

An Essay on Wealth and Inequality, Thinking About Communities and Individualism: Economic Connection in the Subprime Mortgage Crisis

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Table of Contents

Part 1

- I. The Subprime Connection: Individual Choice and Corporate Responsibility
- II. Boomerang Contracts and the Paradox of Financial Engineering: More Interconnection, Not Less
- III. Subprime Inequality: Origins of the Subprime Mortgage Crisis
 - A. Racial and Economic Inequality in Housing Wealth: Necessary Preconditions for Subprime
 - 1. Wealth Gap
 - 2. Homeownership
 - a. General Trends in Homeownership
 - b. Statistical Comparison of Black-White Homeownership
 - c. Home Equity
 - d. House Value Gap

Part 2

- IV. The Inequality Machine: Cashflow Waterfalls and Predatory Loans
 - A. Greenwich Financial Services v Countrywide Mortgage
 - B. The Private Contract Claim
 - C. The Public Economic Justice Claim
 - D. Redrawing the Public/Private Property Line in Securitizations
 - 1. Common Law Doctrines
 - 2. Unconscionability
 - 3. Good Faith and Fair Dealing
 - 4. Antimodification Rules

5. Procedural Avenue

V. Resistance and Self-Help

- A. Democracy and Contracts: Listening to the Outrage
- B. Bonuses and Claw Backs
- C. Squatters
- D. Judges and Sheriffs Nullify Flawed Foreclosure

VI. Formality Bites

- A. How Electronic Efficiencies in Property Recordation
Ran afoul of Ancient Reification Rules
- B. Securitization, Hernando De Soto, and Paper Property
Rules

VII. Conclusion

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*“Practical men who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist”
- John Maynard Keynes¹*

I. The Subprime Connection: Individual Choice and Corporate Responsibility

Comment [a1]: Consider removing the automatic hyphenation.

The Williamsbridge area of the Bronx is a representative ground zero in the subprime devastation that has wracked the nation. This northeast Bronx neighborhood is home to working-class families. Sixty five percent of its residents are black. Many are first-time homeowners who are immigrants from Nigeria, Ghana, and Jamaica. Today, there is block after block of broken windows and abandoned homes with multiple foreclosure and auction notices plastered on the doors.² The empty buildings, the loss of jobs, decreased business and tax revenue, and the broken dreams of families who thought they were moving up the ladder of life to grasp their share of future family stability and the prospects for intergenerational wealth embodied in their first home purchase are the scars that remain.³

¹ John Maynard Keynes, *The General Theory* (New York: Harcourt Brace and World, 1964), 383.

² Eileen Markley, “Subprime Mortgage Wasteland in the Bronx,” *Village Voice*, 26 February 2008. At the beginning of the subprime mortgage crisis, before it drew national attention, some newspapers, such as the *Village Voice*, were running articles on how the heavy investment in subprime mortgages were destroying minority communities, long before they were destroying everyone else’s financial situation.

³ Jenny Shuetz, et al., “Neighborhood Effects of Concentrated Mortgage Foreclosures,” *New York University Law and Economics Paper Series No. 08-41*, Social Science Research Network, 11 July 2008, Social Science Electronic Publishing, 23 February 2009, <<http://ssrn.com/abstract=1270121>> Regression results in this neighborhood tend to show that lower values of homes now exist because of the foreclosures around them, but it is not a linear relationship, and the home values of the other homes are dropping faster than the houses are being foreclosed on.

New York University's Furman Center for Real Estate and Public Policy found that Williamsbridge stands out among subprime-affected communities in New York City for two reasons: it had high rates of homeownership and later high rates of default.⁴ At the peak of the housing bubble in 2006, this neighborhood had one of the highest rates of homeownership in the Bronx. The 31 percent ownership rate here nearly equals the average for the entire city.⁵ These high rates of ownership masked deeper financial defects in the loan products that residents used to become homeowners. Traditional banks once avoided lending in Williamsbridge, engaging in redlining (the practice of refusing to make mortgage loans in geographically defined areas that followed boundaries of racial segregation). In the years 2000-2007, unregulated mortgage brokers and mortgage subsidiaries of the biggest banks filled the void created by years of redlining this community, with high-cost loans. These flexible loan products had unconscionable features that virtually ensured default.⁶ The median annual income in Williamsbridge is a modest \$31,000. However, according to one account, half of the mortgages originated there were subprime, and fully 51 percent of all home equity loans were subprime as well.⁷

The distance from Citibank headquarters in Manhattan to Williamsbridge, in the Bronx, is not measured in miles. Citigroup's signature building, a diagonal-roofed, glass and steel skyscraper sits on East 153rd across the street from its world headquarters on Park Avenue, an economic world away from the devastated blocks of Williamsbridge, filled with a

⁴ Furman Center for Real Estate and Urban Policy, "State of the City's Housing and Neighborhoods." New York University, 2007, Furman Center for Real Estate and Urban Policy, 24 February 2009, < http://furmancenter.org/files/soc2007/Bronx_000.pdf > 61. In 2006, New York University, through the Furman Center for Real Estate and Urban Policy, issued a study of homeownership patterns in New York City neighborhoods and in the city as a whole. Ironically, some of the companies that sponsored the study were Bank of America, Citigroup, and Washington Mutual, which have either failed (Washington Mutual) or are on the verge of nationalization and failure (Bank of America and Citigroup) due to poor investments in toxic loans. This study stated that the home ownership rate in 2006 in Williamsbridge was the second highest in the entire borough of the Bronx and this area ranked eighth in home purchases in the entire area of New York City. At the same time, however, Williamsbridge ranked fifth in subprime mortgages.

⁵ Id. at 40, 61. The study also concluded that the average homeownership rate in 2006 for all of New York City was 34 percent and the homeownership rate in Williamsbridge was 31%.

⁶ Id. at 61. Williamsbridge was starved for credit. The Furman Center study showed that the neighborhood ranked sixth in the whole city in subprime refinance loans as well, showing that even those who already owned their homes and were simply refinancing were also given risky loans.

⁷ Markley. This article in the Village Voice concludes that most of the people in this neighborhood, due to their low income, would have had significant difficulty making a normal mortgage payment. With the higher interest rates imposed when the adjustable rate loans reset, paying back the loan became nearly impossible.

mixture of older wooden homes and new, yet vacant, condos. The trail from Citibank's headquarters on Park Avenue⁸ to Williamsbridge is a literal trail of tears for families who took out mortgages, some of which approached one-half million dollars, based on incomes of less than \$40,000 per year. Many of the loans originated by unregulated mortgage brokers were based on a clearly unsustainable debt-to-income ratio.⁹ Families in the bottom quintile of the income distribution were solicited for loans that promised to deliver the American dream of affordable monthly payments leading to full ownership in thirty years. For the residents of Williamsbridge, this longshot opportunity to achieve a cherished aspiration led to a maze of misrepresentation, deceptive practices, high pressure tactics for repeated refinancing, deceptively low teaser rates, and undisclosed payment shocks that led to the foreclosure epidemic now visible. The subprime foreclosure crisis has now decimated the sense of community that once thrived in the summertime front porch conversations of the proud working class neighbors of Williamsbridge, no less than crack, violence, and infectious disease in other working-class communities in years past.

Citibank has received more than 45 billion in government bailout from three rounds of direct federal assistance.¹⁰ Citibank has a portfolio of "toxic assets," many of which are derivative securities that are based on the collateral of private residences in communities like Williamsbridge, in the northeast Bronx. The modern financial titans of Citibank, like Sherman McCoy, the central character of Tom Wolfe's The Bonfire of the Vanities,¹¹ unwound with a series of strategic wrong turns that carried

⁸ Citibank's headquarters is not housed in its signature building on E153rd Street. It is located across the street on Park Avenue.

