky loans for families while knowing that these families will not be able to pay the loans back."); Gandel et al., *supra* note 145.

163. *See Preserving the American Dream*, *supra* note 3 (statement of Jean Constatine-Davis on behalf of the AARP Foundation) (describing loan officer and broker fraudulent practices); *id.* (statement of Delores King) (describing loan officer's conduct and misrepresentations); *id.* (statement of Amy Womble) (describing loan officer's conduct and misrepresentations); *Frauds Compound Pain of Foreclosures*, MSNBC.COM, Apr. 17, 2007, http://www.msnbc.msn.com/id/18158015/; Schoen, *supra* note 75.

164. Amir Efrati & Kara Scannell, *Countrywide Draws Ire of Judges*, WALL ST. J., Jan. 14, 2008, at A3; Mara Der Hovanesian & Brian Grow, *Did Big Lenders Cross the Line?*, BUS. WK., Aug. 20, 2007, at 33; Jonathan Karp & Miriam Jordan, *House of Cards: How the Subprime Mess Hit Poor Immigrant Groups*, WALL ST. J., Dec. 6, 2007, at A1; Morgenson, *supra* note 154.

165. *Preserving the American Dream*, *supra* note 3, at 7 (statement of Douglas G. Duncan on behalf of the Mortgage Bankers Association); *Calculated Risk*, *supra* note 64, at 4–5 (statement of Allen J. Fishbein on behalf of the Consumer Federation of America and National Consumer Law Center); FISHBEIN & WOODALL, *supra* note 37, at 4–5. *See generally Subprime Mortgage Market Turmoil*, *supra* note 86 (statement of Susan Barnes on behalf of Standard & Poor's Ratings Services).

166. *Subprime and Predatory Lending*, *supra* note 11, at 293–95 (statement of Michael D.

V. RESPONSES TO THE MORTGAGE CRISIS

In early 2005, Alan Greenspan, former Chairman of the Board of Governors of the Federal Reserve, issued "warnings" about the risky nature of nontraditional loans while nonetheless maintaining that most homeowners did not have too much mortgage debt.[167] Likewise, while Federal Deposit Insurance Corporation (FDIC) officials started to issue warnings in 2005 about the risks of using home-equity lines of credit,[168] no government official or agency took action to curb the lending until 2008. Even once it was apparent that the mortgage problem would morph into a crisis, the initial response by many to the housing crisis was to ignore it and to argue that the mortgage market would correct any inefficiencies.[169] Indeed, many argued that the market had corrected problems because many lenders (including the second-largest subprime lender) had either stopped making bad loans or had gone out of business altogether during the initial phase of the mortgage meltdown.[170]

Early on, many mortgage executives predicted that the financial crisis would be relatively brief and limited to the subprime market.[171] Although the market continued to make corrections,[172] it became clear that the subprime market meltdown would spread to other markets, and that the ripple effect of the meltdown was sending the U.S. economy to the brink of a recession and was wreaking havoc in the global financial markets.[173] All now agree that this crisis may last for an extended period of

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Calhoun on behalf of the Center for Responsible Lending); *Foreclosure, Predatory and Payday Lending*, *supra* note 85, at 50–51 (statement of Josh Nassar on behalf of the Center for Responsible Lending) (discussing failure of subprime lenders to escrow for taxes and insurance).

167. Edmund L. Andrews, *Most Homeowners Not Overly in Debt, Fed Chief Says*, N.Y. TIMES, Sept. 27, 2005, at C1; Jeannine Aversa, *Greenspan Concerned About Risky Mortgages*, BUFFALO NEWS, Oct. 10, 2005, at B8.

168. Gail Liberman & Alan Lavine, *FDIC Warns on Home-Equity Lines*, CBSMARKETWATCH.COM, Jan. 10, 2005, http://www.marketwatch.com (search for FDIC Warns on Home-Equity Lines).

169. Martin Crutsinger, *White House Opposes Homeowner Rescue Plan; Greenspan Suggestion Draws a Cool Response*, THE TORONTO STAR, Dec. 18, 2007 (quoting Treasury Secretary Henry Paulson, "I don't think what we need is a big government bailout right now. I think what we need is to help the markets work the way they're intended to work and avoid those foreclosures that are preventable.").

170. *See* Eric Dash, *Mortgage Lender Says It Will Close*, N.Y. TIMES, Aug. 3, 2007, at C1 (discussing companies in the mortgage industry that were closing or facing bankruptcy); Morgenson, *supra* note 138. New Century Financial, the second-largest subprime lender, stopped making subprime loans then filed for bankruptcy, eventually being forced to sell off substantial assets. *See* Ben Fidler, *New Century Assets Sale Continues*, DAILY DEAL, Feb. 14, 2008.

171. Bajaj, *supra* note 118 ("Just a couple of months ago, some executives were predicting a relatively quick recovery and saying that most home loans would be fine with the exception of those made to borrowers with weak credit who stretched too far financially.").

172. For example, Countrywide Financial—the lender most associated with the subprime mortgage crisis and the largest servicer of subprime loans—was acquired by Bank of America in July 2008. Eric Dash, *Bank Beats Forecasts*, N.Y. TIMES, July 22, 2008, at C4.

173. The Federal Reserve has cut the federal funds rate and the discount rate multiple times to try to stabilize the financial markets and central banks in Europe and Canada and also infused

time and that more than a simple market correction is needed. What the solution to the crisis should be, however, is still a matter of debate.

A. Legislative and Industry Responses

1. Regulation

Even before it was clear that the mortgage problem would be a crisis, state and federal regulators considered legislation that would protect homeowners from the effects of subprime and predatory loans.[174] For example, several states passed legislation that require lenders to consider a borrower's ability to repay subprime loans, that ban certain terms commonly found in subprime loans, and that provide protections that give delinquent borrowers additional time to avoid losing their homes.[175] When it became clear that the current mortgage problem would become a crisis, various congressional committees and subcommittees held hearings[176] and convened "home ownership preservation summits."[177]

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additional cash into their banks in response to the liquidity crisis. Greg Ip & Joellen Perry, *Central Banks Launch Effort to Free Up Credit*, WALL ST. J., Dec. 13, 2007, at A1. Indeed, the liquidity crisis that resulted from the subprime meltdown caused a collapse of major U.S. hedge funds and one of the largest U.S. investment banks, caused a run on at least one bank in Great Britain, caused the largest bank in France to freeze funds, and generally continues to wreak havoc with the global financial markets. Vikas Bajaj & Mark Landler, *Mortgage Losses Echo in Europe and on Wall Street*, N.Y. TIMES, Aug. 10, 2007, at A1; Mark Landler & Julia Werdigier, *In Europe, Weathering Credit Storm From U.S.*, N.Y. TIMES, Nov. 24, 2007, at C1; Adam Shell, *Subprime Troubles Send Stocks Into Swoon*, USA TODAY, Mar. 14, 2007, at 1B; Stelzer, *supra* note 88; Werdigier, *supra* note 120; *see also* Anthony Lin, *Thacher Proffitt Warns Associates of Looming Layoffs*, LAW.COM, Nov. 28, 2007, http://www.law.com/jsp/article.jsp?id=1196181559274 (reporting that law firm associates might be terminated because of the mortgage-backed securities fallout).

