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OVER-INDEBTEDNESS, THE SUBPRIME MORTGAGE CRISIS, AND THE EFFECT ON U.S. CITIES

A. Mechele Dickerson[*]

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INTRODUCTION

Too many people in the United States are overwhelmed by debt. While we were once a country of thrift, consumer indebtedness has become a ubiquitous phenomenon that affects people in both urban and rural areas and from all socio-economic groups. Because so many people are over-indebted,[1] the United States is in the midst of a severe economic meltdown and the magnitude of the federal government's intervention in the financial markets is surpassed only by the bailout efforts to end the Great Depression.[2]

The economic crisis was caused by the record number of defaults on subprime mortgage loans and the foreclosures that followed those defaults. For the last two years, U.S. homeowners—like consumers in the rest of the world—have felt the financial pain associated with rising fuel and food prices. The increase in the prices of those commodities, however, was not the reason homeowners started defaulting on their subprime mortgages. Instead, the U.S. subprime mortgage crisis was triggered by (and then morphed into a global financial crisis) the over-consumption of consumer credit generally and our gluttonous consumption of mortgage debt.

This Article discusses the rise in consumer debt generally, the harm that the current credit crisis has caused to the U.S. economy and global capital markets, and the specific threats that the current financial crisis pose to U.S. cities. Part I discusses the increased availability of consumer debt and how deregulated consumer credit markets, along with technological, demographic, and labor market changes, caused lending standards to become so relaxed that people were able to buy homes they clearly could not afford. Part I also notes how shifts in societal views toward thrift and borrowing have caused too many people to borrow too much in a desperate attempt to participate in the "American Dream" of homeownership.

Part II focuses on the current financial crisis. This Part presents current overall consumer debt levels and then discusses the harmful effects of the financial crisis on homeowners, the financial sector, and even groups that are unrelated to the housing industry (such as college students). Part II then briefly describes the initial responses to the financial crisis and the various, but ultimately failed, attempts to prevent the subprime credit crisis from spreading.

Part III suggests that, rather than wait for federal bailouts, localities take proactive steps (including purchasing foreclosed homes) to prevent this fi-

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1. For the purposes of this Article, I define "over-indebtedness" as a consumer's inability to repay all debts in full in the near future.

2. *See infra* note 94 and accompanying text.

nancial crisis from decimating their cities. The Article ends by stressing that the metastasizing mortgage crisis threatens to leave urban areas with a glut of abandoned homes and that an increase in distressed neighborhoods may reverse years of urban renewal projects.

I. THE INCREASED AVAILABILITY OF CONSUMER DEBT

In the 1960s, it was not easy to obtain low-cost credit. At that time, low-cost credit principally existed in only two forms and was given only to consumers who had stable income and who could document assets that could be pledged as collateral.[3] The first type of low-cost credit consisted of long-term, conventional mortgages issued either by commercial banks or the U.S. government.[4] The second type consisted of installment loans from local commercial institutions or credit unions that were issued only after an official of the lending institution examined the borrower's income and assets in detail and concluded that the borrower was creditworthy.[5]

Until the late 1970s, a borrower who wanted to obtain credit to purchase an item almost always would be forced to have a face-to-face meeting with the lender and, except for the wealthy, would be required to document their income and assets.[6] Borrowers who did not have assets they could pledge as collateral and people who could not (or would not) document that they had stable income would almost always be denied credit. The only type of credit that might have been available for them would be offered by local department stores or automobile dealers in the form of installment loans that would allow them to purchase items only from the lender that issued the credit.[7]

That has all changed. Since the late 1970s, consumer credit has risen at astronomical rates in this country.[8] It is impossible to understand the cur-

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3. HOWARD D. CROSSE & GEORGE H. HEMPEL, MANAGEMENT POLICIES FOR COMMERCIAL BANKS 175, 181 (2d ed. 1973).

4. *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, 194 (2005) (describing the evolution of low-cost, long-term credit in the home mortgage market).

5. Michelle J. White, *Bankruptcy Reform and Credit Cards*, 21 J. ECON. PERSP. 175, 180 (2007).

6. CROSSE & HEMPEL, *supra* note 3, at 181. Lenders also waive this requirement for high-income workers, who might prefer not to disclose their income, but can afford the monthly payments, and also for self-employed or seasonal workers, who might have high income, but are unable to verify that income.

7. DAVID CAPLOVITZ, CONSUMERS IN TROUBLE: A STUDY OF DEBTORS IN DEFAULT 37 (1974).

8. In August of 1976, the consumer debt outstanding was just over $216 billion. That number has grown to over $2.5 trillion in 2008. Federal Reserve, Consumer Credit Out-

rent credit crisis without understanding *why* so many consumers started amassing so much debt. To understand that, one must ask why it has become so easy for so many borrowers to get so much credit. For the most part, the over-consumption of credit can be traced to the deregulation of the consumer credit market and to the resulting "democratization" of credit.[9]

A. Deregulation

Starting in the mid-1970s, the U.S. government deregulated the consumer credit market and made it easier and more profitable to extend credit to consumers.[10] With fewer regulatory controls and *especially* with relaxed usury laws, creditors were willing to increase the amount of credit they would extend to a group of consumers who had until then been deemed unworthy of credit.[11] Indeed, until the mortgage meltdown seized the credit markets, anyone (regardless of his credit risk) and anything (whether human or not) could reasonably expect to receive a credit card offer.[12]

With interest rate ceilings largely lifted, extending credit to even high-risk borrowers became quite profitable. Lenders were willing to give credit even to borrowers with bad credit (in other words, subprime borrowers)[13] because they could charge significantly higher rates to compensate for any increased risk of default when lending to riskier borrowers.[14] The effect that a deregulated market had on consumer credit transactions can perhaps

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standing, http://federalreserve.gov/releases/g19/hist/cc_hist_sa.txt (last visited Mar. 19, 2009).

9. SUSAN JENSEN-CONKLIN, AM. BANKR. INST., MINUTES OF MEETING HELD, PLENARY SESSION: CONSUMER BANKRUPTCY (1996); Diane Ellis, *The Effect of Consumer Interest Rate Deregulation on Credit Card Volumes, Charge-Offs, and the Personal Bankruptcy Rate*, *in* DIV. OF INS., FED. DEPOSIT INS. CORP., BANK TRENDS: ANALYSIS OF EMERGING RISKS IN BANKING 9 (FDIC Div. of Ins., Pub. No. 98-05, 1998), *available at* http://www.fdic.gov/bank/analytical /bank/bt_9805.pdf; Jean Braucher, *Chapters, Changes, and Challenges: A Fresh Start for Personal Bankruptcy Reform: The Need for Simplification and a Single Portal*, 55 AM. U. L. REV. 1295, 1302 (2006).

10. Ellis, *supra* note 9, at 5-6.

11. Emilio Fernandez-Corugedo & John Muellbauer, *Consumer Credit Conditions in the United Kingdom* 5, 8 (Bank of Eng., Working Paper No. 314, 2006).

12. *See Credit Cards at 50: The Problems of Ubiquity*, N.Y. TIMES, Mar. 12, 2000, at C11 (noting that former Chair of the U.S. Federal Reserve Alan Greenspan once commented that "[c]hildren, dogs, cats and moose are getting credit cards").

13. 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. Robert B. Avery et al., *Higher-Priced Home Lending and the 2005 HMDA Data*, 92 FED. RES. BULL. A123, A125 (2006), *available at* http://www.federalreserve.gov/pubs/bulletin/2006/hmda/bull06hmda.pdf.

14. Ellis, *supra* note 9, at 7.

best be illustrated by the differences entailed in buying a home pre- and post-deregulation.

1. *Housing Purchases: Then*

People who wanted to borrow money to purchase a home in the United States up until the 1970s were required to make a significant down payment, then agree to make consistent monthly loan payments for an extended period of time, typically fifteen or thirty years.[15] That is, before deregulation, potential homeowners either had to make a down payment of at least 20% or had to purchase private mortgage insurance ("PMI") if they failed to pay 20% down.[16] Forcing borrowers to make down payments protected the lender by lowering the total mortgage debt (and, thus, the lender's total risk of loss) and also forced the borrowers to make up-front financial investments in their housing purchases. The down payment requirement ordinarily would be waived only for wealthy borrowers who actually had the funds to make the down payment but wanted to use their cash to make other investments.[17]

2. *Housing Purchases: Now*

Starting in the early part of this decade, interest rates started to fall and the United States experienced unprecedented home price appreciation. The rate of appreciation in some markets was astronomical.[18] Housing prices in the aggregate increased by more than 50% over the last decade and, in some regions, had annual increases of over 10%.[19] These skyrocketing housing prices benefited some homeowners and created vast sums of

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15. *See* FED. HOUS. AUTH., 28TH ANNUAL REPORT 93-94 (1961) (noting that current investments—down payment plus closing costs—averaged about 16% of income for new-home purchasers). In 1971, 99.9% of all mortgages were for a term of twenty years or more. STATISTICAL ANALYSIS & RESEARCH BRANCH, FED. HOUS. AUTH., FHA TRENDS OF HOME MORTGAGE CHARACTERISTICS: 3D QTR. 1972, at 6 (1973).

16. 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 12 (2006), *available at* http://www.consumerfed.org/pdfs/exotic_toxic_mortgage_report0506.pdf.

17. *Id.*; Pamela Gaynor, *Homeowners May Be Mortgaging Their Future with New Loan Products*, PITTS. POST-GAZETTE, July 31, 2005, at A1.

18. Frederic S. Mishkin, Member, Bd. of Governors of the Fed. Reserve Sys., Speech Before the Forecaster's Club of New York: Enterprise Risk Management and Mortgage Lending (Jan. 17, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/Mishkin20070117a.htm.

19. FISHBEIN & WOODALL, *supra* note 16, at 28.

wealth for them.[20] These gains were not, however, evenly distributed and housing price appreciation ultimately created a significant unaffordability problem for renters who wanted to purchase homes—especially homes in some east and west coast markets.[21]

The extended boom in house price appreciation actually fueled the consumption of housing (and of the mortgages associated with those houses) that otherwise would not have been possible. That is, while non-traditional loan products were offered ostensibly to make housing more affordable, these loan products actually aggravated the meteoric house price appreciation. By allowing cash-strapped borrowers with bad credit to buy a home with no money down, and by letting these borrowers make artificially low monthly payments, consumers who could not afford to buy these homes suddenly *could* afford to become a homeowner even though the loan products placed the borrowers at great financial risk.