⁹ The U.S. Department of the Treasury, "Homeowner Affordability and Stability Plan," The White House, 17 February 2009, U.S. Department of the Treasury, 24 February 2009, <<http://www.treas.gov/initiatives/eesa/homeowner-affordability-plan/ExecutiveSummary.pdf>.> The U.S. Department of the Treasury and the White House recovery plan says that a sustainable debt-to-income ratio is a house payment that is 31 percent or less of family income. The FDIC recommends an income to debt ratio between 31 percent and 38 percent. American Banker, "FDIC Offers Kit for Systematic Loan Modifications," Center for Responsible Lending, 21 November 2008, Center for Responsible Lending, 24 February 2009, <<http://www.responsiblelending.org/news/newsbriefs/fdic-offers-kit-for-systematic-loan-mods.html>.>

¹⁰ "Participants in the Government Investment Plan." The Wall Street Journal, 19 February 2009. This graphic in the Wall Street Journal listed all of the banks that had received government bailout funds so far. Citigroup has received the most: 50 billion dollars. They have received 25 billion dollars from the TARP program and an additional 25 billion dollars from the government outside of the TARP program.

¹¹ Tom Wolfe, BONFIRE OF THE VANITIES (1987). This first novel brings to life the swirling class and economic conflicts in New York City of the 1980s. The city was rife with barely-

them from the heights of money, power and privilege on Wall Street to the anger and rage of the ordinary folks in the South Bronx, and the klieg lights of Congressional hearing rooms. For better or worse, as the foreclosures mount, and housing prices fall, the value of the complex securities, such as collateralized debt obligations, credit default swaps, and pools of securitized loans originated or purchased for its off balance sheet entities by Citibank's subprime mortgage banking division, CitiFinancial, have bound the fate of these two very different worlds together.¹²

There are many causes of the financial crisis of 2008. This paper is confined to exploring the perverse effects of financial products, systems, and strategies that were built on the premise of rational choice, self-interest, and individualism, yet created unbreakable bonds of international linkage and economic community that both pulled apart and pushed together its members, bound to one another by a web of complex financial engineering.

II. Boomerang Contracts and the Paradox of Financial Engineering: More Interconnection, Not Less

Old-fashioned mortgages were issued by bankers, wearing green eyeshades. These community bankers carefully scrutinized the character, reputation, and balance sheet of each individual borrower. The mortgage was issued only if the borrower had accumulated a 20 percent cash down payment. One of the central characteristics of change in the capital market for mortgage-backed securities is the originate-to-distribute model of securitized lending. In this model the first person to deal directly with the loan applicant was a mortgage broker. The mortgage brokers were often small, independent firms that specialized in subprime lending. Richard Bitner was the co-owner of a typical small subprime mortgage bank in Dallas, Texas. Bitner has written a memoir¹³ in which he describes how he made decisions to grant problematic loans. For example, the loan that he extended to a working class couple—"Johnny," a gas station attendant, and his wife "Patti," a cashier. This couple lived with

acknowledged racial and tension. Homelessness increased noticeably. Racial attacks stirred resentments in many parts of the city. Against this backdrop conspicuous consumption by Wall Street traders created a vast chasm between the haves of the city and the have-nots.

¹² Emma Coleman Jordan, "Finding A Way Out of the Lending Crisis," *American Banker*, 19 September 2008. This article was written the day after Lehman Brothers failed. I propose a common-sense approach to solve the crisis I argued then, as now, that Wall Street and Main Street were now connected in their misery.

¹³ Bitner, *Confessions of a Subprime Lender*, Wiley (2008)

their parents for three years to save a \$5,000 down payment for a house. However, they had abysmal credit scores that for Bitner showed that “paying bills had never been a priority for them.” The loan they were granted required a 50 percent debt to income ratio, in which more than half of their joint income before taxes would be dedicated to paying their mortgage.¹⁴

The originate-to-distribute model sought to cut the traditional link of reciprocal accountability between borrower and lender. The effect was the opposite. Instead of distance and separation, the new products created greater enmeshment; an unintended dependence among investors and between lenders and borrowers.

Antje Berndt and Anurag Gupta¹⁵ explore the legitimate reasons for the sale of loans on the secondary market and the potential disadvantages of this practice. They explain that “loans sales allow banks to free up capital that could then be deployed in more profitable activities and to increase their fee-based loan origination activity.” However, “loan buyers who do not have a relationship with the borrowers are at a disadvantage when buying a loan originated by a relationship bank,”¹⁶ which could lead to moral hazard and an adverse selection problem.

Berndt and Gupta examine and compare the long-run performance of borrowers where there is an active secondary market for the loans and those where there is no such market. They show that “borrowers with an active secondary market for loans significantly underperform firms that have borrowed in the syndicated loan market but do have actively traded loans by between 8% and 14% per year, over a three-year period subsequent to their loans being traded in the secondary market.”¹⁷ Borrowers with an active secondary loan market experience long-run underperformance and value destruction of about 15 percent compared to their peers. “The underperformance is stronger for smaller, high-leverage borrowers that have a speculative-grade credit rating.”¹⁸ However, “borrowers without an active loan market do not show any significant long-run underperformance.” Bank loans remain “special”—their announcements

¹⁴ NEED NOTE

¹⁵ Antje Berndt and Anurag Gupta, “Moral Hazard and Adverse Selection in the Originate-to-Distribute Model of Bank Credit,” October 24, 2008. Available at <http://ssrn.com/abstract=1290312>.

¹⁶ Id.

¹⁷ Id.

¹⁸ Id.

elicit positive short-term abnormal returns for the borrowers, in contrast to the announcement effect of most other forms of corporate financing—only if they are not sold.

Berndt and Gupta explain that moral hazard and adverse selection play a significant role in their study results. The banks' superior information about the credit quality of their loans may give rise to "adverse selection," whereby banks sell off loans about which they have private negative information. "Banks may also be originating 'lemons' to expand their origination fee-based income, since they are able to sell these loans, relatively easily in the secondary market to outside investors." Additionally, there could be a moral hazard problem; banks that sell loans would have a reduced incentive to engage in costly screening and monitoring of the borrowers about whom they have negative private information, once the lending relationship is severed. Also, when the "borrowers lose the discipline of bank monitoring, they may be more prone to making suboptimal investment and operating decisions, which leads to their negative long-run performance and value destruction."

Berndt and Gupta conclude that given these moral hazard and adverse selection problems, "the originate-to-distribute model of bank credit needs to be modified, and the transactions made more transparent."¹⁹ They propose regulatory restrictions to alleviate these problems. Originating "banks should be required to retain a certain proportion of the loans on their balance sheet, in order to prevent banks from originating bad loans and to preserve bank monitoring on the part of borrowers. There should be additional disclosure requirements on all participants in the loan sales market, in order to reduce the occurrence of adverse selection."²⁰ They also propose the establishment of a loan trading exchange with a clearinghouse to ensure greater transparency and regulatory oversight.

The convergence of multiple layers of structural risk created glue that bound Citibank to Williamsbridge. The perverse incentives²¹ and principal agent problems in the retail mortgage broker networks paradoxically

¹⁹ Antje Berndt and Anurag Gupta, "Moral Hazard and Adverse Selection in the Originate-to-Distribute Model of Bank Credit," October 24, 2008. Available at <http://ssrn.com/abstract=1290312>

²⁰ Id.