174. *See Subprime and Predatory Lending*, *supra* note 11, at 262–81 (statement of Steven L. Antonakes on behalf of the Conference of State Bank Supervisors) (listing actions individual states have taken to supervise and regulate the mortgage industry).

175. New York, Ohio, Connecticut, Maryland, Minnesota, and North Carolina have all enacted legislation designed to respond to the housing crisis. *See* S. 8143-A, 2008 Leg., Reg. Sess. (N.Y. 2008).

176. *Systemic Risk: Examining Regulators' Ability to Respond to Threats to the Financial System: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. (2007); *Legislative and Regulatory Options for Minimizing and Mitigating Mortgage Foreclosures: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. (2007); *Evolution of an Economic Crisis?: The Subprime Lending Disaster and the Threat to the Broader Economy: S. Hearing Before the Joint Economic Comm.*, 110th Cong. (2007); *A Local Look at the National Foreclosure Crisis: Cleveland Families, Neighborhoods, Economy Under Siege from the Subprime Mortgage Fallout: S. Hearing Before the Joint Economic Comm.*, 110th Cong., (2007); *The National Affordable Housing Trust Fund Act of 2007: Hearing on H.R. 2895 Before the H. Comm. on Fin. Servs.*, 110th Cong. (2007); *Reauthorization of the Hope VI Program: Hearing Before the Subcomm. on Housing and Community Opportunity of the H. Comm. on Fin. Servs.*, 110th Cong. (2007); *The Role of the Secondary Market*, *supra* note 68; *The Expanding American Homeownership Act of 2007: H.R. 1852 and Related FHA Modernization Issues: Hearing Before the Subcomm. on Housing and Community Opportunity of the H. Comm. on Fin. Servs.*, 110th Cong. (2007); *Possible Responses*, *supra* note 79; *Household Incomes and Housing*

Though housing advocates and civil rights organizations have long urged Congress to support loan renegotiation proposals,[178] Congress finally passed legislation in 2008 that creates a program that would allow some borrowers to replace their nontraditional ARM loans with traditional thirty-year fixed-rate loans that have low LTV ratios. [179] The program is still voluntary, however, and lenders are not required to renegotiate the loans. Assuming the lender is willing to renegotiate the loan, the borrower must document his income, cannot take out a home equity loan for five years after receiving this new mortgage, and would be required to give the United States at least fifty percent of any appreciation on the home when he sells it.[180] If the sale takes place within five years of the loan, the borrower might be required to return the entire gain to the federal government.[181]

Congress has also considered legislation that would give relief to homeowners who file for bankruptcy. The legislation would allow homeowners ages fifty-five and older to exempt up to $75,000 in equity they have in their homes,[182] would waive or delay the mandatory credit counseling requirement for consumers who are facing a home foreclosure,[183] and would make the entire mortgage loan dischargeable if the lender engaged in certain fraudulent acts or violated certain state and federal laws. The most controversial aspect of the recent bankruptcy proposal would protect consumers who find themselves "upside down" on their home loans. As noted above, because of multiple refinancings, no down payments, and other exotic loan features, many homeowners now owe more on their homes than the homes are worth. Proposed legislation would let some debtors reduce (or 'strip down') the amount of the lender's

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Costs: A New Squeeze for American Families: Field Hearing Before the H. Comm. on Fin. Servs., 110th Cong. (2007); *Subprime and Predatory Lending*, *supra* note 11; *Foreclosure, Predatory and Payday Lending*, *supra* note 85; *U.S. Department of Housing and Urban Development's Fiscal Year 2008 Budget: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. (2007).

177. U.S. SENATE COMM. ON BANKING, HOUS. & URBAN AFFAIRS, HOMEOWNERSHIP PRESERVATION SUMMIT STATEMENT OF PRINCIPLES (2007), http://dodd.senate.gov/multimedia/2007/050207_Principles.pdf.

178. The Leadership Conference on Civil Rights, the NAACP, the National Fair Housing Alliance, the National Council of La Raza, and the Center for Responsible Lending called for a six-month moratorium on subprime home foreclosures and asked lenders to put homeowners in more affordable loan products to help them keep their homes. *National Civil Rights Groups Call for Immediate Moratorium on Foreclosures Resulting from Risky Subprime Loans*, BUS. WIRE, Apr. 4, 2007, *available at* http://www.businesswire.com/portal/site/google/?ndmViewId=news_view&newsId=200704040 05162 &newsLang=en; *see also Possible Responses*, *supra* note 79, at 112 (statement of David Berenbaum on behalf of the National Community Reinvestment Coalition).

179. Housing and National Recovery Act of 2008, Pub. L. No. 110-289, §§1401–1404, 122 Stat. 2654 (2008), (Title IV of the Act contains §§1401–1404 and discusses the "Hope for Homeowners" program).

180. *Id.*

181. *Id.*

182. Helping Families Save Their Homes in Bankruptcy Act of 2008, S. 2136, 110th Cong. (2007).

183. Home Owners' Mortgage and Equity Savings Act, H.R. 3778, 110th Cong. (2007); S. 2136; Home Owners' Mortgage and Equity Savings Act, S. 2133, 110th Cong. (2007); Emergency Home Ownership and Mortgage Equity Protection Act of 2007, H.R. 3609, 110th Cong. (2007).

interest in the debtor's principal residence to the (lower) market value of the home and also would let the consumer extend maturity dates and reamortize the loan to create a balloon payment that they would finance once interest rates drop.[184]

Affordable housing advocates and civil rights groups generally support these proposals, but stress that any regulations or standards need to be mandatory and should apply to all lenders—not just federally regulated institutions.[185] They further contend that many of the industry standards, while necessary, are not sufficient because they are voluntary and also because they do not provide substantive protections to prevent borrowers from abusive credit practices.[186]

Not surprisingly, the mortgage industry has opposed additional mortgage regulations, largely arguing that the government should avoid anything that would impede the basic American "privilege" of home ownership.[187] Financial institutions also have argued that these protections are not needed, since consumers can protect themselves by obtaining the information needed to make sound borrowing decisions.[188] The industry claims that any additional regulations will harm minority and first-time homeowners and be inconsistent with existing federal laws/policies that encourage and subsidize home ownership.[189] Lenders further contend that additional

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184. S. 2133; H.R. 3609.

185. *Subprime and Predatory Lending*, *supra* note 11, at 354–56 (statement of Allen Fishbein on behalf of the Consumer Federation of America); *Regulators Take First Step in Tougher Oversight of Underwriting*, NAT'L MORTGAGE NEWS, Aug. 3, 2007, at 2 (noting that, in response to pressure from consumer groups and politicians, federal banking regulators are issuing tighter standards).

186. *See Subprime and Predatory Lending*, *supra* note 11, at 318–20 (statement of Josh Silver on behalf of the National Community Reinvestment Coalition); *Foreclosure, Predatory and Payday Lending in America's Cities Before the H. Comm. on Oversight and Government Reform*, 110th Cong. 41 (2007) (statement of Josh Nassar on behalf of the Center for Responsible Lending).

187. *See Subprime and Predatory Lending*, *supra* note 11, at 401 (statement of Harry H. Dinham, on behalf of the National Association of Mortgage Brokers) ("No merchant, no government and no company should superimpose their own moral judgments on what is a basic American privilege of homeownership.").

