THE COST OF INEQUALITY: SOCIAL DISTANCE, PREDATORY CONDUCT, AND THE FINANCIAL CRISIS

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"An imbalance between rich and poor is the oldest and most fatal ailments of all republics."
—*Plutarch*[1]

"The injunction of Jesus to love others as ourselves is a recognition of self-interest . . . . We have to tolerate the inequality as a way to achieving greater prosperity and opportunity for all."
—*Lord Brian Griffiths, Vice Chairman, Goldman Sachs International*[2]

The present financial crisis—what is now commonly referred to as "the Great Recession"[3]—presents, for many, the opportunity to promote a particular economic and socio-political world view about the causes of the crisis. For those on the left, the crisis was the product of a deregulatory philosophy with its roots in Reaganomics, which gained a reckless head of steam during the presidency of George W. Bush.[4] On the right, many blame government policies as well, but not those that promoted de-regulation. Rather, it was liberal Democrats, like Presidents Carter and Clinton and Representative Barney Frank, who purportedly pushed the banking industry to lend to people of low-income who had no business being homeowners.[5] In some ways, the financial crisis is like a Rorschach test: what

1. BRUCE JUDSON, IT COULD HAPPEN HERE: AMERICA ON THE BRINK 76 (2009) (no citation in original).

2. Simon Clark & Caroline Binham, *Profit 'Is Not Satanic,' Barclays CEO Varley Says (Correct)*, BLOOMBERG NEWS (Nov. 3, 2009), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aGR1F_bjSIZw.

3. *See* Barry Eichengreen & Kevin H. O'Rourke, *A Tale of Two Depressions*, ADVISOR PERSPECTIVES (Apr. 21, 2009), http://www.advisorperspectives.com/newsletters09/pdfs/A_Tale_of_Two_Depressions.pdf; *see also* Paul Krugman, *The Great Recession Versus the Great Depression*, N.Y. TIMES, Mar. 20, 2009, http://krugman.blogs.nytimes.com/2009/03/20/the-great-recession-versus-the-great-depression/.

4. For the ways that deregulation laid the groundwork for the financial crisis, see SIMON JOHNSON & JAMES KWAK, 13 BANKERS: THE WALL STREET TAKEOVER AND THE NEXT FINANCIAL MELTDOWN 67–72 (2010).

5. For an argument that the government programs were responsible for fueling the financial crisis, see Howard Husock, Op-Ed., *Housing Goals We Can't Afford*, N.Y. TIMES, Dec. 11, 2008, at A49; *see also Whose [sic] Responsible for Economic Mess?*,

one sees in an ink blot may reveal more about him or her than it does about the picture.

Taking a hard look at some of the economic indicators present in the buildup to the crisis, one such indicator stands out: prior to the crisis, the United States experienced a stunning increase in income inequality.[6] This increase was reminiscent of a similar increase in income inequality that preceded the great economic crisis of the last century—the Great Depression.[7] Given this phenomenon, has income inequality itself had an impact on financial markets to such an extent that it exacerbated, or even led to these financial crises?

There are several potential explanations for the connection between rising income inequality and the great strains on the economy that often follow such inequality. Did rising income for certain sectors lead to an ability to use that income to influence policymaking in such a way that favored those sectors? Did such income inequality pressure politicians to promote policies that favored easy access to credit as a way to mollify lower-income constituents who might otherwise grow frustrated with their own stagnating wages in the face of such inequality? These are the types of explanations that some have offered to help explain the link between income inequality and the Great Recession.[8] This Article offers a third: that both income inequality and racial inequality created greater social distance and that this social distance, in turn, may have led to greater predatory conduct.[9] This predatory conduct helped to pro-

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CITIZEN, May 2009, at 18, *available at* http://www.scribd.com/doc/15419200/Whose-Responsible-for-Economic-Mess (arguing that Barney Frank, as well as the Clinton and Carter Administrations, are to blame for the financial crisis).

6. *See infra* Table 3.

7. U.S. CONG. JOINT ECON. COMM., 111TH CONG., INCOME INEQUALITY AND THE GREAT RECESSION 2–3 (2010) ("Income inequality peaked prior to the United States' two most severe economic crises—the Great Depression and the Great Recession.").

8. *See, e.g.*, JOHNSON & KWAK, *supra* note 4, at 89–90 (describing increased influence of financial sector on legislative process); *infra* text accompanying notes 83-85 (describing argument concerning use of credit to offset income inequalities).

9. For the most part, this predatory conduct took the form of predatory lending, which has been defined as follows:

> [T]he process of engaging in unfair and deceptive lending practices and sales techniques that rely on misrepresentation, threats, unfair pressure, and borrower ignorance. The goal of predatory lending is to coerce or trick homeowners into obtaining loans with interest rates or fees higher than the borrowers' credit profiles and the market would justify or loans larger than or different from what the borrowers need, want or can afford.

mote the risky lending practices that led to an asset bubble in real estate and left many middle class borrowers saddled with onerous loans tethered to overvalued homes. Once the bubble burst, such borrowers were left with mortgage obligations they could not meet and homes they could no longer afford. Since the financial sector was so heavily tied to the health of the U.S. home mortgage market, the collapse of that market led to an economic "tsunami"[10] that swamped all other economic sectors, leading to double-digit foreclosure and unemployment rates in many states. The information presented here suggests that income and racial inequality may have helped foster an environment where predatory conduct could flourish in the home mortgage market. Such predatory conduct crippled home finances and ultimately spread to all sectors of the economy.

This Article is organized as follows. Part I presents an overview of both the financial crisis and the foreclosure crisis embedded within it. Part II discusses the interplay between social distance and predatory conduct. Part III considers an alternative theory that attempts to explain the connection between income inequality and the present financial crisis. Part IV concludes this Article with an analysis of the financial reform legislation passed by Congress in the summer of 2010 to determine to what extent the reforms passed may address social inequality and social distance. Part IV also provides some thoughts on what social distance theory says about potential policy responses to the present crisis.

The review of the information presented here reveals several compelling findings regarding some of the potential causes of the financial crisis, some of which have not received a great deal of attention to date. First, differences in economic inequality within states correspond to differences in mortgage delinquency rates: i.e., the greater the income inequality in a state, on average, the greater the delinquency rate in that state. Second, the greater the level of generalized trust in a state, the lower that state's delinquency rate. Third, the higher the social capital in a state, the lower its delinquency rate. Fourth, the higher the median income in a state, the

Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 507 (2002).

10. Alan Greenspan, former Federal Reserve Chairman, testified before a House of Representatives committee that the "current global financial crisis is a 'once in a century credit tsunami' . . . ." *Greenspan Calls Economic Crisis a 'Credit Tsunami'*, PENNLIVE.COM (Oct. 23, 2008), http://www.pennlive.com/midstate/index.ssf/2008/10/greenspan_calls_economic_crisi.html; *see also* Habib Siddiqui, NRB Council, USA, Corporate America Still Doesn't Get It (Jan. 17, 2010) (working paper), *available at* http://ssrn.com/abstract=1537869.

higher the delinquency rate in that state. Fifth, an index of a series of indicators—including income inequality within a state, the size of the African American population in a state and the median income of the African American population in that state—reveals a strong correlation between these indicators and delinquency rates. This correlation suggests not that low-income African Americans are to blame for the foreclosure crisis, but rather that middle-class African Americans were targeted for and steered towards loans on unfair terms, precipitating the foreclosures that are now concentrated disproportionately in communities of color.

Some cautionary words regarding the use of data in this Article must precede this analysis. Admittedly, the data and analysis presented here does not constitute a deeply sophisticated and granular evaluation using complex statistical techniques. Rather, the information presented here, and the manner in which it is presented, is meant solely as a "conversation starter," a way of looking at features of the financial crisis in a light that, hopefully, helps to start a dialogue about not just the forces that may have been at work in the lead up to the crisis, but also those factors that must be taken into account when considering paths out of it. Furthermore, some of the information that I use in this assessment is itself hard to measure: e.g., mortgage delinquency rates and foreclosure rates,[11] levels of trust in a community,[12] and levels of social capital in a community.[13] Additionally, the purpose of using this data is not to prove theorems about cause and effect but to inform a discussion. Others have engaged in more in-depth analysis of some of the issues addressed in this Article, including, for example, whether, in the lead up to the financial crisis, borrowers of color may have been steered into higher cost loans than White borrowers of similar

11. On the challenges to measuring foreclosure and delinquency rates, see *National Delinquency Survey Facts*, MORTGAGE BANKERS ASSOCIATION, 1 (May 2008), http://www.mbaa.org/files/Research/NDSFactSheet.pdf. This fact summary of the Association's survey demonstrates the complexity and challenges in obtaining current and accurate rates, including having to adjust for such things as seasonal trends and intricacies in state foreclosure statutes. *Id.*

12. On the difficulties involved with measuring generalized trust in a community, see Edward L. Glaeser et al., *Measuring Trust*, 115 Q. J. ECON. 811, 811–12 (2000). For a discussion of this topic, see *infra* text accompanying note 99.

13. On measuring social capital, see *Measuring the Dimensions of Social Capital*, WORLD BANK, http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTSOCIALDEVELOPMENT/EXTTSOCIALCAPITAL/0,,contentMDK:20305939~menuPK:418220~pagePK:148956~piPK:216618~theSitePK:401015~isCURL:Y,00.html (last visited July 28, 2010). On the challenges of measuring social capital, see Robert M. Solow, *But Verify—Trust: The Social Virtues and the Creation of Prosperity by Francis Fukuyama*, THE NEW REPUBLIC, Sept. 11, 1995, at 36.

creditworthiness.[14] While this Article attempts to build on that work, its analysis is not intended to establish a causal relationship between any two phenomena. Rather, its purpose is to attempt to draw connections between phenomena and begin a dialogue about potential responses to them.

One of the techniques used most often in analyzing the information presented in this work is to rank U.S. states according to their relation to one another using a range of different characteristics and sources of data: e.g., the levels of generalized trust in different states, median incomes in the states, and crime rates. This Article compares these and other data sets to the mortgage delinquency rates of different states in an attempt to explore the potential connections between the characteristics of the different states and the level of mortgage distress within their borders. Rather than presenting raw data, this Article ranks the states to make the scatter point graphs utilized easier to read visually and to present information that is easier to process and that serves as a better foil for conversation.[15]

In these ways, this Article attempts to take an approach similar to that used in other settings. Heather Gerken, in her recent work promoting the use of data analysis to assess the relative success of the machinery of democracy in the United States—i.e., our system of casting votes—takes such an approach.[16] There, she argues for the creation of a "Democracy Index," one which would help begin a dialogue about election reform and help point the way to accomplishing it. She describes the value of such an approach as follows:

> Rather than focusing on necessarily atmospheric judgments about what problems exist, the Index would provide concrete, comparative data on bottom-line results. It would allow us to figure out not just what is happening in a given state or locality, but how its performance compares to similarly situated juris-

14. *See infra* text accompanying notes 140–48.

