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**Homeownership as Social Policy in the U.S.:
Risk and Responsibility After the Subprime Crisis**

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Abstract

Homeownership in the U.S. has been used as a vehicle to promote a variety of political, economic and social goals. After briefly reviewing how these objectives were expressed during key phases of U.S. history, the paper traces the events and decisions that led up to the subprime crisis and assesses the impacts, particularly as they relate to the social goals of homeownership. The paper argues that the various changes that occurred in the U.S. system of mortgage finance system between the 1970s and 2000s have altered traditional conceptualizations of how risks and responsibilities should be carried by homeowners and lenders. This second section lays the groundwork for understanding the extent to which factors pertaining to risk and responsibility have contributed to unraveling or at least damaging the likelihood of realizing the social objectives of homeownership. The third section further explores events in the 1970s, which foreshadowed the types of problems arising from the new set of financial arrangements in the mortgage market. Fourth, the paper discusses deregulation of financial institutions in the 1980s and the key characteristics of the mortgage finance system that took shape in the 1990s. The fifth section describes the key elements of the contemporary mortgage finance system, which has continued on the path that emerged during the 1970s. Sixth, the paper examines the many causes of the subprime crisis and how they came together in a “perfect storm.” In the seventh section the paper returns to a discussion of the multiple goals of homeownership and how they have been undermined by the subprime crisis. The eighth and final section concludes with observations about the types of risks and responsibilities that both lenders and homeowners must assume if mortgage lending transactions are to be successful. In particular, in order to achieve the multiple goals of homeownership, specific interventions and safeguards must be instituted that will counter the depersonalized, risk-shifting nature of our contemporary mortgage finance system.

The U.S.'s problems surrounding homeownership, in the form of the subprime crisis, have had global repercussions. By August 2007 *The New York Times* was sounding the alarms: "Mortgage Losses Echo in Europe and on Wall Street" (Bajaj and Landler, 2007) and "Asian Markets Fall as Credit Fears Spread" (Arnold, 2007a). The latter article went on to note that "the losses in Asia today were paced by financial stocks with direct exposure to the U.S. subprime mortgage market, which lends money to people with poor credit records." Less than one week later there was this dire pronouncement: "Global Markets Tumble Amid Mortgage Crisis" (Arnold, 2007b). Within thirteen months, the crisis reached a new low, with *The New York Times* headlining: "Wall St.'s Turmoil Sends Stocks Reeling" (Berenson, 2008). The financial strains also were felt around the world. From London to Kuwait to Brazil, stock exchanges were in an apparent free-fall (*The New York Times*, 2008). And, perhaps most dramatic, Iceland found itself on the brink of bankruptcy (Pfanner and Werdiger, 2008).

Depending on which set of calculations is used foreclosures could range from 6.5 million between 2008 and 2013, to a staggering 2.3 million per year, with subprime loans accounting for just over half that number (Stein, 2008). As of November 2008, there was no end in sight of the worldwide financial declines and instability—a precarious economic situation that was the outcome of a complex web of public and private decisions and relationships.

An important part of the story relates to the U.S.'s longstanding commitment to homeownership and how it has been used as a vehicle to promote a variety of political, economic and social goals. From the enactment of the Homestead Act in the 1860s, to the recovery measures created after the Great Depression of the 1930s, through the latter half of the 20th century, and into the new millennium, a number of homeownership programs were created with each having one or more objectives, besides the obvious concern of providing shelter. These have included: giving people a stake in society by enhancing the financial and personal well-being of the homeowner; promoting confidence in the government; stabilizing and stimulating the economy; quelling social unrest and racial tensions; providing opportunities to nonwhite and low income households to enable them to get a foothold in the "American Dream;" stabilizing and rejuvenating deteriorated

neighborhoods; and promoting wealth accumulation as a way to reduce economic inequality.¹ As the subprime crisis began to unfold in mid-2007, it became clear that the changes in home finance over the past several decades are undermining many of these deeply-ingrained objectives.

The paper first briefly reviews how the multiple objectives of homeownership have been expressed during key phases of U.S. history. Second, it outlines the new mortgage finance system that emerged during the 1970s, emphasizing how it was moving away from a basically “mom and pop” operation, where financial institutions originated and kept loans in their portfolios, to one where investors were far removed from the lending decision. The paper argues that these various changes have altered traditional conceptualizations of how risks and responsibilities should be carried by homeowners and lenders. This lays the groundwork for understanding the extent to which factors pertaining to risk and responsibility have contributed to unraveling or at least damaging the likelihood of realizing the social objectives of homeownership.

The third section of the paper further explores events in the 1970s, which foreshadowed the types of problems arising from the new set of financial arrangements in the mortgage market. During that period, lower-income homeowners in default often had difficulty renegotiating the terms of their loans due, in part, to the disconnect between mortgage originators and the actual lenders. Fourth, the paper discusses deregulation of financial institutions in the 1980s and the key characteristics of the mortgage finance system that took shape in the 1990s. The fifth section describes the key elements of the

¹ A number of researchers have explored the extent to which various goals and assumptions about homeownership do, in fact, materialize. A comprehensive review of the literature concluded that there is “considerable evidence... that homeowners are more likely to be satisfied with their homes and neighborhoods, more likely to participate in voluntary and political activities, and more likely to stay in their homes longer periods of time” the latter purportedly contributing to neighborhood stability. Evidence on several other frequently cited positive impacts is sparse or less consistent. For example, there is some evidence that homeownership can (but not always) lead to increased self-esteem. And there is some research on the positive connection between homeownership and life satisfaction and health. However, the authors caution that there are some doubts about “whether these relationships are causal, since most of the studies do not adequately account for the self-selection of households to owner and renter occupancy” (Rohe, Van Zandt, and McCarthy, 2002, p. 400). In a second review that examined the homeownership experiences of low-income and minority households, the authors concluded that: “these owners are just as likely to see their homes appreciate in value as other owners are... [and homeownership] results in fairly significant wealth accumulation...modest evidence shows that owners do benefit from improved psychological and physical health...fairly convincing evidence shows that the children of low-income owners have greater educational success, and more modest evidence indicates that they have greater success in labor markets, are less likely to have behavioral problems, and are more likely to become homeowners themselves” (Herbert and Belsky, 2008, p. 49).

contemporary mortgage finance system, which has continued on the path that emerged during the 1970s. Sixth, the paper examines the many causes of the subprime crisis and how they came together in a “perfect storm.” In the seventh section the paper returns to a discussion of the multiple goals of homeownership and how they have been undermined by the subprime crisis. The eighth and final section concludes with observations about the types of risks and responsibilities that both lenders and homeowners must assume if mortgage lending transactions are to be successful. In particular, in order to achieve the multiple goals of homeownership, specific interventions and safeguards must be instituted that will counter the depersonalized, risk-shifting nature of our contemporary mortgage finance system.

I. Historical Background

The quest for homeownership has been a driving force in the history of the U.S. Beyond shelter, there are a number of political, economic and social objectives associated with homeownership.

Pre-20th century to President Roosevelt—From the founding of the U.S. until the Depression era, homeownership was most closely related to the social goals of giving people a stake in society and promoting confidence in the government. It is not clear when the phrase, “the American Dream” was coined and when, exactly, it became associated with the goal of homeownership. In any case, a key principle of the young country was that property ownership and good citizenship were intertwined. At the time that the Declaration of Independence was signed, in 1776, only white men with property had the right to vote.² In 1792 New Hampshire was the first state to abolish this rule, but it took another 64 years for the last of the states, North Carolina, to follow.

During the 19th century, promoting property ownership became an important vehicle for settling the vast lands of the west. The Homestead Act of 1862 provided free land to settlers. Fulfilling an economic need, this strategy was viewed as the “only means

² However, this did not pertain to all white men. Catholics, Jews, Quakers and others were excluded. See American Civil Liberties Union: Voting Rights Act Timeline <http://www.aclu.org/votingrights/gen/12999res20050304.html> (accessed July 30, 2008).

of building up in a wilderness great and prosperous communities” (quoted in Hibbard, 1924, p. 354). In addition, providing free land was intended to instill a love of country and patriotism, since the “affections of good citizens are always mingled with their homes and placed upon the country which contains their fields and gardens” (quoted in Hibbard, 1924, p. 352). At the same time, the necessity to create a strong presence in areas occupied by native communities, American Indians, was a compelling political motivation.

In the early 1920s, the Department of Commerce strongly supported the “Better Homes for America” movement, which encouraged households to save for homeownership and that spread information about the home buying process (Dean, 1945). Closely connected to promoting a stake in society and instilling a confidence in the government, this initiative contrasted the American way of life and the opportunity to own a home of one’s own, with communal styles of living under socialist or communist regimes. Indeed, a prevailing view was that “socialism and communism do not take root in the ranks of those who have their feet firmly embedded in the soil of America through homeownership” (cited in Dean, 1945, p. 4). At the same time, the National Association of Real Estate Boards underscored both the financial gains to be achieved through homeownership, as well as the sense that homeowners achieved a higher level of morality than renters and enabled them to become “completely self-reliant and dominant” (cited in Vale, 2007, p. 26).

In 1931, President Herbert Hoover convened a conference on Home Building and Home Ownership at which he noted that: “every one of you here is impelled by the high ideal and aspiration that each family may pass their days in the home which they own” (quoted in Dean, 1945, p. 44; also see Vale, 2007). There was little question in Hoover’s mind about the benefits that would accrue to homeowners as well as to society at large. In addition to democracy and self-government being safeguarded, homeownership “penetrates the heart of our national well-being. It makes for happier married life, it makes for better children, it makes for confidence and security...it makes for better citizenship” (cited in Vale, 2007, p. 32). The flowery rhetoric notwithstanding, it was insufficient to address the escalating rate of home foreclosures and the stagnation in the building industry during the early 1930s.

President Roosevelt to the 1960s--As the Great Depression took hold, a new activist President, Franklin D. Roosevelt, created a series of agencies and programs to help homeowners in default, to promote more affordable home loans through federal mortgage insurance, and more generally to stimulate the construction industry and support the banking and mortgage finance system through a new set of regulatory protections. Nevertheless, the implicit and explicit goals of homeownership during the 18th and 19th centuries—to help households develop a stake in society and to promote confidence in the government—were also prominent during this period.

In proposing the creation of a new Home Owners' Loan Corporation (HOLC), which eventually helped about 800,000 defaulting homeowners to refinance and save their homes from foreclosure, President Franklin D. Roosevelt told the U.S. Congress:

Implicit in the legislation which I am suggesting to you is a declaration of national policy. This policy is that the broad interests of the nation require that special safeguards should be thrown around home ownership as a guarantee of social and economic stability, and that to protect home-owners from inequitable enforced liquidation, in a time of general distress, is a proper concern of government (Home Owner's Loan Act, 1933).

The strategy appeared to work. The new program not only contributed to social stability, but it also enhanced the power of the Roosevelt administration, as historian Arthur M. Schlesinger, Jr. noted:

...by enabling thousands of Americans to save their homes, it (HOLC) strengthened their stake both in the existing order and in the New Deal. Probably no single measure consolidated so much middle-class support for the administration (1959, p. 24).

Even more important than the HOLC, in terms of its longstanding impact on housing in the U.S., the Depression era also saw the creation of the Federal Housing Administration, which provided mortgage insurance for lenders, as a way to stimulate the banking and homebuilding industries and, at the same time, to promote homeownership for moderate-income people. Commenting on the motivations behind this legislation, an astute observer of federal housing policy noted:

While the establishment of the FHA mortgage insurance program had some reform aspects from the standpoint of correcting the mortgage abuses of the

Twenties, it was primarily sold politically as a program to unfreeze the home building industry and thereby stimulate employment and the economy (Keith, 1973, p. 24).

Reflecting on the broader set of post-Depression initiatives, which included both the FHA and HOLC, as well as other new programs, another analyst stated:

The new measures had far-reaching implications and were for the most part intended to be of indefinite duration, but they were enacted when emergency conditions prevailed and had an emergency point of view. Each new housing bill was advocated as a means of stimulating the durable goods industries or putting men to work. Housing thus was looked upon as a remedy for general economic ills rather than a problem in itself (Coleman, 1944, pp. 261-262).

1960s to 1970s--A new wave of Congressional enthusiasm for homeownership surfaced in the 1960s. Similar to the Depression era, there was a strong desire to stimulate the economy. However, a variety of other political and social objectives were also compelling. Prominent in this period were the goals of quelling social unrest and racial tensions and providing opportunities to nonwhite and low-income households to enable them to get a foothold in the “American Dream.”

In 1968, the Secretary of the U.S. Department of Housing and Urban Development (HUD) referred to homeownership with familiar rhetoric: “To own one’s own home is to have a sense of place and purpose. Homeownership creates a pride of possession, engenders responsibility and stability” (Weaver, 1968, p. 7). But homeownership was also grasped as the means to quiet the unrest among blacks and to help rejuvenate the cities. Rutgers University Professor George Sternlieb testified before the U.S. Senate: “There is no question that the chance of riots in Newark or for that matter any other major core area would have been substantially lower with more Negro ownership” (1967, p. 1607). And, echoing the arguments of earlier years—that homeownership is good for the social well-being of the nation—the newly published report of the National Advisory Commission on Civil Disorders stated: “The ambition to own one’s own home is shared by virtually all Americans, and we believe it is in the interest of the nation to permit all who share such a goal to realize it” (1968, p. 477).

Also in 1968, Congress enacted the first major federal homeownership program for the non-rural poor.³ Known as Section 235, this interest rate subsidy initiative was aimed at expanding the number of people who could own their own homes, particularly inner city residents, members of racial minority groups, and those with low- and moderate-incomes. Between 1969 and 1979, the Section 235 program enabled some 500,000 households to achieve homeownership (Hays, 1995, p. 117; Martinez 2000). But the program was short-lived. Major scandals in its operations surfaced less than five years after its creation and the Nixon Administration froze its funding in early 1973 as part of a moratorium on virtually all federal housing subsidy programs. A smaller Section 235 program reappeared in 1976, only to die in 1987 (Carliner 1998, pp. 313-314). Congressional interest in a major federal homeownership subsidy program for the non-rural poor evaporated, with bad memories of the Section 235 program tainting the possibility of any such initiative.

1980s to the new millennium—All of the earlier goals of homeownership have persisted through to the current period, but some new ones have been added: rejuvenating deteriorated neighborhoods and promoting asset accumulation as a way to reduce economic inequality. This latter goal is an expansion of the social goal espoused earlier—to promote a family’s financial well-being. The whole range of social goals associated with homeownership are, however, being threatened with the subprime crisis.