188. *Id.*; *see Possible Responses*, *supra* note 79, at 49–50 (statement of George P. Miller on behalf of the American Securitization Forum and the Securities Industry and Financial Markets Association); *Preserving the American Dream*, *supra* note 3, at 13–14 (statement of Douglas G. Duncan, on behalf of the Mortgage Bankers Association).

189. *Calculated Risk*, *supra* note 64 (statement of George Hanzimanolis on behalf of the National Association of Mortgage Brokers) ("[U]nwarranted tightening of underwriting guidelines could hurt the robust housing industry and deny deserving consumers the chance at homeownership."); *see also* MORTGAGE BANKERS ASS'N, MBA POLICY PAPER SERIES, POLICY PAPER 2007-1, SUITABILITY—DON'T TURN BACK THE CLOCK ON FAIR LENDING AND HOMEOWNERSHIP GAINS 21 (2007) [hereinafter SUITABILITY].

The industry, and some economists, argue that imposing a suitability standard would force lenders to satisfy an "ability to repay" test similar to the restrictions federal securities regulations impose on securities dealers. This, they stress, will have unintended negative consequences because the standard will force lenders to further restrict the availability of credit and increase the likelihood that they would deem a mortgage product unsuitable for a member regulations that make it harder for them to foreclose on properties will increase the cost of credit and, by delaying the foreclosure, will make loans that are already in default go even deeper into default. Thus, they contend, these regulations will create negative externalities by allowing more vacant or deteriorating properties to remain longer in neighborhoods.[190] Finally, lenders vigorously oppose the proposed changes to bankruptcy laws, arguing that letting bankruptcy judges reduce the mortgage holder's secured claim[191] will make it harder for all potential homeowners to get a mortgage loan.[192] Moreover, they stress that giving courts this power would be a dramatic shift in U.S. policy. Even lenders with a secured interest in property they did not help the debtor acquire have always been favored under U.S. bankruptcy laws.[193]

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of a protected class. Stelzer, *supra* note 88 (discussing potential harm to young couples if they can obtain only a fixed rate mortgage).

190. *But cf.* SUITABILITY *supra* note 189, at 22−23 (statement of Douglas G. Duncan on behalf of the Mortgage Bankers Association). Finally, lenders suggest that foreclosure programs may create negative tax consequences for borrowers because any decision to write-down part of the loan is a taxable event because the amount of the forgiven debt would be viewed as ordinary (taxable) income. *Id.* at 23 (statement of Douglas G. Duncan on behalf of the Mortgage Bankers Association).

191. The difference between the loan value of the home and the market value would be treated as an unsecured claim in the bankruptcy case. In most consumer cases, unsecured claims are paid little (often nothing).

192. *See Straightening Out the Mortgage Mess: How Can We Protect Home Ownership and Provide Relief to Consumers in Financial Distress? Hearing Before the Subcomm. on Commercial and Administrative Law of the H. Comm. on the Judiciary*, 110th Cong. 6 (2007), *available at* http://judiciary.house.gov/hearings/hear_092507.html [hereinafter *Straightening Out, Part I*]. *But cf. Straightening Out, Part II*, *supra* note 102, at 2 (statement of Mark Zandi on behalf of Moody's Economy.com) (arguing that the legislation is needed and will not significantly increase the cost of mortgage credit).

Lenders also appear to fear that amending this aspect of the 2005 changes to the Code would encourage the opponents of that legislation to attempt to undo other changes made in 2005. Marcia Coyle, *Will Subprime Crisis Be Impetus for Bankruptcy Reform by Congress*, NAT'L L.J., Nov. 15, 2007, *available at* http://www.law.com/jsp/article.jsp?id=900005558519#.

193. *See* A. Mechele Dickerson, *Bankruptcy and Mortgage Lending: The Homeowner Dilemma*, 38 JOHN MARSHALL L. REV. 19, 54−59 (2007). I argue in this earlier work that mortgages should receive favored treatment only if they actually helped the debtor acquire or remain in the home. Post-acquisition home equity loans should not be treated as fully secured, since this type of loan is substantially similar to credit card or other consumer debt that helps homeowners buy the iPods and plasma TVs inside the home, but does not help the homeowner actually buy the home.

2. Industry Guidelines

Federal regulators proposed agency guidelines in 2008[194] that focused on the importance of ensuring that mortgage originators analyze a borrower's ability to repay the loan at its fully indexed rate while taking into account all other monthly housing expenses (including real estate taxes and property insurance).[195] These guidelines also discouraged liar loans and urged mortgage originators to require borrowers to document their incomes.[196] In addition, mortgage lenders and servicers, at the urging of the United States, entered into a non-binding agreement to adopt a uniform approach when dealing with homeowners who are at risk of losing their homes. In general, lenders agreed to promptly respond to borrowers' requests for foreclosure assistance, to subordinate certain second liens, and to agree to accept a deed in lieu of foreclosure (or a "short-sale") if the homeowner does not want to remain in the home.[197]

3. Voluntary Enhanced Disclosures and Consumer Education

The mortgage industry, the U.S. government, and some housing advocacy groups suggest that enhanced "meaningful" disclosures and consumer education and counseling can best help borrowers who are at risk of losing their homes to foreclosure. To advance this, supporters have proposed ways to prevent misleading or fraudulent behavior,[198] to increase potential homebuyers' understanding of the terms of (and risks associated with) their exotic loan products[199] and to encourage homeowners to obtain foreclosure prevention counseling.[200] Indeed, virtually all bills, guidelines, or

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194. The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve, the FDIC, the Office of Thrift Supervision, the National Credit Union Administration, and other federal banking entities had proposed guidelines in 2006 that also were designed to ensure that the terms of nontraditional lending products are consistent with prudent lending practices and that these standards help prevent borrowers from experiencing a payment shock. *See* Interagency Guidance on Nontraditional Mortgage Product Risks, 71 Fed. Reg. 58,609 (Oct. 4, 2006).

195. *See* 12 C.F.R. §§ 7.4008(b), 34.3(b); Guidelines Establishing Standards for Residential Mortgage Lending Practices, 12 C.F.R. pt. 30, app. C., at 370; Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007); 71 Fed. Reg. 58,609 (Oct. 4, 2006); Interagency Guidance on Nontraditional Mortgage Products, 70 Fed. Reg. 77,249 (Dec. 29, 2005).

196. *See* Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37,569 (July 10, 2007).

197. Michael R. Crittenden, *New Agreement Could Mean More Help for Homeowners*, WALL ST. J., June 16, 2008.

198. *See* Borrower's Protection Act of 2007, S. 1299, 110th Cong. (2007).

199. *See Subprime and Predatory Lending*, *supra* note 11, at 55–57 (statement of Harry H. Dinham on behalf of the National Association of Mortgage Brokers) (urging Congress to modernize outdated disclosures and provide additional funds for consumer financial literacy programs); U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 78, at 10 (noting that borrowers may be confused by confusing advertising and not understand the potential risks of exotic loan products). *See generally Calculated Risk*, *supra* note 64 (statement of Kathryn E. Dick on behalf of the Office of the Comptroller of the Currency).