Of course, some borrowers may have been greedy by attempting to purchase a house they simply could not afford, and others may have engaged in outright fraud. For example, recent reports suggest that some borrowers intentionally inflated their incomes on liar loans,[22] 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.[23]

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20. *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 cannot afford homes in the same area); *see also* Jon Birger, *Should You Cash out While You Can?*, MONEY, Aug. 1, 2005, at 51.

21. *See, e.g.*, Karl E. Case & Robert J. Shiller, *The Behavior of Home Buyers in Boom and Post-Boom Markets* 2 (Nat'l Bureau of Econ. Research, Working Paper No. 2748, 1988) (discussing capriciousness of housing price appreciation wealth distribution); *see also Affordable Housing Needs in the City of Houston: Unique Challenges and Opportunities: Hearing Before the Subcomm. on Housing and Economic Opportunity of the H. Comm. on Financial Servs.*, 110th Cong. 8 (2007) (testimony of Daniel Bustamante, Executive Director, Greater Houston Fair Housing Center), *available at* http://financialservices.house.gov/hearing110/htbustamante102907.pdf (stating that the "dream of home ownership continues to be just a dream for most working people" in Houston).

22. Gretchen Morgenson, *Crisis Looms in Market for Mortgages*, N.Y. TIMES, Mar. 11, 2007, at A1 (reporting that liar loans were 40% 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 were 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.

23. 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 in Subprime Mortgage Lending: Hearing Before the Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Servs.*, 110th Cong. 131 (2007) [hereinafter *The Role of the Secondary Market*] (statement of Larry B. Litton, Jr., President, CEO, Litton Loan Servicing LP) (stat-

Other homeowners, however, especially first-time homeowners, appear to have been naïve, unsophisticated, and genuinely seemed shocked to learn that it would be difficult to sell their homes once the housing market stalled. Likewise some seemed surprised to discover that, even though they had no equity in their homes, refinancing their high-cost loans was not an option.[24] Finally, information asymmetry appears to have caused some of these borrowers to accept expensive, non-traditional, mortgage products even though they did not understand the loan features[25] and even though they may have qualified for a lower-cost loan product.[26]

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ing that defaults were "the result of lax underwriting standards, improper documentation, or borrower fraud"); *see also* MERLE SHARICK ET AL., MORTGAGE ASSET RESEARCH INST., LLC, NINTH PERIODIC MORTGAGE FRAUD CASE REPORT TO MORTGAGE BANKERS ASSOCIATION 11 (2007).

24. *Subprime and Predatory Mortgage 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 Financial Servs.*, 110th Cong. 396-97 (2007) [hereinafter *Subprime and Predatory Lending*] (statement of Harry H. Dinham, President, National Association of Mortgage Brokers) (speculating on the cause of the increase); FISHBEIN & WOODALL, *supra* note 16, at 2, 6, 11; Vikas Bajaj & Julie Creswell, *Home Lenders Hit by Higher Default Rates*, N.Y. TIMES, Feb. 22, 2007, at C1. 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, *Homo Economicus, Homo Myopicus, and the Law and Economics of Consumer Choice: 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).

25. *See Subprime and Predatory Lending*, *supra* note 24, at 72-73 (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation); *id.* at 351 (statement of Allen Fishbein, Director of Housing and Credit Policy, Consumer Federation of America); BRIAN BUCKS & KAREN PENCE, FED. RESERVE BD. OF GOVERNORS, DO HOMEOWNERS KNOW THEIR HOUSE VALUES AND MORTGAGE TERMS? 26 (2006), *available at* http://www.federalreserve.gov/Pubs/feds/2006/200603/200603pap.pdf; MARK WIRANOWSKI, JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., SUSTAINING HOME OWNERSHIP THROUGH EDUCATION AND COUNSELING 6 (2003) (discussing informational rents extracted from naïve homeowners when lenders offer complex products that are not conducive to consumer comprehension), *available at* http://www.jchs.harvard.edu/publications/homeownership/w03-7_wiranowski.pdf.

26. *See Subprime and Predatory Lending*, *supra* note 24, at 76 (statement of Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation); *id.* at 351 (statement of Allen Fishbein, Director of Housing and Credit Policy, Consumer Federation of America); BUCKS & PENCE, *supra* note 25, at 26; 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.

B. Responses to the Unaffordability Problem

Because of the low (and, in many years, negative) U.S. savings rate,[27] the down payment requirement often prevented renters in low-income and urban areas from becoming homeowners.[28] Likewise, because potential homeowners lacked the capital to reduce the principal amount of the mortgage debt by making a sizeable down payment, many found that they could not afford the monthly payments for traditional thirty-year fixed interest rate mortgages. The U.S. government encouraged mortgage originators to help rectify this affordability problem by diversifying their loan products. The lending industry eagerly complied with this request by radically altering the criteria they applied when approving mortgage loans and by creating and extensively marketing a wide array of non-traditional (also called "exotic" or "alternative") products.[29] These exotic loans had several common features.

While conventional mortgage products pre-deregulation typically were for fifteen- or thirty-year periods, to make monthly loan payments more affordable, some of the new mortgage products offered extended maturity mortgage loans for terms up to forty or fifty years.[30] In addition, while lenders historically had required all borrowers (except perhaps very rich ones) to document their income and assets, lenders not only began to gen-

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27. Until the recent financial meltdown, for the last several years the United States has had a negative savings rate: Americans saved less than they spent on goods or services. News Release, Bureau of Econ. Analysis, Personal Income and Outlays (Sept. 2007), http://www.bea.gov/newsreleases/national/pi/2007/pi0907.htm. Ironically, the current economic downturn has now caused U.S. consumers to save more. News Release, Bureau of Econ. Analysis, Personal Income and Outlays (Nov. 2006), http://www.bea.gov/news releases/national/pi/2006/pi1106.htm; *see also* Kelly Evans, *Hard-Hit Families Finally Start Saving, Aggravating Nation's Economic Woes*, WALL. ST. J., Jan. 6, 2009, at A1.

28. *See* Julie Kosterlitz, *Home Sweet Home?*, NAT'L J., Mar. 6, 2004.

29. 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: Predatory Lending Practices and Home Foreclosures: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 110th Cong. 7 (2007) [hereinafter *Preserving the American Dream*] (statement of Douglas G. Duncan, Senior Vice President of Research and Business Development, and Chief Economist, Mortgage Bankers Association), *available at* http://banking.senate.gov/public/_files/duncan.pdf.

30. FITCH RATINGS, 2006 GLOBAL STRUCTURED FINANCE OUTLOOK: ECONOMIC AND SECTOR-BY-SECTOR ANALYSIS (2006); 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, 2006, http://www.bankrate.com/brm/news/ mortgages/20060427a2.asp. Extended maturity mortgage loans have terms for longer than thirty years and produce a product that looks substantially similar to a monthly rental payment. *See id.* (describing the forty-year loan, which results in lower monthly payments).

erally approve loans for borrowers who did not document their income and assets but often would not even ask borrowers to do so. To make it easier to approve loans (and perhaps to make it less likely that either the loan officer or borrower would be forced to falsify documents), lenders approved no documentation or low documentation (commonly referred to as "no doc," "low doc,"" or "liar") loans.[31] In approving these loans, lenders used fairly minimal standards to verify the borrower's income and assets and typically relied on the credit scoring devices that credit card companies used when deciding whether to give a consumer a credit card.[32]

The unaffordability problem that housing price appreciation created, coupled with a negative savings rate, made it difficult for renters in most income groups to amass the funds needed to make a down payment. To alleviate this problem, lenders relaxed (and at times altogether abandoned) the down payment requirement.[33] Moreover, to make it easier for renters without savings to buy homes, lenders offered mortgages with high loan-to-value ("LTV") ratios that would permit borrowers to take out a loan (or loans) equal to the sales price of their home.[34] For example, rather than re-

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31. Peter Henderson et al., *Frenzy of Risky Mortgages Leaves Path of Destruction*, REUTERS, May 8, 2007, http://www.reuters.com/article/reutersEdge/idUSN0329892220070508; *see also Preserving the American Dream*, *supra* note 29, at 4-6 (statement of Jean Constantine-Davis, Senior Attorney, AARP Foundation), *available at* http://banking.senate.gov/public/_files/davis.pdf (describing perils to consumer of "stated income" loans). A different variation 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, e.g.*, No Income Documentation Home Loans, http://www.bestnodocloans.com/content/nina_loan.htm (last visited Mar. 2, 2009). These loans are approved based on the borrower's employment, credit history, the property value, and the down payment (if any). Another variation, a no income no asset, no employment ("NINANE") loan, does not require the borrower to disclose income, assets, *or* employment. *See id.*

32. 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 F1 (describing how low-doc and no-doc loans work). Credit scores are neither designed to predict whether a borrower will face a payment shock and be unable to make payments on an ARM mortgage loan after the interest rate resets, nor are they designed to anticipate whether economic conditions will permit the borrower to refinance the ARM loan to a more affordable product. Therefore, using credit scores to approve liar loans increases the risk that borrowers cannot afford to repay the loans and likely will default.

33. 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, 226–33 (1999) (tracing the history of government intervention in the housing markets to expand home ownership by loosening financial requirements).