In 1990, President George H.W. Bush’s HUD Secretary Jack Kemp revived interest in low-income homeownership. Introducing new legislation to create the HOPE program (Homeownership and Opportunity for People Everywhere), he stated that a key goal was “Expanding homeownership and affordable housing opportunities for low- and moderate-income families and young families just starting out” (Kemp, 1990, p. 40).

³ A rural homeownership program (Section 502) was authorized in the Housing Act of 1949. In addition, two small-scale urban-focused federal programs preceded the Section 235 program. In 1965 a program was created to enable public housing tenants to purchase their units and in 1966 the Section 221(h), provided low-income households the opportunity to buy previously substandard houses from nonprofit sponsors after they had been purchased and rehabilitated by these entities (U.S. Commission on Civil Rights, 1971, p. 4).

The rhetoric and reality of homeownership flourished under the Clinton administration. In 1994 President Clinton reaffirmed the multiple goals of homeownership: “More Americans should own their own homes, for reasons that are economic and tangible, and reasons that are emotional and intangible, but go to the heart of what it means to harbor, to nourish [and] to expand the American Dream” (U.S. Department of Housing and Urban Development, 1995). This was to be achieved, in part, by reducing down payment requirements, making terms more flexible thereby reducing the cost of interest, and increasing the availability of alternative mortgage financing products. Lenders and homeowners responded and the homeownership rate reached 67.7 percent of U.S. households by the end of the Clinton administration (HUD, 2000, p. 52). In that context, the Joint Center for Housing Studies at Harvard University launched a low-income homeownership symposium in November 2000 to provide critical and sophisticated analyses of the “unexamined goal” (Retsinas and Belsky, 2002), particularly its role in contributing to asset accumulation. Reflecting on the 1990s, the Millennial Housing Commission summarized the nation’s overall accomplishments in promoting home ownership by noting that “the number of lower-income home owners increased by about 2.5 million, African-American owners by about 1.2 million, and Hispanic owners by about 1.2 million” from 1994 to 2000. (2002, p. 21).

Homeownership retained its popularity throughout the George W. Bush administration. His first HUD Secretary, Mel Martinez, articulated strong positive feelings about homeownership by noting “the pride my dad and mom had when they bought their first home in America with the help of FHA. Owning your own home is the American Dream,” he continued, “and I intend to fight for those who do not yet own a home, so they can live the American Dream and experience the transformation that can happen in a life through homeownership” (Martinez, 2001). Despite this enthusiasm and the overall gains in homeownership rates, only a relatively small number of low-income homeowner households receive direct federal housing assistance⁴ and there are large

⁴ Only 11 percent of the 5.4 million units that receive direct federal housing assistance are owner-occupied, with the Section 502 Rural Homeownership Program comprising the great majority of these households (547,622). The now-defunct Section 235 program still assists 31,176 households (Millennial Housing Commission 2002, pp. 95, 111-112). Another group of low-income homeowner households receives federal assistance indirectly—through the income tax system’s provision allowing owners to deduct

disparities in the number of low-income and higher-income homeowners, as well as between white and minority homeowners.⁵

In June 2002, President George W. Bush set a new goal: to increase minority homeownership by 5.5 million households by the end of the decade, thereby helping to close the gap between white and minority homeownership (HUD, 2002a). Four months later, HUD released a report supporting this agenda (HUD, 2002b),⁶ but it did not recommend a new deep subsidy to promote low-income homeownership.

In addition to all the previously articulated reasons supporting homeownership, at least part of the current rationale is based on the view that homeownership is an important vehicle for stabilizing and rejuvenating deteriorated neighborhoods. Homeowners are less likely to move than renters (Rohe, Van Zandt, and McCarthy, 2002) and the introduction of affordable homeownership programs have been shown to

mortgage interest and property tax payments in calculating their tax liability. Nearly one million homeowners earning \$30,000 or less receive indirect federal assistance through the mortgage interest deduction. However, this benefit is predominantly enjoyed by those with the highest incomes. In terms of dollar volume, households with incomes of less than \$30,000 receive only about \$400 million in tax relief, compared with over \$65 billion for those earning more than \$30,000. By far the largest benefit of the mortgage interest deduction goes to those earning over \$100,000. Of the more than 16 million households itemizing their tax returns in this income bracket, their mortgage interest deduction totaled over \$47 billion, over 70 percent of the total amount (\$65 billion) of this deduction (Joint Committee on Taxation 2007, p. 43).

⁵ Of those earning less than 80 percent of median income, about 42 percent are homeowners; among those earning greater than 80 percent of median income, the homeownership rate is an impressive 78 percent (calculated from National Low Income Housing Coalition, 2001). Although minorities accounted for about 32 percent of recent, first-time homebuyers in 2001, an increase from about 19 percent since 1973, there is still a huge gap in white and minority homeownership rates. Three-quarters of all white households own their own homes, compared with 48.4 percent of black households and 47.4 percent of Hispanic households (Joint Center for Housing Studies, 2004, p. 35).

⁶ HUD (2002b) outlined the economic benefits that would be realized if the minority homeownership gap were reduced and recommended modest increases or new funding for homeownership education, increasing the supply of affordable homes, providing assistance with down payment and closing costs and offering financing options, thereby making homeownership more accessible to a wider range of households. Specifically, concerning down payment assistance, President George W. Bush was a major supporter of the American Dream Homeownership Act, enacted in December 2003; in FY 2007 it provided \$25 million to assist first-time homebuyers cover down payment and closing costs. The federal HOME program (a block grant program for housing) also has included extra funding for down payment assistance. More generally, both the HOME and Housing Choice Voucher programs allow funds to be used for homeownership. However, these programs only provide modest subsidies.

have a “positive impact on property values within their immediate neighborhoods” (Ellen et al., 2002, p. 475).

Another contemporary goal of homeownership is to assist people build assets. According to this view, homeownership contributes to family well-being by enhancing their economic position. At the same time, this will help to decrease the dramatic levels of economic inequality that are so characteristic of the U.S. and that have become more severe since the late 1980s (Bernstein, McNichol and Nicholas, 2008). Former Federal Reserve Board Chairman Alan Greenspan articulated this point, while also repeating the classic arguments in favor of homeownership:

The choice to buy a home is a decision to plant a family’s roots in a community with all the implicit incentives to make that community thrive. Where home ownership flourishes, it is no surprise to find increased neighborhood stability, more civic-minded residents, better school systems, and reduced crime rates. Just as important is the effect of homeownership on a household’s ability to accumulate assets. For most households, home ownership represents a significant financial milestone and is an important vehicle for ongoing savings... [As of 1998] home ownership represented 44 percent of gross assets for families earning \$50,000 or less annually (2002, p. 1).

Homeownership as a vehicle for wealth accumulation is particularly important for low-income and minority households. Although homeownership does not, of course, guarantee positive financial outcomes, non-housing wealth accumulation for these households is typically negligible or nonexistent; for lower-income households “housing wealth is synonymous with total wealth” (Boehm and Schlottmann, 2008, p. 250).

Toward the end of the Bush administration, in the midst of rising home foreclosures, the president proclaimed June 2008 as “National Homeownership Month” and noted his commitment to “helping Americans achieve their dreams of homeownership.”⁷ One month later, the president signed into law a major housing bill that (among a number of initiatives) attempts to provide relief for homeowners in serious mortgage default and promotes homeownership for first-time buyers, by offering a new

⁷ George W. Bush, Proclamation 8263. National Homeownership Month, 2008. May 29, 2008.

tax credit of up to \$7,500 to be used toward the down payment.⁸ While symbolically important, these likely will turn out to be modest efforts to address some of the defects arising from significant changes in the mortgage finance system over the past four decades.

II. A New System of Mortgage Finance Emerges in the 1970s

By the 1970s we got the first glimpse of what the new mortgage finance system would look like. On the one hand, the conventional mortgage market dominated by savings and loan associations (S&Ls) continued to offer loans to non-FHA-insured homebuyers. On the other hand, mortgage companies utilized FHA-insured mortgages, which were then sold on the secondary mortgage market, particularly Fannie Mae.⁹ Fannie Mae raised money by issuing securities on the capital markets whose timely payments of interest and principal were guaranteed by the agency. Fannie Mae was able to raise funds at lower costs due to the implicit federal guarantee of their securities although, in fact, they were not backed by the U.S. government. By the 1970s the country had created a dual system of housing finance. But before this “modern” era, throughout the 19th century and until at least the early 1970s, there was largely a single system of home mortgage finance; S&Ls were at the center of this system.

In line with the mission of the first building associations (an earlier name for S&Ls) these financial institutions were created to “enable the contributors thereof to build or purchase dwelling houses” (Hoagland and Stone, 1973, p. 179, referring to the

⁸ The maximum tax credit of \$7,500 is only available to individuals and couples with incomes of no more than \$75,000 and \$150,000 per year, respectively. The full amount of the tax credit must be repaid over a 15-year period. A similar tax credit had been proposed by the Millennial Housing Commission. The Commission justified this approach with the observation that “The advantage of the homeownership tax credit over direct subsidy programs is that it devolves authority to states and relies on private-sector partners to deliver allocated resources” (Millennial Housing Commission, 2002, p. 31).

⁹ Fannie Mae stands for the Federal National Mortgage Association, also referred to in earlier periods as FNMA. It was created in 1938 and has been the largest government-sponsored secondary mortgage market entity in the U.S. It was privatized in 1968, but was placed under federal control in September 2008. Ginnie Mae stands for the Government National Mortgage Association and is another government-sponsored secondary mortgage market institution, also referred to in earlier periods as GNMA. Created in 1968, its mission was to purchase mortgages on federally subsidized housing developments and below-market-interest rate loans. It always has been under federal control. The third government-sponsored secondary mortgage market entity, the Federal Home Loan Mortgage Corporation, was created in 1970 as a private corporation. Commonly known as Freddie Mac, it has also been referred to as FHLMC; as with Fannie Mae, it was placed under federal control in September 2008.

first building association, which was organized in Pennsylvania in 1831). During the 1970s, thrift institutions¹⁰ held about 55 percent of all home mortgages in the U.S. (Schwartz, 2006, p. 55). The next largest lender was commercial banks at just over 16 percent (United States Savings and Loan League, 1973, p. 38). The share of thrift-held mortgages declined steadily over the following decades; by 2003 thrift institutions held less than 10 percent of home mortgages (Schwartz, 2006, p. 56).

The roots of the second system of mortgage finance date back to 1934, when the federal government created the Federal Housing Administration. The FHA offered mortgage insurance on loans originated by a wide range of financial institutions, including S&Ls. However, as original opponents of the FHA, S&Ls were never active participants in this program. The highly localized nature of the S&L mission perhaps made them wary of the nationwide scope of the FHA. In addition, FHA-insured loans carried a number of administrative requirements and regulations—so-called “red-tape.” This included time delays in processing FHA insurance forms and relatively low interest rate ceilings on FHA-insured loans. In addition, S&Ls were able to find sufficient investments without using FHA insurance and they had an ideological opposition to the government assuming the risk in mortgage lending (Kendall, p. 1962, pp. 90-91). With S&Ls and other conventional lenders having little interest in originating FHA-insured loans, mortgage companies grew in importance. By the late 1950s mortgage companies had become dominant in the FHA-insured loan system. As of 1972, mortgage companies originated 74.3 percent of all FHA-insured loans; S&Ls and savings bank together were responsible for only 13.1 percent (HUD, 1973b, pp. 173 and 161). And, as noted previously, the overall share of mortgage lending (including both FHA and conventional loans) by thrift institutions had also declined significantly.

With the decline in the thrift share of the mortgage market, secondary mortgage market entities emerged as the dominant holder of mortgages; their share increased from less than 12 percent in 1975 to 62 percent in 2003 (Schwartz, 2006, pp. 56, 58-59). Further, the growth in secondary mortgage market activity was supported by the vigorous activity of mortgage companies. Mortgage companies and the FHA were completely interdependent:

¹⁰ Refers primarily to S&Ls, but also includes mutual savings banks.

More than any other type of institution active in mortgage markets, mortgage companies owe their present structure and method of operation, as well as their extraordinary rapid postwar growth, to the introduction and later expansion of federal mortgage insurance and guaranty (Klaman, 1959, p. 1).

In contrast to S&Ls and other depository institutions, which all have (or are supposed to have) a strong sense of responsibility in terms of safeguarding the assets of their depositors, mortgage companies work as intermediaries, originating loans and then selling them to long-term investors. Income is derived primarily from origination and servicing fees. In addition, unlike depository institutions, which are monitored by one of the federal regulatory agencies,¹¹ mortgage companies are very lightly regulated. The difference in orientations between mortgage companies and depository institutions was illustrated by the following two interchanges that took place in the early 1970s.

First, when a former Chairman of the Board of a large Boston mutual savings bank (a depository institution) was asked, during Senate hearings held in 1971, “What is the risk to the bank if the Federal government insures the mortgage?” he responded: “Well, the risk to the bank is...that we consider any loan that goes sour on us a poor investment. We do not care whether it is insured or not” (Bacheller, 1971, p. 277).

Second, and in contrast to what appears to be a high level of responsibility for each loan originated (both FHA-insured and non-FHA-insured) by thrift institutions, the orientation of mortgage companies is explained in this set of questions and answers between a U.S. Representative from Illinois, George Collins, and Lawrence Katz, a former Director of the HUD Area Office in Milwaukee:

¹¹ These are the Board of Governors of the Federal Reserve System, Office of Thrift Supervision, Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the National Credit Union Administration. The Board of Governors of the Federal Reserve oversees state-chartered banks and trust companies that belong to the Federal Reserve System. The Federal Deposit Insurance Corporation regulates state-chartered banks that do not belong to the Federal Reserve System. The Office of the Comptroller of the Currency regulates banks whose names include the word “National” in or the letters “N.A.” after their names. The Office of Thrift Supervision oversees federal savings and loans and federal savings banks. The National Credit Union Administration regulates federally chartered credit unions (Securities and Exchange Commission, 2005).

Mr. Collins: ...don't you feel that the obligation of determining the quality of the security should be assured more by the lender rather than the FHA than it has been?

Mr. Katz: It is a theory, but in fact it doesn't work; it doesn't work for the very simple reason the lender is an interim lender. The mortgages are taken by FNMA and GNMA.

Mr. Collins: He doesn't give a damn?

Mr. Katz: His risk is almost nonexistent. He is not going to hold a mortgage for 30 years. He turns it over to the quasi-government agency, and the Government agency is the one who takes the mortgages and the risk. All of your mortgage bankers operate this way (U.S. House of Representatives, 1972a, pp. 161-162).