15. Much of the raw data underlying the rankings is available in the Appendix. Heather Gerken explains the value of rankings as follows: "Rankings get more political traction than the alternatives, precisely because they reduce the data to their simplest form." HEATHER K. GERKEN, THE DEMOCRACY INDEX: WHY OUR ELECTION SYSTEM IS FAILING, AND HOW TO FIX IT 34 (2009) (footnote omitted). Gerken argues that, through ranking, information can be presented in a "highly intuitive, accessible format . . . ." *Id.* at 68.

16. *Id.* The recently released "Economic Security Index" is another example of this type of approach. *See* JACOB S. HACKER ET AL., ECONOMIC SECURITY AT RISK: FINDINGS FROM THE ECONOMIC SECURITY INDEX (2010), *available at* http://www.economicsecurityindex.org/assets/Economic%20Security%20Index%20Full%20Report.pdf (describing Economic Security Index).

> dictions'. It would help us spot, surface, and solve the problems that afflict our system. The Democracy Index would, in short, give us the same diagnostic tool used routinely by corporations and government agencies to figure out what's working and what's not.[17]

This Article seeks to apply this approach to the relationship between trust and predatory conduct; the role of social capital in serving as a check on such predatory conduct; and the interplay between race, place and class in the lead up to the financial crisis. The juxtaposition of certain critical pieces of information, as presented in this Article, will hopefully help inform, and perhaps even shape, what should be an ongoing debate about the need for and the contours of financial reform after the passage of the Dodd-Frank bill.

I.
AN OVERVIEW OF THE MORTGAGE CRISIS

A. How Did We Get Here?

The story of the financial crisis has been told many times, and this Article does not attempt to offer a full recount. Suffice it to say, the most immediate seeds of the crisis were planted in the wake of the collapse of the so-called "dot-com" bubble of the late 1990s. The loss in value in that market sector and the attacks of September 11, 2001 led the Federal Reserve to lower interest rates in an attempt to weaken the recessionary effects of those events.[18] A savings glut in other parts of the world, coupled with lowered interest rates, sent investors looking for higher returns than those they could earn from investing in U.S. Treasury securities.[19] At the same time, innovations in home mortgage finance brought about by the increase in securitization of mortgages created investment vehicles that offered investors what they wanted: high returns from a seemingly safe

17. GERKEN, *supra* note 15, at 59. On the mechanics of and values behind the creation of an effective index, see DAVID ROODMAN, CTR. FOR GLOBAL DEV., BUILDING AND RUNNING AN EFFECTIVE POLICY INDEX: LESSONS FROM THE COMMITMENT TO DEVELOPMENT INDEX (2006), *available at* http://cgdev.org/content/publications/detail/6661.

18. Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys., Monetary Policy and the Housing Bubble, Address at the Annual Meeting of the American Economic Association 2–3 (Jan. 3, 2010), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20100103a.htm.

19. DANIEL GROSS, DUMB MONEY: HOW OUR GREATEST FINANCIAL MINDS BANKRUPTED THE NATION 18–20 (2009).

product.[20] Questions about the safety of that product—securitized mortgages—were answered by credit rating agencies that deemed them "AAA" safe, or the safest securities available.[21]

These innovations revolutionized the home mortgage market in the United States by converting the business operations of thousands of home mortgage lenders who transformed their business plan from "lend and hold" to "originate to securitize."[22] Lenders sought out prospective borrowers, not because those lenders could profit from the spread between the interest rate at which they borrowed and the interest rate at which they lent to those customers; rather, their profit came from investment banks that paid those lenders a fee for writing mortgages and selling them to those banks.[23] The model was driven by quantity and not quality.[24] As the pool of potential borrowers dried up, new mortgage products were devised that allowed lenders to offer loans through lowered underwriting standards, on terms that few understood and even fewer could afford.[25] Exotic adjustable rate mortgages were not to be

20. For an overview of the securitization process and a description of the ways in which mortgage securitization was one of the leading causes of the subprime mortgage crisis, see Kurt Eggert, *The Great Collapse: How Securitization Caused the Subprime Meltdown*, 41 CONN. L. REV. 1257 (2009).

21. *See* JOHNSON & KWAK, *supra* note 4, at 131; Jason Cox, Judith Faucette & Consuelo Valenzuela Lickstein, *Why Did the Credit Crisis Spread to Global Markets*, *in* THE E-BOOK ON INTERNATIONAL FINANCE AND DEVELOPMENT Part 5 (Mar. 2010), http://www.uiowa.edu/ifdebook/ebook2/contents/part5-II.shtml ("Many mortgage-backed securities received AAA credit ratings, meaning that they were considered among the safest assets on the market.").

22. As former Securities and Exchange Commissioner Christopher Cox explained before Congress, the "originate to securitize" model was at the heart of the financial crisis because of the risks such an approach encouraged: "When mortgage lending changed from originate-to-hold to originate-to-securitize, an important market discipline was lost. The lenders no longer had to worry about the future losses on the loans, because they had already cashed out." *The Role of Federal Regulators: Lessons from the Credit Crisis for the Future of Regulation, Hearing Before the H. Comm. on Oversight and Gov't Reform*, 110th Cong., 26 (2008) (testimony of Christopher Cox, Sec. and Exch. Comm'n).

23. For a description of the new ways that lenders and investment banks could make money through securitization, including the sale of the underlying interest to generate more money as well as the fees associated with that sale, see JOHNSON & KWAK, *supra* note 4, at 76 ("In each case, the revenues available depended on the volume of mortgage-backed securities.").

24. John Kiff & Paul Mills, *Money for Nothing and Checks for Free: Recent Developments in U.S. Subprime Mortgage Markets* 7 (Int'l Monetary Fund, Working Paper No. 188, 2007), *available at* http://www.imf.org/external/pubs/ft/wp/2007/wp07188.pdf.

25. For an overview of the ways in which lenders lowered underwriting criteria to recruit new customers, see Allan N. Krinsman, *Subprime Mortgage Meltdown:*

feared, however, as lenders promised borrowers the ability to refinance their loans after a short period of time (i.e., before the interest rate adjusted upwards), assuming, of course, that the value of the home securing the mortgage would continue to rise;[26] otherwise such an approach would not work. The idea that a single borrower could generate an initial loan and then could refinance that loan, perhaps even multiple times, held out the promise of a steady stream of income for the lender, who would collect a new set of fees with each transaction.[27]

As home values reached unsustainable heights, fueled by the availability of easy credit,[28] lenders began to pull back on the reins, and borrowers could no longer refinance their mortgages.[29] As credit dried up, borrowers began to fall behind on their mortgages as their interest rates reset to unaffordable levels through opaque formulas that masked their potential for economic destruction.[30] With borrower delinquencies increasing, home prices began to fall and investors grew suspicious of securitized mortgage bonds as investments.[31] The music stopped, leaving investment banks holding both the securities they maintained in their portfolios and those

How Did It Happen and How Will It End?, J. STRUCTURED FIN., Summer 2007, at 13, 14–15; Souphala Chomsisengphet & Anthony Pennington-Cross, *The Evolution of the Subprime Mortgage Market*, 88 FED. RES. BANK ST. LOUIS REV. 31 (2006); MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE 28 (2010).

26. *See* Jane Birnbaum, *The Affluent, Too, Couldn't Resist Adjustable Rates*, N.Y. TIMES, Mar. 20, 2008, http://www.nytimes.com/2008/03/20/business/20mortgage.html. "Today's ARMs were 'designed to fail, so you have to refinance . . . . It shouldn't be surprising that values go up and down in this kind of situation. And when you most need to refinance you can't — the crux of the crunch.'" *Id.* (quoting Susan M. Wachter, Professor, Univ. of Pa.).

27. JOHNSON & KWAK, *supra* note 4, at 128; *see* MARK ZANDI, FINANCIAL SHOCK: A 360¹/₄ LOOK AT THE SUBPRIME MORTGAGE IMPLOSION, AND HOW TO AVOID THE NEXT FINANCIAL CRISIS 95 (2009).

28. JOHNSON & KWAK, *supra* note 4, at 130.

29. *See* Vikas Bajaj & Louise Story, *Mortgage Crisis Spreads Past Subprime Loans*, N.Y. TIMES, Feb. 12, 2008, at A1, *available at* http://www.nytimes.com/2008/02/12/business/12credit.html?pagewanted=1&_r=1 (noting difficulty borrowers have refinancing "[a]s home prices fall and banks tighten lending standards").

30. Jennifer E. Bethel, Allen Ferrell & Gang Hu, *Law and Economic Issues in Subprime Litigation* 19 (Harvard: John M. Olin Ctr. for Law, Econ., and Bus., Discussion Paper No. 612, 2008), *available at* http://www.law.harvard.edu/programs/olin_center/papers/pdf/Ferrell_et_al_612.pdf.

31. *Wall Street and the Financial Crisis: The Role of High Risk Home Loans, Hearing Before the S. Subcomm. on Investigations* (2010) (statement of Sen. Carl Levin), *available at* http://levin.senate.gov/newsroom/release.cfm?id=323765 ("'[R]elaxed credit guidelines, breakdowns in manual underwriting processes, and inexperienced subprime personnel . . . coupled with a push to increase loan volume and the lack of an automated fraud monitoring tool' led to deteriorating loans.").

they had recently constructed for sale to what had become skittish investors.[32] With no one to buy these assets, bank balance sheets turned toxic.[33] These toxic assets produced the credit freeze of the fall of 2008,[34] which turned the collapse of the subprime mortgage market into a full-blown financial crisis.[35] At the heart of the broader financial crisis is a foreclosure crisis, with a national delinquency rate hovering around 10%.[36]

This well-worn history, however, says little about how economic and social inequality might have helped to precipitate this crisis. What role, if any, did inequality play in the lead up to the foreclosure crisis? For an exploration of this issue, and in an attempt to tease out potential causes of the foreclosure crisis itself, this Article turns next to a detailed overview of the present state of that crisis.

B. The Present Foreclosure Crisis

In order to address the role that social inequality may have played in the present financial crisis, an overview of the present state of the foreclosure crisis is in order. Since different states have different foreclosure and delinquency rates, an analysis of these different rates by state may reveal some of the qualities of those states and how those qualities might explain some of the root causes of the foreclosure crisis within those states. One quality analyzed is the extent to which states have different types of social inequality, both

32. *See* LAWRENCE G. MCDONALD & PATRICK ROBINSON, A COLOSSAL FAILURE OF COMMON SENSE: THE INSIDE STORY OF THE COLLAPSE OF LEHMAN BROTHERS 270, 287 (2009).

33. John Parry, *Next Up - Bear Stearns Portfolio Value a Litmus Test for Bonds*, REUTERS (July 2, 2008), http://www.reuters.com/article/idUSN014855672008070 2?pageNumber=1 ("Markets for many of these investments . . . deteriorated further as the outlook for U.S. housing . . . worsened and investors [saw] banks and hedge funds continuing to unload risky assets from balance sheets.").

34. *See* Jeannine Aversa, *Banks Borrow Record Amount from Fed*, USA TODAY (Oct. 24, 2008), http://www.usatoday.com/money/economy/2008-10-24-483413 484_x.htm (discussing increase in bank borrowing from Fed because of investor flight).

35. *See* Cox et al., *supra* note 21 ("Since banks did not know what banks held toxic assets . . . it became impossible to tell what banks were going to be able to pay back loans. The credit freeze thus resulted in a drastic reduction in lending . . . . Thus commenced the global financial crisis."). For a detailed description of the height of the financial crisis in September 2008, see generally ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM — AND THEMSELVES (2009).