34. *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. 4, 6 (2006) [hereinafter *Calculated Risk*] (statement of William A. Simpson, Vice President, Mortgage Insurance

quiring borrowers to make a $20,000 down payment when purchasing a $100,000 home, lenders would let borrowers purchase a home with no money down by taking out a first mortgage (typically for 80% of the value of the home) and then a simultaneous second mortgage (or line of credit) for the balance of the sales price, a loan system commonly referred to as a "piggyback" loan.[35]

Perhaps the most significant differences between pre- and post-deregulation mortgages, however, were the prevalence of the flexible interest rates that the new products offered and the loan features that made it possible for borrowers (including those with poor credit) to have low initial monthly loan payments. Traditional, pre-deregulation, mortgages almost always calculated the borrower's monthly payment based on principal and a fixed rate of interest.[36] In contrast, most of the new non-traditional innovated mortgages typically had adjustable interest rates (known as adjustable rate mortgages, or "ARMs") that started low then adjusted on specific future dates.[37] Once the rate "reset," the low initial monthly payments would increase based on the new, higher "fully-indexed" rate.[38] Because monthly payments could increase dramatically at the reset, there could be catastro-

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Companies of America), *available at* http://banking.senate.gov/public/_files/ACF84D5.pdf; FISHBEIN & WOODALL, *supra* note 16, at 12.

35. Piggyback lending arrangements let borrowers avoid purchasing PMI. Borrowers sometimes put no money down, though many borrowed 80% with a traditional mortgage, 10% as a second loan, and put 10% down. FISHBEIN & WOODALL, *supra* note 16, at 3; Robert B. Avery et al., *Higher-Priced Home Lending and the 2005 HMDA Data*, 92 FED. RES. BULL. A123, A135, A137-38 (2006).

36. *See* Fed. Hous. Admin., Common Questions About an FHA-Insured Loan, http://portal.hud.gov (follow "Consumers" hyperlink; then follow "FHA Consumer Marketplace" hyperlink; then follow "FHA Insured Loans Q&A" hyperlink) (last visited Feb. 10, 2009) (comparing FHA and conventional loans).

37. 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? 3-4 (2006) [hereinafter INTEREST-ONLY MORTGAGE]. Some products, like deferred interest ARMs, included annual caps that let borrowers remain in their homes notwithstanding any temporary payment shock caused when the interest rates reset. If the reset interest rate caused the monthly payments to exceed this cap, the borrower could defer interest payments and the deferred interest would be added to principal balance. *See* Greg McBride, *Home Loan Elements Can Be Risky: Adjustable Rates Can Be Unpredictable for Borrowers*, DETROIT NEWS, Sep. 12, 2004, at 3D.

38. 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 index rate. BD. OF GOVERNORS OF THE FED. RESERVE SYSTEM, CONSUMER HANDBOOK ON ADJUSTABLE-RATE MORTGAGES 8-9 (2006) [hereinafter CONSUMER HANDBOOK ON ARMS], *available at* http://www.federalreserve.gov/pubs/arms/arms_english.htm.

phic consequences if borrowers could not afford the new higher monthly payments and often suffered what is referred to as a "payment shock."[39]

One product in particular is widely believed to be the main reason the U.S. subprime mortgage market started to collapse. This product—a "hybrid ARM"—started as a thirty-year fixed-rate mortgage with a short-term introductory interest rate (a "teaser" rate) then converted to an ARM after two to three years.[40] The interest rate on these "2/28s" and "3/27s" would then periodically reset over the thirty-year term of the loan and the borrower's monthly payment after the first two or three years would be recalculated and would change based on the interest rate in effect when the loan rate reset.[41]

C. Technology

In addition to decreased regulation of consumer credit generally (and mortgage debt specifically), technological advances also made it easier for lenders to dramatically expand the amount of consumer debt (both mortgage and credit card) they were willing to give high-risk borrowers. Mortgage and credit card applications are available and can be approved in a matter of seconds on the internet. No longer are bank officers required to scrutinize a potential borrower's financial information. Instead, when deciding whether to grant a credit application, lenders now rely on credit scores and other modeling devices to evaluate the borrower's credit and determine the probability that a borrower will default. These scoring devices combine individual and statistical risks, and have largely replaced face-to-face meetings between potential borrowers and lenders in most routine consumer credit transactions in the United States and in other nations.[42]

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39. *See* FISHBEIN & WOODALL, *supra* note 16, at 9-12; *see also Subprime and Predatory Lending*, *supra* note 24, at 6 (statement of Shelia C. Bair, Chairman, Federal Deposit Insurance Corporation); Les Christie, *Subprime Bailouts: How They Work*, CNNMONEY, Apr. 24, 2007, http://money.cnn.com/2007/04/24/real_estate/bailout_plans_how_they_work/index.htm. The lending industry also refers to a payment shock as "reset payment sensitivity." *See* CHRISTOPHER L. CAGAN, FIRST AM. REAL ESTATE SOLUTIONS, MORTGAGE PAYMENT RESET: THE RUMOR AND THE REALITY 19 (2006), *available at* http://www.loanperformance.com/infocenter/whitepaper/FARES_resets_whitepaper_021406.pdf.

40. Until recently, hybrid ARMs dominated the ARM market. FISHBEIN & WOODALL, *supra* note 16, at 10; John C. Dugan, Comptroller of the Currency, Remarks at the National Foundation for Credit Counseling Spring Meeting 2 (Apr. 24, 2007), *available at* http://occ.gov/ftp/release/2007-44a.pdf. Many large lenders no longer offer these loans. Vikas Bajaj, *Top Lender Sees Mortgage Woes for 'Good' Risks*, N.Y. TIMES, Jul. 25, 2007, at A1.

41. FISHBEIN & WOODALL, *supra* note 16, at 10. While all ARMs adjust upward, not all of them adjust downward. *See* CONSUMER HANDBOOK ON ARMS, *supra* note 38, at 6-7.

42. *See* RONALD MANN, CHARGING AHEAD: THE GROWTH AND REGULATION OF PAYMENT CARD MARKETS 113-14 (2006) (noting that credit bureaus allowed lenders to deter-

Not surprisingly, because credit can now be quickly and efficiently approved, creditors have extended considerably more credit than they did twenty years ago.[43]

The demand for credit, especially credit cards, has also been fueled by advances in technology. Because of the omnipresence of the internet and the explosion in online shopping opportunities, most consumers need to have a credit card in order to shop on the internet. Though one can, of course, debate whether anyone *needs* to shop on the internet, once the decision is made to shop online it is virtually impossible to do so without a credit card.[44]

D. U.S. Labor Markets

U.S. consumer debt levels also appear to have increased because of dramatic changes in U.S. labor markets over the last two decades. Permanent unemployment rates in the United States have remained at approximately 5% for the last several years. While they have started increasing during the current credit crisis, rates have not increased significantly over the last two decades.[45] Even while permanent unemployment rates have remained fairly low, however, U.S. workers are at an increased risk of having spells of temporary unemployment either because of global outsourcing of jobs from the United States, or because corporate restructurings have resulted in workers either being terminated or laid off for short periods of time.[46] For

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mine the potential performance of future borrowers, resulting in this technique being widely used along with computer technology advancement in the 1990s).

43. Emilio Fernandez-Corugedo & John Muellbauer, *Consumer Credit Conditions in the United Kingdom* 5 (Bank of Eng., Working Paper No. 314, 2006); Oliver J. Haas, *Overindebtedness in Germany* 2 (Int'l Labour Office Geneva, Working Paper No. 44, 2006); *see also* MANN, *supra* note 42, at 113-14 (noting that increased accuracy of risk assessment allowed lenders to increase amounts lent to consumers, indicating a positive relationship between credit bureau data and increased consumer lending).

44. Some companies like Paypal do let buyers make purchases by deducting the cost of the item from their banking accounts. Paypal, http://www.paypal.com/aboutus.cfm (last visited Mar. 25, 2009).

45. BUREAU OF LABOR STATISTICS, U.S. DEP'T OF LABOR, LABOR FORCE STATISTICS FROM THE CURRENT POPULATION SURVEY, *available at* http://www.bls.gov/cps/cpsatabs.htm (last visited Mar. 21, 2009) (follow hyperlink to Table A-10: Employed and Unemployed Persons by Occupation, Not Seasonally Adjusted, and calculate data from 1988 to 2008).

46. *See* TERESA A. SULLIVAN ET AL., THE FRAGILE MIDDLE CLASS 84-85 (2000); Press Release, Bureau of Labor Statistics, Extended Mass Layoffs Associated with Domestic and Overseas Relocations, First Quarter 2004 (June 10, 2004), *available at* http://stats.bls.gov/news.release/pdf/reloc.pdf; N. Gregory Mankiw & Phillip Swagel, *The Politics and Economics of Offshore Outsourcing* 6 (Nat'l Bureau of Econ. Research, Working Paper No. 12398, 1981), *available at* http://www.economics.harvard.edu/pub/hier/2006/HIER2120.pdf.

many workers, a temporary layoff can be just as catastrophic as a job termination because they have no savings and, thus, no nest-egg to rely on to pay their expenses until they get a new job (or get their old job back).

In addition to the increased risk of temporary unemployment, income has not kept pace with inflation, except for those in the highest earning brackets.[47] When combined with a lack of savings, stagnant wages have caused U.S. workers to rely on consumer credit to help them pay their monthly expenses.[48] With flat earnings and no savings, temporarily unemployed workers came to view consumer credit, and especially credit cards, as a substitute for savings.[49]

Finally, even fully employed workers in the United States may find it hard to pay their expenses if they have catastrophic medical expenses. That is, even if the person works and has health insurance, he will likely be required to pay a large percentage of his health costs either in the form of co-payments or because of health insurance lifetime caps. Thus, the combination of stagnant and declining real wages in the United States and virtually no savings causes many consumers to use credit to pay for medical expenses even if they have health insurance.[50]

E. Changed Norms

1. Thrift

While there still seems to be a stigma associated with being insolvent,[51] there no longer seems to be *any* stigma associated with going deeply into debt.[52] Credit is seductive, and for some consumers it almost seems to be addictive.[53] Delayed gratification is simply no longer the norm in the

47. Greg Ip, *Not Your Father's Pay: Why Wages Today Are Weaker*, WALL ST. J., May 25, 2007, at A2.

48. *See* TERESA A. SULLIVAN ET AL., *supra* note 46, at 114.

49. *Id.*

50. *Id.* at 146; *Health Insurance Caps Leave Patients Stranded*, MSNBC, Jul. 13, 2009, http://www.msnbc.msn.com/id/25644309/.