Based on this type of testimony and a wealth of other data, a report issued by a Committee of the U.S. House of Representatives concluded:

Mortgage companies write mortgages for home purchasers and then sell 100 percent FHA-backed mortgages to FNMA. Because of the security afforded by this guarantee, most mortgage companies have abdicated responsibility for screening potential home purchasers and determining if the mortgaged property is structurally sound and fairly valued. Neither FHA nor FNMA has taken steps to bar imprudent mortgage lenders from doing business (1972b, pp. 4-5).

This irresponsible approach created problems throughout the FHA-insured mortgage lending system. Particularly hard-hit were a group of new low- and moderate-income homeowners who had taken advantage of the Section 235 subsidy program. As revealed in the above excerpts, mortgage companies often did little to ascertain the ability of the new homeowners to pay the loan or to properly assess the quality of the property. With FHA insurance, many lenders, particularly mortgage companies, viewed mortgage lending as a virtually risk-free enterprise. HUD, as the overseer of the FHA insurance fund, and as the risk-taker in these transactions, should have been carefully safeguarding its interests through diligent oversight of mortgage companies and with assurances that accurate underwriting and property appraisals had been performed. However, this did not occur. Thousands of pages of Congressional testimony revealed that, at least through the early 1970s, the government abdicated its role and refused to act as though it was carrying the risk.¹²

¹² HUD's role as a public agency should have dictated a far more consumer-oriented set of procedures. The Housing Act of 1954 stated: "The first responsibility...of any agency administering...the housing program(s), is to protect and preserve the public interest in general and the rights of homeowners in particular. Agencies participating in housing programs shall at all times regard as a primary responsibility

Specific examples from this era are reminiscent of the present subprime crisis. In attempting to approve as many households as possible for a mortgage under the Section 235 program, lending personnel often neglected to fully scrutinize borrowers' credit or the quality of the property. A 1973 review of eight HUD area offices found that several lenders were noncompliant with HUD's guidelines and reported numerous cases of inaccurate credit reporting. This inadequate oversight substantially increased HUD's risk and also poorly served the interests of the low-moderate income homebuyers, with thousands eventually losing their homes (Comptroller General of the United States, 1973 and HUD, 1973a). A government audit report concluded that:

HUD assumes the risk of reimbursing the mortgage if the home buyer defaults and the mortgage is foreclosed. HUD increases this risk because it approved buyers for mortgage insurance without determining the reliability of the employment and cash asset data received on the buyer... [In addition, the audit] revealed an unacceptable number of existing properties containing significant defects as well as many minor defects in both new and existing houses in most of the nine field offices audited (HUD, 1973a, pp. 26 and 13).¹³

While HUD Secretary George Romney acknowledged the need to focus more attention on insuring quality mortgages he, nevertheless, tried to place the blame on Congress for providing a faulty legislative mandate. In rebutting these charges, the Chairman of the Senate Banking and Currency Committee stated: "To keep the record straight, there was never any Congressional intent to authorize local FHA offices [offices within HUD] to insure substandard housing or to accept as mortgagors the poor whose financial condition did not justify homeownership" (Senator John Sparkman, as quoted in U.S. House of Representatives, 1972b, p. 56).

The laissez-faire attitude toward approving mortgagors and properties was fueled by the opportunities for a number of private sector actors to make significant profits. Many real estate agents purchased properties for cash at low prices and quickly re-sold them to lower-income mortgagors carrying FHA insurance. Mortgage companies, in turn, realized profits from origination fees and from bulk sales of mortgages to the secondary mortgage market entities. Oversight of the system broke down as HUD personnel were under pressure to approve loans for FHA insurance. Far worse, scores of HUD personnel,

their duty to act in the interest of the individual home purchaser and in so doing protect his interest to the extent feasible" (P.L. 560, 68 Stat. 590, 593).

¹³ For further detail, see Bratt, 1976.

as well as others hired by the agency on a fee-for-service basis, were eventually indicted for fraud related to the implementation of the housing programs (*Housing and Development Reporter*, 1975, p. 1185).

Thus, during the 1970s the long-entrenched patterns of mortgage lending were suspended or at least severely compromised for the new group of lower-income households who were encouraged to purchase homes under the new federal homeownership subsidy program. Participating mortgage lenders, who were for the most part mortgage companies, often performed both inadequate property inspections and assessments of the ability of households to carry the costs of ownership. With the risk for these programs transferred to the federal government, but with similar levels of laxity on the part of HUD-FHA staff, mortgage lending became a virtual free-for-all. At the same time, the new homeowners were unprepared for the responsibilities of homeownership, with counseling services underfunded and sparse (Bratt, 1976). A Congressional report summed up the situation:

Historically, HUD has relied on the assumption that value and price are fairly determined when a prudent buyer and a knowledgeable seller meet in the marketplace and negotiate for the purchase and sale of a house. For low and moderate income families this is often not the case. Often...a very knowledgeable, if not unscrupulous, speculator deals with an uninitiated and unknowledgeable buyer. The consequences are tragic (U.S. House of Representatives, 1972b, p. 16).

In short, the entity assuming the risk on the loans, HUD-FHA, took little responsibility in fulfilling its role as risk-taker. Similarly, the ultimate investor in the loans, typically Ginnie Mae, also was an absent actor in terms of assuring the integrity and credit-worthiness of the lending transaction. Mortgage companies, on the other hand, assumed very little risk, but had a great deal of responsibility over property appraisals and approving households for loans. But these tasks often were performed poorly with little regard for whether or not the loan would be repaid. The experiences with homeownership during the 1970s predicted, with startling accuracy, the events that surfaced during the subprime crisis.

III. Homeowners in Default in the 1970s: Foreshadowing a Key Problem that Surfaced During the Subprime Crisis

In addition to playing a weak role at the point of loan origination, HUD-FHA also failed to enforce its own rules stipulating how lenders should provide relief to families facing default and foreclosure. While Congressional hearings documented many of the defects of the Section 235 program, HUD's unwillingness to require mortgagees to extend forbearance to defaulting homeowners was barely acknowledged. This shortcoming was significant; greater attention to the problem and more rigid enforcement of regulations might have helped large numbers of homeowners keep their homes.

HUD's guidelines explicitly described foreclosure as a last resort, but mortgagees consistently failed to follow those guidelines and HUD failed to intervene on behalf of the low-moderate income homeowners. A Fannie Mae report published in 1973 disclosed that only 3.3 percent of 26,575 delinquent but eligible FHA loans were receiving forbearance. Reports from HUD personnel confirmed that the agency rarely followed its own guidelines and seldom gave relief to defaulting mortgagors (Bratt, 1976).

Problems with HUD's foreclosure prevention procedures led to litigation. The most frequently cited decision, *Brown v. Lynn*, blamed HUD for its failure to protect defaulting homeowners. Despite this ruling, allegations continued that HUD failed to consistently follow judicial mandates. Reflecting back on this era, a 1996 HUD report noted: "Until 1976 HUD maintained a hands-off approach to defaults and foreclosures, effectively leaving policy decisions to each individual mortgagee" (p. 71).

In 1992, Congress finally required HUD to determine how to avoid foreclosures. The agency then changed its operation significantly and it claimed to be "moving forward in a proactive way to develop a full menu of options for assisting borrowers with financial difficulties" (HUD, 1996, p. 91). More specifically, HUD initiated a "program whereby it takes assignment of qualifying loans in default and provides direct servicing and forbearances" (HUD, 1996, p. 71). Despite these improvements, the 1996 HUD report outlined a number of initiatives that were still needed to assist homeowners avoid foreclosure.

Recognizing the importance of providing creative mechanisms for assisting homeowners in default, at least some lenders in the early 2000s were extending forbearance to such mortgagors with positive results: “Adopting an approach that economists say has led to one of the most important changes in the housing market in recent years, mortgage lenders significantly reduced the rate at which they repossessed homes. In place of foreclosure, many altered the schedule of loan payments in the hope that the drop in borrowers’ income would turn out to be relatively brief (Leonhardt, 2002).

But, as it turns out, all is still not well in terms of the ability of borrowers to renegotiate the terms of their loans. As discussed the first section of Part VI of this paper, determining who owns the mortgage and how a new repayment schedule can be instituted is even more difficult today than in the 1970s. In addition, as the subprime crisis has evolved, we are again seeing other patterns that first arose in the 1970s, but on a much larger scale, with layers of investors involved. The entity assuming the responsibility for the mortgage lending decision assumes little risk in the transaction and, at the same time, the risk-taker in the form of the ultimate investor, is far removed from the actual responsibilities of the mortgage lending decision—assessing the property and income credit-worthiness of borrowers. While the seeds for this situation were sown in the 1960s and 1970s, a straight line can be drawn from the federal deregulation of financial institutions that began in the 1980s to the recent upheavals we have witnessed in the mortgage market.

IV. Deregulation in the 1980s

The federal financial regulatory framework that was instituted during the Depression remained relatively unchanged until the 1960s. Up to that time (and through the 1970s and early 1980s), S&Ls were, as discussed earlier, the dominant mortgage lenders in the non-FHA-insured market. With the goal of keeping mortgage interest rates low, S&Ls and other thrift institutions had to comply with ceilings set by federal regulators on the amount of interest they were allowed to pay on savings accounts (Regulation Q). As Michael E. Stone explains:

As long as there was little inflation and other interest rates were also low, this posed no problem for thrifts. But in the tight-money period of 1966, wealthier

households diverted more than \$16 billion of their savings into other types of investments paying higher rates of interest (2006, p. 84).

In response to this loss of investment assets, and in an attempt to protect the role of S&Ls as the nation's chief mortgage lenders, in 1966 Congress authorized federal regulators to set the ceiling on accounts in commercial banks lower than the interest rate that S&Ls were permitted to pay. This did not, however, stem the outflow of funds from S&Ls and, to compensate, S&Ls borrowed money from the central bank that had been set up during the Depression to support and regulate this sector of the banking industry, the Federal Home Loan Bank.

Additional liquidity in the mortgage lending system was provided by sales to secondary mortgage market entities. While Fannie Mae originally was not able to buy loans that did not carry FHA insurance (thereby essentially eliminating mortgage purchases from S&Ls), this restriction was removed in 1970. In addition, that same year, the federal government created another secondary mortgage market institution, "Freddie Mac," which was authorized to purchase both FHA and non-FHA-insured mortgages and was particularly oriented to S&L operations. (see n. 9).

Despite federal efforts to assist S&Ls retain their savings, the inflationary pressures of the late 1960s and 1970s encouraged investors to take their money elsewhere. Non-regulated entities such as brokerage firms were often the beneficiaries. S&Ls argued that to stay competitive, interest rate ceilings would have to be eliminated. Deregulation did not, however, occur until the 1980s when tight money, high interest rates, and instability within the S&L sector prompted legislative action.

The first major deregulation initiative phased out federal control over interest rates on deposits in both S&Ls and commercial banks and it allowed S&Ls to slowly diversify their portfolios; mortgage lending would no longer have to be virtually their sole investment option. However, the provisions outlined in this legislation, the Depository Institutions Deregulation and Monetary Control Act of 1980 "were too gradual to have much impact on the thrift crisis" (Stone, 2006, p. 88).

The move toward financial deregulation continued with the enactment of the Garn-St. Germain Act of 1982. Most importantly, the new law accelerated the deregulation of interest rate caps and allowed S&Ls to lend money for a wide range of non-housing activities. In addition, and with ominous implications for the current sub-

prime crisis, Garn-St. Germain facilitated the ability of lenders to offer variable interest rate mortgages. In this way, interest rates on mortgages would not be locked in for decades into the future; instead, they could fluctuate with the cost of money being paid to attract deposits.

As S&Ls were freed from their traditional mortgage lending role and allowed to pursue other investment opportunities, the three federally supported secondary mortgage market institutions filled the void and became the dominant investor in mortgages. Other financial entities also entered the mortgage market by purchasing securities from Fannie Mae, Freddie Mac and to a much lesser extent, Ginnie Mae, that were backed by mortgages held in their portfolios—so-called mortgage-backed securities. In 1986, for the first time, thrift institutions lost their position as the major providers of mortgage credit (as cited in Stone, 2006, p. 89).

In the lax regulatory environment of the 1980s, S&Ls rapidly moved away from the familiar turf of mortgage lending and they often entered into high-risk, speculative ventures. However, these were deals that S&L personnel were ill-equipped to assess prudently, based on a lack of experience with this type of transaction. To make matters worse, a number of S&Ls were found to be engaging in fraudulent operations. By the late 1980s, the problems facing S&Ls emerged as a full-blown crisis. The insurance fund that had been set up to insure the deposits in these institutions became insolvent and over one thousand thrifts eventually collapsed. In response, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), known as the S&L bailout legislation, was enacted in 1989. In addition to revamping much of the federal financial institution regulatory structure, including adding the requirement that thrifts have higher levels of assets backing up their lending activities, taxpayer funds were authorized to ensure that the full amount of money in all thrift savings accounts would be safeguarded and available to depositors.

Several additional pieces of legislation enacted during the 1980s and detailed by Immergluck further altered the credit landscape by supporting the securitization of mortgages, while weakening the relative position of S&Ls. Specifically, “Larger, national scale mortgage companies could provide loans at lower cost—in part because Fannie Mae and Freddie Mac passed on some of their explicit and implicit federal subsidies in the form of lower cost capital” (2009, p. 32 in manuscript).

A prevailing feeling during this period was that it was time for the private sector to be liberated from federal regulation. President Reagan's 1982 Commission on Housing emphasized that "the genius of the market economy, freed of the distortions forced by government housing policies and regulations...can provide for housing far better than Federal programs" (Report of the President's Commission on Housing, 1982, p. vxii). And discussing the broad changes needed in housing finance, it stated that "the nation can no longer rely so completely on a system of highly regulated and specialized mortgage investors and a single type of mortgage instrument if the strong underlying demand for housing credit is to be met." Arguing for "a new legal and regulatory structure" and a "broader-based, more resilient system of housing finance," it called for "unrestricted access of all mortgage lenders and borrowers to the money and capital markets...[and for] sweeping policy measures to change the structure of the housing finance system..." (Report of the President's Commission on Housing, 1982, p. 120).

This free-market ideology shaped federal thinking for the following 25 years and turned out to be one of the key factors leading to the subprime crisis. Clearly, many of the issues first observed during this period became even more problematic in the subprime crisis of the 2000s—a lax federal regulatory structure encouraged aggressive and sometimes reckless behavior on the part of lending entities and, ultimately, there was a federal bailout paid for by taxpayers.

V. Contemporary Mortgage Finance System Takes Shape in the 1990s

At the close of the 1980s the mortgage finance system was unrecognizable from its historic roots. The relationships formed during that period have accelerated over the past two decades, with the mortgage finance system becoming intertwined with national, as well as global capital markets. No longer are mortgage loans originated by local lenders who have a deep knowledge of the neighborhoods in which they operate and who hold the loans in their long-term investment portfolios. Today, mortgage loan originators are most often mortgage companies, which are largely unregulated and sell the "paper" to a host of investors through a variety of investment vehicles.