36. *See* Press Release, Mortgage Bankers Ass'n, Delinquencies and Foreclosure Starts Decrease in Latest MBA National Delinquency Survey (Aug. 26, 2010), *available at* http://www.mortgagebankers.org/NewsandMedia/PressCenter/ 73799.htm.

economic and racial. This analysis may shed light on the extent to which social inequality may have fed into the current foreclosure crisis afflicting community after community throughout the United States.

Any discussion of the foreclosure crisis should begin with a snapshot of the residential real estate market in the U.S. There are approximately seventy-five million owner-occupied residential properties in the United States.[37] About 70% of those, roughly fifty-two million properties, have outstanding mortgages on them.[38] Of those, roughly one in seven, nearly eight million, are presently in some stage of the foreclosure process, or are at least thirty days delinquent on a mortgage payment.[39] Furthermore, one in five mortgaged properties are presently "underwater"—that is, the owner owes more on the mortgage than the property is worth.[40] The success of efforts to curb the wave of foreclosures has proven elusive. As of the end of November 2010, nearly 550,000 borrowers had entered into permanent modifications through the Obama Administration's loan modification efforts.[41] The map below shows in graphic form the state of foreclosures across the United States.

37. *Selected Housing Characteristics: 2006-2008*, U.S. CENSUS BUREAU, http://factfinder.census.gov/ (select "Data Sets"; then "American Community Survey"; then "2006-2008 American Community Survey 3-Year Estimates"; then "Data Profiles"; then "Show Result") (last visited Dec. 10, 2010).

38. *Id.*

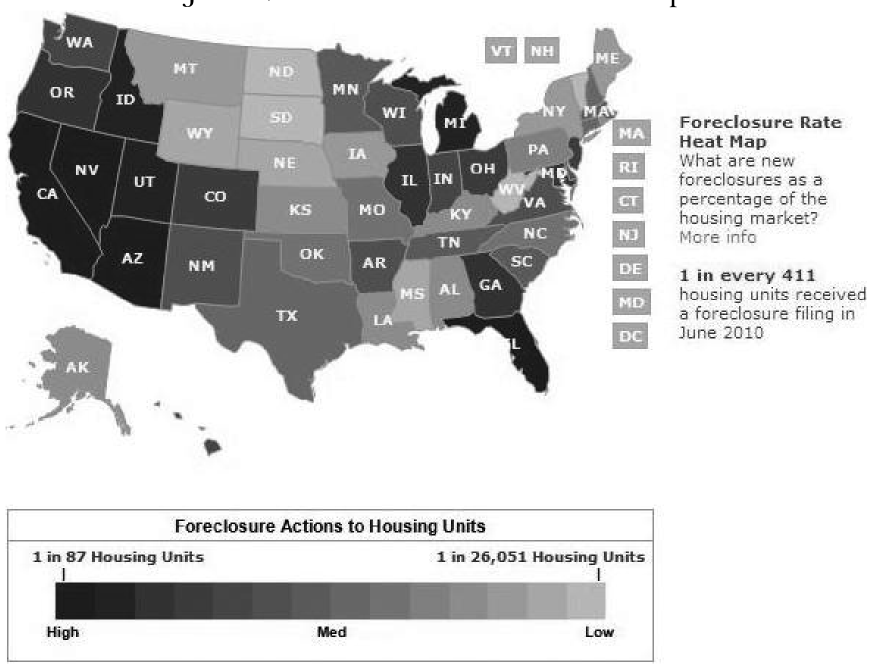
39. E. Scott Reckard, *Foreclosures Will Keep Rising Through 2010, Report Says*, L.A. TIMES, Nov. 20, 2009, at B1, *available at* http://articles.latimes.com/2009/nov/20/business/la-fi-mortgage-defaults20-2009nov20.

40. Jonathan Stempel, *One in Five U.S. Mortgage Borrowers are Underwater*, REUTERS, Mar. 4, 2009, http://www.reuters.com/article/idUSN0349273420090304. For a discussion of the social norms that prevent borrowers from engaging in "strategic default" when outstanding principal on a mortgage is higher than the value of the underlying property, see Brent T. White, *Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis* (Ariz. Legal Studies, Discussion Paper No. 09-35, 2009), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1494467.

41. U.S. DEP'T OF THE TREASURY, MAKING HOME AFFORDABLE PROGRAM: SERVICER PERFORMANCE REPORT THROUGH NOVEMBER 2010 (2010), *available at* http://www.treasury.gov/initiatives/financial-stability/results/MHA-Reports/Documents/Nov%202010%20MHA%20Report.pdf.

Table 1: U.S. Map by Delinquency Activity[42]

June 2010 Foreclosure Rate Heat Map



The foreclosure crisis affects not only those saddled with debt they cannot afford. Loss of home value due to foreclosures impacts the prices of homes in a neighborhood considerably, with estimates suggesting that foreclosures reduce the property values of homes in close proximity to the foreclosed property (as far away as one eighth of a mile) from .9% to 1.3% for each foreclosure.[43] In 2009 alone, one estimate concluded that U.S. homeowners would lose a

42. *National Real Estate Trends: June 2010 Foreclosure Rate Heat Map*, REALTYTRAC, http://www.realtytrac.com/trendcenter/default.aspx (last visited July 28, 2010).

43. A number of studies estimate the costs of foreclosures on neighborhoods and surrounding properties. Immergluck and Smith conducted a study in 2006, examining foreclosures in Chicago from 1997 and 1998, using data originally collected by the Illinois Department of Revenue. *See* Dan Immergluck & Geoff Smith, *The External Costs of Foreclosure: The Impact of Single-Family Mortgage Foreclosures on Property Values*, 17 HOUSING POL'Y DEBATE 57, 58 (2006). They concluded that "each conventional foreclosure within an eighth of a mile of a single-family home results in a 0.9 percent decline in the value of that home." *Id.* They also found that, "for the entire city of Chicago, the 3,750 foreclosures that occurred in 1997 and 1998 are estimated to have reduced nearby property values by more than $598 million, or an average of $159,000 per foreclosure." *Id.*

combined $500 billion in wealth due to the loss of home value as a direct result of neighboring foreclosures in just that year.[44] Furthermore, it is estimated that before the crisis is over, American homeowners will have lost nearly $2 trillion in the value of their homes.[45] Falling home prices reduce the local tax base, starving localities of revenue at a time when they are desperate for funds and when foreclosed and warehoused properties actually require greater municipal services, like police and fire protection.[46]

The foreclosure crisis is adversely impacting certain communities more than others. Certain states, such as Florida, Nevada, Arizona, California, Illinois and Michigan, have been hit the hardest.[47] Are there ways to explain these differences with reference to macro- or microeconomic trends? Some states, such as California and Florida, experienced a large upswing in property values before property values declined significantly, resulting in an increased number of

A 2008 study by Harding, Rosenblatt, and Yao, using data from thirty-seven Metropolitan Statistical Areas (MSAs) and thirteen states, showed "that foreclosed properties within 300 feet of the subject property create[d] a negative externality effect of approximately 1.3% per distressed property. This contagion discount diminished rapidly with distance and [fell] to .6% at a distance of 500 feet and beyond." John P. Harding, Eric Rosenblatt & Vincent W. Yao, The Contagion Effect of Foreclosed Properties 14, 20 (2008), *available at* http://ssrn.com/abstract=1160354; *see also* John Y. Campbell et al., *Forced Sales and House Prices (*Nat'l Bureau of Econ. Research, Working Paper No. 14866, 2009) (studying foreclosures in Massachusetts and reaching similar findings as Harding et al.), *available at* http://ssrn.com/abstract=1376188.

44. Ctr. for Responsible Lending, Soaring Spillover: Accelerating Foreclosures to Cost Neighbors $502 Billion in 2009 Alone; 69.5 Million Homes Lose $7,200 on Average 1 (2009), *available at* http://www.responsiblelending.org/mortgage-lending/research-analysis/soaring-spillover-3-09.pdf. The Center for Responsible Lending (CRL) used the estimate from the 2008 study of Harding et al. that a 0.744% home value decline occurs for each foreclosure within one-eighth of a mile. *Id.* at 2. The national results reported by the CRL were for 56,777 census tracts or similar geographies and only included counties located in MSAs. *Id.* The CRL outlined the foreclosure spillover by state, including data for 2009 foreclosures and anticipated foreclosures from 2009 to 2012. *Id.* at 3.

45. The CRL estimated that "[o]ver the next four years, foreclosures will affect 91.5 million nearby homes, reducing property values $1.86 trillion in total, or $20,300 per household." *Id.* at 2.

46. William C. Apgar & Mark Duda, *Collateral Damage: The Municipal Impact of Today's Mortgage Foreclosure Boom*, Homeownership Preservation Foundation, 6–7 (May 11, 2005), http://www.995hope.org/content/pdf/Apgar_Duda_Study_Short_Version.pdf.

47. The delinquency rates for these five states are as follows: Florida (20.43%), Nevada (19.04%), Arizona (13.20%), California (12.49%), Illinois (11.23%), and Michigan (11.13%). Mortgage Bankers Ass'n, National Delinquency Survey 4 (2010) [hereinafter MBA Data], *available at* http://media.oregonlive.com/frontporch/other/NDS_Q409.pdf.

underwater properties.[48] But other high-priced markets that experienced large increases in property values have not had similarly high foreclosure or delinquency rates. For example, in New York City, the first quarter of 2010 saw only 164 foreclosure starts in Manhattan, where home values skyrocketed in the last decade.[49]

Unemployment likely has also played a role in many markets. Unemployment is high in Michigan and Ohio,[50] where a substantial percentage of both states' residential properties are facing delinquency and entering foreclosure, particularly in cities.[51] But there is also high unemployment in Mississippi and South Carolina, which are not experiencing the same sort of delinquencies and foreclosures as some of the hardest hit states.[52]

While there is no doubt that price fluctuations and unemployment are driving delinquencies and foreclosures, there are also other forces at work. In the following section, I will address the interplay between income inequality and financial crises. This review reveals that there appears to be a correlation between social inequality and the incidence of foreclosures presently plaguing the states.

48. STANDARD & POOR'S, S&P/CASE-SHILLER HOME PRICE INDICES 2008, A YEAR IN REVIEW 5 (2009), *available at* http://www2.standardandpoors.com/spf/pdf/index/Case-Shiller_Housing_Whitepaper_YearinReview.pdf ("The area traditionally defined as the Sun Belt — Arizona, California, Florida and Nevada — clearly had both the largest run-up in prices since 2000 and has been the hardest hit in the downturn.").

49. Constance Mitchell Ford, *City Foreclosures Climb in First Quarter*, WALL ST. J., May 21, 2010, at A21, *available at* http://online.wsj.com/article/SB10001424052748703559004575256573362821934.html?mod=rss_newyork_main. New York City also experienced a drop in property values. *See* Press Release, Standard and Poor's, Home Prices in the New Year Continue the Trend Set in Late 2009 According to the S&P/Case-Shiller Home Price Indices 3 (Mar. 30, 2010), *available at* http://www.standardandpoors.com/spf/CSHomePrice_Release_033056.pdf. This drop continued into the second quarter. *See* James Comtois, *NY-Area Home Prices Back to 2004 Levels*, CRAIN'S NEW YORK BUSINESS.COM (Aug. 9, 2010, 1:25 PM), http://www.crainsnewyork.com/article/20100809/REAL_ESTATE/100809846.