200. *Strengthening Our Economy: Foreclosure Prevention and Neighborhood Preservation: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. (2008), *available at*

proposals enhanced disclosures to help borrowers understand the relative benefits/risks of using nontraditional loan products.[201] For example, the Bush Administration aggressively supported increased funding for the Neighborhood Reinvestment Corporation, which works with cities and municipalities to provide mortgage assistance and homebuyer counseling and education.[202]

While consumer advocates generally support enhanced disclosures, they (and others) have suggested that many of the nontraditional products are so complex, and some are so abusive, that even enhanced disclosures would not really help.[203] Consumers are already bombarded with disclosures. Moreover, many of the existing consumer credit disclosures are unreadable. For example, a recent Federal Trade Commission study found that even the most readable mortgage disclosure forms were confusing and failed to effectively explain the costs and risks of home loans, especially subprime mortgages.[204] In addition, most studies show (and lenders agree) that consumers do not understand many of the disclosures currently required by the Truth in Lending Act (TILA). Also, the General Accounting Agency recently concluded that existing federal disclosures fail to adequately explain that some "exotic" loans contain features that may lead to negative amortization or payment shocks.[205]

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http://banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Detail&HearingID=728c6e4b-de1d-4f02-b91f-a5c7a76ae1c7 (statement of Robert K. Steel, Under Secretary for Domestic Finance, United States Treasury Department) (discussing Administration's support for HOPE NOW and NeighborWorks counseling services).

201. *See, e.g.*, S.B. 987, 80th Leg., Reg. Sess. (Tex. 2007) (requiring counseling from approved housing counseling agency before closing on high cost loans); H.B. 2274, 80th Leg., Reg. Sess. (Tex. 2007); Interagency Statement on Subprime Mortgage Lending, 72 Fed. Reg. 10,533 (Mar. 8, 2007); Illustrations of Consumer Information for Nontraditional Mortgage Products, 73 Fed. Reg. 30,997 (May 29, 2008); Advisory Letter 97-7 from Leann G. Britton, Senior Deputy Comptroller for Bank Supervision Operations, Office of the Comptroller of the Currency to Chief Executive Officers of all Nat'l Banks, Dep't and Div. Heads, and all Examining Personnel, *available at* http://www.occ.treas.gov/ftp/advisory/97-7.txt.

202. OFFICE OF MGMT. & BUDGET, EXECUTIVE OFFICE OF THE PRESIDENT, THE BUDGET FOR FISCAL YEAR 2007 147 (2006).

203. *See* Gandel et al., *supra* note 145; *Preserving the American Dream*, *supra* note 3 (statement of Hilary Shelton on behalf of the NAACP); *Calculated Risk*, *supra* note 64 (statement of Sandra F. Braunstein on behalf of the Board of Governors of the Federal Reserve System); Stelzer, *supra* note 88.

204. *See* JAMES M. LACKO & JANIS K. PAPPALARDO, FED. TRADE COMM'N, IMPROVING CONSUMER MORTGAGE DISCLOSURES—AN EMPIRICAL ASSESSMENT OF CURRENT AND PROTOTYPE DISCLOSURE FORMS (2007); *see also* Kathy M. Kristof, *Loan Data Proves Baffling to Many, FTC Says*, L.A. TIMES, June 14, 2007, at C1 (discussing view that most consumers are confused by mortgage documents).

205. *Improving Credit Card Consumer Protection: Recent Industry and Regulatory Initiatives: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Servs.*, 110th Cong. 46–47 (2007) (testimony of John P. Carey on behalf of Citi Cards) (supporting proposed changes to credit card disclosures because they would move "towards the successful model of food labeling, where consumers can get all the information they need in simple, uniform terms"); *Preserving the American Dream*, *supra* note 3, at 13 (statement of Douglas G. Duncan on behalf of the Mortgage Bankers Association) ("Sadly, every new layer of disclosure simply increases the likelihood that the consumer will merely initial all of them without even a cursory reading."); U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 78.

Even clear disclosure requirements will not solve the housing problems unless all lenders are required to provide the disclosures. Moreover, since most consumer credit contracts are written at a level that exceeds the literacy levels of most American adults, additional disclosures are not likely to protect consumers. Many borrowers will not know the importance of the loan terms they do not understand.[206] And, even with clear disclosures, existing disclosures can only explain existing products and will not help borrowers understand new products. Indeed, enacting disclosure requirements for existing products gives lenders an incentive to create new products since the new redesigned products would not be subject to the disclosure requirements.

4. Consumer Education

Providing effective financial education is difficult and often fails to have any long-term positive effects on consumer spending habits unless it is provided early enough in the credit transaction to prevent (or easily remedy) a credit default.[207] The recent experience with mandatory credit counseling in bankruptcy cases suggests that education alone will not solve the housing crisis.[208]

In 2005, Congress amended the Bankruptcy Code to mandate that consumers take a mandatory credit counseling course before they file for bankruptcy. Congress assumed that, after consulting with an impartial counselor, consumers would realize that they actually had the ability to repay their debts outside of bankruptcy in a private debt management plan[209] and that they had been filing for bankruptcy in the past because they did not really understand bankruptcy, its alternatives, and the consequences of filing for bankruptcy.[210] There is uniform agreement, however, that the pre-filing credit

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206. *See* Renuart & Thompson, *supra* note 148, at 191; Craig R. Fox & Amos Tversky, *Ambiguity Aversion and Comparative Ignorance*, *in* CHOICES, VALUES, AND FRAMES, 528, 539–42 (Daniel Kahneman & Amos Tversky eds., 2000) (suggesting that people will obtain additional information only if they have reason to believe the information will be helpful).

207. *See generally* Sandra Braunstein & Carolyn Welch, *Financial Literacy: An Overview of Practice, Research, and Policy*, 88 FED. RES. BULL. 445, 446 (2002). *Cf.* MARK WIRANOWSKI, NEIGHBORHOOD REINVESTMENT CORPORATION, SUSTAINING HOME OWNERSHIP THROUGH EDUCATION AND COUNSELING 25 (2003) (discussing successful home ownership counseling programs).

208. *See* 11 U.S.C. § 109(h)(1) (2006) (mandating that "debtors" are ineligible for bankruptcy relief unless they receive a "briefing" from a credit counseling agency approved by the Office of the United States Trustee within 180 days before they file for bankruptcy); 11 U.S.C. § 1328(g)(1) (2006) (requiring all consumers to participate in mandatory credit counseling *before* they file their bankruptcy petition and mandating that Chapter 13 debtors receive financial management training from an approved financial education provider before they can receive a discharge).

209. 147 CONG. REC. 3737 (2001) (statement of Sen. Sessions)

> "[T]his is fundamentally what the lawyer tells them. He says: Now, when you get your paycheck, you save that money, and you bring it straight to me—all that money—and maybe your second check. As soon as I have $1,500 or $1,000, I will file your bankruptcy. Don't pay any of your other debts. . . . Use your credit card. Run up everything you want to on your credit card. . . . They are told this is the right thing to do."

210. *See* H.R. Rep. No. 109-31, pt. 1, at 2 (2005).

counseling requirement has added little because most consumers fail to consult with a credit counselor until they meet with their bankruptcy attorney. By the time they decide to consult with an attorney, their financial situation is so dire that they have no realistic alternative but to file for bankruptcy.[211] In addition, the requirement itself is largely being circumvented since most debtors take the "course" on the Internet in their lawyer's office just before they file their bankruptcy petition.[212] Because Congress mandated that the pre-bankruptcy counseling services be provided at a reasonable cost,[213] most counselors provide counseling on the Internet because that is the cheapest (though least effective) way to counsel consumers.[214]

5. Loss Mitigation Programs

Many suggest that the best way to help delinquent borrowers, especially those who are facing ARM resets, is by informing them of affordable refinance opportunities or other alternatives to foreclosures.[215] States have increased their support for programs

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211. NAT'L FOUND. FOR CREDIT COUNSELING, MEETING THE MANDATE: CONSUMER COUNSELING AND EDUCATION UNDER THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT 9 (2006), *available at* http://www.nfcc. org/Newsroom/NFCC%206%20month%20report%20FINAL.pdf; *see also* INST. FOR FIN. LITERACY, FIRST DEMOGRAPHIC ANALYSIS OF POST-BAPCPA DEBTORS 4 (2006), *available at* http://www.financiallit.org/news/white/2006-04-16%20First%20Demographic%20Analysis%20of%20Post %20v.2.pdf.