Since subprime mortgages carry higher interest rates than standard loans, they have been attractive investments for hedge funds and other investors seeking high returns, the greater level of risk notwithstanding. As a result, mortgage companies have

been particularly interested in originating such loans. As of 2005, “30 percent of [subprime] loans [were] made by subsidiaries of banks and thrifts, less lightly supervised than their parent company, and 50 percent [were] made by independent mortgage companies, state-chartered but not subject to much federal supervision at all” (cited in Joint Economic Committee, 2007, p. 17).

Adding another layer to the mortgage finance system are mortgage brokers, who often work in tandem with mortgage companies. Brokers are yet another type of intermediary; they work with homebuyers to gather the necessary paperwork and then place the loan with a lender. Since they receive a fee for their services from the mortgage lender once the loan has closed, they have a strong incentive to qualify as many borrowers as possible and to place a high volume of loans. In fact, they may even receive extra payments for brokering high interest loans or ones that carry prepayment penalties. Mortgage brokers operate in a virtually risk-free environment; there are no financial implications whether loans are likely to succeed either over the short or long-term. In 2006, it was estimated that over 63 percent of the subprime loan originations and more than 29 percent of all mortgage originations were placed by mortgage brokers (cited in Joint Economic Committee, 2007).

The new system of mortgage finance has been supported by sophisticated computer techniques that have guided how money could be pumped into the mortgage market through a line of investors. The lender has a great deal of responsibility when the loan is originated, but that entity carries virtually no risk once the loan is sold. Indeed, as explained more fully in the next section, it is becoming increasingly difficult to determine who actually owns any particular loan. Michael E. Stone explains the substantial complexity of the new system:

During the period from 1991 through 1993, interest rates on MBSs (mortgage-backed securities) were higher than corporate and Treasury bonds and seemed virtually risk-free, due to the explicit government guarantee on Ginnie Mae securities and implicit guarantee on Fannie Mae and Freddie Mac securities. In response, many major investment houses bought MBSs issued by these government-sponsored entities and then issued and promoted another type of security, called collateralized mortgage obligations (CMOs)¹⁴ backed by these securities. CMOs...divide the expected interest payments and principal repayments from pools of mortgages into slices called “tranches.” Each type of CMO, which is very much like a bond, corresponds to a particular tranche; each

¹⁴ These are a specific type of collateralized debt obligation, or CDO, that is backed by mortgages.

has a unique combination of interest rate, term to maturity, rate of repayment of principal and risk. Because different kinds of investors have different financial goals, tax situations and tolerance for risk, the diversity of CMOs has opened up housing finance to a whole array of wealthy individual and institutional investors, including pension funds, insurance companies, banks, and Wall Street firms themselves (2006, p. 91).

As the securities were being purchased by investors farther and farther removed from the originators of the mortgages, payments for these securities were mostly made with highly leveraged dollars. That is, investors typically borrowed money to buy their new assets, making their own financial exposure that much smaller. However, the entities lending this money were taking a large portion of the risk, without any oversight or even apparent interest in the quality of the assets backing the loans.

While the deregulation of the financial industry took hold in the 1980s, the trend continued through the 1990s and, as explored in the following section, is one of the causes of the subprime crisis.

VI. The Many Causes of the Subprime Crisis Come Together in a “Perfect Storm”

The many causes of the subprime crisis can be grouped into several broad categories. Of course, some of these categories overlap. For example, the overall structure of the home finance system is directly related to the many issues pertaining to regulatory oversight and also to the private sector’s quest for profits. However, the following is offered as a framework for understanding the complexity of the causes of the subprime crisis:

- Overall structure and decisions of key home finance system actors
- Private sector’s quest for profits
- Mission and regulatory oversight of Fannie Mae and Freddie Mac
- Other regulatory actions (and inactions)
- General economic trends
- Housing market discrimination and government responses
- Role of homebuyers

Overall structure and decisions of key home finance system actors— Many of the factors that contributed to the subprime crisis already have been discussed. In particular, earlier sections of the paper have reviewed the ways in which deregulation of financial

institutions laid the groundwork for mortgage companies to become more dominant than the traditional, historically cautious S&Ls. These entities, however, have little if any connection to their local communities and borrowers. In addition, mortgage originators in the contemporary home finance system are rarely the holders of the mortgage paper. Instead, loans are sold to one of the government-sponsored secondary mortgage market entities or to other investors. Adding further complexity and an additional layer of investor involvement, the mortgage notes were often repackaged and sorted based on specific loan characteristics and resold again to other investors as collateralized mortgage obligations. Funds for these transactions were often borrowed, and investments were made with highly leveraged dollars.

In addition, for a borrower in default, locating the lender with a stake in the loan, working out a forbearance agreement, and setting up a new payment schedule often have become an extremely difficult, if not impossible, set of tasks. Mortgage servicers often cannot even advise a defaulting homeowner whom they should contact to work out a new payment arrangement. An article in *The New York Times* stated: “Because of the way mortgages are packaged into pools and sold to investors, it is still not clear who owns the faltering loans...” (Morgenson, 2007c). And this front page story appeared in *The Boston Globe*: “Tangle of Loans Feeds Foreclosure Crisis,” with a sub-heading that stated: “Borrowers can’t tell where to turn for change in terms” (Gavin, 2007). Further describing a family that had fallen behind on their payments and their request to renegotiate their loan with the mortgage servicer, Chase Home Finance, the family was told, “no.”

What [they] did not know was that Chase was not calling the shots. Chase merely services the loan, acting as bill collector and administrator. The mortgage was held by an unknown investor, whom Chase declined to identify and who refused to modify the terms of the [family’s] loan...Most home loans issued today pass through a nationwide chain of brokers, lenders, service companies, Wall Street firms, and investors. That makes tracing ownership difficult, if not impossible (Gavin, 2007).

Another *New York Times* article bluntly stated: “Mortgage Maze May Increase Foreclosures.” The article went on to describe how the current mortgage system undermines the ability of a homeowner in default to renegotiate the terms of the loan in the hope that foreclosure can be avoided:

The very innovation that made mortgages so easily available—an assembly line process known on Wall Street as securitization—is creating an obstacle for troubled borrowers. As they try to restructure their loans, they are often thwarted, lawyers say, by strict protections put in place for investors who bought the mortgage pools...Some homeowners have problems simply identifying who holds their mortgages. Others find the companies that handle their loan payments, known as servicers, are unresponsive, partly because modifying loans cuts into their profits...Compounding the problem is a law stating that when a loan is passed to another party, that entity cannot be held liable for problems (Morgenson, 2007b).

Until about the 1990s, Fannie Mae and Freddie Mac were the major entities involved with secondary mortgage market transactions—pooling and selling mortgage securities. Over the past few years, however, the government-sponsored enterprises have been joined by a host of other private for-profit firms. The latter pool thousands of loans at a time and sell them to investors, with oversight provided by a trustee bank; the transaction is governed by a document that spells out the various responsibilities of each party, including the role of servicers in assisting distressed borrowers. These agreements may limit the number or percent of loans in any given pool of mortgages that can be modified or they may state that “any modifications to loans in or near default should be in the best interests of those who hold the securities” (Morgenson, 2007b) — clearly, a situation that runs exactly counter to the needs of distressed borrowers.

If they are done properly, loan modifications are likely to be very helpful in assisting defaulting homeowners keep their homes. IndyMac, a large mortgage company that was seized by the FDIC, was ordered to modify the loans of thousands of defaulting borrowers. In an effort to reduce the number of foreclosures, which would be costly to the FDIC, eligible homeowners are being offered a reduced interest rate, to as low as 3 percent for a five-year period (Associated Press, 2008a).

Some loan modifications are unsustainable and may result in another default. Rather than fundamentally changing the terms of the loan by reducing the amount of principal owed or lowering the interest rate, modifications often “just add fees and interest to the loan balance and amortize them into the loan, add them to the end of the loan term, or provide temporary forbearance” (Stein, 2008, p. 16). A study by researchers at Freddie Mac found that:

the probability of failure drops sharply when borrowers get into a repayment plan. And while such plans are not quite as effective for low-to-moderate income borrowers or for those who live in underserved areas, they are nevertheless still very effective. At samples means, being in a repayment plan lowers the probability of failure by *68 percent* for low-to-moderate income borrowers. While this is not quite as impressive as is the result for non-low-mod borrowers (where failure probability is reduced by almost 80 percent), it remains nevertheless remarkable. Based on the results from our analysis, we believe that repayment plans are both statistically significant and economically important—that is, they work very well at keeping delinquent borrowers in their homes (Cutts and Green, 2004, p. 21).

Another key feature of the contemporary mortgage finance system is the level of securitization of mortgage instruments—a process that has been supported by a number of pieces of federal legislation enacted during the 1980s. This, in turn, has made the selling of collateralized mortgage obligations and derivative products flow smoothly through the finance system. In addition, many issuers of collateralized mortgage obligations (such as the large Wall Street investment banks) sought to decrease the risk to investors still further by purchasing a specialized type of insurance known as “credit default swaps,” which covered about 15-20 percent of a given security. But by giving this insurance product a new name, rather than calling it what it was, “insurance,” the normal regulatory structure governing insurance products was by-passed.¹⁵ American International Group (AIG), the largest insurer of this type of debt amassed a credit default swap portfolio of some \$527 billion, but ended up being unable to meet all its obligations.¹⁶ Even though most of the losses were only on paper, due to the internal structure of how AIG issued this insurance,

it had to put up collateral to its trading partners when the value of the underlying securities they had insured declined...So began AIG’s downward spiral as it, its trading partners and other companies were swept into the drowning pool by the housing downturn. Mortgage foreclosures set off questions about the quality of debts across the entire credit spectrum (Morgenson, 2008a).

¹⁵ The story is even more complex, however. Some credit default swaps did not actually insure an investment owned by the first investor; the asset on which the credit default swap was issued was owned by someone else. Credit default swaps that are purchased by a completely disinterested party would not be considered insurance.

¹⁶ In fact, it was only a small unit within AIG, that was based in London, which was at the center of the credit default swap business (Morgenson, 2008a).

In view of AIG's pivotal role in the overall structure of the finance system, in September 2008 Secretary of the Treasury Henry Paulsen and Federal Reserve Bank Chairman Ben Bernanke orchestrated a bailout of AIG in the form of an \$85 billion loan from the federal government, with the government taking control of the company. But, for our purposes, the point is that this type of insurance created a further layer of risk-shifting with yet another opportunity for lenders (albeit those that were far removed from originating the mortgages) to create the illusion of a secure debt instrument (Goldstein, 2008). This set of intertwined and difficult-to-trace financial arrangements were in place as the subprime crisis unfolded in mid-2007.

Finally, fueling the aggressive investment activity during much of the 2000s was the Federal Reserve Bank, the central bank of the U.S., and its adoption of what has been called an “overly accommodative” monetary policy.¹⁷ Characterized by low short-term interest rates, from the second quarter of 2002 through the third quarter of 2006, there was a significant decrease in the cost of funds for banks, and to other depository and non-depository institutions. This availability of credit lent itself to a virtual “feeding frenzy” on the part of lenders and mortgage originators, who stood to profit handsomely if they could move the money through the system as quickly as possible. With easy credit and attractive “teaser” interest rates, inflation in housing costs followed—the so-called “housing bubble” (Joint Economic Committee, 2008a).

Private sector quest for profits—Underlying the structure of the U.S. home finance system is a private sector that is focused on maximizing profits. This, in itself, may not be problematic given the capitalist goals of the economy. But when this fundamental orientation combined with laxity in regulation, along with the series of other factors described below, the results were catastrophic.

With the Federal Reserve Bank creating a long period of easy availability of credit, lenders vigorously pursued potential borrowers, attracting them with low initial interest rates and offering mortgages with very high loan to value ratios. While conventional loans typically had required that owners contribute 20-30 percent of the

¹⁷ In addition to U.S. monetary policies that kept interest rates low, in the aftermath of the Asian Financial Crisis of 1997-98 a series of policies in China and elsewhere resulted in holding down medium and long-term U.S. interest rates (Joint Economic Committee, 2008a).

total value of the home with the mortgage covering the remainder of the cost, many buyers were able to purchase homes with very low downpayments—3, 5, or 10 percent of the purchase price—or even no downpayment at all.¹⁸ This meant that in a market downturn, such as the one that unfolded in 2007, homeowners had minimal equity to cushion a price decline.

While the front-line mortgage originators stood a great deal to gain by making loans, profits depended on a ready market for these mortgages. Hedge funds and other investors looking for high-yielding investments created an “all but insatiable demand” that had been “unmet as a result of low, long-term interest rates worldwide on traditional investment vehicles” (Mallach, 2008, p. 2). Mallach continues:

The notion that, instead of avoiding risk, one could simply raise the cost on the basis of the risk involved, coupled with the demand for high-yield investments, set off a race among brokers and lender to create the most mortgages at the highest possible interest. This was encouraged by lender’s use of Yield Spread Premiums, which gave brokers higher commissions for making higher interest, riskier loans. To meet demand from investors for still higher yields, brokers and lenders came up with increasingly ingenious ways to qualify more buyer and make more loans (2008. p. 2).

Among these vehicles were adjustable or variable interest rate loans—another contributing factor to the subprime crisis. While homeowners were lured into purchasing due, in part, to low “teaser” interest rates, these rates would re-set at some point in the future, generally one to three years from the time of mortgage origination. Some of the owners who went into mortgage default were caught in an income squeeze, as the new payments on the re-set higher interest loans were higher than their incomes could cover. In addition, many lenders assessed the ability of borrowers to pay the loan based on the initial interest rate only, not the interest rate on the re-set mortgage. As a result, it was likely that a subprime borrower would have to sell, refinance or default when the mortgage was re-set. But as the overall housing market declined, equity in the homes was also diminished, and potential buyers were scarce, contributing to foreclosure problems.

The very meaning of “subprime” loans is that households may be approved for mortgages with weaker credit histories or income qualifications than typically would be permissible. At least some of the households who bought homes should never have been

¹⁸ Liberalization of lending terms started during the Clinton administration.

approved for loans in the first place, since they could not afford the mortgage payments, either in the short or long-term. However, in such cases, another term is used: “predatory lending.” This is characterized by loans that are based on the value of the asset, with little or any consideration for whether the borrower is able to cover the debt. Subprime loans, whether predatory or not, also carry significant prepayment penalties. If a homeowner wants to sell or refinance their home during the period of restriction, one to three years or longer, thousands of dollars of prepayment fees may be added into the transaction, thereby reducing any equity that may have accrued. Many homeowners may lapse into mortgage default and foreclosure, directly because of the financial disincentive associated with prepayment penalties (Quercia, Stegman, and Davis, 2005). Similar to subprime loans are what is known as “Alt-A” loans, which typically were extended to people with good credit scores, but without proof of income or assets. Alt-A borrowers are also experiencing a high rate of default (Bajaj, 2008).