50. Press Release, U.S. Dep't of Labor: Bureau of Labor Statistics, Regional and State Employment and Unemployment (June 18, 2010) (on file with author). The most recent unemployment numbers are available at http://www.bls.gov/news.release/laus.nr0.htm.

51. *See* MBA DATA, *supra* note 47, at 4.

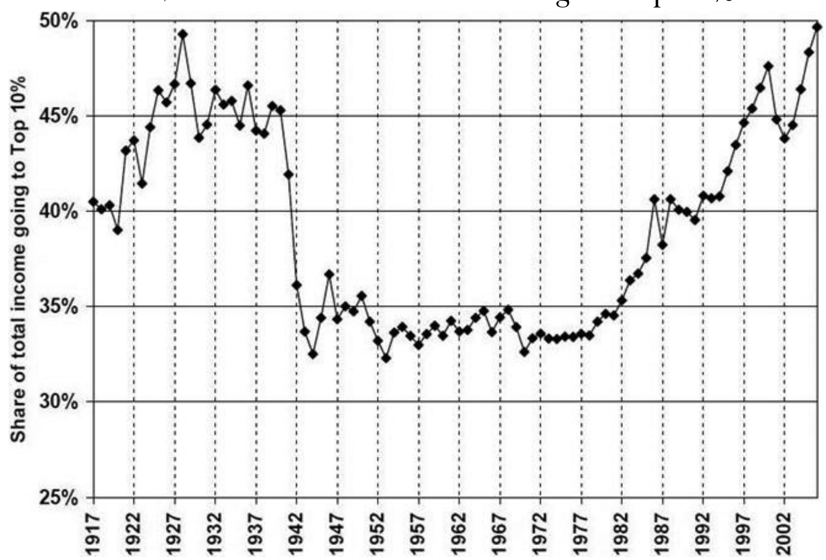
52. *See* U.S. DEP'T OF LABOR: BUREAU OF LABOR STATISTICS, *supra* note 50; MBA DATA, *supra* note 47, at 4.

II.
INEQUALITY AND FINANCIAL CRISES

A. *On Game Theory, Trust, and Social Distance*

Table 2 is a timeline of the share of total income enjoyed by the wealthiest 10% of the population in the U.S. over the last ninety years. This share was remarkably high in both the lead up to the Great Depression and the years preceding the Great Recession.

Table 2: Share of Total Income Going to Top 10%[53]



53. Emmanuel Saez, Econometrics Laboratory Software Archive at the University of California, Berkeley, *Striking it Richer: The Evolution of Top Incomes in the United States (Update with 2007 Estimates)*, 6 fig.1 (Aug. 5, 2009), http://elsa.berkeley.edu/~saez/saez-UStopincomes-2007.pdf.

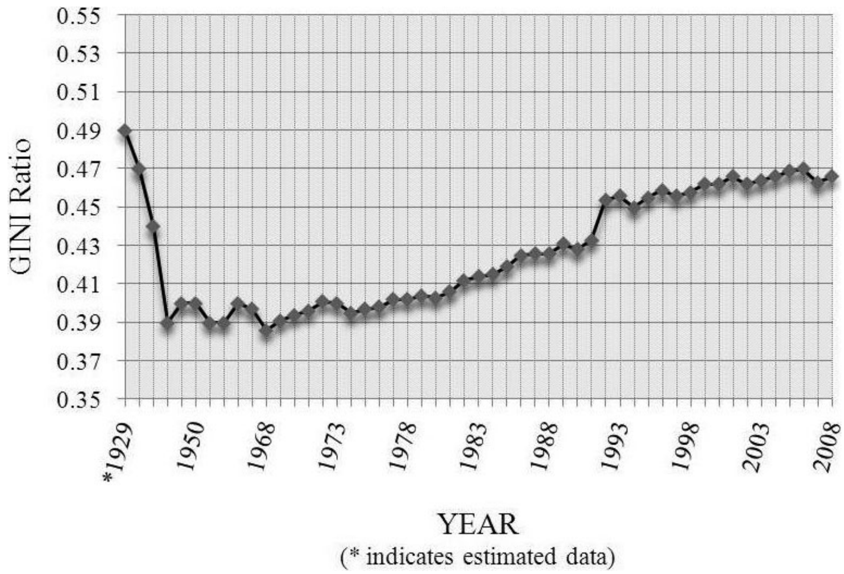
If the past is prologue, one might guess that some event or shock similar to that which occurred near the left hand side of the time line might occur again when this indicator rises again. Similarly, as Table 3 reveals, income inequality, as measured using the GINI Coefficient,[54] also shows that income inequality has generally increased in the United States since about the early 1970s, reaching levels in the middle of this decade similar to those seen immediately prior to the Great Depression.

54. The U.S. Central Intelligence Agency describes the GINI coefficient as follows:

> This index measures the degree of inequality in the distribution of family income in a country. The index is calculated from the Lorenz curve, in which cumulative family income is plotted against the number of families arranged from the poorest to the richest. The index is the ratio of (a) the area between a country's Lorenz curve and the 45 degree helping line to (b) the entire triangular area under the 45 degree line. The more nearly equal a country's income distribution, the closer its Lorenz curve to the 45 degree line and the lower its Gini index, e.g., a Scandinavian country with an index of 25. The more unequal a country's income distribution, the farther its Lorenz curve from the 45 degree line and the higher its Gini index, e.g., a Sub-Saharan country with an index of 50. If income were distributed with perfect equality, the Lorenz curve would coincide with the 45 degree line and the index would be zero; if income were distributed with perfect inequality, the Lorenz curve would coincide with the horizontal axis and the right vertical axis and the index would be 100.

Cent. Intelligence Agency, *The World Factbook: Distribution of Family Income - GINI Index*, THE WORLD FACTBOOK, https://www.cia.gov/library/publications/the-world-factbook/fields/2172.html (last visited July 29, 2010). A range of societal ills are linked to having a high GINI coefficient, e.g., poor public health outcomes and civil unrest, to name just two. *See* U.N. COMM. FOR DEV. POL'Y, IMPLEMENTING THE MILLENNIUM DEVELOPMENT GOALS: HEALTH INEQUALITY AND THE ROLE OF GLOBAL HEALTH PARTNERSHIPS, at 4, 10, U.N. Sales No. E.09.II.A.2 (2009), *available at* http://www.un.org/esa/policy/devplan/cdppublications/2009cdp_mdghealth.pdf (finding that "when income distribution becomes more unequal, health inequality worsens"); Craig Bradford, *Effects of Globalization on Income Inequality in High Income Countries*, 2 BRYANT ECON. RES. PAPER 7, Spring 2009, at 7, *available at* http://web.bryant.edu/~economix/Research%20Papers/Vol%202/Vol%202%20No%202%20Bradford.pdf. *See generally* Patrick M. Regan & Daniel Norton, *Greed, Grievance, and Mobilization in Civil Wars*, 49 J. CONFLICT RESOL. 319 (2005), *available at* http://jcr.sagepub.com/content/49/3/319.full.pdftml (finding that "[r]esource distribution—as indicated by the extent of political discrimination—is one of the strongest predictors of the onset of violent forms of antistate activity").

Table 3: GINI Timeline[55]



55. For estimated 1929 data, see Eugene Smolensky & Robert Plotnick, *Inequality and Poverty in the United States: 1900 to 1990*, at 6 fig.2, 8–9 (Univ. of Wis.-Madison, Inst. for Res. on Poverty, Discussion Paper No. 998-93, 1993). The authors explain that by utilizing income tax return data from the period, identifying the relationship for 1947 through 1989 (using the concrete GINI data), and then projecting backwards, they were able to obtain the GINI ratios for the first half of the century. *Id.* at 8–9; *see also* Edward C. Budd, *Introduction* to PROBLEMS OF THE MODERN ECONOMY: INEQUALITY AND POVERTY xiii tbl.1 (Edward C. Budd ed., 1967) (citations omitted). The 1929 data was obtained from a 1958 article which used figures generated by the Brookings Institution. *Id.* at xiii n.2; Selma F. Goldsmith, *The Relation of Census Income Distribution Statistics to Other Income Data*, *in* 23 NAT'L BUREAU OF ECON. RES., AN APPRAISAL OF THE 1950 CENSUS INCOME DATA 63, 92–94 (1958), *available at* http://www.nber.org/chapters/c1050.pdf. The Institution combined a number of different income statistics for persons and then converted those statistics to a family-unit basis. *Id.* at 94. They also utilized data from federal individual income tax returns. *Id.* Goldsmith adjusted the figures from the Brookings Institution to remove capital gains and losses from her 1929 figure. *Id.* "The adjustments were necessarily rough, but they serve to make the estimates for 1929 more comparable with those for recent years and thereby make it possible to avoid some mistaken conclusions drawn by [those] who compared postwar income distributions directly with the Brookings figures." *Id.* For 1929 to 1962 data, see Budd, *supra*, at xiii tbl.1. For 1967 to 2008 data, see U.S. CENSUS BUREAU, SELECTED MEASURES OF HOUSEHOLD INCOME DISPERSION: 1967–2008, at 1–2 tbl.A-3, *available at* http://www.census.gov/hhes/www/income/data/historical/inequality/IE-1.pdf; *see also* Arthur F. Jones Jr. & Daniel H. Weinberg, U.S. CENSUS BUREAU, P60-204, THE CHANGING SHAPE OF THE NATION'S INCOME DISTRIBUTION: 1947–1998 (2000), *available at* http://www.census.gov/prod/2000pubs/p60-204.pdf. The GINI coefficient for 2009 was virtually

Comparing international GINI scores, in 2008 the United States came in relatively high at 0.466 in money income, or 0.451 in equivalence-adjusted income.[56] That is, the United States has relatively high income inequality, scoring just above Ghana and Turkmenistan, and just below Senegal and Cambodia.[57]

As former Secretary of Labor under President Clinton, Robert Reich, recently explained:

> Consider: in 1928 the richest 1 percent of Americans received 23.9 percent of the nation's total income. After that, the share going to the richest 1 percent steadily declined. New Deal reforms, followed by World War II, the GI Bill and the Great Society expanded the circle of prosperity. By the late 1970s the top 1 percent raked in only 8 to 9 percent of America's total annual income. But after that, inequality began to widen again, and income reconcentrated at the top. By 2007 the richest 1 percent were back to where they were in 1928—with 23.5 percent of the total.[58]

Even David Stockman, director of the Office of Management and Budget under President Reagan, in an op-ed piece recently penned for the New York Times, raised concerns about growing income inequality and its impact on markets:

> It is not surprising, then, that during the last bubble (from 2002 to 2006) the top 1 percent of Americans — paid mainly

unchanged from 2008. Carmen DeNavas-Walt et al., U.S. Census Bureau, P60-238, Income, Poverty and Health Insurance Coverage in the United States: 2009, at 4–5 (2010), *available at* http://www.census.gov/prod/2010pubs/p60-238.pdf.