212. 11 U.S.C. § 109(h)(1) (2006) (providing that counseling can occur either in person, over the phone, or over the Internet). Most counseling has taken place over the Internet even though most counseling experts agree that that is the least effective way to provide counseling. Even an ostensibly effective counseling program may be subject to criticism if it is perceived as having negative, unintended effects. For example, one state-sponsored counseling program was suspended shortly after it began because of criticisms that the program amounted to "state-sanctioned redlining" that detrimentally harmed black and Hispanic borrowers by discouraging them from taking out new or additional mortgages. Illinois suspended the program in January 2007—only three months after it started to operate—after mortgage brokers (who, with lenders, were required to pay for the counseling programs), real estate agents, and some members of the minority community complained that it amounted to racial redlining and that it encouraged the government to unnecessarily interfere with the potential borrowers choice to take out a loan. *See* Vikas Bajaj, *Efforts to Advise on Risky Loans Runs Into Snag*, N.Y. TIMES, June 12, 2007, at A1.

213. 11 U.S.C. § 111(c)(2)(B) (2006) (mandating that if a fee is charged for counseling services, the nonprofit budget and credit counseling must charge a "reasonable" fee).

214. *See* Leslie E. Linfield, *Credit Counseling: BAPCPA's Grendel*, AM. BANKR. INST. J., Oct. 2005, at 28; Kathleen Day, *Credit Counseling Agencies Dealt Setback; Banks Reduce Funding as Bankruptcies Rise; Consumer Groups Hit Move*, WASH. POST, July 16, 1999, at E1 (quoting Craig Streem, spokesman for creditor Household International). Consumers also tend to prefer telephone or Internet counseling, largely because it is the most efficient way to satisfy the counseling requirement. *See also* YVONNE D. JONES, BANKRUPTCY REFORM: VALUE OF CREDIT COUNSELING REQUIREMENT IS NOT CLEAR 13–15 (2007); NAT'L FOUND. FOR CREDIT COUNSELING, *supra* note 211, at 3.

215. *Possible Responses*, *supra* note 79, 47–48 (statement of John H. Dalton on behalf of the Housing Policy Council of the Financial Services Roundtable) (discussing loan modification programs and other efforts to assist distressed subprime borrowers); *id.* at 2, 42–43 (statement of Kenneth D. Wade on behalf of the Neighborhood Reinvestment Corporation); WIRANOWSKI,

that help borrowers refinance their high interest loans, and numerous advertising campaigns (most funded by the mortgage industry) have been launched to encourage borrowers to contact lenders or loan servicers to find a way to avoid foreclosure.[216] Largely because of recent congressional hearings, several prominent lenders or lending organizations agreed to a set of (voluntary) principles that would encourage lenders to contact distressed borrowers early to attempt to reduce interest rates or otherwise modify loan terms, and many financial institutions have committed funds to help borrowers refinance high-interest loans to prevent foreclosures.[217] Indeed, before it found itself in need of a bailout, Freddie Mac announced that it would offer homeowners long-term, fixed-rate loans and would purchase a substantial number of fixed rate and ARM prime and subprime loans to help the borrowers refinance out of high-interest ARMs or other exotic loan products.[218]

While housing advocates and civil rights groups generally support loan modification programs, they argue that such voluntary programs are inadequate and that many lenders have refused to modify loans even though they purport to have a modification program.[219] In addition, lenders who hold equity loans and second liens often oppose modifications unless the first lienholder agrees to pay them a percentage of the debt owed on the home equity loan.[220] Another limitation of voluntary loss mitigation proposals is that they will do little to help borrowers whose loans are in a securitized pool if the securitization contract prevents the loan servicers or trustees from modifying the underlying loans or if the borrower cannot determine who owns the debt because it has been packaged in a securitization trust.[221] In such cases, the

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supra note 207, at 21.

The Comptroller of the Currency developed public service announcements aimed at encouraging homeowners to contact their lenders for help avoiding foreclosure. Press Release, Comptroller of the Currency, Admin. of Nat'l Banks, Comptroller Dugan Unveils Pub. Serv. Announcements Encouraging Delinquent Borrowers to Contact Lenders for Help to Avoid Foreclosure (Jun. 25, 2007), *available at* http://www.occ.treas.gov/ftp/release/2007-61.htm.

216. *Possible Responses*, *supra* note 79, at 50–52 (statement of Douglas A. Garver on behalf of the Ohio Housing Finance Agency) (discussing Opportunity Loan Refinance Program that offers mortgage products designed to help borrowers avoid foreclosure); Dina Elboghdady, *Alarms Sound on Dangerous Loans; Counseling, Advertising Aim to Keep Borrowers Out of Foreclosure*, WASH. POST June 30, 2007, at F1; Press Release, Comptroller of the Currency, *supra* note 215 (discussing new public service announcements designed to encourage borrowers to contact lender or housing counselor); Les Christie, *Subprime Bailouts: How They Work: There's Some State-Sponsored Help On the Way For Subprime Borrowers*, CNNMONEY.COM, Apr. 24, 2007, http://www.money.cnn.com/2007/04/24/real_estate/bailout_plans_how_they_work/index.htm.

217. Dina Elboghdady & Nell Henderson, *$1 Billion Pledged to Help Fend off Foreclosures*, WASH. POST, Apr.12, 2007, at D1; *Borrowers in Trouble May Get Some Relief*, MSNBC.COM, May 2, 2007, http://msnbc.msn.com/id/18445587/%5D.

218. *Major Lenders Move to Offer Subprime Help: Freddie Mac, Washington Mutual Will Help Refinance Billions in Mortgages*, MSNBC.COM, Apr. 18, 2007, http://www.msnbc.msn.com/id/18184371/.

219. *See Straightening Out, Part II, supra* note 102, at 2 (statement of Mark Zandi on behalf of Moody's Economy.com).

220. Vikas Bajaj, *Equity Loans as Next Round in Credit Crisis*, N.Y. TIMES, Mar. 27, 2008, at A1.

221. *Compare* Engel & McCoy, *supra* note 96, at 2078 (suggesting that most securitization

servicer or trustee could restructure the loan only if the applicable investor classes (tranches) consent to the modification.[222] While some home ownership initiative programs appear to have been successful in helping residents avoid foreclosure,[223] approximately fifty-five percent of all mortgage loans and seventy-five percent of the subprime mortgages entered into in 2006 were securitized. Given this fact, the vast majority of those borrowers would not benefit from lenders' buyback or refinance programs.[224]

Finally, while the modification programs may be of great use to borrowers who are in default because of a temporary financial setback (like a job loss), they are of significantly less use to borrowers who could never afford the homes they decided to purchase. Perhaps more importantly, lenders may vigorously support loan modification programs now, but they are not likely to do so if they have other financially feasible alternatives. Lenders resisted earlier attempts to force them to voluntarily modify subprime loans but, not surprisingly, now support loan modification programs because they appear to be the only reasonable alternative to foreclosure.[225] Even more troubling is the contention by housing advocates that lenders who ostensibly support loan modification programs regularly refuse to modify loans even though these same lenders purport to have their own modification programs.[226] Even lenders who support these programs now are likely to revert to more aggressive collection techniques and

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contracts prohibit servicers from modifying mortgage loans), *with Subprime Mortgage Market Turmoil*, *supra* note 86 (statement of Susan Barnes on behalf of Standard & Poor's Ratings Services) (suggesting that most securitization contracts allow servicers to modify mortgage loans).