Repeating the problems that arose in the 1970s in connection with Section 235 low-income homeownership program, many mortgage originators abandoned the basic responsibility to verify borrower incomes and debt. Many loans were permitted on the basis of “no income documentation required” (a problem in itself). For example, from 2000 to 2005 there was a sharp increase in the number of subprime loans originated without full documentation—from 26 percent to 44 percent (cited in Stein, 2008). In addition, many originators also explicitly falsified income data in order to help homeowners qualify for loans. At the same time, property inspections were sometimes inadequate, resulting in households assuming ownership without accurate information about the repairs needed and the accompanying costs.

Also, as noted earlier, mortgage brokers represented another layer of actors in the mortgage origination process. Although seemingly working in the buyer’s interest they do not, in fact, have any explicit responsibility to do so. Playing a “particularly destructive role in the subprime market,” loans originated through mortgage brokers typically end up costing the homeowner thousands of dollars more than loans originated directly through a lender (Stein, 2008, p. 19).

At the other end of the lending spectrum are the investors. But before an investor buys a block of mortgages, securities that are backed by mortgages, or any other derivative product, rating agencies assess the credit-worthiness of the asset backing the

investment. This is an important step in the overall mortgage lending system, since federal regulatory agencies “require banks, insurance companies and pension managers to purchase only high-quality debt — and the quality is judged by rating agencies” (Rosner, 2007). However, the rating agencies are neither passive nor disinterested parties in transactions involving the sale of mortgage securities; a great deal of their business in recent years has been dependent on the ratings they give these assets. Moreover, rating agencies are paid by the entities issuing the securities. This has created an incentive for rating agencies to provide as favorable ratings as possible in an effort to win contracts from major investment banks (Joint Economic Committee, 2008b). Furthermore, rating agencies:

actively advise issuers of these securities on how to achieve their desired ratings. They appear to be helping investment banks, hedge funds and fund companies, all of which have a fiduciary obligation to investors, to develop the worst possible product that would still achieve a certain rating. Only slightly more than a handful of American non-financial corporations get the highest AAA rating, but almost 90 percent of collateralized debt obligations that receive a rating are bestowed such a title. The willingness of Fitch, Moody’s and S&P [Standard and Poor’s] to rate as investment grade many assets that are apparently not has made structured securities ratings their fastest-growing line of business (Rosner, 2007).

Thus, rating agencies occupy another level of risk-shifting with investors apparently relegating too much authority to these agencies, rather than carrying out their own analyses about the risk and credit-worthiness of a given security (Forbes.com, 2007). At each step of the mortgage lending process, and with each new private sector entity involved, there were opportunities for significant profits—opportunities that were pursued vigorously.

While the ratings agencies were clearly culpable, they were only middlemen; fueling their activities were the investors. As Eric Stein, Senior Vice President of the Center for Responsible Lending, testified:

As long as housing prices continued to rise, the underlying quality of the mortgages was of no particular interest to the investment firms. Bonuses depended on short-term revenue, which trumped any incentives to worry about what would happen if the market changed. Demand from Wall Street for subprime loans was so intense that it encouraged subprime lenders to abandon reasonable qualifying standards, to forget about standard documentation requirements, and to ignore whether borrowers could actually afford the loan (2008, p. 17).

Further detailing the profits that were being made, Stein notes that the five major investment firms “took in an estimated \$7.6 billion in revenues from selling and trading mortgage-backed securities in 1976—including \$1.75 billion in revenues related to subprime mortgage-backed securities (2008, p. 17).

Mission and regulatory oversight of Fannie Mae and Freddie Mac —A wide variety of regulatory lapses or omissions have contributed to the subprime crisis. This section focuses on Fannie Mae and Freddie Mac, and the following examines other key actors who were regulated weakly, or not at all, by the government.

The affordable housing goals of Fannie Mae and Freddie Mac may have confused lenders about the types of loans that were to be offered and to whom. As Government Sponsored Enterprises (GSEs), both were obligated under the Federal Housing Enterprises Financial Safety and Soundness Act of 1992 to target a certain percentage of their lending activity to very low, low, and moderate-income households, as well as to buyers of homes located in census tracts with high levels of low-income and minority households. During the 1990s, the Clinton administration put increasing pressure on Fannie Mae to more aggressively buy subprime mortgages, thereby encouraging lending to low- and moderate-income people, even if they had credit records that were too weak for conventional loans. In a prescient 1999 statement, a *New York Times* journalist stated:

In moving, even tentatively, into this new area of lending, Fannie Mae is taking on significantly more risk, which may not pose any difficulties during flush economic times. But the government-subsidized corporation may run into trouble in an economic downturn, prompting a government rescue similar to that of the savings and loan industry in the 1980s (Holmes, 1999).

This trend, which involved strong federal government encouragement of the GSEs to meet the credit needs of less traditional borrowers, continued through the 2000s. Affordable housing goals for the years 2005-2008 were increased significantly over the GSEs’ housing goal levels for 2001-2004, thereby creating added pressure on Fannie Mae and Freddie Mac to extend credit to more low-income households. Despite allegedly being alerted to the fact that Freddie Mac’s underwriting standards had declined and that this was exposing the company to losses, the chairman and chief executive office of Freddie Mac, Richard F. Syron, is reported to have said: “we couldn’t say no to anyone” (Duhigg, 2008a). Others have been critical of that type of response. A former high-

ranking Freddie Mac executive stated: “Sure, it’s hard to deal with the pressures of Congress and shareholders and regulators. But that’s why executives get paid so much. It’s not acceptable to blame those pressures for making bad choices” (cited in Duhigg, 2008a). Moreover, while the GSEs had standards on loans they were purchasing (even if those standards may not always have been followed), investments purchased by Fannie Mae and Freddie Mac were not covered by those guidelines and, in fact, many of those assets would not have met those guidelines. In 2007 Freddie Mac offered to stop making these types of investments; shortly thereafter they were both ordered to stop (Stein, 2008).

A second regulatory issue is also connected to the GSEs. In contrast to all other Fortune 500 companies, all of which have publicly traded stock, neither Fannie Mae nor Freddie Mac was regulated by the Securities and Exchange Commission (SEC), although at least in recent years they have voluntarily filed reports with that agency. Instead, Fannie Mae and Freddie Mac have been overseen by an independent entity within HUD, the Office of Federal Housing Enterprise Oversight, which provided a less stringent level of oversight of the agencies’ financial dealings than what would have been required by the SEC. This arrangement may have contributed to the problems auditors discovered in each company’s accounting procedures, some of which were serious enough to launch federal investigations. In fact, two reports “concluded that Fannie Mae improperly used financial reserves and deferred expenses to meet profit goals, which underpinned the payment of millions in executive bonuses” (Bajaj, 2006). Similarly, according to the SEC Freddie Mac “engaged in a fraudulent scheme that deceived investors about its true performance, profitability and growth trends” (Associate Press, 2007). Federal fines to Fannie Mae and Freddie Mac amounted to \$400 million and \$50 million, respectively.

In 2005, led by Republican Senator Chuck Hagel, a bill was introduced that would have provided a greater level of federal oversight of the GSEs by creating a new independent regulatory agency. A partisan fight ensued with Democrats opposing the bill, accompanied by vigorous lobbying by a consulting firm retained by Freddie Mac (Associated Press, 2008b). The bill, the Federal Housing Enterprise Regulatory Reform Act of 2005 (S. 190) died with the 109th Congress.

While the problems at the GSEs went far beyond any set of individuals, Daniel H. Mudd, former CEO of Fannie Mae appears to be an appropriate target for at least some of

the blame. Apparently warned by his staff that “lenders were making too many loans that would never be repaid, he steered Fannie into more treacherous corners of the mortgage market...Between 2005 and 2008, Fannie purchased or guaranteed at least \$270 billion in loans to risky borrowers—more than three times as much as in all its earlier years combined” (Duhigg, 2008b). Furthermore, as Fannie Mae was losing business to Wall Street firms, it came under even more pressure to lower its standards. A Fannie Mae senior executive was quoted in a *New York Times* article as having stated: “Everybody understood that we were now buying loans that we would have previously rejected...But our mandate was to stay relevant and to serve low-income borrowers. So that’s what we did” (Duhigg, 2008b).

Taking a much more forgiving position concerning the role of the GSEs are Eric Stein and Nobel Prize winning economist, Paul Krugman. Stein notes that the GSE share of the mortgage market diminished substantially as subprime lending increased and the level of GSE purchases of mortgage-backed securities issued by the Wall Street investment houses was far less than the purchases made by hedge funds and other firms and investors. Moreover, Stein rejects the notion that the affordable housing goals are to blame, noting that subprime loans constitute a very small portion of the GSEs’ portfolios and account for only a small percentage of current losses. Instead, he places the blame on GSE purchases of A1-A loans, which went to somewhat higher income borrowers and that account for 50 percent of the combined losses of Fannie Mae and Freddie Mac. Stein sums up his assessment of the GSEs as follows:

Although they contributed to the subprime market, and they made wrongheaded investments in loans that did not document income, they were a lifeline for the economy when the Wall street-driven asset-backed securities market dried up in 2007 because of excessive mortgage-related losses...the GSEs and FHA provided liquidity for virtually all conforming sized loans in the country. If the GSEs had not stepped in when they did, the credit crunch that we are facing would be infinitely worse, as would the current recession. Further ... [Fannie Mae’s] investment in sustainable loans in low-income and low-wealth communities has substantially improved the lives of hundreds of thousands of American families (2008).

Krugman bluntly states that Fannie Mae and Freddie Mac “aren’t responsible for the mess we’re in...[they] had nothing to do with the explosion of high-risk lending a few years ago...Fannie and Freddie, after growing rapidly in the 1990s, largely faded from

the scene during the height of the housing bubble” (2008). He attributes the problems at the GSEs to the size of the housing bubble and the extent of the price declines now occurring. In addition, he sees the low capital requirements as problematic

Whether or not the GSEs’ interpretations of the country’s affordable housing goals were over-zealously interpreted is clearly open to debate. Nevertheless, the fundamental policy issue of how to combine the needs of low income but credit-worthy borrowers, with a disciplined approach to underwriting, was probably confronted more directly by the GSEs than by any other set of actors. This question will be raised again in the final section of the paper.

Other regulatory actions (and inactions)--In addition to weak oversight of the GSEs, there has been an almost total lack of regulation of the entities that have become the dominant originators of mortgage loans—mortgage companies. Whereas thrift institutions and commercial banks have operated under federal oversight since the Depression, the mortgage company business has not had to meet the guidelines or requirements of any of the federal regulatory agencies. Unhampered by the kinds of restrictions imposed on depository institutions, mortgage companies have been allowed to operate on a more or less laissez-faire basis. While they take very little risk in mortgage lending transactions, since they sell the loans they originate to Fannie Mae, Freddie Mac or to other investors, mortgage companies are responsible for the decision of whether to lend and on what terms. However, as early as the 1970s it was observed that this responsibility often was severely neglected.

Investment banks were other key actors that were subject to weak federal oversight. Under pressure from the big investment banks, in 2004 the SEC changed a key rule that allowed these entities to assume significantly higher levels of debt, for every dollar of assets. This change was intended to:

unshackle billions of dollars held in reserve as a cushion against losses on their investments [and was to facilitate investment] in the fast-growing but opaque world of mortgage-backed securities; credit derivatives...and other exotic instruments....In loosening the rules, which are supposed to provide a buffer in turbulent times, the agency also decided to rely on the firms’ own computer models for determining the riskiness of investments, essentially outsourcing the job of monitoring risk to the banks themselves. Over the following months and years, each of the firms would take advantage of the looser rules. At Bear Stearns,

the leverage ratio—a measurement of how much the firm was borrowing compared to its total assets—rose sharply, to 33 to 1. In other words, for every dollar in equity, it had \$33 of debt. The ratios at the other firms also rose significantly. The 2004 decision for the first time gave the SEC, a window on the banks’ increasingly risky investment in mortgage-related securities. But the agency never took true advantage of that part of the bargain. The supervisory program ...was a low priority (Labaton, 2008).

In commenting on the expectation that the investment firms would voluntarily regulate themselves, a Duke School of Law professor observed that it: “made sense to me because I didn’t think the SEC had the staff and wherewithal to impose its own standards and I foolishly thought the market would impose its own self-discipline. We’ve all learned a terrible lesson” (James D. Cox, quoted in Labaton, 2008).

As early as 1994 there were clear signals that financial derivatives, which were being issued by investment firms, needed much greater federal scrutiny. In an accurate foreshadowing of the 2007-08 subprime crisis, a report issued by the U.S. General Accounting Office stated:

Much derivatives activity in the United States is concentrated among 15 major U.S. dealers who are extensively linked to one another and their customers. The sudden failure or abrupt withdrawal from trading of any of these large dealers could cause liquidity problems in the markets and pose risks to the others, including federally insured banks and the financial system as a whole. Federal intervention could involve industry loans or a financial bailout paid for by taxpayers...Comprehensive industry or federal regulatory requirements are lacking to ensure that U.S. over-the-counter derivatives dealers follow good risk-management practices...Federal regulators have begun to address derivatives activities, but significant gaps and weaknesses exist in the regulation of many major over-the-counter derivatives dealers...In GAO’s view, the issue is how to allow U.S. financial services to grow and innovate while protecting the safety and soundness of the nation’s financial system (U.S. General Accounting Office, 1994).

In particular, the report called for firms dealing in derivatives to be regulated by the SEC (Hansell, 1994). Without attempting to trace the adequacy of the GAO recommendations or their implementation, suffice to say that they either were insufficient, ill-conceived, never carried out, or poorly monitored. One point, however, about the lack of regulation of the derivatives market is worth highlighting: the role of former Federal Reserve Chairman, Alan Greenspan. As a staunch supporter of the derivatives market operating in an environment unfettered by government regulation, Greenspan opposed additional federal oversight, arguing that “You can have huge

amounts of regulation and I will guarantee nothing will go wrong, but nothing will go right either” (quoted in Goodman, 2008). But what is not debatable is the accuracy with which the GAO predicted a dire scenario if the derivatives market was not more closely regulated.¹⁹

Other issues also have been raised concerning the adequacy of the Federal Reserve Board’s oversight functions. Although a law prohibiting abusive and deceptive lending by all originators was passed in 1994, the Federal Reserve Board neglected to exercise its regulatory responsibilities, or at least to exercise them in a way that would have prevented the kinds of abuses that have been so prevalent over the past decade. It was not until July 2008 that Federal Reserve Chairman Ben Bernanke issued a strong rule implementing The Home Ownership and Equity Protection Act; “had these rules been issued just three years earlier, countless foreclosures could have been prevented” (Stein, 2008, p. 20).²⁰

In hindsight, even Alan Greenspan has acknowledged that he made mistakes in opposing greater federal regulation, particularly of the derivatives market. In response to questions by the House Government Oversight Committee, Mr. Greenspan testified: “Those of us who have looked to the self-interest of lending institutions to protect shareholder’s equity (myself especially) are in a state of shocked disbelief.” And further admitting a flaw in his faith in the free market and the need for limited federal oversight, he noted that he was partially wrong to oppose regulation of credit default swaps, which he now sees as having “serious problems” (cited by Scannell and Reddy, 2008).