²¹ Berndt and Gupta supra conclude that the originating bank has superior information about the quality of the loans that it originates. These banks can "originate loans, earn their fees, and then distribute it to other investors in a largely opaque manner. They ask "are the banks selling off loans about which they have negative private (unobservable) information?"

provided high yields and high compensation structures for participants in the mortgage and mortgage backed securities business, even while the entire system developed extraordinary levels of contractual interdependence. The use of diversification to minimize risk engendered deeper and broader entanglements. Like the other major banks who ran aground on the risk arising from exotic structured products, arbitrarily selected pools of loans were constructed to mask poor credit quality.²² Finally, Credit Enhancements were awarded to artificial financial structures (tranches) within the SIVs to entice a global pool of unwary investors to fund these creations, thus spreading the coming contagion across the global financial system.

Comment [a2]: This is the first use of this acronym—you should spell it out and put SIV in parens. Also, consider moving definition from next paragraph to this one.

Citibank adopted the off-balance sheet Structured Investment Vehicle (SIV), one of the features used by the largest banks to avoid close scrutiny of their risky investments in subprime mortgages. For example, this report in the Wall Street Journal describes how Citibank used the SIV to dramatically increase their profits, even as they evaded close scrutiny of their lack of adequate capital to support the risk they incurred. SIVs issued short-term debt at relatively low interest rates and used the proceeds to buy longer-term debt carrying higher rates, including debt backed by mortgages. Banks aimed to profit by pocketing the difference between the rates.

But the off-balance-sheet entities were severely hurt by the credit crisis, which left buyers for the debt on the sidelines amid concerns about exposure to subprime-mortgage securities. In December 2007, Citigroup bailed out seven affiliated SIVs, bringing \$49 billion in assets onto its balance sheet and denting its capital base.²³

The SIV was designed to dilute the perception of the risk Citibank was taking in the eyes of the capital markets and its own shareholders.²⁴ The SIV is best viewed as an invisible cloak to mask the risky connection between the subprime mortgages securing houses like those in Williamsbridge and the pristine balance sheets of Citibank. The process of using artificial corporate structures like the SIV to externalize risk was a time-delayed boomerang. As the description above reveals, ultimately, Citibank was forced by the failure of the market for mortgage-backed securities to

²² Id.

²³ Kevin Kingbury, "Moody's Downgrades Citigroup's SIV's," WSJ March 5, 2009.

²⁴ Id. Citibank's SIVs have \$7.36 billion of debt outstanding.

bring the holdings of their SIV's back onto their own balance sheet.²⁵ The return to the balance sheet operated like a boomerang that made Citibank technically insolvent, without massive assistance from the Treasury Department.²⁶

III. Subprime Inequality: Origins of the Subprime Mortgage Crisis

The current financial crisis is a sad and tangled morass of human and economic failures that span the depth and breadth of the market for home mortgages.²⁷ In this section, I look first at the active role of pre-existing economic and social inequality²⁸ in setting the original conditions for the introduction of the first subprime products. These loan products contained onerous features, including higher interest rates²⁹ points and fees, prepayment penalties, variable rate payment schedules, and pay option loans with negative amortization balloons. The high risk no-documentation loan, dubbed "liars loans," became an important part of the subprime mortgage market.³⁰ John Martin argues that the high risk cocktail of loan features when combined with the originate-to-distribute model eventually led to the current global financial panic and economic collapse.³¹ Second, I explore how economic theories³² about the dynamics of racial discrimination in markets³³ served to retard the governmental response to the growing evidence of widespread origination problems in the markets for subprime loans.

²⁵ Id.

²⁶ The Wall Street Journal lamented the virtual insolvency of Citibank and its dependence on taxpayer support. "Taxpayers have already put more than \$50 billion in capital into the bank, while guaranteeing \$301 billion of its bad assets." Review and Outlook, February 28, 2009, "Your Citibank, Too Big to Fail, Too Big to Succeed."

²⁷ Ben S. Bernanke, "Housing, Mortgage Markets, and Foreclosures," speech to Federal Reserve System. Conference on Housing and Mortgage Markets, Washington, D.C.: 4 December, 2008.

²⁸ U.S. Census Bureau, U.S. Department of Commerce, Household Income by Race and Hispanic Origin (2000). The data indicates that in 1999, the median income of Blacks was \$29,423, compared to \$45,367 for whites.

²⁹ NOTE

³⁰ John D. Martin, A Primer on the Role of Securitization in the Credit Market Crisis of 2007 (January 1, 2009).

³¹ Id. at 10

³² Gary Becker, The Economics of Racial Discrimination (Chicago: University of Chicago Press, 1955), at 41.

³³ Id. Edward M. Gramlich, Subprime Mortgages: America's Latest Boom and Bust (Urban Institute Press, 2007), 24. Concludes that "racial minorities were basically shut out of the first American housing boom at the close of World War II. Currently, housing and mortgage markets have become so complicated that discrimination seems to take place in many subtle ways."

Computer technology,³⁴ an apparently neutral feature of home mortgage underwriting, which made it inexpensive to assign and track individual credit scores³⁵ on a daily basis also had the effect of making it easier to expand the distribution of the prime as well as subprime mortgages.³⁶

The New Century Financial securitization of 3,949 subprime loans in the second quarter of 2006 is one example of the use of technology to rapidly expand the volume of subprime loans.³⁷ A 2008 New York Federal Reserve staff study of subprime securitizations identified this 2006 pool of loans as emblematic of “how typical subprime loans from what proved to be the worst-performing vintage (2006) came to be originated.”³⁸ In 2006, New Century Financial was the second largest subprime lender. It originated \$51.6 billion in mortgage loans during 2006.³⁹ During this year, the company relied on “an automated internet-based loan submission and pre-approval system called FastQual.”⁴⁰ The New York Fed study found that the volume of New Century Financial loans “grew at a compound annual growth rate of 59% between 2000-2004.”⁴¹ The performance of the early

³⁴ Id. at 4. Gramlich refers to the development and refinement of automated credit scoring techniques and automatic processing of loan applications. “This process led to a faster and more inclusive mechanism for generating mortgage approvals. By the early 2000s, some lenders were offering to process mortgage applications in less than 15 minutes.”

³⁵ NOTE

³⁶ See Paul Calem, Firestone and Wachter, et al. “Credit Impairment, and Housing Tenure Choice, University of Pennsylvania Inst. For Law and Economics Research Paper No. 08-31, Social Science Research Network, 3 October 2008, Social Science Electronic Publishing, 28 January 2009 <<http://ssrn.com/abstract=1310203>>The authors conclude that “The introduction of automated underwriting systems may have been an additional factor contributing to wider availability of mortgage credit. Gates, Waldron, and Zorn (2003) present evidence that introduction of Freddie Mac’s automated underwriting model in 1995 led to an increase in acceptance rates of applications for mortgages on properties located in low- and moderate-income neighborhoods. They conclude that implementation of automated underwriting systems reduced the cost and increased the accuracy of credit decisions, making mortgage credit more accessible.” At 10-11.

In direct contrast to the automated Freddie Mac underwriting process, Adam B. Ashcraft and Til Schuermann, “Understanding the Securitization of Subprime Mortgage Credit” Federal Reserve Bank of New York Staff Reports, Staff Report no. 318 (March 2008) found that automated underwriting by New Century Financial, a private loan originator, led to increased early defaults, a clear sign of underwriting inaccuracy. See note 28 *infra*.