56. Carmen DeNavas-Walt et al., U.S. Census Bureau, P60-236, Income, Poverty, and Health Insurance Coverage in the United States: 2008, at 10 (2009), *available at* http://www.census.gov/prod/2009pubs/p60-236.pdf.

57. *See* Kevin Watkins et al., U.N. Dev. Programme, *Human Development Report 2007/2008*, at 281–83 (2007), *available at* http://hdr.undp.org/en/media/HDR_20072008_EN_Complete.pdf. The GINI coefficients used by the U.N. reflected GINI data for different years for each country, based on the data available at the time the report was issued. *Id.* The countries were then ranked according to the human development index (a "composite index that measures the average achievements in a country in three basic dimensions of human development: a long and healthy life; access to knowledge; and a decent standard of living"), not by GINI indexes. *Id.* at 225. Using the most recent data available, in 2006 the U.S.'s GINI coefficient actually increased to .464. *See* Bruce H. Webster Jr. & Alemayehu Bishaw, U.S. Census Bureau, ACS-08, Income, Earnings, and Poverty Data From the 2006 American Community Survey 10–11 (2007), *available at* http://www.census.gov/prod/2007pubs/acs-08.pdf. Applying this number to the 2008 report, the U.S. would actually rank 19 spots higher (i.e., worse—with greater income inequality) than presently reflected in the U.N. report.

58. Robert Reich, *Unjust Spoils*, The Nation, July 19, 2010, *available at* http://www.thenation.com/article/36893/unjust-spoils.

> from the Wall Street casino — received two-thirds of the gain in national income, while the bottom 90 percent — mainly dependent on Main Street's shrinking economy — got only 12 percent. This growing wealth gap is not the market's fault. It's the decaying fruit of bad economic policy.[59]

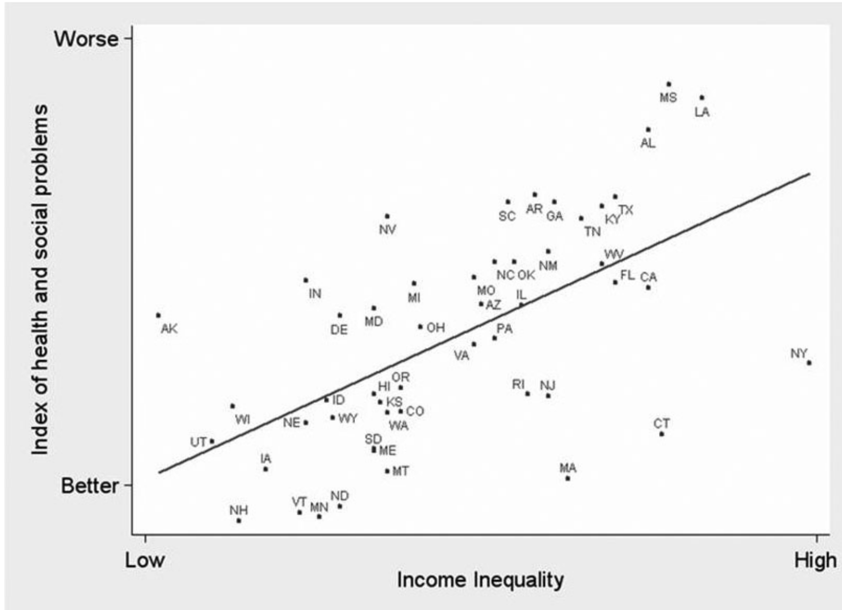
Why concern ourselves with economic inequality, though? Speaking generally, Wilkinson and Pickett, in their recent book *The Spirit Level*, show that, globally, income inequality corresponds strongly with a range of societal ills.[60] By creating an index of these societal problems, such as crime rates, and measuring them against income inequality, the authors find that nations with higher income inequality have the greatest prevalence of these social ills.[61] State-by-state analysis in the U.S. yields a similar pattern, as Table 4 indicates.

59. David Stockman, *Four Deformations of the Apocalypse*, N.Y. TIMES, July 31, 2010, at WK9, *available at* http://www.nytimes.com/2010/08/01/opinion/01stockman.html?pagewanted=1&ref=opinion.

60. RICHARD WILKINSON & KATE PICKETT, THE SPIRIT LEVEL: WHY GREATER EQUALITY MAKES SOCIETIES STRONGER (2009). For a critique of *The Spirit Level*, together with the Authors' response to the critique, see Christopher Snowdon, *20 Questions for Richard Wilkinson & Kate Pickett*, THE SPIRIT LEVEL DELUSION: FACT-CHECKING THE LEFT'S NEW THEORY OF EVERYTHING (July 29, 2010), http://spiritleveldelusion.blogspot.com/2010/04/20-questions-for-richard-wilkinson-kate.html.

61. This Author makes no claim that the data presented in this graph exposes any causal connection between inequality and the societal problems Wilkinson and Pickett studied and made a part of this index.

Table 4: State-by-State Spirit Level Scores[62]



A graph with a trend line like this indicates a possible positive correlation between the data represented on the two axes. Here, scoring high on the Wilkinson and Pickett index of social problems correlates with having high income inequality.

But what relationship, if any, does economic inequality have with financial crises? In his seminal work on the Great Depression, Galbraith pointed to the severe income inequality in the United States—what he called the "bad distribution of income"—as one of the five "weaknesses" in the economy that "had an especially intimate bearing on the ensuing disaster."[63]

> In 1929 the rich were indubitably rich. The figures are not entirely satisfactory, but it seems certain that the 5 per cent of the population with the highest incomes in that year received approximately one third of all personal income. The proportion of personal income received in the form of interest, dividends, and rent — the income, broadly speaking, of the well-to-do — was about twice as great as in the years following the Second World War.[64]

62. Wilkinson & Pickett, *supra* note 60, at 22 fig.2.4.

63. John Kenneth Galbraith, The Great Crash 1929, at 177 (1997).

64. *Id.* Galbraith explained the impact of this imbalance on consumer spending as follows:

Another view on income inequality comes from Bruce Judson of the Yale School of Management. According to Judson, rising income inequality creates a "governance problem."[65] This governance problem begins with the wealthy developing a "sense of entitlement" and insulating themselves from society.[66] They then:

> become less dependent on public services and less connected to the concerns of the rest of society . . . . [T]his leads the bulk of those in the top income strata to oppose tax increases that would fund enhanced public amenities . . . . [T]hey use their wealth to obtain political influence that solidifies their privileges.[67]

Teddy Roosevelt, discussing the need for an estate tax, described the corrosive effect of income inequality on the political process as follows:

> The absence of effective State, and, especially, national, restraint upon unfair money-getting has tended to create a small class of enormously wealthy and economically powerful men, whose chief object is to hold and increase their power. The prime need is to change the conditions which enable these men to accumulate power which is not for the general welfare that they should hold or exercise.[68]

Turning to the present financial crisis, as a description of the forces at work in the lead up to the financial crisis, Judson's theory—and Roosevelt's fears—would seem to apply. If one traces the recent rise in income inequality in the U.S. over the last forty years, it corresponds with two phenomena: (1) a greater share of the rising income of the wealthy going to the financial sector, and (2) a

> This highly unequal income distribution meant that the economy was dependent on a high level of investment or a high level of luxury consumer spending or both. The rich cannot buy great quantities of bread. If they are to dispose of what they receive it must be on luxuries or by way of investment in new plants and new projects. Both investment and luxury spending are subject, inevitably, to more erratic influences and to wider fluctuations than the bread and rent outlays of the $25-a-week workman. This high-bracket spending and investment was especially susceptible, one may assume, to the crushing news from the stock market in October of 1929.

Id. at 177–78. For a further discussion of the economic distortions caused by the concentration wealth among top earners, see ROBERT B. REICH, AFTERSHOCK: THE NEXT ECONOMY AND AMERICA'S FUTURE 32–38 (2010).

65. BRUCE JUDSON, IT COULD HAPPEN HERE: AMERICA ON THE BRINK 77 (2009).

66. *Id.*

67. *Id.*

68. Theodore Roosevelt, The New Nationalism, Speech at John Brown Memorial Park (Aug. 31, 1910), *available at* http://www.theodore-roosevelt.com/images/research/speeches/trnationalismspeech.pdf.

push towards deregulation of the financial sector in the service of greater profits. As stated earlier, rising income inequality in the United States commenced in the late 1970s and a disproportionate share of that income was ceded to households earning their income in the financial sector. In 1978, average banker compensation was on par with pay in the private sector overall. By 2007, it was more than twice that of the average private sector employee.[69] Moreover, since the 1970s, a disproportionate share of profits, in relation to gross domestic product, has gone to the financial sector.[70]

This rising share of income for the financial sector corresponds with the era of financial deregulation that began in the 1980s. That era brought about laws and policies that accomplished a range of "innovations": lifting interest rate caps on mortgages, which ushered in the creation of subprime mortgage products;[71] permitting investment banks to take on more debt, lowering margin requirements;[72] preempting state anti-predatory lending laws that allowed a wide range of banking entities to operate with light federal regulation despite state efforts to rein in risky lending;[73] lowering the wall between investment banks and commercial banks through the repeal of the Glass-Steagall Act;[74] and prohibiting the regulation of derivatives through passage of the Commodity Fu-

69. JOHNSON & KWAK, *supra* note 4, at 60–61 (citation omitted).

70. John Bellamy Foster & Fred Magdoff, *Financial Implosion and Stagnation: Back to the Real Economy*, MONTHLY REV., Dec. 2008, at 12 chart 2 (citation omitted), *available at* http://www.monthlyreview.org/081201foster-magdoff.php.

71. Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 226 (2006).

72. For a description of the SEC's efforts permitting certain investment banks to increase their leverage, see Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt*, N.Y. TIMES, Oct. 3, 2008, at A1, *available at* http://www.nytimes.com/2008/10/03/business/03sec.html; Joseph E. Stieglitz, *Capitalist Fools*, VANITY FAIR, Jan. 2009, at 48. For a description of the risks of increased leverage on the financial system, see Eric S. Rosengren, President & CEO Fed. Reserve Bank of Bos., Could a Systemic Regulator Have Seen the Current Crisis?, Before the 10th Seoul International Financial Forum (Apr. 5, 2009), *available at* http://www.bos.frb.org/news/speeches/rosengren/2009/041509.pdf.

73. For a description of federal bank regulators' efforts to preempt state anti-predatory lending laws, see Julia Patterson Forrester, *Still Mortgaging the American Dream: Predatory Lending, Preemption, and Federally Supported Lenders*, 74 U. CIN. L. REV. 1303, 1339–49 (2006); Christopher L. Peterson, *Federalism and Predatory Lending: Unmasking the Deregulatory Agenda*, 78 TEMP. L. REV. 1, 68–84 (2005).