¹⁹ Alan Greenspan also was instrumental in the repeal of the Glass-Steagall Act, a Depression-era initiative that separated commercial and investment banking. The Gramm-Leach-Bliley Act of 1999 signaled the end of commercial banks owning investments banks and vice versa. Investments banks continued to be unregulated, while the commercial banks were subject to oversight by one of the federal financial regulatory agencies (see n. 11). Despite the regulatory oversight, however, banks were, for the first time, allowed to underwrite and trade instruments such as mortgage-backed securities and collateralized debt obligations in the international market. The repeal of Glass-Steagall has been cited as a key contributing factor to the subprime crisis (Kuttner, 2007).

²⁰ According to Immergluck, “HOEPA did little to actually proscribe abusive or unsound lending practices for the vast majority of mortgages—even the majority of high-risk or high-cost mortgages—because it only had any real teeth for loans priced over very high fee and rate thresholds. In fact, it is arguable the HOEPA helped pave the way for the emergence of the subprime mortgage market by implicitly sanctioning many high-cost and high-risk loans that were not prohibited by the law and that did not reach the HOEPA pricing thresholds. In effect HOEPA provided lenders with an implicit endorsement for high-risk loans that were priced under—even just under—these thresholds (2009, p. 7 in manuscript).

Another regulatory issue that has been cited as a possible contributing factor to the subprime crisis also relates to the SEC. Specifically, the SEC's "mark to market" rule has required banks to value assets, such as mortgage backed securities and other derivative products, at the prevailing market value of those assets. Since many mortgage securities have experienced precipitous declines in value, financial entities, including insurance firms such as AIG, have been forced to write-down the value of those assets. Critics of this accounting method have claimed that in view of the low current value of these assets, they should not be forced to devalue those assets, since the market price is sure to increase at some point in the future. Some analysts, however, have argued that the SEC rule is not the problem, and that the root of the difficulties can be traced back to the original purchase of the risky assets (Norris, 2008). Nevertheless, the SEC has made some modest changes in the rule that bankers felt would allow them to use valuation techniques that would price the asset above "fire-sale" levels.

The Office of the Comptroller of the Currency and The Office of Thrift Supervision are other federal regulatory entities that have been cited for lax regulation. Concerning the OCC, which supervises nationally-chartered lending institutions, not only was oversight inadequate, but it appears that the OCC worked at cross-purposes with states that were attempting to enact and implement laws aimed at banning predatory lending. By expanding federal preemption guidelines, the OCC neglected its responsibilities to oversee the activities of the lenders within their domain, as dictated by the federal regulatory framework (Stein, 2008).

The Office of Thrift Supervision's actions also have been faulted, as three large institutions under its purview went out of business. With specific reference to two of them, IndyMac and Washington Mutual:

OTS failed to take effective action to halt the unsafe and unfair lending practices that eventually doomed both. And even as it became clear that these two banks' loan performance and financial returns were rapidly taking a turn for the worse, OTS failed to act aggressively to alleviate the damage. In fact, OTS prevented FDIC from taking timely action by declining to put the two banks on the government's list of trouble banks until just before they went under—far too late to make any difference (Stein, 2008, p. 23).

These various failures in regulatory oversight may have been partly due to the revolving door nature between government regulators and the industry being regulated. In fact, the 2004 request to change the SEC rule (which allowed investment banks to more

aggressively lend based on their equity) was led by the head of Goldman Sachs—the same Henry M. Paulson who, two years later, was appointed Secretary of the Treasury. And it was Paulson who ended up proposing the massive \$700 billion bailout which will benefit the remaining two investment banks, including Goldman Sachs, as well as playing a major role in the implementation of this complex effort.

Most prominent among those who will be directly involved implementing the bailout effort is Neel Kashkari who, before becoming an assistant secretary at the Treasury Department, was a vice president at Goldman Sachs. In early October 2008 Kashkari was appointed by Paulson to head the new Office of Financial Stability, the government's lead bailout agency. Others who will be involved in assessing and purchasing the weak securities from banks and investment firms also are sure to be former employees of the financial industry who may, in fact, still have ties to that industry. While there are murmurings that these are the same individuals who may have been reckless and irresponsible in their former positions, the argument is being made that no one else has the kind of expertise needed for the complex transactions being anticipated.

General economic trends—Another broad set of reasons behind the subprime crisis relates to the downturn in the housing market as overpriced properties began to decline in value—the bursting of the “housing bubble.” For years leading up to the crisis, housing analysts had bemoaned the high cost of housing in many market areas and predicted that the “housing bubble” would burst at some point in the foreseeable future. As the first waves of recession began to ripple through the economy in mid-2007, house prices in many areas fell and owners with little equity in their homes were unable to sell for an amount that would cover the outstanding principal balance on their mortgage.

As part of the overall economic decline in 2007, workers began to lose jobs making it difficult or impossible to cover their mortgage payments, whether or not the loans had re-set to higher interest rates. As of July 2008, the unemployment rate reached a four-year high (Bajaj, 2008).

Housing market discrimination and government responses—Discrimination in the housing and mortgage market has been a common practice among lenders and real estate

brokers for decades. Recently, government responses to this problem have been blamed for at least some portion of the current financial crisis, although this writer rejects these assertions. However, for the sake of thoroughness, the following provides a brief background of this argument.

Throughout the 20th century lenders systematically provided loans less often to people of color and in low-income communities than their white counterparts. Discriminatory practices also were prevalent among real estate brokers, which have been found to steer nonwhite households to certain neighborhoods, to withhold information about properties for sale or rent, and to simply state that a house or apartment was no longer available (see, for example, Turner et al. 2000).

Discrimination in the mortgage markets also were legitimized and supported by the Federal Housing Administration in the 1930s and 1940s, whose underwriting manuals explicitly directed appraisers not to approve mortgage insurance in neighborhoods with “incompatible racial and social groups” or that were subject to “being invaded by such groups” (Federal Housing Administration, 1938). Describing what has become known as redlining, the early FHA also stipulated that large areas of cities were unsuitable for mortgage insurance, labeling them “central reject areas” (Federal Housing Administration, 1938).

The most blatant discriminatory language was removed from the FHA manuals by 1949, but as recently as the late 1960s there still was de facto government support for discriminatory lending practices. For example, one government report stated:

up until the summer of 1967, FHA almost never insured mortgages on homes in slum districts, and did so very seldom in the “gray areas” that surrounded them...There was evidence of a tacit agreement among all groups—lending institutions, fire insurance companies, and FHA—to block off certain areas of cities with “red lines,” and not to loan or insure within them...The main weakness of FHA from a social point of view has not been in what it has done, but in what it has failed to do—in its relative neglect of the inner cities and of the poor, an especially Negro poor (The Report of the National Commission on Urban Problems, 1968, p. 100).

The Civil Rights Act of 1968 banned discrimination both by real estate agents and by mortgage lenders. But it was not until 1975 that activists were successful in forcing the government to pass a first piece of legislation explicitly aimed at discrimination in the mortgage market. The Home Mortgage Disclosure Act of 1975 required depository

institutions to disclose where their deposits were coming from, in terms of geographic areas, and to whom, and where, loans were being made.

The Community Reinvestment Act of 1977 took additional steps toward eliminating redlining, by requiring banks to meet the credit needs of their local communities, with a particular emphasis on the needs of low-income areas and non-white borrowers. The “stick” for noncompliance was the ability of a federal regulatory agency to reject a bank’s application to change some form of its operations, such as merging with another institution or open or closing a branch.

Some critics of CRA have argued that the federal government’s implementation of CRA was a key cause of the irresponsible lending of the subprime era. For example, a *Boston Globe* columnist stated:

Lenders responded [to CRA] by loosening their underwriting standards and making increasingly shoddy loans...Fannie Mae and Freddie Mac encouraged this “subprime” lending by authorizing even more “flexible” criteria by which high-risk borrowers could be qualified for home loans, and then buying up the questionable mortgages that ensued...Affirmative-action policies trumped sound business practices (Jacoby, 2008).

This argument is, however, misleading and inaccurate. While CRA did, indeed, direct financial institutions to meet the credit needs of low-income communities, it did not advise or demand banks to make unsound loans. Also, as discussed previously, the great majority of poor lending decisions were made by mortgage companies, which were not even subject to CRA. These lenders failed to distinguish between shoddy loans that should not have been made, and those that were warranted based on the borrower’s credit history, income, and value of the property.

In fact, lenders that fall under CRA regulations have been able to make money by advancing responsible loans to credit-worthy borrowers, as the senior vice president of a Boston bank noted: “I have been involved in millions of dollars lent to low-and moderate-income, first-time homebuyers. These borrowers, many of whom are from minority groups, are solid borrowers who pay back their loans” (Schlorholtz, 2008).

Based on 2006 Home Mortgage Disclosure Act data in the 15 most populous metropolitan areas, Traiger and Hinckley, LLP concluded that CRA banks were “substantially less likely than other lenders to make the kinds of risky home purchase loans that helped fuel the foreclosure crisis” (2008, p. 1).

Blaming the CRA is a weak attempt at shifting the responsibility from those that should bear it—the lenders and investors. Pointing the finger at the federal government for excessive regulation in the form of CRA gets the story backwards: it was not too much regulation, it was too little.

Role of homebuyers—Many people who bought or refinanced homes with subprime loans were ill-prepared for the responsibilities of homeownership and assumed these new debts with a limited understanding of their legal obligations.²¹ Homeownership counseling programs are a key way to help prepare unsophisticated buyers for assuming ownership, but participation in such programs was not a prerequisite for loan approval. In addition to the lack of knowledge about homeownership, many people were lured into becoming homeowners in response to the widespread availability of mortgage products with low down payments and low initial monthly payments, and because media reports constantly warned about the escalating costs of homeownership; if one didn't buy soon, they might “miss the boat” and permanently be locked out of the homeownership market. As a Joint Economic Committee report noted, “media promotion of housing as an investment caused a surge in the speculative demand for housing during the first half of this decade” (2008, p. 15). But with low down payments required for many mortgages, risks of default were increased (Stone, 2006). Also, not all homeowners were truthful about reporting their income or assets with a number of independent reviews finding significant discrepancies between the information provided on mortgage loan applications and with the tax forms filed with the Internal Revenue Service²²

But how did so many people come to believe that they could manage the challenges of homeownership with, perhaps, skimpy savings and an unstable low-paying job? The generation of homebuyers in the latter part of the 20th century and into the new

²¹ In fact, in the early days of subprime lending, the late 1990s, only about 20 percent of subprime loans were for home purchase, as opposed to refinancing. In 2006, the share of home purchase subprime loans rose to 43 percent (Immergluck, 2009, p. 52 in manuscript).

²² According to Morgenson (2007a): “An April 2006 report by the Mortgage Asset Research Institute, a consulting concern in Reston, Va., analyzed 100 loans in which the borrowers merely stated their incomes, and then looked at documents those borrowers had filed with the I.R.S. The resulting differences were significant: in 90 percent of loans, borrowers overstated their incomes 5 percent or more. But in almost 60 percent of cases, borrowers inflated their incomes by more than half.” In addition, a [Deutsche Bank](#) report indicated that loans on which the applicant had lied about their income or assets loans accounted for 40 percent of the subprime mortgages in a single year.

millennium was vastly different from their parents and grandparents. Those who lived through the Great Depression, or who grew up in homes with parents who had experienced the financial turmoil of that period, were typically risk averse, viewed debt as something to be avoided at nearly all costs, and believed in saving (not borrowing) for those items that one needed. The late 20th century, however, saw huge shifts in the basic fiscal conservatism of the U.S. population. Whether lured by the credit card boom of the 1970s, the many offers of easy credit, and the sense that “you can have it all now,” it appears that people came to believe in a robust future, albeit one likely saddled with debt.

A sympathetic response is that households were willingly assuming more and more debt, particularly those who were refinancing their homes with subprime loans because they were becoming increasingly pinched, financially. As housing prices rose much more steeply than incomes through the 1980s and 1990s, it became virtually impossible to close the gap. More and more families had to borrow money to cover the basic necessities of living and many were trying to stabilize their housing costs through homeownership (as opposed to fast-increasing rental costs), or by borrowing against the equity in their homes. But whatever the explanation for why families took on more debt than they could manage, it is clear that the events leading up to the subprime crisis fueled and reinforced the sense that assuming an unaffordable mortgage was, perhaps, a good bet.

The combined result of these numerous factors produced a “perfect storm”—the subprime crisis of 2007-08 that has created dislocations in the U.S. as well as in capital markets across the globe. What appears to have happened is the following: as defaults and foreclosures on sub-prime as well as conventional loans started to mount, investors were required to mark down the value of various investment vehicles—the assets whose ultimate value rested on the sub-prime and conventional mortgage loans. With the balance sheets of these investors weakening, it became difficult or impossible for these entities to raise additional credit on the capital markets, both to cover the widening asset-capital spread, as well as to raise new funds. As credit dried up, the markets began to shut down. Federal Reserve Chairman Ben Bernanke, Treasury Secretary Henry M. Paulson and President Bush created a bailout scheme to pump money into the credit markets directly, by federal purchases of so-called “toxic investments”— investments that were based on the underlying defaulting or likely-to-default mortgages. Of course, many of

these investments had been sold and then recollateralized (raising new funds all along the way) and they were now buried deep in tranches, with various gradations of risk associated with them. Nevertheless, the actual asset was an actual mortgage to some individual, in some part of the country, which some mortgage originator had made.