Calem, Firestone, and Wachter’s conclusion that the automated underwriting model increased the accuracy of credit decisions for the is The Federal Reserve Study,

³⁷ Adam B. Ashcraft and Til Schuermann, Understanding the Securitization of Subprime Mortgage Credit, Federal Reserve Bank of New York Staff Reports, Staff Report no. 318 (March 2008).

³⁸ Id. at 13. New Century Financial was the second largest subprime lender in 2004-2006. In each of the years 2004-2006 they originated \$51.6 billion in mortgage loans.

³⁹ Id.

⁴⁰ Id. at 13

⁴¹ Id.

loans in this period tracked the overall performance of the industry. However, by early 2007 there was an explosion of early defaults by borrowers who could not, and did not pay from the very beginning of the loan repayment period. The large number of defaults by borrowers caused New Century Financial ultimately to file for bankruptcy on April 2, 2007. It was brought down by the rapid expansion of its loan volume and the use of an automated internet-based computer system for screening loan applicants. The performance of the loans originated in 2006 make clear that the programmed criteria for this batch of loans was set much too low. The short-term profitability of this high-volume intake process ultimately proved insufficient to mitigate the escalating defaults from low credit selection standards, compromising the solvency of the entire company as a result. Although subprime loans were initially marketed to racial minorities,⁴² these flawed loans eventually encompass the general pool of borrowers across the full spectrum of credit quality.⁴³ One important source of unregulated risk was the introduction of lending models that were dependent on loan fees generated by transferring the original whole loan several times through the severing the relationship between the borrower and the lender became morbidly toxic for the entire financial system.⁴⁴

Martin argues that “if the originate-to-distribute model is the real culprit in the credit crisis there should be evidence of deteriorating credit standards for mortgages originated in 2006.”⁴⁵ He concludes that there is anecdotal evidence of declining credit standards. One example of such evidence is the percentage of poorly documented income and expenses of borrowers “rose dramatically over the period 2001-2006. These loans were 28.5 percent of new subprime mortgages in 2001 and by 2006 the percentage had grown to 50.9 percent.”⁴⁶

Eventually, the problematic features of subprime mortgage prod-

⁴² “Mortgages and Minorities,” New York Times, December 9, 2008, A34. The author states that “minorities were more likely than whites to be steered into risky, high-priced loans.”

⁴³ Bob Tedeschi, “Subprime Loans Wide Reach,” New York Times, August 3, 2008. “Tedeschi refers to a study by Compliance Technologies, a lending-industry consultancy, which analyzed more than 1.9 million subprime loans originated in 2006, the height of the subprime lending frenzy, and found that roughly 56 percent went to non-Hispanic whites. Affluent borrowers, those with annual income at least 120 percent of their given area’s median income, meanwhile, took out more than 39 percent of the loans. Gramlich supra note 5, at (cannot find in bk)

⁴⁴ Emma C. Jordan, “Finding a Way Out of the Lending Crisis,” The American Banker, September 19, 2008, 11.

⁴⁵ Martin, supra at 10.

⁴⁶ Martin, at 10.

ucts that initially made it easy for borrowers to qualify for credit that they could not sustain over the long term came to dominate the entire market.

Subprime loans are loans to borrowers who do not qualify for prime mortgage loans. These loans carry higher interest rates, points, and fees than prime mortgage loans. When points and fees are amortized, the average percentage rate on subprime loans is often in double digits.⁴⁷ As Edward Gramlich writes, “the new ownership boom has moved one step down the income scale, focusing largely...on the so-called subprime market. Subprime borrowers generally have lower incomes and are often not able to put as much down—their loan-to-value ratios often go up to 100 percent. Because of their worse credit history, subprime borrowers have to pay much higher interest rates, points, and fees, and they normally must accept prepayment penalties to get their home secured loans.”⁴⁸

Government regulators who could have intervened⁴⁹ in the first market failures for home mortgages issued to borrowers with credit defects,⁵⁰ were instead blinded by economic assumptions⁵¹ about how markets ought to work,⁵² despite empirical evidence⁵³ of widespread fraud⁵⁴ and grossly inappropriate business models for originating and

⁴⁷ Id. at 17.

⁴⁸ Edward M. Gramlich, *Subprime Mortgages* (Washington D.C: Urban Inst. Press, 2007).

⁴⁹ “Things Go Better with Rules,” *New York Times*, September 30, 2007. “Consumer advocates have been warning for years about the unfair and deceptive lending that has taken place in plain view of do-nothing regulators. All along, they have presented detailed analyses and recommendations for regulatory action. And yet, Mr. Paulson has dismissed even the suggestion that a lack of regulation may have precipitated today’s financial turmoil, saying that ‘history says it’s very difficult for policy to keep up with innovation’.” “Treasury Secretary Henry Paulson Jr. has inveighed against a ‘rush’ to regulation following the mortgage meltdown, and two Treasury under secretaries, writing recently in *The Financial Times*, criticized calls for ‘immediate’ regulation.”

⁵⁰ “Countrywide In the Courts,” Center for Responsible Lending, 7 January 2007, Center for Responsible Lending, 29 January 2009 <<http://www.responsiblelending.org/pdfs/countrywide-litigation-database-01072007.pdf>>

⁵¹ Alan Greenspan, Testimony to the House of Representatives, Committee on Oversight and Government Reform (October 23, 2008). Greenspan admits that he had been surprised by the subprime mortgage crisis because his economic ideology that free, competitive markets are by far the best way to organize economies, seemed to have worked well for past forty years. He stated that he “found a flaw in the model” that he “perceived as the critical functioning structure that defines how the world works.”

⁵² Raymond Hernandez, “Countrywide Said To Be Subject of Federal Criminal Inquiry,” *New York Times*, 9 March 2008.

⁵³ Vicki Been, et al., “Neighboring Effects of Concentrated Mortgage Foreclosures,” Furman Center for Real Estate and Urban Policy, October 2008, New York University, 29 January 2009, <http://furmancenter.org/files/foreclosure_08-03.pdf>

⁵⁴ “FBI Investigates Countrywide,” *The Wall Street Journal*, March 8, 2008, A3. Sonia Garrison et. al., “Continued Decay and Shaky Repairs: The State of Sub-prime Loans Today,” Center For Responsible Lending Studies, 2 (2009). “In 2005, Alan Greenspan, then chairman of the Federal

financing home mortgages.⁵⁵

In addition, during the height of the housing bubble (2004-2007) federal regulators relied upon the dynamics of unregulated markets to eliminate racial discrimination,⁵⁶ without government intervention.