51. 151 CONG. REC. S2421 (daily ed. Mar. 10, 2005) (statement of Sen. Durbin) ("People I have known who have gone through bankruptcy are not proudly announcing to their friends: Well, I had a great day in bankruptcy court. These are people who are a little embarrassed, a little ashamed of what they had to go through."); Rafael Efrat, *Bankruptcy Stigma: Plausible Causes for Shifting Norms*, 22 EMORY BANKR. DEV. J. 481, 485-87 & nn.21-27 (2006); Teresa A. Sullivan et al., *Less Stigma or More Financial Distress*, 59 STAN. L. REV. 213, 218 (2006).

52. STUART VYSE, GOING BROKE: WHY AMERICANS CAN'T HOLD ON TO THEIR MONEY 61-89 (2008); David Brooks, *The Culture of Debt*, N.Y. TIMES, Jul. 22, 2008, at A19.

53. *See* Jennifer Levitz, *Hi, My Name Is Fred, and I'm Addicted to Credit*, WALL ST. J., June 10, 2008, at 1; Steven Mufson, *End of Cheap Credit Hits Homes, Businesses*, WASH.

United States, and people no longer seem to think there is a moral or ethical duty to exercise the restraint to actually wait until one can afford to pay for non-essential goods and services with cash before purchasing those items.[54] Consumers today want the immediate gratification associated with having goods and services, and with having those things *now*.[55] Indeed, many now argue that the United States no longer has a culture of thrift and, instead, has a culture of debt fueled in large part by these changed norms.[56]

2. *The Myth of Homeownership*

Even when it became clear that irresponsible lending practices would force the government to intervene in the financial markets, many in the lending community and many governmental officials blamed consumers for buying homes they could not afford and argued that borrowers should not be pitied or rescued because to do so would create a moral hazard problem.[57] When lenders made it easier for potential homebuyers to increase their mortgage debt, borrowers (both homeowners and real estate speculators) voraciously consumed mortgage debt to ensure that they could take advantage of the supra-normal housing price appreciation.[58] Renters were desperate to become homeowners principally because they believed in the hype associated with the "American Dream of Homeownership."

The belief that homeownership is a good thing financially and psychologically caused many renters to do whatever it took to enter into the vaulted state of homeownership. For example, it is undisputed that many consumers borrowed recklessly in order to live in a "McMansion."[59] As

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POST, Mar. 18, 2008, at D1 (discussing Bankaholic.com, a website that lets consumers "shop" for credit cards and mortgages).

54. VYSE, *supra* note 52.

55. *Id.* at 75.

56. *See* Brooks, *supra* note 52.

57. Patrice Hill, *Blame Abounds for Housing Bust*, WASH. TIMES, Dec. 26, 2007, at A1; Editorial, *The American Dream in Reverse*, N.Y. TIMES, Oct. 8, 2007.

58. JOINT CTR. FOR HOUS. STUDIES OF HARVARD UNIV., THE STATE OF THE NATION'S HOUSING 5 (2007), *available at* http://www.jchs.harvard.edu/publications/markets/son2007/son2007.pdf.

59. *See* Larry Rohter & Edmund L. Andrews, *McCain Rejects Broad U.S. Aid on Mortgages*, N.Y. TIMES, Mar. 26, 2008, at A1 (quoting Republican Presidential nominee John McCain "[s]ome Americans bought homes they couldn't afford, betting that rising prices would make it easier to refinance later at more affordable rates"); *see also* Jessica Holzer, *Major Bailout Is Unlikely on Sub-prime Mortgages*, HILL, Sept. 4, 2007, http://thehill.com/business--lobby/major-bailout-is-unlikely-on-sub-prime-mortgages-2007-09-04.html (reporting quote of President Bush, "[i]t'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"); Irwin M. Stelzer, *Why They Call It the Dismal Science*, WKLY. STANDARD, Nov. 26, 2007, at 1.

noted earlier, some borrowers inflated their incomes on liar loans or attempted to use the credit of more creditworthy borrowers [60]

Even if it was utterly unrealistic for borrowers to think that their houses would never stop appreciating, homebuyers routinely discounted the risks associated with buying a home.[61] For example, some borrowers were naïve (and perhaps greedy) in assuming that they could always expect their homes to increase in value. Though this, obviously, is an unrealistic perspective, homebuyers' behavior during the most recent housing boom was entirely consistent with buyer behavior during any boom market. That is, once home prices start to rise, the market builds in the expectation that the increase is the norm and this expectation, in turn, increases borrower demand for houses which, in turn, stimulates the demand for those homes and further causes the price of the houses to increase.[62] As has been the case during other housing booms, some borrowers made irrational decisions in order to reap the potentially enormous profits in the housing price appreciation game.[63] While borrowers may not have understood the true risks associated with home ownership, the more sophisticated players (like economists, home builders, and lenders) were, of course, fully aware of the effect house appreciation has on borrower behavior. [64]

Whether greed, naiveté, or some other human factor caused borrowers to purchase homes they could not afford using mortgage products they often could not understand, once deregulation made it possible for consumers to borrow, borrow they did. For the last decade, this country's views about the norm of homeownership caused people to routinely buy homes using mortgage products they knew they would not be able to afford once the interest rates increased. Some borrowers knew they did not have the savings necessary to make mortgage payments once interest rates increased, but nonetheless signed the loan documents. These borrowers gambled that the supra-normal trend in house price appreciation would continue and that interest rates would remain low. They gambled that they would be able to refinance the loans when the monthly payments increased, or that they

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60. *See supra* notes 22-23 and accompanying text.

61. Case & Shiller, *supra* note 21, at 35-37.

62. *Id.* at 9-13; KARL E. CASE ET AL., HOME-BUYERS, HOUSING AND THE MACROECONOMY (2003), *available at* http://urbanpolicy.berkeley.edu/pdf/CQSAustralia0804PB.pdf.

63. Robert J. Shiller, *A Psychology Lesson from the Markets*, N.Y. TIMES, Aug. 26, 2007, at C6. *See generally* Case & Shiller, *supra* note 21, at 8-13 (discussing investment motives for homebuyers who intended to occupy their houses).

64. Mishkin, *supra* note 18.

would be able to sell their homes and make a profit.[65] Sadly, the current foreclosure rates (which are the highest they have been in three decades) and the depth of the financial crisis are the result of this gamble.[66]

II. CONSUMER DEBT AND THE FINANCIAL CRISIS

A. Overall Debt Levels

The United States has the highest consumer debt levels per capita of any nation, and consumer debt has grown exponentially since 1976. Home and automobile loans, credit card debt, and consumer credit have all increased dramatically in the last few years.[67] For example, in 1977, total U.S. household debt outstanding was $946.7 billion; over $600 billion of that was home mortgage debt. By 2007, that $946.7 billion grew to $13.825 trillion (an increase of over one trillion from 2006)[68] and consumers had $957 billion in credit card and revolving debt *just in March 2008*.[69] Similarly, by 2007, home mortgage debt had increased from $600 billion to a staggering level of $10.508 trillion, and other consumer debt in 2007 was $2.550 trillion.[70] Another indication of the shockingly high levels of consumer debt can be found by comparing household debt to income and the U.S. gross domestic product ("GDP").[71] That is, in 2007, U.S. household

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65. FISHBEIN & WOODALL, *supra* note 16, at 2, 11. *See generally Subprime and Predatory Lending*, *supra* note 24, at 7 (statement of Sheila C. Bair, Chairman, Fed. Deposit Insurance Corporation); Christie, *supra* note 39.

66. Timothy R. Homan, *U.S. Pending Home Resales Rise 7.4% as Prices Drop* BLOOMBERG, Oct. 8, 2008, http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aM0QF6wHRPoI.

67. As discussed in more detail below, lenders issued mortgage loans using relaxed criteria that let borrowers purchase homes without documenting their income, without putting money down, and in some instances without paying the full cost of their monthly payments for the first few years of the loan term. Similarly, automobile lenders started to extend credit to consumers with subprime credit and in some instances let consumers pay for the cars over longer periods. David Cho & Nancy Trejos, *From Foreclosure Signs to Auto Repo Lots*, WASH. POST, Feb. 18, 2008, at A1; Robin Sidel, *Smaller Banks Begin to Pay Price for their Boomtime Expansion*, WALL ST. J., Apr. 21, 2008, at A1.

68. Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Statistical Release: Consumer Credit—G.19 (Mar. 7, 2008) [hereinafter G19 Press Release], *available at* http://federalreserve.gov/releases/g19/20080307/g19.pdf.

69. Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Statistical Release: Consumer Credit—G.19 (July 8, 2008), *available at* http://federalreserve.gov/releases/g19/20080708/g19.pdf.

70. G19 Press Release, *supra* note 68.

71. Gross domestic product is "the output of goods and services produced by labor or property located in the United States." News Release, Bureau of Econ. Analysis, Gross Domestic Products: Fourth Quarter 2008 (Advance) (Jan. 30, 2009), *available at* http://www.bea.gov/newsreleases/national/gdp/2009/pdf/gdp408a.pdf.

debt grew at a faster pace than income (or overall economic activity), and the level of total household debt ($13.825 trillion) in 2007 was virtually identical to GDP ($13.843 trillion).[72]

For the last several years, consumer spending in the United States has accounted for almost 70% of all U.S. economic activity.[73] Similarly, housing expenditures have helped buoy U.S. economic growth for the last decade and, at times, contributed to 40% of total economic growth.[74] The U.S. economy is now in a recession largely because of the role that consumer debt plays in this country and the vast amount of credit that has been extended to consumers over the last thirty years.[75] The country's current economic crisis was caused principally by staggering mortgage debt levels and borrowers' inability to repay their mortgage loans. While the problems started with subprime mortgages, the financial crisis spread to the entire housing sector and is now having devastating effects on the entire U.S. economy as well as global markets.[76]

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72. G19 Press Release, *supra* note 68.