There have been many statements by key actors in the mortgage finance system or in government indicating that they and others had no warning that a subprime crisis was looming on the horizon. For example, in September 2007, Barney Frank, Chairman of the House Financial Service Committee, wrote about “the unanticipated impact it [the subprime crisis] had on financial markets in general.” Indeed,” he wrote, “that lack of anticipation is a danger sign: None of the entities charged with supervision of the economy predicted that the crisis would have broader negative effects” (Frank, 2007). And the chief executive of Countrywide Financial, which at the time was the country’s largest mortgage company and one of the major originators of subprime mortgages, stated: “Nobody saw this coming. S&P and Moody’s didn’t see it coming...Bear Stearns didn’t see it coming, Merrill Lynch didn’t see it coming. Nobody saw it coming” (quoted in Ryan, 2007).

Despite these comments of utter surprise, as noted earlier, various reports and papers, written as early as 1994 (and even before),²³ predicted the precariousness of the institutions and arrangements that were being devised. More recently, writing in 2007, Nobel Prize winning economist Paul Krugman stated:

What’s been happening in financial markets over the past few days is something that truly scares monetary economists: liquidity has dried up. That is, markets in stuff that is normally traded all the time — in particular, financial instruments backed by home mortgages — have shut down because there are no buyers. This could turn out to be nothing more than a brief scare. At worst, however, it could cause a chain reaction of debt defaults...Financial institution A can’t sell its mortgage-backed securities, so it can’t raise enough cash to make the payment it

²³ For example, writing in 1986, Michael E. Stone stated: “The changes in mortgage financing over the past decade and a half thus gave a tremendous boost to real growth in the economy, but also to the unprecedented inflation and the overblown credit bubble...Residential finance is no longer a relatively separate and insulated component of the credit system. Many investors other than thrift institutions and small savers now have hundreds of billions of dollars tied up with the mortgage system. The stability of the structure of residential debt is thus increasingly vital for the stability of the entire financial structure of American capitalism. But the stability of the housing debt system depends upon continued mortgage payments from people in existing housing... The present situation is really quite desperate... it is very likely that in the next few years the number of people unable to pay for their housing will again dramatically increase” (pp. 57-58).

owes to institution B, which then doesn't have the cash to pay institution C — and those who do have cash sit on it, because they don't trust anyone else to repay a loan, which makes things even worse. And here's the truly scary thing about liquidity crises: it's very hard for policy makers to do anything about them.

Difficult or not, the U.S. federal government has attempted to reverse the decline. A \$700 billion bailout bill was signed into law on Friday, October 3, 2008 less than two weeks after it had been proposed, on Saturday September 20. Opponents argued, among other concerns, that it would be far better to focus on the underlying problem of mortgage foreclosures and work with defaulting homeowners to refinance their loans, mirroring the efforts of the successful Home Owners' Loan Corporation of the 1930s (see, for example, Clinton, 2008). However, this proposal was not supported by the Bush administration and the credit bailout was approved. Other initiatives in October 2008 involved meetings between the U.S. and the other members of the G-7 group of industrialized to create a coordinated multinational set of initiatives to prop up the global banking industry.

As the chaos surrounding the subprime crisis has continued to unfold, it is clear that, in addition to the broad-scale economic implications and outcomes, this crisis has undermined many of the longstanding social goals associated with homeownership.

VII. Impacts of the Subprime Crisis and the Multiple Goals of Homeownership

The subprime crisis began to take shape in mid-2007. Since then, the foreclosure rate has skyrocketed. In July 2008 there were foreclosure filings on 272,171 properties during the month, an 8 percent increase from the previous month and a 55 percent increase from July 2007.²⁴ One out of every 464 U.S. households received a foreclosure filing during the month. Bank repossessions, combined with a slow sales market, have created an enormous inventory of bank-owned properties for sale, with more than such 750,000 listings. This represents about 17 percent of the inventory of existing homes for sale reported in June by the National Association of Realtors (RealtyTrac, 2008; see also Bajaj, 2008). And, as noted at the outset of this paper, the total number of foreclosures between 2008 and 2013 could go as high as 6 to 10 million homes.

In the U.S., new and existing home sales have declined, accompanied by a loss in house values, and overall declines in employment in the residential construction sector.

²⁴ A foreclosure filing is a default notice, auction sale notice, or bank repossession.

Unemployment in other sectors of the economy also is expected to increase. In addition, dozens of mortgage banks have gone bankrupt and even those that did not specialize in subprime lending have encountered serious losses. Countrywide Financial had enjoyed a 17 percent share of the origination market and was rescued from going out of business by being sold to Bank of America, albeit at a fraction of its value one year earlier (Joint Economic Committee, 2008a). Banks all across the country have been struggling to maintain liquidity and the Federal Reserve Bank has instituted a number of procedures to enhance the availability of credit and to stabilize the banking industry.

In March 2008 the Federal Reserve Bank facilitated the acquisition of the non-depository investment firm, Bear-Stearns, to another investment entity, JP Morgan-Chase, in response to the former's report that its liquidity had dropped from \$18 billion to \$2 billion in less than a week (Joint Economic Committee, 2008b). Further, Fannie Mae and Freddie Mac have experienced huge losses and, on September 7, 2008 the U.S. Treasury activated measures authorized by Housing and Economic Recovery Act of 2008 to provide a line of credit to Fannie Mae and Freddie Mac in order to assist these entities to maintain liquidity and continue operating.²⁵ They are now directly under federal control. Later in September, the largest S&L in the country was seized by federal regulators in what was the biggest bank failure in the history of the U.S. Just a few weeks later, one of the largest commercial banks in the U.S., Wachovia, was acquired by another large bank, Wells-Fargo. Not surprisingly, perhaps, one of the responses to all these major upheavals has been a series of lawsuits, as aggrieved parties attempt to shift the blame on others.²⁶

At a larger economic level, there have been severe dislocations both in the U.S. and in countries all across the world. According to several studies, global subprime-related credit losses will reach over \$400 billion (cited in Joint Economic Committee, 2008a) and if one factors in global credit losses for all loans and other securities that have occurred as a result of the U.S. financial crisis, losses will be far higher, reaching \$945 billion (cited in Joint Economic Committee, 2008b).

²⁵ Shares of Fannie Mae and Freddie Mac stock declined dramatically in 2008, with prices hitting a 17-year (Labaton and Weisman, 2008). This loss of confidence led to investor caution about buying additional assets from these institutions and to what is being referred to as a federal bailout of these huge GSEs.

²⁶ See, for example, Morgenson, 2008b and Streitfeld, 2008a.

This paper started with observations about the several ways in which homeownership has been used in the U.S as a vehicle to fulfill a number of political, economic and social goals. Clearly, whether the subprime loan was used for the purchase of a new home or for refinancing an existing one, the current high rate of defaults and foreclosures are undermining these objectives. First, people all homeowners are aspiring to gain a stake in society. At the dawn of the new millennium President Bush's first HUD Secretary made clear that the new administration was committed to homeownership, in part, to do just that. A foreclosure, however, produces the opposite effect. It diminishes the opportunity of households to set down roots and for them to feel connected to the broader community. Households lose not only their shelter, but also whatever financial investment they had, while almost certainly experiencing a sense of personal failure. A worst case scenario unfolded in Massachusetts, when a woman committed suicide as her house was about to be taken by the bank. She faxed a chilling note to her mortgage company saying: "by the time they foreclosed on the house today she'd be dead." And, in another note to her family she said, "Take the [life] insurance money and pay for the house" (Levenson, 2008). While we can hope that few people take this drastic step, at the very least, we know there will be many more people whose "dreams are foreclosed" (Ballou, 2008). Of course, with so many people losing their homes, the relatively recently articulated goal of homeownership—to promote wealth accumulation as a way to reduce economic inequality—also is being severely undermined as result of the subprime crisis.²⁷

Several homeownership initiatives, starting in the 1960s, also embraced the specific goal of opening opportunities to nonwhite and low-income households to enable them to gain a foothold in the "American Dream." We now know that the subprime crisis is having a particularly negative impact on this population. Although subprime borrowers are not necessarily lower-income and can, in fact, involve borrowers with a wide range of income levels, nonwhite households comprise a disproportionate number of subprime borrowers. "Over 55 percent of African-American and 46 percent of Latino households

²⁷ An earlier section of the paper discussed the ways in which homeownership, in the past, was used to quell social unrest and racial tensions. This does not appear to have been a key goal in recent years, nor does social unrest appear to be exacerbated by the increase in foreclosures.

financed [in 2006] received subprime loans compared to fewer than 20 percent of white borrowers” (Fishbein, 2007, p. 2).²⁸

Closely connected to the above goals is the sense that homeownership promotes confidence in the government. However, this too, is certain to be thwarted as families lose their homes through foreclosure. Where, one might ask, was the safety net to help people overcome temporary difficulties? With the passage of the Housing and Economic Recovery Act of 2008, it is possible that thousands of homeowners will be able to avoid foreclosure. The Hope for Homeowners Program was launched on October 1, 2008 and calls for lenders to refinance loans, with FHA insurance, at 90 percent of the current value of the home. The reduced principal is not, however, supposed to be a gift to the homeowner. The government has developed a profit-sharing plan, whereby any increase in the value of the home is to be shared between the government and the homeowner. While, the government hopes to assist some 400,000 homeowners in default, the extent to which financial institutions volunteer to enter into the types of work-out agreements authorized by the new law remains to be seen.

In addition to confidence in the federal government likely being undermined, many states also are encountering serious problems with California probably presenting the most extreme case. Even before the impacts of the subprime crisis began to shake the state, California was encountering serious fiscal difficulties. However, the subprime crisis has added a new set of massive obstacles, as the budget shortfall has soared to \$1 billion, with expectations that it could go higher “as collection from sources like sales taxes and real estate transactions plummet as buyers close their wallets” (Archibold, 2008).

Another key goal of homeownership, helping to stimulate and stabilize the economy, has been profoundly impacted by the subprime crisis. The national and international dislocations in credit markets are concrete indicators of how the subprime crisis has de-stabilized the full breadth of the financial sector. With investment houses such as Bear Stearns and Merrill Lynch being purchased by other banks and with Lehman

²⁸ Although promoting homeownership opportunities for women has not been a traditional goal of homeownership programs, foreclosures stemming from the subprime crisis appear to be having a disproportionately negative impact on this population (Leland, 2008).

Brothers going bankrupt,²⁹ on top of a broad range of financial institutions posting huge losses, and with the September 2008 federal bail-out of Fannie Mae and Freddie Mac, the dramatic outcomes of the subprime crisis are continuing to wreak havoc throughout the economy. With recent experiences in mind, it is hard to imagine that earlier homeownership programs were not only aimed at stimulating or stabilizing the economy, but they were actually able to do so.

Homeownership programs are typically viewed as generally good for a community, and they also have been used to stabilize and rejuvenate deteriorated neighborhoods. But the increase in foreclosures is already having a damaging, if not devastating effect on communities across the country and neighborhoods with large percentages of nonwhite households experiencing particularly high rates of foreclosure (Ludwig, 2007). Here is one account of a neighborhood in South Jamaica, Queens with a large African-American and immigrant non-white population:

More than two years ago, most homes here were occupied and the neighborhood was making strides against the drugs, violence and abandonment that had plagued it in the past...But today [residents and merchants] mostly talk about decreasing property values, increasing crime, struggling small businesses and fraying community bonds (Fernandez, 2008).

When there are a large numbers of foreclosures in a given neighborhood, these vacant and unsold homes depress the overall local housing market and also create shortfalls in property tax revenues (Immergluck, 2008; Joint Economic Committee, 2007). In Los Banos, California: “The bust is apparent throughout town. Storefronts in its older strip malls are empty. Citywide, sales-tax revenue is down 15% from initial projections and the city is also bracing for big declines in property tax revenue” (Corkery and Karp, 2008). And in another California town, Perris, about 1 out of 53 houses have received notices of default, the first step toward foreclosure. This means that whole blocks are becoming abandoned as foreclosed homes sit vacant waiting for a buyer (Streitfeld, 2007).

The Midwest has, perhaps, been hit even more profoundly than the east and west coasts, as described in this chilling vignette from Cleveland, Ohio. While one particular neighborhood, Slavic Village, is viewed as “ground zero” for the foreclosure problems,

²⁹ There are now only two of the big five investment firms still in business: Morgan Stanley and Goldman Sachs. However, both are being converted to bank holding companies, effectively ending the era of the large Wall Street investment firms.

the subprime crisis is having ripple effects throughout the entire city, creating a major downward spiral:

For decades, the neighborhood, which abuts a steel mill in the city's southeast, was a struggling working-class community with an aging population and few new residents. But Slavic Village underwent a dramatic change beginning in the late 1990s as the tide of mortgage money flooded the area with new homeowners, lifting prices to unprecedented heights. Thousands of the neighborhood's small wooden homes turned over, with investors selling to new buyers at multiples of their purchase price, sometimes within months, and often after making only cosmetic repairs.

“The deals became toxic immediately,” said City Council member Anthony Brancatelli, who for 17 years headed the Slavic Village Development Corp. “What should have been \$20,000 or \$30,000 homes became \$80,000 or \$90,000 homes with toxic loans.”

The result has been a rush of foreclosures. The number of foreclosure sales in the five-square-mile neighborhood swelled from 114 in 2001 to 840 last year. In the first six months of this year, 316 Slavic Village properties have been through foreclosure, according to figures compiled by the development corporation.

The story has been repeated to varying degrees throughout Cleveland, and the result has been the virtual collapse of the city's housing market. Livable homes can be had for as little as \$6,000 or \$7,000, while many others have tumbled into complete disrepair, leaving city officials in a desperate battle against the resultant blight. In Slavic Village alone, more than 50 arson fires have been set this year, while many of the vacant homes are ravaged by scavengers, looking to cash in on the copper wiring and plumbing and aluminum siding that they sell as scrap metal. It is a stunning decline that is sure to shrink the city's property tax base for years to come.

Jackson, the mayor, said the collapse is rippling across the region, with declining property values hurting even residents of more affluent neighborhoods...The demand for goods and services are negatively impacted and the city has avoided deficits only by making across-the-board spending cuts in the past two years (Fletcher, 2008).

In foreclosed homes with tenants, another set of problems occurs. Foreclosures typically mean that tenants are evicted, since banks usually require that houses be vacant before they assume ownership, thereby dislocating completely innocent victims in the subprime crisis (Leland, 2007; Harris, 2008).

In addition to homeownership being viewed as a mechanism for promoting community development, there is evidence that, in comparison to renters, homeowners tend to participate more in civic activities and that the greater length of time that they stay

in their homes contributes to neighborhood stability (see n. 1). All these goals are being undermined as families lose their homes to foreclosure.

Clearly, the subprime crisis has created personal tragedies, community, city-wide and state-wide problems, as well as national and international economic upheavals. At the core of the problems are the new set of relationships within the mortgage lending industry that has reallocated traditional roles involving risk and responsibility on the part of both homebuyers as well as key actors in the mortgage finance system.