Reserve Bank, praised subprime mortgages as a positive innovation made possible by better risk assessment, and “representative of the market responses that have driven the financial services industry throughout the history of our country. Only two years later, there was growing concern that failing subprime loans, which had shot up to nearly a quarter of the total mortgage market originations, were driving our economy into recession.” Unfair and Unsafe: How Countrywide’s Irresponsible Practices Have Harmed Borrowers and Shareholders, Center for Responsible Lending, February 7, 2008, at 2. The author states that borrowers and regulators have accused Countrywide of engaging in: “Steering borrowers with good credit into higher-cost “subprime” loans; gouging minority borrowers with discriminatory rates and fees; working in cahoots with mortgage brokers who use bait-and-switch tactics to land borrowers into loans they can’t afford; targeting elderly and non-English-speaking borrowers for abusive loans; and packing loans with inflated and unauthorized fees.” Eric Lichtblau et. al., “FBI Struggles to Handle Financial Fraud Cases,” New York Times, October 18, 2008. The authors describe the FBI’s difficulties in trying to handle the numerous financial fraud cases that have come out of the recent mortgage crises. They describe the problem as being rooted in the failure of federal regulators to heed the warnings of individuals within the FBI and consumer groups about the dangers of subprime loans. “Since 2004, F.B.I. officials have warned that mortgage fraud posed a looming threat, and the bureau has repeatedly asked the Bush administration for more money to replenish the ranks of agents handling nonterrorism investigations, according to records and interviews. But each year, the requests have been denied, with no new agents approved for financial crimes, as policy makers focused on counterterrorism.” “This spring and summer, as public concerns about the subprime mortgage crisis were growing, Attorney General Michael B. Mukasey rejected repeated calls for the creation of a national task force like the one used after the Enron collapse. The attorney general likened the problem to ‘white-collar street-crime’ that could best be handled by individual United States attorneys’ offices.” Michael Hudson and Jim Overton, “The Second Savings and Loans Scandal,” Forbes, January 21, 2009. The authors describe the Office of Thrift Supervision (OTS) as the agency put in place to fix the savings and loans crises that occurred in 1989. However, during the current financial crises, OTS failed to take action to prevent thrifts from engaging in irresponsible lending “OTS did little to stop WaMu, IndyMac and other thrifts from engaging in risky behavior—and then failed to respond aggressively to the crises that inevitably followed.” “OTS fiddled, taking no real action until it was too late. In the IndyMac case, a federal inspector general discovered that a senior OTS official gave IndyMac permission to falsify its financial reports, a move that allowed the thrift to stave off increased regulatory oversight.” Id.

⁵⁵ Gramlich, supra note 5, at (??).20; Antje Berndt and Anurag Gupta, “Moral Hazard and Adverse Selection in the Originate-to-Distribute Model of Bank Credit,” Social Science Research Network, 24 October 2008, Social Science Electronic Publishing, 28 January 2009. <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=+1290312, But see Steven L. Schwarcz, “Understanding the ‘Subprime’ Financial Crisis. Univ. of South Carolina L. Rev. Duke Public Law and Legal Theory Paper Series No. 222, Social Science Research Network, 30 October 2008), Social Science Electronic Publishing, 5 December 2008

<http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1288687.> He argues instead that “nor was the originate-and-distribute model of mortgage lending, and its (allegedly) resulting moral hazard, the problem causing the crisis as some have alleged. This model is critical to ensuring lending liquidity” 12/5/2008 7:06:10 PM ~~11/5/2009 10:52:42 AM~~,

⁵⁶ Richard Posner, comment on “Competitions, Discrimination, and Law,” The Becker-Posner Blog, comment posted September 7, 2008, http://www.becker-posnerblog.com/archives/2008/09/competition_dis.html. Posner states that “deregulation is a minor but

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Chairman Henry Waxman's opening remarks for a hearing of the House Committee on Oversight and Government Reform⁵⁷ captures very well the criticism of the failures of regulatory oversight in the financial sector. "[F]or too long, the prevailing attitude in Washington has been that the market always knows best."⁵⁸ The Federal Reserve had the authority to stop the irresponsible lending practices that fueled the subprime mortgage market, but its long-time chairman, Alan Greenspan, rejected pleas that he intervene.⁵⁹

In one news report, Federal Reserve Chairman Alan Greenspan is described as rebuffing a series of explicit warnings, beginning as early as 2000, about the rapidly expanding, unscrupulous practices of mortgage brokers.⁶⁰ The absence of involvement by the Federal Reserve is especially noteworthy in light of what we now know was a persistent effort by both experts inside the Fed itself,⁶¹ at the Treasury Department, and consumer advocates outside.⁶² In one analysis, a review of "regulatory

interesting legal change that tends to reduce discrimination." He argues that a "regulated monopoly is constrained in the amount of monetary profit that it can obtain, but unconstrained in nonmonetary perks, including indulging a taste for discrimination."

⁵⁷ Greenspan, *supra* note 12, at 4. Henry Waxman and Alan Greenspan, "The Financial Crisis and the Role of Federal Regulators," House of Representatives Committee on Oversight and Reform Hearing, Washington D.C., 23 October 2008.

⁵⁸ *Id.*

⁵⁹ *Id.* at 38.

⁶⁰ Edmund L. Andrews, "Fed Shrugged As Subprime Crisis Spread," *New York Times*, 18 December, 2007, B1-B3. Andrews describes a growing list of warnings from both inside and outside of the Federal Reserve. Inside the Federal Reserve, Governor Edward Gramlich "privately urged Fed examiners to investigate mortgage lenders affiliated with national banks, he was rebuffed by Alan Greenspan, the Fed Chairman." From the Treasury Department, Sheila Bair, now Chair of the Federal Deposit Insurance Corporation, urged subprime lenders to adopt a code of "best practices," under which outside monitors would certify their compliance. Finally, a consumer advocacy organization, The Greenlining Institute, wrote to Greenspan urging him to address the growing evidence of abuses in the market for subprime loans. Greenlining advocates told the NYT: "He never gave us a good reason, but he didn't want to do it, h[is] just wasn't interested."

⁶¹ Gramlich, *supra* note 5, at xi. Gramlich states that he "gave many speeches on the topic" of subprime mortgages and "kept challenging other economists" to explore the problems and potential solutions. Greenspan, *supra* note 12, at 38. Greenspan admits that "Gramlich along with individuals at the Department of the Treasury and HUD," had suggested that he "put in place regulations" to curb "these emerging abuses in subprime lending."

⁶² Michael S. Barr, Testimony before the Committee on Financial Services, U.S. House of Representatives Hearing on "The Community Reinvestment Act: Thirty Years of Accomplishments, But Challenges Remain" (February 13, 2008). According to Barr, "the housing crisis, driven by serious problems in the subprime lending, suggests that our system of home mortgage regulation, including CRA, is seriously deficient." "We need to fill what my friend, the late Federal Reserve Board Governor Ned Gramlich aptly termed, 'the giant hole in the supervisory safety net.'" Michael Barr et. al., "Behaviorally Informed Home Mortgage Regulation," in *Borrowing to Live: Consumer and Mortgage Credit Revisited*, ed. N. Retsinas and E. Belsky (Washington, D.C.:

decisions show that the Federal Reserve and other agencies waited until it was too late before trying to tame the industry's excesses. Both the Fed and the Bush administration placed a higher priority on promoting "financial innovation" and "the ownership society." In this same interview, "Mr. Greenspan, vigorously defended his actions, saying the Fed was poorly equipped to investigate deceptive lending and that it was not to blame for the housing bubble and bust."⁶³

In testimony before the House Government Oversight Committee Hearings Greenspan elaborated further on his failure to respond to the Gramlich warnings. Committee chairman Henry Waxman challenged Greenspan to explain the role of economic ideology in shaping his regulatory choices. In one especially telling exchange, Greenspan concedes the flaw in his ideological precepts for responding to the earlier warnings. Waxman begins:

"...[Y]ou had an ideology. You [said] that 'I do have an ideology. My judgment is that free competitive markets are by far the unrivaled way to organize economies. We have tried regulation, none meaningfully worked."

"You had the authority to prevent irresponsible lending practices that led to the subprime mortgage crisis. You were advised to do so by many others. Do you feel that your ideology pushed you to make decisions that you wish you had not made?"⁶⁴

Mr. Greenspan answered:

"Well, remember, though, whether or not ideology is a conceptual framework with the way people deal with reality. Everyone has one. You have to. To exist, you need an ideology. The question is, not whether it exists or not, it is whether it is accurate or not."