73. FANNIE MAE, THE GROWING DEMAND FOR HOUSING: 2002 FANNIE MAE NATIONAL HOUSING SURVEY (2002), http://www.fanniemae.com/global/pdf/media/survey/survey 2002.pdf; Peter S. Goodman, *Homeowners Feel the Pinch of Lost Equity*, N.Y. TIMES, Nov. 8, 2007, at A1; Jack Healy, *As the Recession Worsens, Consumers Save More and Spend Less*, N.Y. TIMES, Feb. 3, 2009, at B3. Because higher home prices increase household wealth, housing price appreciation stimulates consumer spending. *See* David Leonhardt, *Debt and Spending May Slow as Housing Falters, Fed Suggests*, N.Y. TIMES, Aug. 20, 2007, at C3; Mishkin, *supra* note 18.

74. FANNIE MAE, *supra* note 73, at 2; Morgenson, *supra* note 30; *see also* Liz Wolgemuth, *The Credit Crunch Squeezes Municipal Bonds*, U.S. NEWS & WORLD REP., Feb. 28, 2008, *available at* http://www.usnews.com/articles/business/economy/2008/02/28/the-credit-crunch-squeezes-municipal-bonds.html.

75. *See* Brooks, *supra* note 52.

76. The liquidity crisis that originally began in the subprime mortgage market has (as of October 2008) forced the U.S. government to take over Fannie Mae and Freddie Mac and place them in a conservatorship; David M. Herszenhorn, *Administration Is Seeking $700 Billion for Wall Street in Possible Record Bailout*, N.Y. TIMES, Sept. 21, 2008, at A1; to purchase an 80% interest in the country's largest insurance conglomerate (American International Group), Gretchen Morgenson, *Your Money at Work, Fixing Others' Mistakes*, N.Y. TIMES, Sept. 21, 2008, at B1; to devote up to $700 billion in taxpayer dollars to purchase bad mortgage-backed securities from U.S. banks, Mark Landler & Edmund L. Andrews, *Bailout Plan Wins Approval; Democrats Vow Tighter Rules*, N.Y. TIMES, Oct. 4, 2008, at A1; and has forced the liquidation of a number of mortgage lenders and hedge funds that invested in those lenders. Vikas Bajaj & Julie Creswell, *A Lender Failed. Did Its Auditor?*, N.Y. TIMES, Apr. 13, 2008, at B1; Zachary A. Goldfarb & Alec Klein, *The Bubble; How Homeowners' Missed Mortgage Payments Set off Widespread Problems and Woke up the Fed.*, WASH. POST, June 16, 2008, at A1. The U.S. financial crisis has also caused a run on or contributed to the insolvency of banks in Great Britain and France, caused the largest bank in France to freeze funds, and generally continues to wreak havoc on 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,*

B. The Housing Crisis

Homeowners are losing their homes in record numbers. Mortgage loan defaults and foreclosure rates in the United States have hit record levels. Foreclosures in the United States increased by 81% over 2007 rates, increased by 225% from 2006 rates, and, for much of 2008, almost one in ten mortgages were either past due or in foreclosure.[77] The delinquency rates on non-traditional loans with adjustable interest rates have been especially high: the default rates increased by 141% in 2006 over 2005 rates.[78] Foreclosure filings on subprime mortgages have steadily increased for the last five years.[79] Subprime loan foreclosures now account for over 60% of total foreclosure filings even though they accounted for less than 25% of loan originations, and until recently subprime mortgages were only 13% of all outstanding mortgages.[80] Foreclosure rates on subprime ARMs are especially high[81] and reports indicate that more than 40% of the most recent foreclosures were ARMs made to subprime borrowers.[82] Industry experts project that the higher mortgage default and foreclosure rates will continue well into 2009.[83]

Weathering Credit Storm from U.S., N.Y. TIMES, Nov. 24, 2007, at C1; Joe Nocera, *36 Hours of Alarm and Action as Crisis Spiraled*, N.Y. TIMES, Oct. 2, 2008, at A1; Adam Shell, *Subprime Troubles Send Stocks into Swoon*, U.S.A. TODAY, Mar. 14, 2007, at 1B.

77. Vikas Bajaj & Michael M. Grynbaum, *About 1 in 11 Mortgageholders Face Loan Problems*, N.Y. TIMES, June 6, 2008, at C1; Realty Trac, Foreclosure Activity Increases 81 Percent in 2008, http://www.realtytrac.com/foreclosure/foreclosure-rates.html (last visited Mar. 13, 2009).

78. *Calculated Risk*, *supra* note 34, at 11 (statement of Allen J. Fishbein, Director of Housing and Credit Policy, Consumer Federation of America), *available at* http://banking.senate.gov/public/_files/ACF84D1.pdf.

79. Dan Levy, *Foreclosures Doubled in September as Loan Rates Rise*, BLOOMBERG, Oct. 11, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=apDsvvy6RO7M&refer=home; Credit & Collections World, Nationwide Foreclosures Jumped 75% in 2007, Oct. 11, 2007, http://www.creditcollectionsworld.com/article.html?id=20080129S4FTCWQT.

80. *Subprime and Predatory Lending*, *supra* note 24, at 5 (statement of Michael D. Calhoun, President, Center for Responsible Lending).

81. 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. *See* Press Release, Ctr. for Responsible Lending, National Civil Rights Groups Call for Immediate Moratorium on Foreclosures Resulting From Risky Subprime Loans (Apr. 4, 2007), *available at* http://www.responsiblelending.org/press/releases/page.jsp?itemID=32110619.

82. Levy, *supra* note 79.

83. *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. 2 (2007) [hereinafter *Straightening Out*] (statement of Mark Zandi, Chief Economist, Moody's Economy.com); CTR. FOR RESPONSIBLE LENDING, UPDATED PROJECTIONS OF SUB-

1. Harm to Cash-Strapped Borrowers

When borrowers started to default and the number of foreclosed houses started to rise, the value of their homes either became stagnant or dropped. Lenders would not extend these borrowers additional credit, even if they were high-income borrowers. Because of this, homeowners could not tap into their home equity or refinance their homes to reduce their monthly payments to attempt to avoid a potential foreclosure.[84]

Of course, some borrowers were destined to default since they could never afford the monthly loan payments. But, some borrowers appear to have accepted exotic loans without understanding that other less expensive lending options might be available, and some mortgage brokers steered borrowers with good credit into higher-cost subprime mortgages.[85] Borrowers without college degrees, lower income borrowers, and black and Hispanic borrowers seemed especially likely to accept loan products they did not understand and could not afford.[86] Unsophisticated borrowers also did not seem to be aware of the additional costs associated with homeownership, like setting aside money for routine maintenance,[87] or did not realize that their loans did not escrow for taxes or property insurance.[88]

PRIME FORECLOSURES IN THE UNITED STATES AND THEIR IMPACT ON HOME VALUES AND COMMUNITIES (2008), http://www.responsiblelending.org/pdfs/updated-foreclosure-and-spillover-brief-8-18.pdf; Levy, *supra* note 79.

84. *Calculated Risk*, *supra* note 34, at 12-13 (statement of Allen J. Fishbein, Director of Housing and Credit Policy, Consumer Federation of America). Some reports suggest that housing prices have not dropped this steeply since the Great Depression. *See* Bob Ivry & Brian Louis, *U.S. Home Construction Bust May Last Until 2011*, BLOOMBERG, May 29, 2007, http://www.bloomberg.com/apps/news?pid=20601087&sid=aKQoeHb1MraI; Levy, *supra* note 79. 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.

85. *See Subprime and Predatory Lending*, *supra* note 24 (statement of Shelia C. Bair, Chairman, Fed. Deposit Insurance Corporation); *id.* at 6 (statement of Allen Fishbein, Director of Housing and Credit Policy, Consumer Federation of America); BUCKS & PENCE, *supra* note 25.

86. BUCKS & PENCE, *supra* note 25, at 22; Patricia A. McCoy, *Elder Law: A Behavioral Analysis of Predatory Lending*, 38 AKRON. L. REV. 725, 735 (2005) (explaining how predatory lenders prey on borrowers' inexperience and lack of education).

87. John W. Schoen, *Mortgage Woes Could Be* '*Tip of the Iceberg*', MSNBC, Apr. 10, 2007, http://www.msnbc.msn.com/id/17929461/.

88. *See The Role of the Secondary Market*, *supra* note 23, at 17 (statement of Larry B. Litton, Jr., President, CEO, Litton Loan Servicing LP) (recommending that subprime borrowers establish an escrow account to pay taxes and insurance); Susan Schmidt Bies, Member, Bd. of Governors of the Fed. Reserve Sys., Remarks at the National Credit Union Administration 2007 Risk Mitigation Summit (Jan. 11, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/bies20070111a.htm (suggesting the prudence of escrowing tax and insurance payments or informing borrowers how much they should set aside for those payments).

2. *Other Homeowners*

Since mid-2007, homeowners who did not have risky mortgages and who were not in default on those mortgages have bemoaned the fact that their homes have plummeted in value because of foreclosed and vacant homes in their neighborhoods. Studies consistently show that an increase in foreclosures almost always will impose costs on neighboring properties by decreasing the value of homes that are near the foreclosed property.[89] Because appraisers determine the value of homes by considering comparable sales, foreclosed properties can reduce the value of all homes in the neighboring area if they are used as comparables. Thus, owners of neighboring properties who have acted responsibly and borrowed wisely may still be harmed when they try to sell their properties or refinance higher rate loans because of the stigma, economic effects, and the appearance of foreclosed properties near their homes.[90]

One of the main differences between this recession and the last recession is the inability of homeowners to borrow against their homes to help them pay their expenses during the recession.[91] Once it became harder for potential home buyers to refinance loans or to borrow money to buy new homes, the pool of available homebuyers shrank. With fewer buyers, the demand dropped, which increased the supply of homes on the market, which then caused the price of *all* homes to drop.[92] For example, single-

89. Editorial, *Losing Homes and Neighborhoods*, N.Y. TIMES, Apr. 10, 2007, at A20; Les Christie, *The Ugly Face of Foreclosure*, CNNMONEY, May 7, 2007, http://money.cnn.com/2007/05/02/real_estate/face_of_foreclosure/index.htm.