74. On the connection between the repeal of the Glass-Steagall Act and the financial crisis, see Joseph Karl Grant, *What the Financial Services Industry Puts Together Let No Person Put Asunder: How the Gramm-Leach-Bliley Act Contributed to the 2008-2009 American Capital Markets Crisis*, 73 ALB. L. REV. 371 (2010).

tures Modernization Act.[75] In the words of Simon Johnson and James Kwak: "The Wall Street banks are the new American oligarchy—a group that gains political power because of its economic power, and then uses that political power for its own benefit."[76] These commentators describe the power of the financial sector due to its growing share of income as follows:

> The unprecedented amounts of money flowing through the financial sector, increasingly concentrated in a handful of megabanks, were the foundation of the new financial oligarchy . . . . Wall Street used an arsenal of other, completely legal weapons in its rise to power. The first was traditional capital: money, which yielded its influence directly via campaign contributions and lobbying expenses. The second was human capital: the Wall Street veterans who came to Washington to shape government policy and shape a new generation of civil servants. The third, and perhaps most important, was cultural capital: the spread and ultimate victory of the idea that a large, sophisticated financial sector is good for America.[77]

And the banks did not stop throwing their financial weight around once the financial crisis hit; to the contrary, their lobbying reached a fevered pitch. According to one study, the six largest banks and their trade associations spent nearly $600 million lobbying Congress on financial reform.[78] Moreover, some companies, like AIG, continued to devote resources to lobbying even after receiving federal bailout funds,[79] and some, like Bank of America,

75. Commodity Futures Modernization Act of 2000, 7 U.S.C. §§ 1-27f (2006). For a description of the passage of the CFMA, see JUDSON & KWAK, *supra* note 4, at 9. For a description of the role of credit default swaps, a form of derivative, in promoting risky lending practices during the build up to the financial crisis, see RICHARD A. POSNER, A FAILURE OF CAPITALISM: THE CRISIS OF '08 AND THE DESCENT INTO DEPRESSION 56–60 (2009).

76. JOHNSON & KWAK, *supra* note 4, at 6.

77. *Id.* at 89–90. For a further description of how this "governance problem" may have played out in the transformation of the U.S. economy over the last forty years, see JACOB S. HACKER & PAUL PIERSON, WINNER-TAKE-ALL POLITICS: HOW WASHINGTON MADE THE RICH RICHER—AND TURNED ITS BACK ON THE MIDDLE CLASS 66–72 (2010).

78. KEVIN CONNOR, INST. FOR AMERICAN'S FUTURE, BIG BANK TAKEOVER: HOW TOO-BIG-TO-FAIL'S ARMY OF LOBBYISTS HAS CAPTURED WASHINGTON 5 (2010), *available at* http://www.ourfuture.org/files/documents/big-bank-takeover-final.pdf.

79. Elizabeth Williamson, *AIG Still Lobbies to Relax Oversight Rules: After Receiving Federal Aid, Insurer Focuses on Laws Aimed at Keeping Tabs on Mortgage Originators,* WALL ST. J., Oct. 16, 2008, at A6, *available at* http://online.wsj.com/article_email/SB122409634988737247-lMyQjAxMDI4MjE0NjAxOTY2Wj.html.

actually increased such expenditures after receiving bailout assistance from the federal government.[80]

It is hard to argue that a "governance problem" does not lie at the heart of the connection between financial sector influence, deregulation, and the financial crisis. Lifting many of the constraints on the financial sector created a shadow banking system that operated without a net (at least one that was not taxpayer financed), taking on greater and greater risk, and operating with little oversight.[81] The practices that deregulation authorized—excessive leverage, an unregulated market in derivatives, exotic mortgage products—were at the center of an interconnected and overextended financial sector, a sector that ultimately collapsed under its own weight.[82] While the governance problem seems to explain a great deal, it may not be the only potential connection between rising income inequality and this financial crisis.

An alternate theory that may explain this connection comes from former International Monetary Fund economist, now at the University of Chicago, Raghuram Rajan, who posits that growing economic inequality in the United States led to the present financial crisis because politicians used easy access to credit to mollify people of low income, in an effort offset the possibility of discontent that might arise from growing inequality.[83] He argues that this

80. Paul Kiel, *Bailed-Out Companies Spend Millions to Lobby Congress*, PROPUBLICA (July 22, 2009), http://www.propublica.org/article/bailed-out-companies-spend-millions-to-lobby-congress.

81. For a discussion of the interplay between de-regulation and the financial crisis, see Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 5–7 (2009); Sally Pittman, Comment, *ARMs, But No Legs to Stand on: "Subprime" Solutions Plague the Subprime Mortgage Crisis*, 40 TEX. TECH L. REV. 1089, 1093–94 (2008); Patricia A. McCoy & Elizabeth Renuart, *The Legal Infrastructure of Subprime and Nontraditional Home Mortgages*, *in* BORROWING TO LIVE: CONSUMER AND MORTGAGE CREDIT REVISITED 110 (Nicolas P. Retsinas & Eric S. Belsky eds., 2008).

82. *See* Luis A. Aguilar, Commissioner, U.S. Sec. & Exch. Comm'n, Speech at Compliance Week 2010: Market Upheaval and Investor Harm Should Not be the New Normal (May 24, 2010), *available at* http://www.sec.gov/news/speech/2010/spch052410laa-1.htm (stating that "[t]he financial crisis and its enormous costs to society were the direct result of years of deregulation . . . . This market breakdown and the difficulty in determining how and why it occurred are yet further stark reminders of the dangers of weak oversight of our tightly interconnected financial markets").

83. RAGHURAM RAJAN, FAULT LINES: HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY (2010). Rajan explains this phenomenon as follows: because it is hard to impact income disparities:

> [P]oliticians have looked, or been steered into looking, for other, quicker ways to mollify their constituents. We have long understood that it is not in-

push from elected officials is reflected in such laws as the Community Reinvestment Act (CRA)[84] and the behavior of the Government-Sponsored Entities (GSEs), Fannie Mae and Freddie Mac. According to Rajan, the CRA and the affordable housing goals of the GSEs—promoted by Congress, and the Clinton and Bush Administrations—forced banks to make risky loans to unworthy borrowers.[85] Similarly, the prevalence of risky lending in communities of color, as discussed below, has led some to blame those same communities for the financial crisis.[86] This Article will return to these and other arguments in Part III, *infra*. In that section, a review of the hard facts on these issues—for example, that 94% of the riskiest lending carried out during the inflation of the housing bubble took place beyond the reach of the CRA—renders such arguments unconvincing.

A third potential explanation of the connection between financial crises and social inequality is that social inequality increases social distance. And increased social distance reduces trust within a community, which leads to non-cooperative and predatory conduct.[87] Adam Smith,[88] John Stuart Mill,[89] Kenneth Arrow,[90] Amartya Sen,[91] and Niall Ferguson[92] extol the importance of trust

> come that matters but consumption. Stripped to its essentials, the argument is that if somehow the consumption of middle-class householders keeps up, if they can afford a new car every few years and the occasional exotic holiday, perhaps they will pay less attention to their stagnant monthly paychecks.

Id. at 8–9.

84. 12 U.S.C. §§ 2901–08 (2006).

85. RAJAN, *supra* note 83, at 32–45. For a description of the policies of the Clinton and Bush Administrations in promoting so-called "affordable housing goals" through the GSEs, see ALYSSA KATZ, OUR LOT: HOW REAL ESTATE CAME TO OWN US (2009).

86. *See* discussion *infra* Part II.C.

87. *See infra* Part II.B.

88. ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS 292 (R.H. Campbell & A.S. Skinner eds., Oxford Univ. Press 1976) (describing importance of trust in extensions of credit and bank transactions).

89. JOHN STUART MILL, PRINCIPLES OF POLITICAL ECONOMY 111 (W.J. Ashley ed., new ed. 1909) (stressing importance of trust in "conjoint" human action).

90. Kenneth J. Arrow, *Gifts and Exchanges*, 1 PHIL. & PUB. AFFS. 343, 357 (1972).

91. Amartya Sen, *Adam Smith's Market Never Stood Alone*, FIN. TIMES, Mar. 11, 2009, *available at* http://www.ft.com/cms/s/0/f8e0b1be-0ddc-11de-8ea3-0000779fd2ac.html (defending Adam Smith as offering a more nuanced view of capitalism than those that assert he stood solely for unfettered free market, and affirming that "an economy needs other values and commitments such as mutual trust and confidence to work efficiently").

92. NIALL FERGUSON, THE ASCENT OF MONEY: A FINANCIAL HISTORY OF THE WORLD 29–30 (2008) (describing money as "trust inscribed").

in economic exchanges. It is difficult to engage in any economic activity without trusting, at least to some degree, a counterparty's willingness to honor their contracts; the currency system—that the money changing hands is valid and redeemable; the financial system—that the method of payment can convey value; and the courts and the legal system—that they will police and punish breaches of trust. As Arrow posits, "Virtually every commercial transaction" has an element of trust in it.[93]

Since trust is at the heart of cooperative economic exchange, does a lack of trust diminish the capacity for trusting, and raise the prospect of untrustworthy behavior? Furthermore, what are some of the forces that might diminish trust, and lead to a lack of trustworthiness? Research resulting from the prisoner's dilemma and similar games, as well as field studies, reveals that where there is greater social distance between game participants, participants are less trusting and each is more willing to take advantage of other participants.[94] For example, when studying rubber traders in Singapore and Malaysia in the 1960s, Janet Landa unearthed a complex hierarchy of social relations among these traders.[95] The extent to which a trader trusted another trader depended on the level of social distance between the two of them; those closest in kinship were trusted more, and as social distance increased, trust decreased.[96]

93. Arrow, *supra* note 90, at 357.

94. *See, e.g.*, Elizabeth Hoffman et al., *Social Distance and Other-Regarding Behavior in Dictator Games*, 86 AM. ECON. REV. 653, 658 (1996) (finding increase in non-cooperative behavior as social distance widens). Summarizing a body of research on group dynamics, Elizabeth Chamblee Burch describes conduct within groups as follows:

> Group members exhibit other-regarding preferences—trust, reciprocity, and altruism—toward other members. Their fairness considerations change based on whether the situation involves another group member (inclusionary concerns) or individuals outside the group (exclusionary concerns). Cohesive group members are more likely to cooperate with one another and care about the collective outcome, and less likely to exit the group when doing so benefits the individual rather than the group. These theory-based insights suggest that group membership plays a pivotal role in attitude changes, particularly when group identity is salient and relevant to the attitudinal issue. Shared histories, implicit feedback, and trust, for example, offer insights about whether individuals will cooperate or defect.

Elizabeth Chamblee Burch, *Litigating Groups*, 61 ALA. L. REV. 1, 17 (2009) (citations omitted).

95. Janet T. Landa, *A Theory of the Ethnically Homogeneous Middleman Group: An Institutional Alternative to Contract Law*, 10 J. LEGAL STUD. 349, 350 (1981).

96. *Id.* at 352.

Like it or not, individuals trust those who they perceive to be similar, whom they perceive as being members of the same group.[97] At the same time, we are more prone to take advantage of individuals who are less like us, whom we perceive to not share certain characteristics as ourselves.[98]

Since trust is critical to economic exchange, and a lack of trust can make such exchange more difficult, is there a way to measure the relative trust within a society or community? One commonly accepted way to measure the presence of trust in a community is to review responses to the General Values Survey, which asks, among many other questions, whether "most people can be trusted."[99] Looking at responses to this question, in the U.S., generalized trust has declined in recent years as income inequality has increased, as Table 5 indicates.