"...Yes, I've found a flaw. I don't know how significant or permanent it is. But I've been very distressed by that fact."⁶⁵

In response to other questions he further conceded that:

"I found a flaw in the model that I perceived is the critical func-

Brookings Institution Press, 2008), 170-202. The authors argue "Existing regulations based on the rational actor model have been shown to have significant short-comings" in protecting consumer welfare, particularly in the subprime lending environment. They advocate the adoption of "behaviorally informed" mode of home mortgage regulation, encompassing "the gap between information and understanding, and intention and action, decisional conflict and other psychological factors affecting how people behave as well as economic insights about markets."

⁶³ Greenspan, *supra* note 12. *Id.*

⁶⁴ Waxman.

⁶⁵ *Id.*

tioning structure that defines how the world works, so to speak.”

Waxman: “Your ideology, was not right, it was not working.”

Greenspan: “Precisely. That’s precisely the reason I was shocked, because I had been going for 40 years or more with very considerable evidence that it was working exceptionally well.”

“Those of us who have looked to the self-interest of lending institutions to protect shareholders’ equity, myself included, are in a state of shocked disbelief.”⁶⁶

Thus, during the period of the housing bubble, the most powerful regulator of financial markets operated under what he now acknowledges were profoundly flawed theoretical assumptions.⁶⁷

Greenspan argued that “my judgment is that free competitive markets are by far the unrivaled way to organize economies. We have tried regulation, none meaningfully worked.”⁶⁸

It proved to be a false assumption that self-interest of financial firms and their gatekeepers⁶⁹ could substitute for competent, focused governmental decision-making. This false⁷⁰ premise⁷¹ delayed the response to the first indicators that subprime mortgages were extending, rather than ending, economic inequality in housing finance.⁷²

⁶⁶ Id.

⁶⁷ Id. Alan Greenspan, *The Age of Turbulence* (New York: The Penguin Press, 2007), 368. Greenspan states that the apparent stability of our financial system is a reaffirmation of the simple, time-tested principle that individuals trading freely with one another following their own self-interest leads to a growing, stable economy. “People must be free to act in their self-interest, unencumbered by external shocks or economic policy.”

⁶⁸ Id.

⁶⁹ Gary S. Becker and Kevin M. Murphy, “Social Economics: Market Behavior in a Social Environment,” (Cambridge, Belknap Press of Harvard University Press, 2000).

⁷⁰ Gary S. Becker. “Does the Free Market Corrode Moral Character?” The Becker-Posner Blog, Gary S. Becker and Richard Posner, 2 November 2008, Gary S. Becker and Richard Posner, 27 January 2008, <<http://www.becker-posner-blog.com/archives/2008/11>>

⁷¹ Gary S. Becker. “The Evidence Against Banks Does Not Prove Bias.” *BusinessWeek*, 19 April 1993, 18.

⁷² Greenspan, *supra* note 12, at 17. Greenspan states “those of us who have looked to the self-interest of lending institutions to protect shareholders equity, myself especially, are in a state of shocked disbelief.” Becker *supra* note 4, at .

Gary Becker, comment on “Greater Regulation of Financial Markets,” The Becker-Posner Blog, comment posted April 28, 2008, http://www.becker-posner.com/archives/2008/09/competition_dis.html. According to Becker, “one reason why extensive regulation of commercial banks did not prevent many banks from getting into trouble is that bank examiners became optimistic along with banks about the risks associated with mortgages and other bank assets because the market priced these assets as if they carried little risk.” “One can expect regulators to mainly follow rather than lead the market in assessing riskiness and other asset characteristics.” Munnell, Alicia H. Geoffrey, M.B. Tootell, Lynn E. Browne, and James McEneaney. 1996. “Mortgage Lending in Boston: Interpreting HMDA Data.” *American Economic Review* 86(1): 25–53. Study revealed that black and Hispanic mortgage applicants in the Boston area were more likely to be turned down than white applicants with similar characteristics. Tim

Racial disparities in housing finance posed systemic financial risks, because pre-existing income, credit, wealth, and previous housing ownership disparities between blacks and whites created virtually irresistible pools of mortgage transactions, with scant government oversight. Because of the racial disparities described below, the failure to control exploitative mortgage products combined with social attitudes and racially discriminatory housing preferences to create a perfect storm that devastated the global financial community.⁷³ In this storm the individual choice about where to live combined with the artificial community of the originate to distribute model of housing finance of pools.

Racial and Economic Inequality in Housing Wealth: Necessary Preconditions for Subprime Loans

In the eleven-year period between 1994 and 2005, the subprime mortgage became a new product for financing the homes of middle- and working-class borrowers.⁷⁴ Unlike the prime borrowers who fueled the growth of middle class wealth in the post-war years, in the late 1990s, subprime borrowers had lower incomes, more compromised credit scores, and had less money for down payments on a house. The earlier prime borrowers took mortgages for thirty years, with 20 percent cash down payments, borrowing 80 percent at interest rates averaging about 6 percent. Most subprime borrowers required 100% financing for two reasons: First, limited incomes with no room for saving a down payment; Second, at much higher interest rates to compensate lenders for the risk of default inherent in lending to buyers with no equity in the mortgage origination.⁷⁵

The key distinction between the prime and subprime borrower during the period of rapid growth of home ownership 1994-2005⁷⁶ is that

Rutten, "Greenspan's Blind Spot," Los Angeles Times, 25 October 2008.

⁷³ Joint Center for Housing Studies at Harvard University, "Homeownership." State of Nation's Housing 2008, (Cambridge, Joint Center for Housing Studies at Harvard University, 2008), 17.

⁷⁴ Gramlich, supra note 5, at 3. Gramlich states "while all income groups have participated in this new opening up the mortgage market and rise in homeownership, low- and moderate- income households and racial and ethnic minorities have been at the center of the boom."

⁷⁵ Gramlich.

⁷⁶ Gramlich, supra note 5, at 3. Gramlich discusses the dramatic expansion of homeownership Home ownership expanded dramatically in the period immediately following World War II. "The overall homeownership rate/percentage of home owners rose from 45% to 65% in the ten years following after the war. Adam Gordon, "The Creation of Homeownership: How New Deal Changes in Banking Regulation Simultaneously Made Homeownership Accessible to Whites and Out of Reach for Blacks," Yale Law Journal (2005): 186-226 Gramlich, at 1. Gordon describes a racially discriminatory pattern of access to home mortgage finance based on the underwriting criteria for the FHA mortgage program that provided for the first timed thirty year fixed rate

subprime borrowers had lower family incomes.⁷⁷ With lower incomes, these families could not accumulate the savings required for a 20 percent or even a 10 percent down payment.⁷⁸ In addition, these families did not have the benefit of the wealth accumulated from previous home ownership. These new entrants to homeownership could only aspire to move from renting to home-owning when the new subprime mortgage products allowed them to substitute borrowing over thirty years for accumulated home equity from previous homes, or saving out of current income for the standard 10-20 percent down payment.⁷⁹

Comment [a3]: Note 79 repeats text from note 77.

The data that follows shows that preexisting income inequalities by race, when combined with inequalities in accumulated housing wealth, created opportunities for introducing new loan products to borrowers who had previously been excluded from home ownership because of the amount, sources, and stability of family income; absence of previous

mortgages with down payments as low as 20 percent. The FHA criteria were based on the view that stable neighborhoods were racially homogeneous and white. The geographic boundaries of the neighborhoods in which FHA was willing to guarantee home mortgages excluded all black neighborhoods, and previously white neighborhoods that were in transition from white to integrated. Thomas M. Shapiro and Melvin L. Oliver, "Subprime as a Black Catastrophe," *American Prospect*, September 22, 2008, available at http://www.prospect.org/cs/articles?article=sub_prime_as_a_black_catastrophe. The authors argue "African Americans, along with other minorities and low-income populations, have been the targets of the sub-prime mortgage system."