222. *Subprime Mortgage Market Turmoil*, *supra* note 86 (discussing "tranche warfare" that occurs when a trustee of a security attempts to modify a loan and divert payments from one investor class to another); *see* JOINT MEMORANDUM, *supra* note 107, at 2 (discussing risks of loan modification, workout, or loss-mitigation programs). If a loan has been pooled and securitized into tranches (sets of investors) that hold different interests—that is, right to principal or interest repayment in a particular year of the loan term—allowing the borrower to modify the payment stream necessarily would transfer part of the income stream from the loan between the tranches.

223. *Subprime Mortgage Market Turmoil*, *supra* note 86 (statement of Susan Barnes on behalf of Standard & Poor's Ratings Services); *Possible Responses*, *supra* note 79, at 42 (statement of Kenneth D. Wade on behalf of the Neighborhood Reinvestment Corporation); Donna Sheline, *Sustaining Homeownership and Communities*, COMMUNITY DEV. ONLINE, Spring 2006, http://www.occ.treas.gov/CDD/spring06b/cd/sustaininghomeownership.htm (discussing Chicago Home Ownership Preservation Initiative).

224. *Straightening Out, Part I*, *supra* note 192 (statement of Eric Stein, on behalf of Center for Responsible Lending and Center for Community Self-Help) (describing difficulties of modifying loans with servicers, servicers' fears of litigation of their modified loans, and inability of services to respond because of the sheer volume of demand). Hedge funds who invested in mortgage-backed securities often resist loan modification efforts because they invested short, that is, they profit when the value of the securities decrease as a result of increased homeowner default. See James Surowiecki, Performance-Pay Perplexes, THE NEW YORKER, Nov. 12, 2007, at 34 (describing how hedge funds contributed to subprime crisis).

225. *See* Stelzer, *supra* note 88 (discussing reasons why lenders needed little prodding to support loan modification).

226. *See Straightening Out, Part II*, *supra* note 102, at 2 (statement of Mark Zandi on behalf of Moody's Economy.com).

resist all efforts to provide relief to financially struggling homeowners once economic conditions improve.[227]

B. Private Litigation

In addition to the legislative and regulatory proposals, cities and even states have now started suing lenders and entities that securitized subprime loans, accusing them of defrauding borrowers by selling them overpriced mortgages they could not afford and that quickly went into foreclosure.[228] The Federal Bureau of Investigation recently announced that it is criminally investigating a host of companies for possible accounting fraud and insider trading as a result of loans the companies made to subprime borrowers and the Securities and Exchange Commission. The Federal Trade Commission is also investigating the practices of some mortgage lenders and their managers.[229] Frustrated and disappointed homeowners have also started suing various parties as a result of the housing market crash. For example, buyers have sued their agents and brokers, alleging that they breached their fiduciary duties by misrepresenting information about the fair market value of the house, or by steering them into higher-cost loans, or by failing to properly disclose the loan terms.[230]

C. Other Responses

There have been other, unorthodox responses as well. The sheriff of the City of Philadelphia crafted a novel, though likely illegal, response to the foreclosure crisis. After Philadelphia citizens defaulted on their mortgages in record numbers, the sheriff refused to conduct court-ordered foreclosure auctions even though the sheriff's office is responsible for conducting foreclosure sales.[231] Once mortgage lenders, servicers, and their attorneys realized that the sheriff's decision, whether legal or not, was becoming a public relations nightmare for them (not him), they entered into an

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227. *But cf. Preserving the American Dream*, *supra* note 3, at 18 (statement of Douglas G. Duncan, on behalf of the Mortgage Bankers Association) ("[L]ong-standing claims that lenders purposely put borrowers into products they cannot afford in order to take the property through foreclosure is simply unfounded.").

228. Christopher Maag, *Cleveland Sues 21 Lenders Over Subprime Mortgages*, N.Y. TIMES, Jan. 12, 2008, at A9. The States of California, New York, Massachusetts, and Illinois and the Cities of Baltimore and Cleveland have sued or are contemplating whether to sue various financial institutions that packaged subprime loans. Kate Kelly, Amir Efrati, & Ruth Simon, *State Subprime Probe Takes a New Tack*, WALL ST. J., Jan. 31, 2008, at A3; Greg Morcroft, *Massachusetts Charges Merrill with Fraud, Misrepresentation*, WALL ST. J., Feb. 1, 2008; Morgenson, *supra* note 154, at C1.

229. Evan Perez, *FBI Begins Subprime Inquiry*, WALL ST. J., Jan. 30, 2008, at A3; Gretchen Morgenson, *supra* note 154, at C1; Gretchen Morgenson, *Lenders Who Sold and Left*, N.Y. TIMES, Feb. 3, 2008, § BU, at 1.

230. Vikas Bajaj & Miguel Helft, *The Loan That Keeps on Taking*, N.Y. TIMES, Sept. 25, 2008, at C1; Jonathan D. Glater, *Wave of Lawsuits Over Losses Could Hit a Wall*, N.Y. TIMES, May 8, 2008, at C1; David Streitfeld, *Feeling Misled on Home Price, Buyers Are Suing Their Agent*, N.Y. TIMES, Jan. 22, 2008, at A1.

231. Michael M. Phillips, *He's Taking Law into His Own Hands to Help Broke Homeowners*, WALL ST. J., Jun. 6, 2008, at A1.

agreement with housing advocates and local judges to work out a process that would help make loans more affordable for delinquent borrowers. This unique solution worked principally because the local judges were not willing to order the sheriff to hold the foreclosure sales, and also because housing advocates had successfully lobbied members of the city council, who also supported the sheriff's stonewall.[232]

VI. PROVIDING RATIONAL HOME OWNERSHIP SUBSIDIES

The biggest problem with proposed responses to the current mortgage crisis is that the proposals address the symptoms (increased foreclosures) instead of the underlying problem (an irrational obsession with attaining the status of homeowner). Even if states and the federal government enacted laws that eliminated all fraud by mortgage lenders or brokers, provided extensive counseling for borrowers, and ensured that lenders and brokers disclosed in detail all aspects of the mortgage loan, the mortgage "crisis" will not really go away. That is, as long as this country continues to tell consumers that "owning a home remains the best long-term investment a family can make,"[233] and continues to encourage people to do whatever it takes to achieve the home ownership dream, renters and existing homeowners will continue to make unwise housing investment decisions.