97. *See* studies cited *infra* note 98. The findings of the studies support the proposition "that levels of cooperation tend to be higher the stronger the ties between actors in the exchange." Nancy R. Buchan et al., *Swift Neighbors and Persistent Strangers: A Cross-Cultural Investigation of Trust and Reciprocity in Social Exchange*, 108 AM. J. SOC. 168, 200 (2002) (citation omitted).

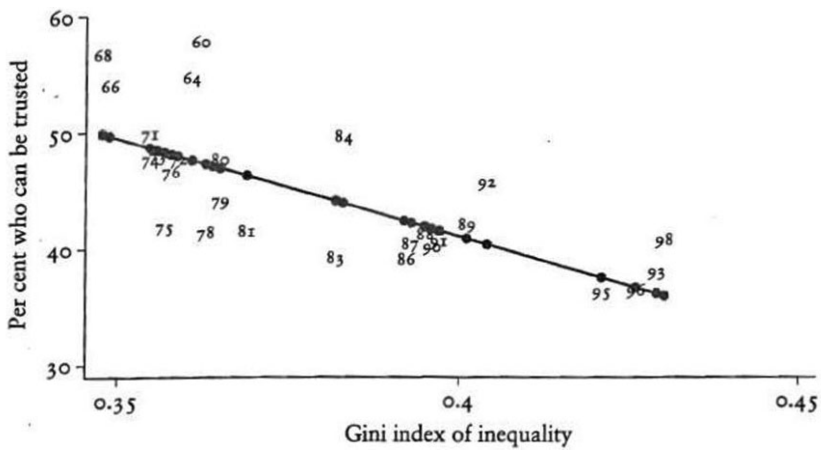
98. For a discussion of the relationship between social distance and cooperation, see Buchan et al., *supra* note 97; Iris Bohnet & Bruno S. Frey, *The Sound of Silence in Prisoner's Dilemma and Dictator Games*, 38 J. ECON. BEHAV. & ORG. 43 (1999); Michael W. Macy & John Skvoretz, *The Evolution of Trust and Cooperation Between Strangers: A Computational Model*, 63 AM. SOC. REV. 638 (1998). As one commentator remarks:

> Because we actively, and sometimes unconsciously, participate in the preservation of our perceptions and preferences, situations of great conflict and social distance are especially troublesome. We perceive our enemies to be evil, distant, strange, unapproachable, unfamiliar, distasteful, and unknowable. Moreover, we actively resist any evidence to the contrary.

David Sally, *Game Theory Behaves*, 87 MARQ. L. REV. 783, 791 (2004) (citation omitted).

99. *See* C. MÓNICA CAPRA ET AL., ATTITUDINAL AND BEHAVIORAL MEASURES OF TRUST: A NEW COMPARISON 1 (2008), *available at* https://www.gate.cnrs.fr/IMG/pdf/Capra.pdf. The finding of their study "supports the continued use of the GSS . . . questions to measure trust for policy purposes . . . ." *Id.* at 2.

Table 5: On Income Inequality and Trust[100]



The numbers on this chart indicate the level of trust in the U.S. in a given year in the late twentieth century, together with income inequality in those same years. Here we see a negative correlation: as income inequality has increased in the United States over the last few decades, trust has declined.

If we believe inequality and social distance reduce cooperative behavior and encourage rent-seeking, to what extent might the financial crisis bear such a theory out? Turning first to economic inequality, the theory suggests there would be less cooperative behavior and higher incidents of predatory conduct in communities in which there is higher income inequality.[101] The following section addresses these questions.

100. Eric M. Uslaner, The Moral Foundations of Trust 187 fig.6-6 (2002). The methodology used in creating this graph was fairly straightforward, comparing the level of trust in the United States in a given year to the level of inequality in that year, revealing an apparent correlation between the two. *Id.* Without more, no claim that one causes the other is made by Uslaner or this Author.

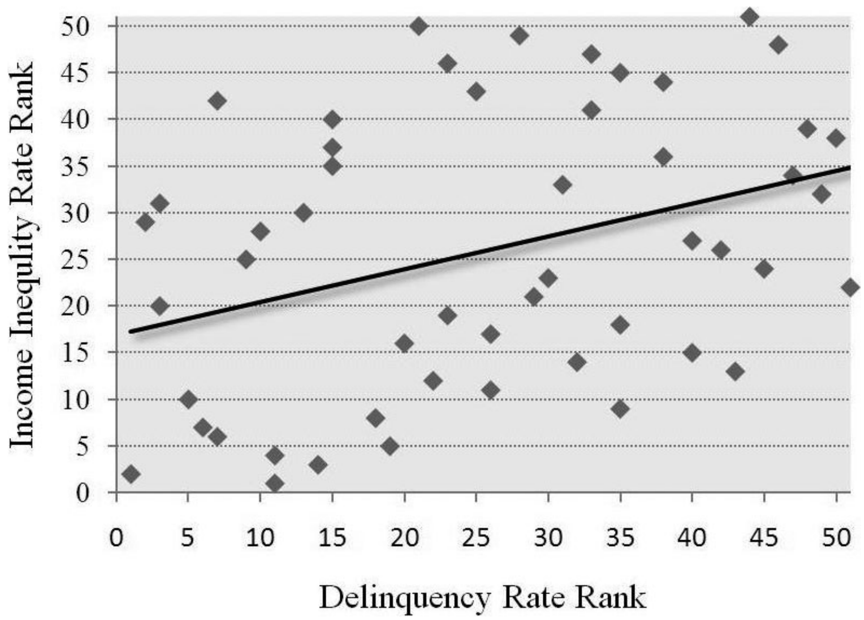
101. There are obviously many bases for social distance. This paper focuses on the ways that two such bases appear to have played out in the lead up to the present financial crisis: social distance based on income and that based on race. For a discussion of gender and subprime lending, see Nat'l Council of Negro Women, Income is No Shield, Part III, Assessing the Double Burden: Examining Racial and Gender Disparities in Mortgage Lending (2009), *available at* http://www.ncrc.org/images/stories/pdf/research/ncrc%20nosheild%20june%2009.pdf.

B. *Income Inequality, Social Distance and the Foreclosure Crisis*

If delinquency rates are one of the key symptoms of the financial crisis and income inequality may lie at the heart of the financial crisis, does a community's level of economic inequality correspond to its delinquency rate?

As Table 6 reveals, there appears to be some correlation between income inequality by state at the height of the subprime mortgage frenzy—2006, the last year in which such information is available from the U.S. Census Bureau—and present delinquency rates by state.

Table 6: Income Inequality and Delinquency Rates by State[102]



102. Tables 6 through 9, 12, 13, and 15 were generated by the author. For the income inequality data used, see WEBSTER JR. & BISHAW, *supra* note 57, at 11 tbl.5. For the delinquency rate data, see MBA DATA, *supra* note 47, at 4. The measurement of the statistical significance of this and the other author-generated tables, the "P-Value" of each such table, is set forth in *infra* Appendix, Data Set 3. It is generally accepted that a P-Value that is below .05, which means there is no more than a 5% chance that a particular outcome could happen by chance, reveals statistical significance. With this data set, which compares each state's delinquency rate rank to the level of inequality within each state, reveals a P-Value of .011. *Id.* One of the reasons for requiring such a low P-Value is to make up for sampling error, which is not an issue with this data set, because no sampling was done: the universe of state-by-state data was used, which might suggest that one could be

This graph shows the rank of states in terms of their ranking on the GINI index, lowest income inequality to highest, together with their rank in terms of their delinquency rates (combining properties in foreclosure with properties where the borrower is more than ninety days past due on his or her mortgage) as of December 2009. This graph shows that there is a statistically significant correlation between income inequality and delinquency rates.

Using 2006 data on income inequality and 2009 foreclosure data actually makes some sense. Many of the problems in the mortgage market stem from activities in 2005 and 2006, when underwriting standards were loosened to maintain mortgage volume to feed the securitization market.[103] Furthermore, subprime adjustable rate mortgages written in 2006 often had two- or three-year teaser rates so that the monthly payments on mortgages written in those years likely did not increase dramatically until 2008 or 2009, when the foreclosure crisis started to hit the hardest.[104]

Admittedly, many other forces might also be driving this correlation between income inequality and delinquency rates. It would be easy to posit that the higher the number of people living in poverty, the higher the delinquency rate is likely to be. But the facts do not support this theory.

Table 7 suggests that the poverty rate in a given state may have little influence on delinquency rates. A higher poverty rate appears to have little correlation with delinquency rates.[105]

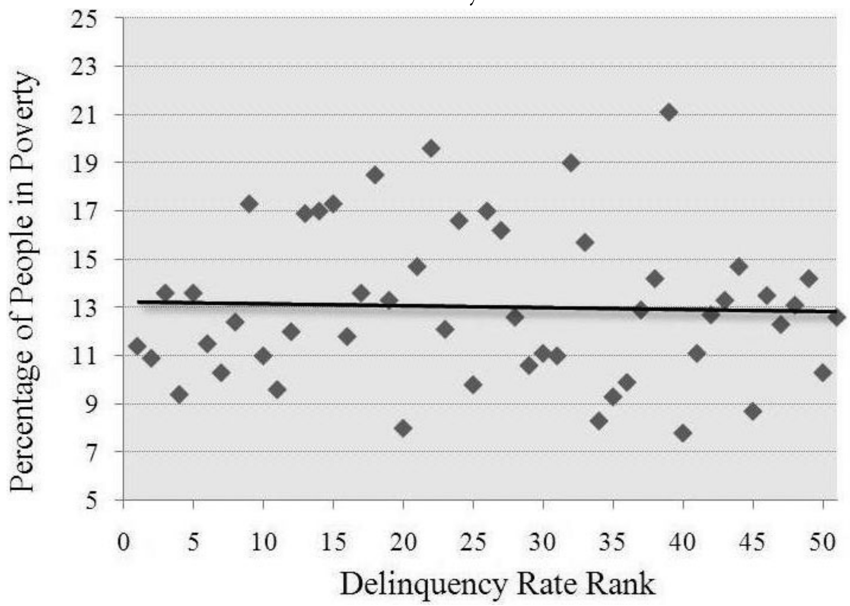
more comfortable with the statistical significance of a data set with a higher P-Value in this setting. On the importance of P-Value and its value in settings where sampling is used, see Michael D. Green, *Expert Witnesses and Sufficiency of Evidence in Toxic Substances Litigation: The Legacy of* Agent Orange *and Bendectin Litigation*, 86 NW. U. L. REV. 643, 682–86 (1992).

103. *See* OFFICE OF THE COMPTROLLER OF THE CURRENCY, SURVEY OF CREDIT UNDERWRITING PRACTICES 4 (2006), *available at* http://www.occ.gov/publications/publications-by-type/survey-credit-underwriting/pub-survey-cred-under-2006.pdf.

104. *See A Second Mortgage Disaster on the Horizon?*, CBS NEWS (Dec. 14, 2008), http://www.cbsnews.com/stories/2008/12/12/60minutes/main4666112.shtml. At the end of 2008, the "loans made back in the heyday [started] to reset, causing the mortgage payments to go up and homeowners to default." *Id.*

105. Indeed, the P-Value for this graph is quite high (.8), revealing no meaningful statistical significance. *See infra* Appendix, Data Set 3. Since the poverty rate data and the median income data revealed in this and the next table tend to create a "spread" between the highest and lowest states that can be graphically displayed in a way that is similar to a ranking, no ranking was used in this table or the following one, which displays median income within each state.