⁷⁷ Thomas M. Shapiro, *The Hidden Cost of Being African American* (Oxford: Oxford University Press, 2004), 119. Shapiro highlights the crucial role that "private wealth plays in perpetuating inequality from one generation to the next." Historical differences in the private wealth of whites and African Americans have led to the two groups having distinct experiences in homeownership. White families are more likely than African American families to "receive parental financial assistance for down payment and closing costs." Therefore, "white families typically bring more assets to the table, use them to lower the amount of the loan or to pay up-front points on the loan, and they consequently receive a lower interest rate on their mortgage." "These families also pointed to equity taken out of previous homes as key to buying bigger homes in better communities." Without access to similar assets as whites, "African Americans pay higher interest rates and have less favorable loan terms than their white counterparts."

⁷⁸ Adam Gordon, "The Creation of Homeownership: How New Deal Changes in Banking Regulation Made Homeownership Accessible to Whites and Out of Reach for Blacks," *Yale Law Journal*, October 2005, 115 *Yale L.J.* 186. Gordon describes a racially discriminatory pattern of access to home mortgage finance based on the underwriting criteria for the FHA mortgage program that provided for the first time thirty year fixed rate mortgages with down payments as low as 20 percent. The FHA criteria were based upon the view that stable neighborhoods were racially homogeneous and white. The geographic boundaries of the neighborhoods in which FHA was willing to guarantee home mortgages excluded all black neighborhoods, and previously white neighborhoods that were in transition from white to integrated.

⁷⁹ Melvin L. Oliver and Thomas M. Shapiro, *Black Wealth, White Wealth: A New Perspective on Racial Inequality* (New York: Routledge, 1997). "Blocked from low-interest government-backed loans, redlined out by financial institutions, or barred from homeownership by banks, black families have been denied the benefits of housing inflation and the subsequent vast increase in home equity assets." Gramlich.

homeownership; and structural features of government-facilitated discrimination in the home mortgage industry.⁸⁰

If we look at income measures we can see that by 2001, the beginning of the housing bubble in America, the nominal gap in median net household wealth between blacks and whites had grown from \$44,000 in 1984 to \$86,000 in 2001. This income gap set the stage for differences in home ownership rates.⁸¹

1. Wealth Gap

Median total household net wealth in U.S. dollars (nominal)

	1984	1989	1994	1999	2001
Black	2000	4200	6950	8075	10000
White	46000	57000	78000	87000	96000
Nominal Gap	44000	52800	71050	78925	86000

Source: 1984-2001 PSID, using 2001 weights, all years with available data. Real values are based on CPI with base period 1982-1984=100 (based on U.S. city average and all items). (Joint Center for Housing Studies Harvard University, State of the Nation’s Housing Ch. 4 (2008))

2. Homeownership Gap

a. General Trends in Homeownership

According to the Harvard Joint Center for Housing Studies, “[t]he

⁸⁰ Gordon, supra note 26, 190-209. Gordon explains that when the FHA decided that it would insure low-down-payment, long-term mortgages to promote homeownership, “it produced underwriting guidelines based on an economically and historically flawed understanding of a “natural” progression of neighborhood racial change from all-white (with high property values) to all-black (with low property values). These guidelines rated a neighborhood’s suitability for insurance based on racial composition; ‘A’ neighborhoods had to be ‘homogenous’—meaning ‘American business and professional men’—and ‘American’—meaning white and often, native-born. Predominantly black neighborhoods received a “D” grade. Consequently, the FHA’s underwriting criteria resulted in “much lower rates of lending to nonwhites than to whites.” “African Americans were denied the opportunities to buy a home in developing suburban neighborhoods and to build the wealth that became the mainstay of the American white middle class.” When African Americans did buy homes, usually using conventional mortgages, they not only tended to pay more in down payments and roughly the same monthly payments when compared with whites using FHA-insured mortgages, but they also got much lower-quality homes. While private insurers might have arisen to offer African-Americans the opportunities denied to them by the FHA, Congress and state legislatures amended safety-and-soundness regulations in a way that disallowed competition with the FHA.”

⁸¹ Gramlich, supra at note 5, at 3. According to Gramlich, “from 1994 to 2005, the overall rate rose from 64 to 69 percent.” However, “the rate for blacks rose from 42 to 49 percent.”

homeownership rate began to retreat in 2005 and 2006 and then dropped more sharply in 2007, to 67.8 percent in the fourth quarter.”⁸²

“Innovations in prime mortgage lending contributed to larger homeownership rate advances among blacks (up 5.9 points), Hispanics (up 6.1 points), and households under 35 years old (up 3.9 points). After the 2001 recession but before house prices and lending practices went wild, the national homeownership rate climbed another 1.2 percentage points to a peak of 69.0 percent. In the three years since, homeownership rates have fallen back for most groups, including a nearly 2.0-point drop among black households and a 1.4-point drop among young households.”⁸³

“According to the Current Population Survey, the homeownership gap between Blacks and Whites has increased by 2.5 percentage points to 27.1 percent between 1985 and 2005.”⁸⁴

“Moreover, using data from the Survey of Consumer Finance from 1983 to 2001, a recent study by Gabriel and Rosenthal (2005) suggests that credit barriers account for no more than 5 percentage points of the roughly 25 percentage point (or higher) homeownership differential between Blacks and Whites.”⁸⁵

b. Statistical Comparison of Black-White Homeownership

Homeownership Rate in %

	1985	1990	1995	2000	2005
Total	64.3	64.1	64.7	67.2	68.9
Black	44.4	42.6	42.4	47.6	48.8
White	69.0	69.4	70.8	73.6	75.8
Gap	24.6	26.8	28.6	26.0	27.1

Source: Current Population Survey (Bureau of the Census). State of the Nation’s Housing 2008, Joint Center for Housing Studies at Harvard University, Chapter 4, 2008)
Homeownership by units

⁸² State of the Nation’s Housing 2008, Joint Center for Housing Studies at Harvard University, Chapter 4, 2008) 17.

⁸³ Id.

⁸⁴ Christian A.L. Hilber and Yingchun Liu, “Explaining the Black-White Ownership Gap: The Role of Own Wealth, Parental Externalities, and Locational Preferences,” Munich Personal RePEc Archive, 7 November 2007, Munich Personal RePEc Archive, Date Downloaded, <<http://mpira.ub.uni-muenchen.de/5136/>>

⁸⁵ Id.