90. Ian Urbina, *Foreclosures Prompt Cities to Make Plea for Aid*, N.Y. TIMES, Jan. 24, 2008, at A15; *see also Calculated Risk*, *supra* note 34, at 10 (statement of William A. Simpson, Vice President, Mortgage Insurance Companies of America); Stelzer, *supra* note 59 (discussing externalities caused by mortgage crisis and the presence of homes with uncut grass); CTR. FOR RESPONSIBLE LENDING, *supra* note 83; Les Christie, *Home Prices in Record 9% Decline*, CNNMONEY, Nov. 18, 2008, http://money.cnn.com/2008/11/18/real_estate/home_prices_third_quarter/index.htm.

91. After borrowers started to default on their homes loans and were unable to borrow money or obtain additional credit, they started to default on other loans. For example, the automobile loan delinquency rate dramatically increased as a result of the mortgage meltdown, especially for borrowers who had subprime credit. David Cho & Nancy Trejos, *From Foreclosure Signs to Auto Repo Lots*, WASH. POST, Feb. 18, 2008, at A1; Jeffrey McCracken & Gregory Zuckerman, *Surge in Auto-Loan Delinquencies Is Latest Trouble for the Economy*, WALL. ST. J., Dec. 6, 2007, at A1.

92. Tara Siegel Bernard, *Tighter Mortgage Standards Could Prolong Housing Slump*, CNBC, May 15, 2007, http://www.cnbc.com/id/18663869/. Lenders appear to have become especially wary of no doc and piggyback loans. *See* Bob Tedeschi, *Ripples From the Subprime Storm*, N.Y. TIMES, Mar. 25, 2007, at 11-13, *available at* http://www.nytimes.com/2007/03/25/realestate/25MORT.html?scp=1&sq=Ripples%20From%20the%20Subprime%20Storm&st=cse.

family housing prices have dropped approximately 8% since 2007 and are at their lowest level since 1982.[93]

3. *Other Negative Externalities*

As noted earlier, this financial crisis has had a catastrophic effect on the entire financial community—especially the financial industry and other entities involved with mortgage securitization. Specifically, the liquidity restriction that led to the collapse of Bear Stearns and Lehman Brothers, two of the largest investment banks in the world, caused the U.S. government to take over Fannie Mae and Freddie Mac and place them in a conservatorship, to purchase an 80% interest in American International Group (the country's largest insurance conglomerate) to agree to insure the holdings of some money market mutual funds, to spend hundreds of billions of taxpayer dollars to purchase debt from (and stocks of) U.S. banks, and has forced the liquidation of a number of mortgage lenders and hedge funds that invested in those lenders.[94]

In addition to the investment banks that collapsed (Morgan Stanley and Goldman Sachs) two other giant firms ceased to function as investment banks and instead became bank holding companies.[95] Smaller, regional banks that expanded their operations in distant markets or offered new, risky products also have suffered losses and have had lower than expected earnings because of the liquidity crisis and increased defaults on consumer loans.[96] In addition, executives of large financial institutions, including Citigroup, Merrill Lynch (which recently was sold because of its financial problems), and Wachovia (the fourth largest bank in the United States which was sold to Wells Fargo at the end of 2008[97]), have been fired be-

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93. Kenneth Musante, *Foreclosure Filings Hit Record in April*, CNNMONEY, May 14, 2008, http://money.cnn.com/2008/05/14/real_estate/foreclosure_rates/index.htm?postversion=2008051408. Japan experienced a similar housing crisis in the 1990s, when prices escalated drastically in the 1980s, then collapsed in the 1990s. Alex Tabarrok, *Home Sweet Investment,* N.Y. TIMES, Mar. 18, 2008, at A23; Christie, *supra* note 90.

94. Edmund L. Andrews, *Vast Bailout by U.S. Proposed in Bid to Stem Financial Crisis,* N.Y. TIMES, Sept. 19, 2008, at A1; Julia Werdigier, *Official Assurances Fail to Stem Rush of Withdrawals at British Bank*, N.Y. TIMES, Sept. 18, 2007, at C3.

95. Ron Chernow, *The Lost Tycoons*, N.Y. TIMES, Sept. 28, 2008, at WK12.

96. Geraldine Fabrikant, *Tempest for a Bank That Bet on Risky Loans*, N.Y. TIMES, Aug. 7, 2008, at C1; Robin Sidel, *Smaller Banks Begin to Pay Price for Their Boomtime Expansion,* WALL ST. J., Apr. 21, 2008, at A1; David Ellis, *Wachovia CEO out at Board's Request*, CNNMONEY, June 2, 2008, http://money.cnn.com/2008/06/02/news/companies/wachovia_thompson/index.htm.

97. Michael J. de la Merced, *Regulators Approve Wells Fargo Takeover of Wachovia*, N.Y. TIMES, Oct. 9, 2008, at B1.

cause of decisions they made concerning mortgage products.[98] Finally, our domestic credit crisis extended to Europe, forcing governments there to seize banks, bail out lenders, and guarantee all national bank deposits.[99]

4. Other Non-Homeowner Borrowers

The mortgage crisis has had unintended consequences for people who are not attempting to buy a house and who have not invested in or otherwise been involved with the buying or selling of mortgage products. Because of the credit restriction, college students are finding it harder to finance their educations because the economic crisis has made it harder for families to pay for college.[100] Students who attend community colleges, for-profit technical schools, or colleges who have opted out of the federal student loan program are finding it especially difficult to pay for college.[101] Student loan lenders often raise money to make new loans by selling old loans to companies that then bundled them into securitized financial instruments.

Similarly, because the mortgage crisis has now created an overall credit crunch, many student loan lenders withdrew or retreated from the student loan market when the number of investors willing to purchase the securitized financial instruments declined or severely tightened their lending standards.[102] Because of the student loan crisis, the U.S. government has also been forced to intervene in the student loan industry to ensure that college students will be able to finance their educations.[103]

Finally, the credit squeeze has also made it difficult for colleges to raise money by issuing bonds or by increasing tuition, or by raising money from donors. As a result of the credit freeze, declining state support, and losses on endowment earnings, colleges have been forced to halt construction pro-

98. Stelzer, *supra* note 59 (discussing the dismissal of Merrill Lynch's Stanley O'Neal and Citigroup's Charles Prince); Jenny Anderson & Vikas Bajaj, *Wary of Risk, Bankers Sold Shaky Mortgage Debt*, N.Y. TIMES, Dec. 6, 2007, at A1; Ellis, *supra* note 96.

99. Joe Nocera, *A Day (Gasp) Like Any Other*, N.Y. TIMES, Oct. 7, 2008, at A1.

100. Jonathan D. Glater, *Government Seeks to Buy Student Loans,* N.Y. TIMES, Apr. 23, 2008, at A11.

101. *An Alternative to Armageddon*, N.Y. TIMES, Sept. 30, 2008, at C2; Jonathan D. Glater, *Student Loans Start to Bypass 2-Year Colleges*, N.Y. TIMES, June 2, 2008, at A1.

102. Robert Tomsho, *Credit Crisis May Limit Options for Student Loans*, WALL. ST. J., June 3, 2008, at D2. Included in this group are large lenders, such as Bank of America and Citigroup. Robert Tomsho, *Students Face Hit as Private Lending Dries Up*, WALL. ST. J., Aug. 11, 2008, at A1.

103. Karla Schuster, *Schumer to Feds: Help Students*, NEWSDAY, Oct. 7, 2008, at A41.

jects, impose hiring freezes, and, in some instances, have made it difficult for colleges to pay their employees.[104]

5. Urban Areas

For a number of reasons, the housing crisis has severely harmed urban areas. Rising mortgage foreclosures have had a devastating effect on U.S. cities because of the lower revenues they have received due to properties which are now less valuable. Vallejo, a suburb of San Francisco, California, recently filed for bankruptcy protection because plunging home values coupled with a sharp decline in property taxes and retail sales rendered it unable to cover its expenses.[105] Other cities have been forced to radically reduce municipal services (like operating swimming pools or providing free snow plowing services for older citizens) or to significantly increase the municipal taxes and fees to compensate for lower than projected revenues.[106]

The seizing up of the credit markets has made investors leery of investing in the stock market or any security other than U.S. Treasury securities.[107] This has made it increasingly difficult for localities to finance their operations by issuing tax-exempt municipal bonds.[108] Unlike the huge capital infusion into the private financial markets, the Internal Revenue Code generally prevents the federal government from guaranteeing tax-exempt bonds.[109]

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104. Kelly Field, *Bank Freeze Leaves Hundreds of Colleges Cut off from Short-Term Funds*, CHRON. HIGHER EDUC., Oct. 10, 2008, at A20; Karin Fischer, *Public Universities Keep a Wary Eye on the Bond Market*, CHRON. HIGHER EDUC., Oct. 9, 2008, at A1; Robin Wilson, *As Credit Crisis Freezes Colleges, Worries Mount*, CHRON. HIGHER EDUC., Oct. 10, 2008, at A1.

105. Adam Tanner, *San Francisco Suburb Vallejo Files for Bankruptcy*, REUTERS, May 23, 2008, http://www.reuters.com/article/bondsNews/idUSN2352179020080523.

106. Nelson D. Schwartz, *Can the Mortgage Crisis Swallow a Town?*, N.Y. TIMES, Sept. 2, 2007, at C1.

107. David Goldman, *Credit 2008: Year of the Freeze*, CNNMONEY, http://money.cnn.com/2008/12/31/markets/bondcenter/credit_market/index.htm. The credit market endured a disastrous year in which the pipes of lending practically froze solid. But trillions of dollars of bailouts is sending credit on the road to recovery. *Id.*

108. *See* 26 U.S.C. § 149(b) (2006); NAT'L ASS'N OF BOND LAWYERS, OPTIONS FOR COORDINATING TAX-EXEMPT FINANCING WITH STIMULUS AND ECONOMIC RECOVERY LEGISLATION (2009), *available at* http://www.nabl.org/AM/Template.cfm?Section=NABL_Comment_Letters_Position_Statements1&TEMPLATE=/CM/ContentDisplay.cfm&CONTENTID=9109.

109. *See* NAT'L ASS'N OF BOND LAWYERS, *supra* note 108.