The initial justifications for subsidizing home ownership (to encourage long-term investments in homes and communities) no longer support the significant subsidies some homebuyers receive when they purchase a home. If increasing consumer wealth is the primary goal of encouraging home ownership, it is unclear why the United States should provide such significant subsidies for this particular investment activity. And, if the United States chooses to significantly subsidize housing investments, justifications for this investment subsidy should be divorced from the emotional sentiments associated with the status of being a homeowner. As the rest of this Article argues, it is time for this country to radically reshape our views toward the wisdom of encouraging and subsidizing universal home ownership and we should then create rational but limited housing subsidies.

A. Subsidizing Renting

Most of the past and current responses to the problem of unaffordable housing have focused on helping renters achieve their aspiration of owning their own homes. Thus, even housing advocates who focus on the needs of renters have argued that renters should receive a tax credit to help them save money for a down payment.[234] To help renters become homeowners, federal and state governments have been asked to provide vouchers to help renters pay the expenses associated with owning a home and also to teach them how to be responsible homeowners.[235] Rather than focus solely on

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232. *Id.*

233. THE WHITE HOUSE, HOMEOWNERSHIP: PRESIDENT'S AGENDA TO EXPAND OPPORTUNITIES TO HOMEOWNERSHIP (2007), *available at* http://www.whitehouse.gov/ask/20070906.html (statement of Alphonso Jackson, Secretary of Housing and Urban Development) (discussing long-term benefit of home ownership).

234. Covington & Harrell, *supra* note 32, at 108.

235. *See* U.S. Department of Housing and Urban Development, Homes and Communities,

pushing renters into housing, U.S. home ownership subsidies should be used to help Americans live in affordable housing whether rented or owned.

Despite dramatic increases in home ownership for the last decade and persistent rental vacancy rates for the last five years, there nonetheless has been a gap between the demand and supply of affordable rental housing for low-income households.[236] One reason even rental housing remains out of the reach for many Americans is because prices for rental housing and owner-occupied housing tend to move in the same direction. Since housing prices have appreciated dramatically for the last decade, it is not surprising that rents have also increased quite dramatically. Rent also appears to have increased because many of the recently built rental units target upper-income consumers. Another reason may be the hostility that some localities exhibit toward rental housing generally and low-income housing specifically, including restrictive zoning laws or land-use policies that impose density requirements that have the effect of severely restricting the construction of affordable rental housing.[237] Ironically, this shortage of affordable rental housing may be exacerbated by the housing crisis, since many renters are now finding that their rental units are being sold in foreclosure.

With the introduction of the forty- and fifty-year fixed mortgage, and with interest-only and payment-option loans that do not allow the borrower to build significant equity, many people who call themselves homeowners are essentially renters. Because of the lore of the myth of home ownership, however, renters likely will continue to aspire to become homeowners even if it is not in their financial best interest as long as the United States continues to subsidize the decision to purchase shelter instead of the decision to rent shelter. To discourage renters from investing in the risky home ownership market and to help combat the problem of unaffordable housing, the United States should increase subsidies for programs or projects that are designed to construct or rehabilitate low-income housing.

Congress considered (but failed to enact) legislation that would create a National Housing Trust Fund to give builders financial incentives to construct, rehabilitate, or preserve housing units that would, in part, be occupied by low-income families.[238] Rather than continue to subsidize the economic decision of renters or existing homeowners to purchase expensive homes or homes that they actually cannot afford, the United States should continue to subsidize (or to increase subsidies for) programs that encourage developers to construct or substantially rehabilitate rental housing occupied by tenants whose incomes fall below specified levels.[239]

Housing Choice Vouchers Fact Sheet, *available at* http://www.hud.gov/offices/pih/programs/hcv/about/fact_sheet.cfm.

236. *See* DANILO PELLETIERE, NAT'L LOW INCOME HOUS. COAL., THE RENTAL HOUSING AFFORDABILITY GAP: COMPARISON OF 2001 AND 2003 AMERICAN HOUSING SURVEYS 8 (2006).

237. JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., AMERICA'S RENTAL HOUSING: HOMES FOR A DIVERSE NATION 2 (2006); LARRY KEATING, ATLANTA: RACE, CLASS AND URBAN EXPANSION 51–53 (2001) (describing how zoning is used to perpetuate racial and economic exclusion); PELLETIERE, *supra* note 236, at 9.

238. 152 CONG. REC. H11, 416 (2007); *see also* Editorial, *A New Approach to Housing*, N.Y. TIMES, Oct. 15, 2007, at A20. That fund would have been financed by contributions from the GSEs (Fannie Mae, Freddie Mac, and the FHA), Fannie Mae and Freddie Mac have now been bailed out by the United States because of the mortgage meltdown.

239. I.R.C. § 42 (2000). To be eligible for this tax benefit, the rental units must be rent-restricted and either twenty percent of the renters in a multi-unit residential unit must have incomes that are less than fifty percent of the state median gross income *or* forty percent of the

Similarly, instead of sponsoring down payment assistance programs, the United States should support security deposit assistance programs that help renters get loans to pay for rental security deposits since many renters find it difficult to save enough to pay the security deposit required to rent an apartment.[240] Likewise, home ownership subsidies should be replaced by rental subsidies that encourage landlords to create escrow or reserve accounts that lower-income renters who have uneven incomes could use to manage their monthly rental payments.

Finally, the United States should provide a standard housing tax deduction or tax credit, rather than a deduction that differentiates between homeowners and renters. While Congress recently agreed to increase the tax deduction for homeowners who do not itemize on their income tax returns, housing relief should not be limited to homeowners and Congress also should provide a deduction or credit for renters. Similarly, state exemption laws and the U.S. Bankruptcy Code should replace the protections it provides to real property debtors with a housing exemption that would benefit all debtors regardless of whether they own or rent their homes.

B. Subsidizing Only Economically Rational Mortgage Products

The nontraditional products that were innovated, ostensibly to make homebuying affordable for lower- and middle-class renters, have until recently been quite profitable for the mortgage originators, secondary market buyers, Lowe's, the U.S. economy, and global capital markets.[241] Unfortunately, these products are not always economically rational for borrowers. Potential homebuyers should not accept mortgage products that they do not understand, and should not be encouraged to buy a house that they cannot

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renters must have incomes less than sixty percent of the median income. *Hearing on Tax Incentives for Affordable Housing: Before Subcomm. on Select Revenue Measures of the H. Comm. on Ways & Means*, 110th Cong. (2007), *available at* http://waysandmeans.house.gov/hearings.asp?formmode=detail&hearing=563. While this tax credit was designed to make rental housing more affordable, it has become controversial because of claims that it is an inefficient way to provide housing for moderate income households and because some suggest that private investors (not builders or moderate income homeowners) disproportionately benefit because they can exchange equity investments in the housing for the tax credits. Iglesias, *supra* note 1, at 528 (discussing the commodification of the Low Income Housing Tax Credit program).

240. *See, e.g.*, Gwen Florio, *Nearly a Month Later, Evicted Tenants Still Lack Housing: Fund Established, Consulate Helping Mexican Immigrants*, DENVER POST, Aug. 30, 2001, at B7 (discussing difficulty of raising security deposits for immigrants); Robert Landauer, *Poverty's Berlin Wall*, THE OREGONIAN, May 9, 1998, at D11 (discussing difficulty of raising security deposits for low-income women); Nancy Parello, *Rent Vouchers Open Few Doors; Section 8 Law Not Master Key*, THE RECORD (Bergen County, N.J.), May 6, 2001, at A1 (suggesting that government pay security deposits for Section 8 tenants); Rich Shopes, *Farm Hands Need Help: Studies Delve into Living Conditions of Migrant Workers*, SARASOTA HERALD-TRIBUNE (Fla.), Jul. 3, 1999, at A1 (discussing difficulty of finding housing for migrant workers).