* Numbers in Thousands

Note: 75,647 total housing units owned

	Units occupied	Units Owned	Households below poverty level
Black Households Alone	13,856	6,464	3,522 (24% of units occupied)
White Households Alone	90,413	65,554	9,705 (10.7% of units occupied)

Source: 2007 AHS (<http://www.census.gov/prod/2008pubs/h150-07.pdf>)

pp. 46, Introductory Characteristics—Occupied Units

c. Home Equity

In general: Over half the black households have less than \$52,882 in equity, while the white median is at least \$20,000 higher.⁸⁶

Effects of increased length of residence on home equity: “Blacks and Hispanics gain considerably less equity than do whites for each additional year of ownership, but Asians accrue equity more rapidly than any other group. Ten years of residence results in an average gain of \$31,570 for whites, but only half that much for blacks (\$15,830) and 60 percent of that for Hispanics (\$18,940). Asian housing equity would have increased by \$48,920 over the same ten-year period, 55 percent more than for whites.”⁸⁷

Effects of increased income and education on home equity: Black, Asian, and Hispanic households gain substantially lower equity returns to income and education than do white households. Each \$10,000 of income increases housing equity for whites by \$17,770, but only by \$15,900, \$9,500, and \$15,150 for blacks, Asians, and Hispanics, respectively. A four-year difference in education (e.g., a college versus a high school degree) leads to an increase of almost \$20,000 in whites’ home equity, but increases of only \$12,616 in Asians’, \$6,852 in blacks’, and a mere \$2,564 in Hispanics’ home equity. Clearly, minority households must have notably higher incomes and levels of education than otherwise similar white households to accumulate as much wealth in their homes.”⁸⁸

For black households, home equity accounts for 63 percent of total average net worth. In sharp contrast, home equity represents only

⁸⁶ Robert L. Kaufman and Lauren J. Krivo, “Housing and Wealth Inequality: Racial-Ethnic Differences in Home Equity in the United States, 41,” *Demography* 585 (1 August 2004): 585-605.

⁸⁷ *Id.* at 600.

⁸⁸ *Id.*

38.5 percent of average white net worth.⁸⁹

Pelletierre concludes that “compared with Whites and even Hispanics, who have the same rate of homeownership as Blacks, Blacks have the lowest median home equity. According to the most recent numbers, from 2002, Black homeowners had nearly \$41,000 in home equity compared with more than \$81,000 for Whites.”⁹⁰

In 2003, the Joint Center for Housing Studies at Harvard noted that, “while blacks lagged whites by \$100,000 to \$130,000 in median net wealth, black homeowners lagged by just \$43,000 in median home equity.”⁹¹

d. House Value Gap

See two attached tables outlining the value of total units owned and the value of units owned by black households.

As Thomas Shapiro and Melvin Oliver have established, the down payment deficit of lower-income borrowers is a direct byproduct of intergenerational wealth differences between blacks and whites that are attributable to the legacy of slavery and Jim Crow employment and residential segregation. In this data we can see that gifts from parents are a frequent source of down payments in many white families.⁹² In light of the racial disparity in the capacity to provide intergenerational wealth transfers to assist family members who are first time homebuyers, what Shapiro calls “transformative assets,” we can see that home ownership for lower income families who do not have access to these family resources places them in the unenviable position of being lifetime renters, or dependent on either the public home ownership assistance programs, such as FHA, or market innovations like the subprime mortgage.

⁸⁹ Melvin Oliver and Thomas Shapiro, supra note 26. “Subprime as a Black Catastrophe.” *The American Prospect*, 22 September 2008, *The American Prospect Magazine*, 29 January 2008, <http://www.prospect.org/cs/articles?article=sub_prime_as_a_black_catastrophe.>

⁹⁰ Danilo Pelletiere, “House of Cards: The State of Black Housing,” *BNet Business Network*, *The Crisis* (May/Series, June 2005); available at , CBS Interactive, Inc., 29 January 2008, <http://findarticles.com/p/articles/mi_qa4081ga4081/is_200505/ai_n15665714.>

⁹¹ *Id.*

⁹² Shapiro, supra note 27, at 112. Shapiro explains that “parental assistance gives young white adults a significant head start that enables them to acquire better first homes and to do so earlier.” “Wealth constrained white families come from wealthier parents and hence are more likely to receive parental financial assistance for down payment an close cost requirements.” Thomas Shapiro, *The Hidden Cost of Being African American* (New York, Oxford University Press, 2004).

The modern subprime loans were simply less safe compared to the FHA subsidized⁹³ loan that allowed low-income buyers to purchase with only a 3 percent down payment.

However, during their peak (2001-2006), subprime loans, originated by unregulated private mortgage brokers displaced the regulated FHA mortgage for low income borrowers.

B. Securitizations: The New Inequality Machine

Mortgage securitizations are not new. However, what is new is the lethal combination of pools of predatory whole mortgages that were artificially deconstructed into “tranches” that represent layers of payment stacked according to risk of default, assigned a rating by a credit rating agencies that had not actually checked the assumptions upon which the riskiness of each tranche was based. Each layer of the mortgage backed securitization contained a series of contracts that produced cash flow waterfalls that promised to pay investors aggressive returns. Each step in constructing the securitization had been the subject of commissions for transferring the risk of default, further and further away from the brokers who actually made loans to people who could not afford to repay them.

Mortgage brokers earned commissions for each mortgage they closed. The commissions were retained, whether or not the mortgage performed as agreed. In fact, the commission structure was completely disconnected from the ultimate long term performance of the mortgage. There were no financial incentives for brokers to monitor loan quality. The legal rules completely severed mortgage originations from the stability of the mortgage performance over time. Because the growth of independent brokers led to unregulated loan quality and aggressive marketing tactics were not uniformly regulated by federal regulators, there were neither economic or regulatory incentives for mortgage brokers in the newly exploding subprime mortgage market to make sure that the loan terms were suited to the borrowers, income, savings, and job stability. The loans were sold after origination, without recourse. This non-recourse

⁹³ President Kennedy issued Executive Order 11063 in 1962 ending the FHA policy of neighborhood redlining that had prevented blacks from getting the benefit of FHA subsidized loans for more than 2025 years. Source: David Freund, Princeton University, “Democracy’s Unfinished Business: Federal Policy and the Search for Fair Housing,” Poverty and Race Research Action Council, 11 June 2004: 3.

disclaimer of future liability for the assigned loan products meant that at each stage of the process the brokers, lawyers, and trustees could accumulate returns for quantity of loans without regard to quality.

The problematic loan products generated “cash flow waterfalls” for loan originators, processors, trustees, and securitizers. At the same time the consequences of the increasingly high risk of default were concentrated in the communities of first time homeowners. The stark polarity of these results created a smoothly efficient inequality machine, in which collateral consisting of mortgages with a high risk of default were “transformed” into investment grade securities. { insert discussion of Hernando de Soto, “These derivatives are the root of the credit crunch, why? Unlike all other property paper are not required by law to be recorded, continually tracked and tied to the assets they represent. Nobody know precisely how many there are, where they are, and who is finally accountable for them. Thus there is widespread fear... Hernando de Soto, Toxic Assets Were Hidden Assets, March 25, 2009, Wall Street Journal. }

understand the liability structure, the cashflow waterfalls

and had no responsibility for the success of their loans beyond obtaining the buyers’ signature on the complex mortgage contract.

Conclusion

The difference between the social and economic impact of these different periods of rapidly expanding home ownership is that the earlier loans lead to real ownership and wealth, which could be passed on to future generations. The subprime illusion has led to instability for families and communities, and economic exploitation of borrowers who reached for the golden ring of first-time homeownership, despite low incomes.

Who is responsible for ensuring that homeownership, the centerpiece of middle- and working-class wealth potential, is financed with stable, suitable financial products that lead to eventual ownership? Transitory occupancy of homes that never yield real wealth, or the community stability associated with the pride of eventual complete ownership is a cruel economic hoax. A central role of government is to mediate the market forces that manipulate the deep longing for participation in homeownership as a fundamental marker of economic citizenship.⁹⁴

⁹⁴ Franklin D. Roosevelt, State of the Union Address (January 11, 1944). “We have come to a clear realization of the fact that true individual freedom cannot exist without economic security and

Notes for Chapter 4

independence. We have accepted, so to speak, a second Bill of Rights under which a new basis of security and prosperity can be established for all—regardless of station, race, or creed.” Among these is “the right of every family to a decent home.”