VIII. Reinstating Risk and Responsibility in Mortgage Lending

There already have been a number of federal responses to the subprime crisis. The Housing and Economic Recovery Act, enacted in July 2008, provided guidelines through which mortgage lenders could voluntarily modify the principal of defaulting mortgages using FHA insurance. In addition, that same month, the Federal Reserve Board issued new rules, amending Regulation Z (Truth in Lending), adopted under the Home Ownership and Equity Protection Act. As noted earlier, these rules “are intended to protect consumers from unfair or deceptive acts and practices in mortgage lending, while keeping credit available to qualified borrowers and supporting sustainable homeownership” (Ben Bernanke, quoted in Board of Governors of the Federal Reserve System, 2008). Four new rules, which apply to all mortgage lenders, not just those supervised and examined by the Federal Reserve Board, include: a prohibition from making a loan without regard to the borrower’s ability to repay, taking into account the highest possible payments that could occur within the first seven years of the loan; the need to verify borrower income and assets; strict requirements concerning prepayment penalties; and the requirement that lenders establish escrow accounts for property taxes and insurance on all first-lien mortgage loans.

The massive \$700 billion bailout authorized by Emergency Economic Stabilization Act, which was signed into law on October 3, 2008, gives the federal government the authority to purchase distressed assets from financial institutions and thereby to give investors and the credit markets more generally renewed confidence in the financial system. Unfortunately, this boost has only partially quelled the financial unrest, as worldwide markets have tumbled and financial instability has spread across the globe.

In the midst of the financial chaos, numerous proposals have been made to provide more direct assistance to homeowners in distress, as opposed to indirectly—pumping money into financial institutions and the credit markets. Particularly noteworthy was the proposal by Federal Deposit Insurance Corporation Chairman, Sheila Bair, to “encourage mortgage investors to permit struggling homeowners to refinance by having the government guarantee part of the rewritten loans.” Such a measure would help to overcome the competing interests that servicers face (e.g., legal responsibility to their investors) by making the incentives more attractive, including the government sharing in a portion of the losses if the new, more affordable mortgages go into default (McKinnon and Holzer, 2008). Opposing any type of leniency for defaulting homeowners, however, are some homeowners who are not themselves in default, and who have worked hard to stay current with their payments. They, too, would welcome a reduced mortgage payment and do not support federal assistance for which they would not be eligible. Particularly disgruntled are homeowners who are making mortgage payments on homes that have declined in value. In short, “if the lunch truly is free, the demand for free lunches will be large” (quoted in Streifeld, 2008b).

Another set of suggestions for directly assisting homeowners facing difficulties relates to the U.S.’s bankruptcy laws, which do not allow a bankruptcy judge to rewrite the terms of a first mortgage. Here, too, is another possible approach at forcing lenders to modify loans.

Whether and how the various emergency efforts and proposals are finally implemented, it is important to stand back and to try to make some sense of the “big picture,” in the hope that future crises will be averted. The following comments do not attempt to prescribe solutions to the overall economic crisis facing the U.S. and the rest of the world. Instead, they are largely focused on how risk and responsibility can be reintroduced into the mortgage system and on the types of regulatory interventions that will be needed.

It is clear that the U.S. has created a mortgage finance system where the two sides that carry the risk are either ill-prepared for this responsibility (as with many homeowners) or are cushioned by layers of investors and intermediaries (as with the lenders). At the same time, mortgage brokers and originators assume little or no risk and, while their role on the front-line of mortgage transactions would suggest that they should

carry out their tasks with a sense of responsibility, they often fail to do so. The financial incentives for aggressive and even irresponsible lending have been significant, while there have been no disincentives for these types of actions. It is necessary to re-create a mortgage lending system where both consumers and lenders, the two sides of the transaction that carry the risk, also both assume responsibility.

Thus, the first set of recommendations relates to the need to reinstitute risk and responsibility on the part of both borrowers and lenders. We need to create a system whereby homeowners are assisted in understanding their level of risk and responsibility. In order to cushion homebuyers and to help them navigate the complexities of the homeownership experience, a support system needs to be put into place. Both the experiences with the Section 235 program of the late 1960s and early 1970s, as well as the problems that have unfolded with the subprime crisis, underscore that homeownership initiatives aimed either at low-income households or households with poor credit histories, must pay careful attention to the many possibilities for private market actors to take advantage of the generally inexperienced homebuyers. Nonprofit organizations have a critical role to play by providing counseling services before the mortgage is executed. This is particularly critical for low-income households or people with poor credit histories. A report by the Neighborhood Reinvestment Corporation, a large nonprofit intermediary that supports homeownership programs noted that “buyers who understand the homebuying process and who are financially ready to assume home-ownership responsibilities” are critical to successful outcomes” (DiPetta et al. 2001, p. 2-2; see also Rohe, Quercia, and Van Zandt 2002; Werwath 1997).

Similar observations have been made about the positive impacts of post-purchase counseling and the need for homebuyers to be assisted in understanding their home’s maintenance needs, impacts of market changes, and opportunities to avoid foreclosure (DiPetta et al. 2001, p. 5-2; Werwath 1997). Post-purchase counseling services provided by an outside party without a financial stake in the transaction, are critical to help the household work out a repayment arrangement and thereby avoid foreclosure. A new nonprofit organization that was created in July 2007, HOPE NOW, is committed to assisting homeowners in default work out new payment plans with their mortgage servicers. The organization’s executive director boasts that in the ten months since its

creation, as of May 2008, its member mortgage servicers had helped nearly 1.7 million borrowers avoid foreclosure through loan workouts. However, she also emphasizes that servicers report difficulty getting in touch with homeowners in default; the great majority do not seem to be responding to letters from the servicers offering assistance (Schwartz, 2008).

In addition, the Housing and Economic Recovery Act of 2008 authorizes new funding for eligible organizations to provide financial education and counseling to prospective homebuyers. It also will be providing funds to support five pilot programs aimed at promoting “financial empowerment” and establishing models for effective counseling. These are positive steps that, hopefully, will begin to give significantly more weight to homeowner counseling programs.

Beyond making sure that homebuyers understand the full set of responsibilities being assumed, they also should shoulder some measure of risk. Entering into a mortgage arrangement where there is little or no financial exposure on the part of the homeowner is unlikely to foster a sense of responsibility. For example, in low-income homeownership programs operated by the nonprofit organizations Habitat for Humanity and Nehemiah, this issue is addressed head-on. Nehemiah homeowners often make an initial investment of several thousand dollars and while Habitat homeowners may make no more than a limited financial investment, they are required to invest a huge amount of their time in the project and their “sweat equity” is substantial (Bratt, 2007). Whether investing time or money, or both, these efforts promote a sense of responsibility on the part of the homeowners. And the outcomes, in terms of lowered foreclosure rates, are compelling (Applied Real Estate Analysis, 1998, III-19, VI-3).

The subprime crisis reveals a basic dilemma concerning homeownership programs. On the one hand, there is a desire to make the loan terms attractive and to set credit limits low enough to qualify as many households as possible. On the other hand, it is essential that lenders make realistic credit assessments to prevent households from purchasing when they are unlikely to do so successfully. Lessons from the Section 235 program should have taught us that inadequate credit checks and income verifications will result in approving people for loans who are ill-equipped financially for

homeownership. But it was not until the subprime crisis that this message was heard, loud and clear. New procedures should be instituted to ensure that all actors involved in underwriting a loan are assuming both the responsibility, as well as a degree of risk.

To the extent that FHA insurance is involved in mortgage transactions, or if any other government-sponsored programs are being utilized, it is important for a revitalized Department of Housing and Urban Development to play a much stronger role in protecting consumers. If a government agency is assuming any level of risk in a given transaction, it is critical that the agency take seriously this commitment. Moreover, as the subprime crisis has unfolded, HUD has been almost completely absent as a potential contributor to resolving the problems facing lower income homeowners. As the nation's lead housing agency, HUD needs to be brought back into the discussions and to take seriously its legislative mandate, to "achieve the best administration of the principal programs of the Federal Government which provide assistance for housing and for the development of the Nation's communities" (P.L. 89-174, 42 U.S.C.A. 3537a [1965]).

The subprime crisis has demonstrated the importance of lenders playing a much more responsible role in ascertaining the ability of the borrower to pay the cost of the loan. It is both startling and somewhat embarrassing that a recommendation contained in a report by the U.S. Congress' Joint Economic Committee contained the following self-apparent and common sense statement:

At a minimum, the federal government should require lenders to determine that the borrower has the ability to repay a loan at the fully-indexed rate³⁰ and assume fully amortized payments. Federal banking regulators have issued strong guidance requiring depository banks and their affiliates to underwrite loans at the fully indexed interest rate, but a clear federal standard is needed that apply this requirement to the whole mortgage market. Policymakers should also require lenders to verify a borrower's income using tax documents or other reasonable documentation (2007, p. 25).

At the same time, it is critical that lenders carry some levels of risk and we need to devise a mechanism for all actors in the mortgage lending system to be held accountable for the decisions that they make. The concept of "moral hazard" is relevant

³⁰ This takes into account potential changes in interest rates that may occur in the future on adjustable or variable rate loans. Interest rate changes are pegged to any one of several benchmark interest rates, or indices based on, for example, the prime interest rate or U.S. Treasury bills.

to this discussion. “A ‘moral hazard’ is a disposition on the part of individuals or organizations to engage in riskier behavior, than they otherwise would, because of a tacit assumption that someone else will bear part or all of the costs and consequences if the incurred risk turns out badly” (Wolf, 2002, p. 19). With reference to the 1997 Asian financial crisis, it appears that moral hazard “operated as a prominent part of the circumstances encouraging risky and overoptimistic behaviors by lenders, borrowers, and other economic actors...” (Wolf, 2002, p. 21). As with the current financial crisis, “moral hazard” also seems to have encouraged irresponsible behaviors on the part of numerous private sector actors, as each attempted to shift the risk to other entities.

If insurance against risk is to be reintroduced into the financial marketplace, the problem of how to minimize irresponsible behaviors will need to be addressed. Based on an idea originally offered by George Soros, Rand Corporation economist Charles Wolf suggests that a new International Credit Insurance Corporation be created. The corporate financial community would “self-fund the ICIC through premium charges that might conceivably be performance-based. A performance-based premium schedule would ease, if not fully resolve, the MH problem because unnecessarily risky behavior would, over time, be penalized by charging a higher premium for wayward member of the insurance pool” (Wolf, 2002, p.22). Whether this mechanism or another were instituted, it is clear that, by now, we all should have learned the lesson that a totally risk free mortgage finance environment is prone to irresponsible activities and ultimately enormously destructive outcomes.

The following set of recommendations all relate to the need for various types of regulatory reforms. Although it may be ideal for lenders and others involved in mortgage transactions to assume responsibility on their own, recent events have shown that they are very unlikely to do so without serious government oversight.

First, there needs to be a much greater degree of regulation of all the various intermediary actors who are involved with mortgage lending decisions—mortgage brokers, all types of mortgage companies, and rating agencies. All must be held accountable for responsible lending behavior. Although some states have regulations pertaining to these entities, and others have “tried to apply federal predatory lending advisories to all lenders or regulate brokers or lenders in their state ...the resources that

states have for oversight are far fewer than those of the federal government” (Joint Economic Committee, 2007, p. 18). The Housing and Economic Recovery Act of 2008 includes provisions to provide a greater degree of regulatory control over mortgage companies, including new licensing requirements. Although it remains to be seen how effective these provisions will be, they require mortgage companies to demonstrate financial responsibility and good character, the completion of a 20-hour course, passing a written test, and meeting net worth and surety bond requirements. In addition, a license will not be granted if the applicant has ever had a loan originator license revoked, been convicted of/pleaded no contest to a felony involving an act of fraud, dishonesty, a breach of trust or money laundering or been convicted of any other felony within the past seven years (as cited in Citizens Housing and Planning Association, 2008).³¹

Second, the entire regulatory structure through which mortgage-backed securities are sold needs to be thoroughly reviewed and revamped. While it is beyond the scope of this paper to make specific recommendations about what such a new set of guidelines and requirements should look like, suffice to say that the subprime crisis has underscored the necessity of a rigorous assessment and, almost certainly, a wide range of regulatory reforms. As part of this restructuring, there is a need for much more transparency in the system. Not only will this make the task of regulation much easier, but it is also critical from the consumer’s standpoint. At the very least, each mortgage document must be traceable from origination to the final investor; the borrower should know, at all times, whom to contact if payment difficulties arise and if there is need to request a renegotiation of the terms of the loan. In addition, the documents governing all transactions related to any future sales of the mortgage paper must allow for this type of renegotiation. In calling for a simpler, much more basic banking system, journalist and social critic Robert Kuttner has stated:

³¹ “In late 2006, the Conference of State Bank supervisors established the Nationwide Mortgage Licensing System and Registry to provide a nationwide licensing system for state-regulated residential loan originators. It functions as a back office to state mortgage regulators, accepting and processing a uniform set of license application and renewal forms for all participating states...The system began operating in January 2008. Currently 14 states are using the system and another 26 expect to be using it by the end of 2009...The new bill extends coverage by requiring all loan originators working for federally-regulated depository institutions to join the system [and] imposes minimum licensing requirements...It encourages use of the Registry database to provide consumers with free information on the employment history of loan originators and any enforcement actions taken against them” (Citizens Housing and Planning Association, 2008).

So the next financial system, rebuilt by the government on the ruins of the old one, needs to be plain vanilla. The banking system should be restored to its basic role of supplying credit to the real economy, with as few complications as possible. We need a system in which banks accept savings and make loans; where investment banks underwrite securities such as ordinary stocks and bonds; and where the complexity of bonds is strictly limited (2008).

Third, whatever form Fannie Mae and Freddie Mac will take in the future, as owners or backers of about one half of the mortgage debt in the country, much closer regulatory oversight will be required. As noted earlier, as of September 2008, these agencies were placed under federal control, but it is not yet clear how the revamped regulatory structure that was authorized by the Housing and Economic Recovery Act of 2008 to oversee Fannie Mae and Freddie Mac's activities will operate. Presumably, a continued area of focus will be on monitoring these entities' housing goals, with particular attention to interest rates charged to minority borrowers and developing loan products and flexible underwriting to facilitate secondary mortgage market purchases for loans originated in underserved areas. Of course, we do not know whether Fannie Mae or Freddie Mac will re-emerge as private or public entities. Whatever the final outcome, there will likely be significantly more federal oversight in the future.

Over the long-term, we may see the development of a new mortgage and homeownership system that puts consumer needs in the forefront of the lending decision. This reorientation would ensure that the multiple goals of homeownership would be more readily achieved. In the short-term, however, we will continue to witness large numbers of households losing their homes and their American Dream severely interrupted, if not totally forgotten.

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