241. *See* Julie Creswell & Michael J. de la Merced, *Even Nonhousing Markets Feel Mortgage Fallout*, N.Y. TIMES, Aug. 7, 2007, at C1 (describing how the mortgage meltdown created a financial crisis that made it harder for corporate borrowers outside the housing sector to raise money); Telis Demos, *Leading Indicators*, FORTUNE, Sept. 17, 2007, at 30 (discussing lower predicted earnings for Wal-Mart, Target, and Staples); Press Release, *supra* note 3.

afford at the time of purchase simply because the house might become affordable if housing prices continue to appreciate.

The United States should subsidize and provide tax benefits only for economically sensible mortgage products (e.g., fixed rates for fifteen or thirty years) that consumers can afford to repay at the time they enter into the mortgage agreement. While lenders should not be prevented from offering exotic loan products to borrowers who can afford them, the United States should not encourage renters or existing homeowners to participate in an activity (borrowing money to buy an expensive home using a loan they cannot afford)—especially since the result of that activity is often foreclosure—not increased home ownership rates.

C. Encouraging Home Ownership Linked with Education

Whether a potential homeowner has a post-secondary education has a tremendous impact on a worker's success in the labor market and, ultimately, in her ability to be competitive in the housing market. Graduating from high school and attending college dramatically increases the likelihood that a worker will not be a member of the working poor.[242] Workers with less than a high school diploma are the most likely to be among the working poor. Notably, the income for high school graduates has largely remained flat over the last twenty-five years and median male income has stagnated since 2000.[243]

Rather than provide subsidies that encourage renters to buy a home (or homeowners to remove equity from their homes to use for any purpose), the United States should increase subsidies for housing investments that are linked to education. Encouraging renters or existing homeowners to weigh the benefits of education versus housing has a number of benefits. First, given the shifts in the workplace, it will be impossible to lessen the wage disparity between workers who either do not have post-secondary training or who have inadequate secondary training and those who attend college unless more workers receive better secondary educations and at least some training after high school. In addition, unlike the brick-and-mortar investment in a house, an education investment does not restrict the worker's mobility. Homeowners who are locked into a largely immobile asset are unable to move quickly to another locale even for a higher-paying job.

To encourage home ownership and also encourage consumers to increase their investment in education, homeowners who remove equity from their homes and use those funds to pay for their (or their dependents') secondary or college expenses should be allowed to deduct the interest on those loans. In contrast, homeowners who remove equity from their homes to purchase a consumer durable like a boat or to pay off a lower interest debt should not be allowed to deduct the interest on those debts unless all taxpayers can deduct similar interest on their tax returns. Unlike sailing on a boat, a consumer's decision to increase the type or amount of education for herself or her dependents provides a more stable economic future and access to higher future earnings.

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242. *See* U.S. DEP'T OF LABOR, U.S. BUREAU OF LABOR STATISTICS, A PROFILE OF THE WORKING POOR, 2004 2 (2006).

243. *Id.*; Greg Ip, *American Men Lagging Behind Their Fathers in Pay*, ALB. TIMES UNION, May 26, 2007, at A1.

Likewise, rather than subsidizing all housing purchases, the United States should support increased funding for schools serving residents living in affordable housing (or multi-family housing) developments.[244] The quality of public schools in this country positively correlates with local property taxes and, thus, housing prices.[245] Similarly, schools with higher-income students tend to perform better than schools with lower-income students.[246] Linking housing subsidies to school districts should help remove some of the financial disparities that exist between high- and low-income school districts, and especially between at-risk schools and wealthier schools. To help further reduce these disparities, the United States should subsidize or otherwise provide financial support for programs that provide homebuyer assistance to teachers who agree to teach in "hard to staff" public schools.[247]

D. Environmentally Green Housing

Another way to provide a targeted housing subsidy that advances a valuable societal goal is to link housing to certain environmental concerns. For example, the United States justifiably could subsidize home purchases if the owner buys or builds a green, eco-friendly home, or if the owner uses a home equity loan to renovate an existing home to make it more environmentally friendly. While there are no set standards for "green housing," the subsidy should be available if a home is built consistent with guidelines[248] that ensure, among other things, that the home decreases the harm to the natural features and resources surrounding the site, uses green building materials[249] from local sources, generates on-site renewable (e.g., solar, green roofs, rain gardens) energy, or uses energy efficient heating and cooling systems.

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244. S.B. 220, 95th General Assem., Reg. Sess. (Ill. 2007) (setting the goal of increasing funding for affordable or multi-family housing).

245. *See* ROBERT H. FRANK, FALLING BEHIND: HOW RISING INEQUALITY HARMS THE MIDDLE CLASS 44−45 (2007) (discussing relationship between housing size, socioeconomic status, and public schools).

246. *See* Roslyn Arlin Mickelson, *Achieving Equality of Educational Opportunity in the Wake of Judicial Retreat from Race Sensitive Remedies: Lessons from North Carolina*, 52 AM. U. L. REV. 1477, 1484–85 (2003) (describing the resource-poor schools that low-income students often attend); Andrew Benson, *Rich or Poor, Family Income Is Prime Predictor of How Well a Student will Perform in School*, CLEV. PLAIN DEALER, Oct. 8, 1995, at C1 (describing results of a study showing performance differentials between low- and high-income students).

247. This is the goal of the Illinois Teacher Homebuyer Assistance Act, S.B. 1224, 95th General Assem., Reg. Sess. (Ill. 2007) (setting the goal of payment assistance for housing for public school teachers who work in hard to staff schools or hard to staff positions).

248. *See, e.g.*, Green Building Initiative, Green Building Factsheet, http://www.thegbi.org/assets/pdfs/GBFactSheet.pdf; NAT'L ASSOC. OF HOMEBUILDERS, NAHB MODEL GREEN HOME BUILDING GUIDELINES (2006), http://www.nahb.org/fileUpload_details.aspx?contentTypeID=7&contentID=1994.

249. Green building materials include renewable plant materials (like bamboo and straw), recycled stone, recycled metal, and other products that are non-toxic, reusable, renewable, and/or recyclable. *See* Green Building Initiative, *supra* note 248.

CONCLUSION

The cultural attachment to home ownership significantly influences public policy discussions about housing. In pursuing the home ownership dream, consumers routinely ignore the financial risks associated with making this large, long-term investment in real property. Though home ownership is touted and subsidized because it helps increase jobs, boosts the demand for goods and services, and helps build prosperity, no one wants to admit that U.S. businesses need potential or existing homeowners to go deeply into debt in order to maintain high corporate earnings for U.S. companies.

Though inconsistent with the home ownership myth, the time has come for consumers to start ignoring the immediate, likely short-term, end result of achieving the status of homeowner. To force consumers to consider the long-term risks on investing in a house, home ownership subsidies should encourage renters and potential homeowners to focus on the likely long-term benefits of the investment itself. This should cause homeowners to decide whether it is in their best interest to devote limited investment funds to purchasing a house and also to consider the economic consequences of a failed investment; that is, the inability to use those funds to make other investments, and potentially losing the home to foreclosure.