This financial crisis threatens to create the type of urban blight that cities have struggled to eradicate and avoid over the last twenty years.[110] Cities, especially in urban areas, are now facing increased expenses because they are often forced to repair vacant homes to eliminate problems (like roofs and peeling paint) that are visible from the street. Studies suggest that foreclosure rates increase a neighborhood's rates for violent crime and, as a result of the mortgage crisis, cities have been forced to increase police protection in neighborhoods populated by vacant homes.[111] The mortgage crisis also is placing additional burdens on police departments because of the increase in suspected arsons committed by homeowners who cannot afford their mortgage payments and who are suspected of burning them rather than losing them in foreclosure.[112]

Abandoned houses are natural targets for vandals and vagrants and, for the last two years, neighbors and others have reported that criminals have stripped foreclosed homes vacant of valuable items like copper and steel and have used the homes for illegal activities, such as harvesting marijuana.[113] Cities are also seeing shifts in the homeless population as renters are joining the ranks of the homeless because they have been evicted from homes they rented after the owners defaulted on their mortgages and the homes were sold in foreclosure.[114] Increased levels of homelessness have put strains on shelters and also on public school systems, which are now faced with the task of educating more transient children.[115] Ironically, the mortgage crisis has had one small benefit for people who were already

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110. Ian Urbina, *Foreclosures Prompt Cities to Make Plea for Aid*, N. Y. TIMES, Jan. 24, 2008, at A15 (discussing costs to board up properties, cut grass, demolish abandoned structures, collect trash, and protect from vandals). The costs imposed on cities also may include the inability to borrow cheaply because of the decreased value of the collateral for those 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.

111. J.W. Elphinstone, *Squalor, Crime Follow Wave of Foreclosures*, MSNBC, Nov. 13, 2007, http://www.msnbc.msn.com/id/21773482.

112. Dan Immergluck & Geoff Smith, *The Impact of Single-Family Mortgage Foreclosures on Neighborhood Crime*, 21 HOUSING STUD. 851 (2006), *available at* http://www.chicagofed.org/cedric/files/2005_conf_paper_session1_immergluck.pdf; Stelzer, *supra* note 59 (discussing how homes are stripped of sinks and aluminum siding during the eviction process); Jon Birger, *Will Foreclosures Spark an Arson Boom?*, CNNMONEY, Jan. 10, 2008, http://money.cnn.com/2008/01/09/news/economy/birger_arson.fortune/index.htm.

113. *Preserving the American Dream*, *supra* note 29, at 22-23 (statement of Douglas G. Duncan, Senior Vice President of Research and Business Development, and Chief Economist, Mortgage Bankers Association), *available at* http://banking.senate.gov/public/_files/duncan.pdf; Christie, *supra* note 89; Elphinstone, *supra* note 111.

114. Stephanie Armour, *New Faces Join Ranks of Nation's Homeless*, U.S.A. TODAY, June 26, 2008, at 1B.

115. Schwartz, *supra* note 106.

homeless, as many homeless persons increasingly are squatting in vacant homes. This, though, has placed yet more strains on police departments who are forced to increase their patrols of certain neighborhoods.[116]

C. Responses to Current Debt Levels

The initial response to the mortgage crisis was to ignore it and assume that the mortgage market would correct any inefficiencies.[117] Indeed, the United States appeared to accept the mortgage industry's contention that additional mortgage regulations are harmful and unnecessary, would make it harder for borrowers to get mortgage loans, would impede the basic American "privilege" of homeownership,[118] and would conflict with existing federal laws and policies that encourage and subsidize homeownership.[119] Moreover, borrowers theoretically could protect themselves from harmful credit products by shopping around in the marketplace, then choosing the product that best suits their needs.

For a short period of time, it did appear that the market had corrected problems because many lenders (including the second-largest subprime lender at that time, New Century Financial) stopped making bad loans as soon as borrowers started to default and others went out of business altogether.[120] But, market corrections simply were not enough to prevent the

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116. Thomas J. Sheeran, *Foreclosures Benefit One Group—Homeless*, CHI. SUN TIMES, Feb. 18, 2008, at 22.

117. Martin Crutsinger, *Paulson Says Administration Is Opposed to Government Bailout in Current Housing Crisis*, ASSOCIATED PRESS, Dec. 17, 2007, at 1 (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.").

118. *See Subprime and Predatory Lending*, *supra* note 24, at 8 (statement of Harry H. Dinham, President, 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.").

119. MORTGAGE BANKERS ASS'N, SUITABILITY—DON'T TURN BACK THE CLOCK ON FAIR LENDING AND HOMEOWNERSHIP GAINS 20 (2007), *available at* http://www.mortgagebankers.org/files/News/InternalResource/48134_Suitability-DontTurnBacktheClockonFairLendingandHomeownershipGains.pdf; *see Calculated Risk*, *supra* note 34, at 13 (statement of George Hanzimanolis, President-Elect, National Association of Mortgage Brokers), *available at* http://banking.senate.gov/public/_files/hanzimanolis.pdf ("Unwarranted tightening of underwriting guidelines could hurt the robust housing industry and deny deserving consumers the chance at homeownership."). While most entities involved with the mortgage industry oppose moratoriums of any kind, at least one loan servicing agency agreed that a two-week "delay" would be appropriate. *See The Role of the Secondary Market*, *supra* note 23, at 17 (statement of Larry B. Litton, Jr., President, CEO, Litton Loan Servicing LP).

120. New Century Financial stopped making subprime loans, filed for bankruptcy on April 2, 2007, and is now in the process of selling off assets. *See* Ben Fidler, *New Century*

subprime crisis from rippling through all financial sectors, or from sending the U.S. economy into a recession and wreaking havoc in the global capital markets. Starting with the Bear Stearns bailout, U.S. policy-makers were forced to concede that a market response alone was woefully inadequate.

Market responses have failed, and will not prevent borrowers from making poor or totally irrational credit choices in the future in large part because of the information asymmetry that plagues the consumer credit market.[121] The plethora and complexity of terms that govern credit card transactions and non-traditional mortgage products make it almost inevitable that borrowers will be confused by the products, will be unable to comprehend the loan terms, and that it will be virtually impossible for borrowers to easily determine which loan product best meets their needs.[122] While credit card use is common, individual borrowers typically take out mortgages on an infrequent basis which means that borrowers will always be at an informational disadvantage relative to lenders. Because of the complexity of credit card and mortgage products, "information overload" appears to cause many borrowers to agree to terms and to accept products that have terms they do not understand.[123]

Both state and federal regulators and legislators have attempted to find ways to solve the over-indebtedness problem generally and the mortgage crisis specifically. For example, federal regulators have considered standards used in some state consumer protection laws that require lenders to consider whether mortgage loans, especially subprime loans, are suitable for the borrower's objectives and circumstances, and that such loans would provide a demonstrable benefit to homeowners.[124] In addition, some states

Assets Sale Continues, DEAL, Feb. 14, 2008; Morgenson, *supra* note 22; *see also* Eric Dash, *American Home Mortgage Says It Will Close*, N.Y. TIMES, Aug. 3, 2007, at C1 (discussing companies in the mortgage industry that were closing or facing bankruptcy).

121. *See Subprime and Predatory Lending*, *supra* note 24, at 5 (statement of Shelia C. Bair, Chairman, Federal Deposit Insurance Corporation); *id.* at 6 (statement of Allen Fishbein, Director of Housing and Credit Policy, Consumer Federation of America); BUCKS & PENCE, *supra* note 25, at 3; WIRANOWSKI, *supra* note 25, at 6 (discussing informational rents extracted from naïve consumers by sophisticated lenders).

122. *See* Stephen Gandel et al., *For Sale: Scenes from a Bubble*, MONEY, May 2007, at 114; *see also Preserving the American Dream*, *supra* note 29, at 5 (statement of Hilary Shelton, Director, NAACP Washington Bureau), *available at* http://banking.senate.gov/public/_files/shelton.pdf.

123. 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).

124. *See Possible Responses to Rising Mortgage Foreclosures: Hearing Before the H. Comm. on Financial Services*, 110th Cong. 1 (2007) [hereinafter *Possible Responses*] (statement of John H. Dalton, President, Housing Policy Council of the Financial Services Roundtable), *available at* http://financialservices.house.gov/hearing110/htdalton041707.pdf.

have enacted laws that require lenders to consider the borrower's ability to repay the loan, rather than the foreclosure value of the house, when approving a mortgage loan.[125]

Congress also has considered legislation that would revise the U.S. bankruptcy laws to protect borrowers who owe more to the lender than the home is worth because, for example, the borrowers paid interest only early in the loan term, made no down payment and had not yet built up equity in the home, or removed their equity with a home equity loan. The proposed legislation would let borrowers reduce the amount of the lender's interest in the debtor's principal residence to the market value of the home, and also would let the consumer modify the terms of the loan, including extending maturity dates and reamortizing the loan to potentially create a "balloon" payment in anticipation of a loan refinance when interest rates (hopefully) drop.[126]

The mortgage industry continues to fight bankruptcy reforms, even as they aggressively lobby for bailouts for their industry. Lenders argue that making it easier for borrowers to reduce the amount of their mortgage debt will harm young, first-time homeowners as well as black and Hispanic borrowers by making loans that are already in default sink deeper into default, and by forcing lenders to increase the costs of future loans to account for the possibility that it may be harder for them to seize the collateral (the home) through foreclosure.[127] Lenders argue that the restrictions are not needed because consumers can protect themselves by becoming more financially sophisticated and obtaining the information needed to make sound borrowing decisions.[128] Finally, lenders argue that preventing them

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125. *The Mortgage Lending Market: An Insiders' Guide to Legislation and Litigation*, 124 BANKING L.J. 867, 880-81 (2007); *see also* COLO. REV. STAT. § 38-40-105 (2007) (an unconscionable practice is "providing residential mortgage loans to consumers . . . without regard to the consumer's ability to repay a loan in accordance with its terms"); MINN. STAT. § 58.13 (2007) (no residential mortgage originator may "make, provide, or arrange for a residential mortgage loan without verifying the borrower's reasonable ability to pay the scheduled payments"); OHIO REV. CODE ANN. § 1345.031 (West 2007) (an unconscionable practice is "providing consumer transactions . . . without regard to the consumer's ability to repay the loan in accordance with its terms").

126. S. 2136, 110th Cong. § 102 (2008); S. 2133, 110th Cong. § 2 (2007); H.R. 3778, 110th Cong. § 2 (2007); H.R. 3609, 110th Cong. (2007).

127. *See Straightening Out*, *supra* note 83 (statement of Steve Bartlett, President, CEO, Financial Services Roundtable). *But cf. id.* (statement of Mark Zandi, Ph.D., Chief Economist, Moody's Economy.com) (arguing that the legislation is needed and will not significantly increase the cost of mortgage credit).

128. *Subprime and Predatory Lending*, *supra* note 24, at 8 (statement of Harry H. Dinham, President, National Association of Mortgage Brokers); *Preserving the American Dream*, *supra* note 29, at 29-30 (statement of Douglas G. Duncan, Senior Vice President, Research and Business Development, and Chief Economist, Mortgage Bankers Associa-

from foreclosing on properties will also create negative externalities, such as lowering the value of neighboring homes and giving criminals an incentive to vandalize vacant homes.[129]

While Congress has not been willing to revise bankruptcy laws to allow debtors to reduce the amount of the debt they owe on homes that are now worth less than their mortgages, Congress did create a program that allowed some borrowers to replace their non-traditional ARM loans with traditional thirty-year fixed-rate loans that have low LTV ratios. While the program is voluntary, lenders who are willing to renegotiate the loan can require borrowers to document their income, borrowers cannot take out a home equity loan for five years after receiving this new mortgage, and borrowers must give the United States at least 50% of any appreciation on the home when he sells it. Moreover, to prevent pure real estate flipping, if the sale takes place in less than five years, the borrower might be required to return all the gain to the government.[130]

In addition to rejecting the approach of not intervening at all in the market, or of embracing the government's limited relief for borrowers (rather than for lenders or those who invested in mortgage-backed securities), others have suggested or taken somewhat more radical approaches. Harvard Law Professor Elizabeth Warren has recently argued that the United States needs to have a "Financial Product Safety Commission" that reviews credit cards, mortgage loans, and health and life insurance policies to make sure the products have terms that consumers have a realistic chance of understanding. Professor Warren argues that this commission should be charged with preparing and promoting uniform disclosures that make it easier for consumers to compare different lenders'' products. She also contends that a commission of this type could be used to make sure that credit products do not have terms that are impossible for the average consumer to assess.[131]

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tion), *available at* http://banking.senate.gov/public/_files/duncan.pdf; *Possible Responses*, *supra* note 124, at 11 (statement of George P. Miller, Executive Director, American Securitization Forum, also on behalf of the Securities Industry and Financial Markets Association), *available at* http://financialservices.house.gov/hearing110/htmiller041707.pdf.

129. *Preserving the American Dream*, *supra* note 29, at 22-23 (statement of Douglas G. Duncan, Senior Vice President, Research and Business Development, and Chief Economist, Mortgage Bankers Association); s*ee also* Christie, *supra* note 89.

130. *See* Housing and Economic Recovery Act of 2008, H.R. 3221, 110th Cong. (2008); Kenneth R. Harney, *A Look at Congress's Long-Promised, Long-Delayed Mortgage Relief*, WASH. POST, Jul. 19, 2008, at F1; News Release, U.S. Dep't of Housing & Urban Dev., Bush Administration Launches "Hope for Homeowners" Program to Help More Struggling Families Keep Their Homes (Oct. 1, 2008), *available at* http://www.hud.gov/news/release.cfm?content=pr08-150.cfm.

131. Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PA. L. REV. 1 (2008).

The sheriff of the City of Philadelphia, with the implicit support of local judges and political leaders, crafted a novel (though likely illegal) response to the foreclosure crisis. As is true in many jurisdictions, the sheriff's office in the City of Philadelphia has the legal duty to conduct foreclosure sales. After Philadelphia citizens defaulted on their mortgages in record numbers, the sheriff declared that his office would no longer conduct court-ordered foreclosure auctions.[132] Once mortgage lenders, servicers, and their attorneys realized that the sheriff's decision was becoming a public relations problem for them—not the sheriff—they entered into an agreement with housing advocates and local judges to work out a process that would make loans more affordable for delinquent borrowers.[133] This response worked principally because the local judges were not willing to enter an order forcing the sheriff to conduct the foreclosures, and also because housing advocates had successfully lobbied members of the city council, who also supported the sheriff's decision to halt foreclosure sales.[134]

III. POTENTIAL RESPONSES BY URBAN COMMUNITIES

While it may be unrealistic to expect cities to be the primary opponents to the consumer credit industry, cities can no longer afford to take a hands-off approach to consumer credit or to expect the U.S. government to provide a billion-dollar bailout for cities or for the homeowners who live in those cities. Therefore, urban areas will need to take a more proactive approach to protect themselves and their citizens during this financial crisis.

For a number of reasons, urban areas should be concerned with consumer over-indebtedness in general, as well as with the current mortgage meltdown. Localities desire economically stable citizens and neighborhoods because they "market" their cities and citizens when attempting to attract both new citizens and businesses. Having overwhelmed, over-indebted citizens is not a particularly attractive selling point for cities that wish to attract new businesses. Localities also have an interest in having citizens who are not over-indebted because of the value this country generally places on individual entrepreneurship. To the extent the locality (or, indeed, the nation) wants to encourage innovation, there must be some way to help relieve the financial burdens that over-indebtedness poses on individuals, because individuals who are permanently in debt will never be able to fully participate in a market society and will never be able to start a new

132. Michael M. Phillips, *To Help Broke Homeowners, He's Taking the Law into His Own Hands*, WALL ST. J., June 6, 2008, at A1.

133. *Id.*

134. *Id.*

business. Similarly, because this country and, as a result, localities depend on consumer spending, localities, have an incentive to prevent over-indebted consumers from drowning in credit; otherwise those consumers will never be able to meaningfully contribute to the market economy.

Increased foreclosures also create the unexpected problem of the displaced voter. This unexpected challenge is particularly problematic for localities during a presidential election year. Because of the number of people who have been evicted from their homes this year, cities were forced to address election issues like determining which residents were allowed to vote in particular elections and where the residents should vote if they were forced to move because of a foreclosure but failed to notify their local election boards.[135] Fortunately, though, there is no indication that this affected the 2008 national elections.[136]

To directly combat the problem of abandoned homes, urban areas will need to consider how (or whether) to expand their role as landlords or land developers. Because of the number of foreclosed properties in some urban areas, cities have started to purchase, repair, and then resell foreclosed properties rather than allow dilapidated properties to cause additional harm to distressed neighborhoods.[137] The subprime meltdown has forced other cities to take even more drastic measures, including demolishing some vacant homes and turning the real property into parks or additional yards for neighbors who remain in the neighborhood.[138]

Because of decreased property tax revenues, some localities cannot afford to purchase these properties and have sought financial assistance from state legislatures, Congress, and in some instances, from the courts.[139] While the Bush Administration originally opposed federal grants to help localities purchase foreclosed properties, because of the recent massive mortgage bailout,[140] the Obama Administration has expressed its willingness to support governmental intervention in jump-starting local housing

135. *See* Ian Urbina, *As Homes Are Lost, Fears that Votes Will Be, Too*, N.Y. TIMES, Sept. 25, 2008, at A18 (describing methods localities and states are using to verify voters' addresses).

136. ASS'N OF CMTY. ORGS. FOR REFORM NOW, ADDING INSULT TO INJURY (2008), *available at* www.acorn.org/fileadmin/Reports/Insult_to_Injury_Report.pdf (discussing how residency issues could potentially affect the then-upcoming 2008 presidential election).

137. *See* Vikas Bajaj, *Communities Become Home Buyers to Fight Decay*, N.Y. TIMES, Aug. 26, 2008, at C1; Manny Fernandez, *To Avert Blight, City Will Repair and Resell Vacant Homes*, N.Y. TIMES, Jan. 15, 2009, at A27.

138. *See* Bajaj, *supra* note 137.

139. *See* Conor Dougherty & Amy Merrick, *States Squeeze Cities, Spreading the Economic Pain*, WALL ST. J., Dec. 18, 2008, at A4.

140. *See* Rosalind S. Helderman & Ovetta Wiggins, *Localities Firming up Foreclosure Aid Plans; Proposals Due Soon on Use of $22 Million*, WASH. POST, Nov. 8, 2008, at B1.

markets.[141] Municipalities may also need to encourage Congress to consider revising the Internal Revenue Code or find other ways to allow the federal government to guarantee municipal bonds without placing the municipalities' tax-exempt status at risk.

Finally, since deregulating the consumer credit market caused the consumer credit explosion, another way to protect urban areas and innocent homeowners is to intercede and re-regulate—at least partially—the mortgage market.[142] Localities may need to lobby state legislators to make it harder for payday lenders or title pawn companies to operate in their cities. Further, while states currently allow their citizens to take out home equity loans, localities should consider whether it is time to lobby their state legislators to enact laws that make it harder for cash-strapped borrowers to treat their homes like an ATM card.

CONCLUSION

Record numbers of mortgage defaults have triggered a financial crisis that has threatened the U.S. and global capital markets and will continue to have a dramatic effect on U.S. cities. Given the magnitude of the mortgage mess, most of the focus is on stemming the number of foreclosures and preventing greater harm to the economy.

The bigger problem, of course, is the larger issue of consumer over-indebtedness itself. While this country (and urban areas) certainly should be concerned that people are losing their homes, to ensure that our current problems do not repeat themselves in the future it is time for everyone to focus not just on the mortgage debt that has caused borrowers to lose their homes, but also to focus on ways to reduce the numbers of borrowers who are just too deeply in debt.

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141. Tami Luhby, *Saving a City—One House at a Time*, CNNMONEY, Jan. 29, 2009, http://money.cnn.com/2009/01/29/news/economy/neighborhood_stabilization/.

142. *On Strengthening our Economy: Foreclosure Prevention and Neighborhood Preservation: Hearing Before S. Banking Comm.*, 110th Cong. 4-5 (2008) (statement of Doris W. Koo, President, CEO, Enterprise Community Partners, Inc.).