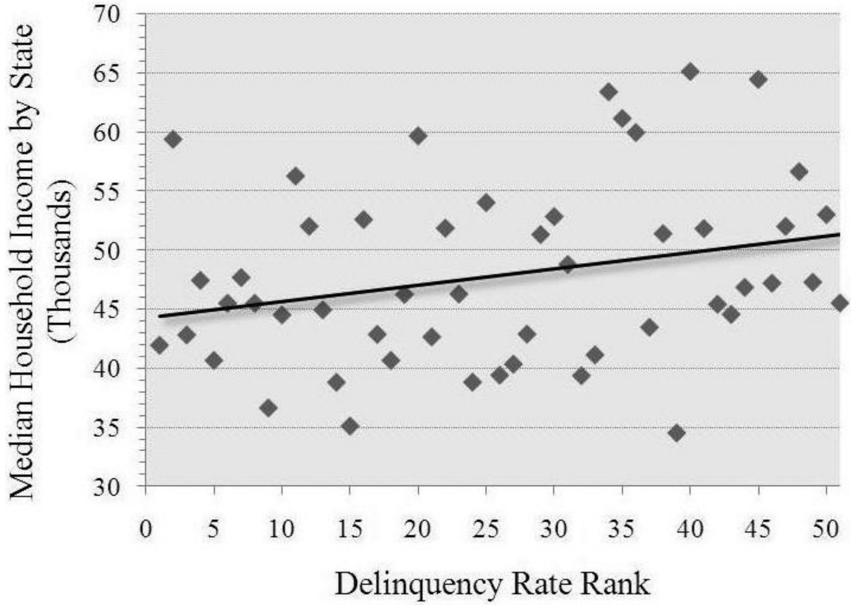
Table 7: Poverty Rate[106]



Digging deeper into the delinquency data, however, reveals an interesting phenomenon about the impact of the foreclosure crisis; the higher the median income in a state, the higher the delinquency rate in that state, as reflected in Table 8.

106. For the data on poverty rates by state, see WEBSTER JR. & BISHAW, *supra* note 57, at 21 tbl.9. For the delinquency data used, see MBA DATA, *supra* note 47, at 4.

Table 8: Median Income by State[107]



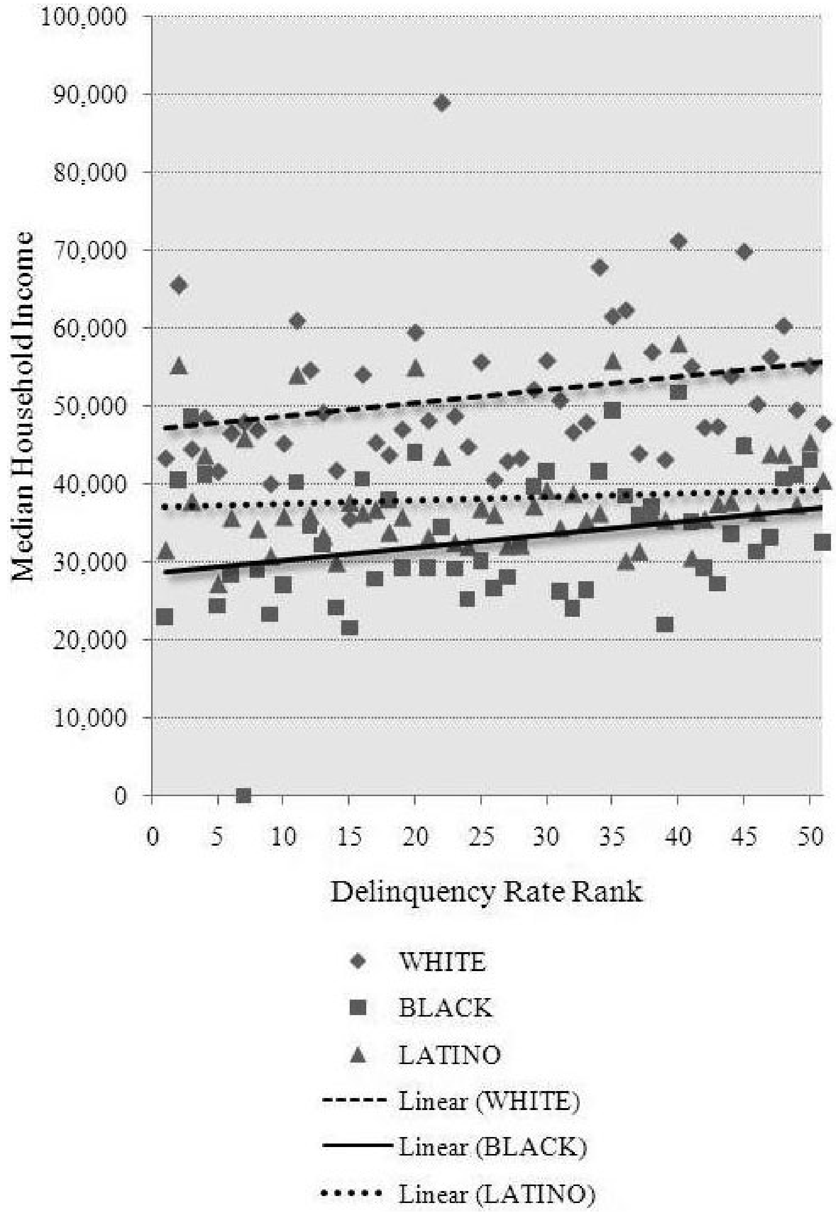
It would be easy to say that it is income inequality that is driving this correlation, but median income in a state does not dictate income inequality. There are states with high income inequality but low median income, like Louisiana, and states where the opposite is true, like New Hampshire, where residents enjoy a high median income while the state as a whole ranks low on the income inequality scale.[108]

Interestingly, when we look at delinquency rates compared to median income by race, we actually see that for Whites, African Americans, and to a lesser extent, Latinos, the higher the median income by state for each racial classification, the higher the delinquency rate.

107. For the data on the median household income by state, see WEBSTER JR. & BISHAW, *supra* note 57, at 4 tbl.2 & 5 fig.1. The data on delinquency rate ranks by state can be found at MBA DATA, *supra* note 47, at 4. Admittedly, this data generates a P-Value of .056, placing it just above the level generally recognized as indicating statistical significance. As Table Nine indicates, when this is data is separated by race, we see new P-Values generated for each racial group measured. These values reveal a correlation between African American median income within a state and the delinquency rate in that state.

108. Louisiana's median income is $23,986, while its inequality rate is 0.475, ranking it forty-eighth (third highest) in the U.S. In contrast, New Hampshire's median income is $43,933, while its inequality rate is 0.417, ranking it third lowest in the United States.

Table 9: Median Income by Race[109]

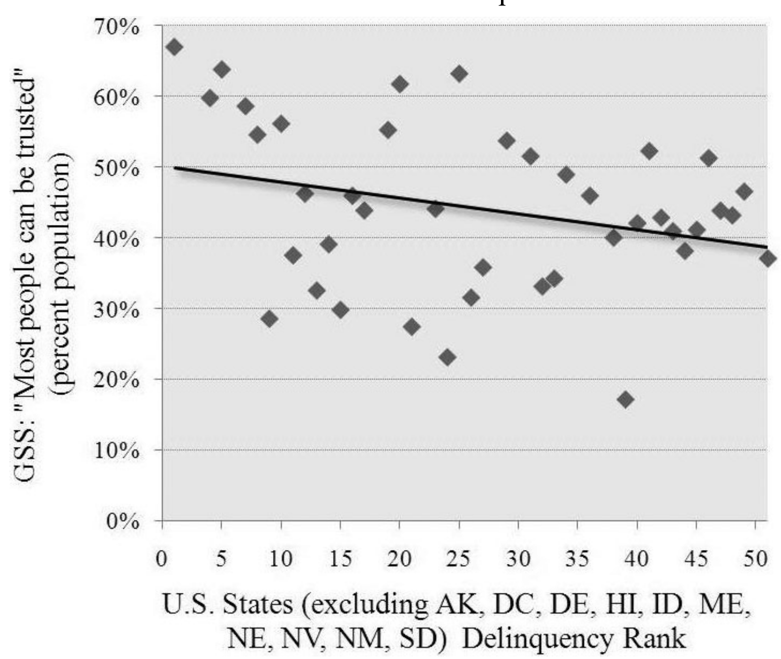


109. For the data on the median household income by race, see *American Factfinder*, U.S. CENSUS BUREAU (2007), http://factfinder.census.gov/ (select "Data Sets"; then "American Community Survey"; then "2006 American Community Survey"; then "Selected Population Profiles"; then apply the geographic filters).

These graphs raise the question: how might we explain this difference in delinquency rates in relation to levels of inequality by state? As stated earlier, a feature of societies with greater economic inequality is that they have lower levels of trust: that is, members of the community are less willing to trust other members of that community.[110] Research also suggests that lower levels of trust correspond with lower levels of trustworthiness, as discussed further below.[111]

Looking at how states with high trust fare in terms of delinquencies, states with higher levels of trust have *lower* delinquency rates. Table 10 reveals the possible negative correlation between trust and delinquencies.

Table 10: Trust and Delinquencies[112]



For the data on delinquency rate ranks, see MBA DATA, *supra* note 47, at 4. As stated above, see *supra* note 107, once median income is separated by race, the relationship between median income of the African American population in a state and the delinquency rate in that state seems to indicate a positive, and statistically significant, correlation. *See infra* Appendix, Data Set 3.

110. *See* USLANER, *supra* note 100, at 187 fig.6-6.

111. *See infra* text accompanying notes 113–22.

112. For the trust data, see data from ROBERT D. PUTNAM, BOWLING ALONE: THE COLLAPSE AND REVIVAL OF AMERICAN COMMUNITY (2000) [hereinafter BOWLING

What, then, does generalized trust itself have to do with predatory conduct? Arguably, this measure of trust also identifies the level of *trustworthiness* in a community. That is, when an individual responds to a question that asks whether he or she trusts others, what the respondent may actually be saying is whether that individual considers him or herself trustworthy. Numerous studies lend credence to this supposition.

In one such study, researchers assessed the cooperative tendencies of undergraduates who were paired together as "senders" and "receivers."[113] Senders were given a sum of money and invited to share this sum with a receiver; whatever sum the sender sent was matched by the researchers, and receivers were encouraged to share what they received with the senders by returning a portion of what they received.[114] The optimal outcome for both participants involved the sender sharing his or her entire grant with the receiver, and the receiver splitting what he or she received evenly and sending one of the divided portions back to the sender.

Prior to conducting the study, the researchers measured the level of trust among the study's participants. The answers revealed that the level of trust among senders bore little relation to the amount they shared with their partners.[115] Instead, the extent and level of cooperation by the *receiver* was directly related to his or her level of trust, leading the researchers to conclude that "the standard trust questions may be picking up trustworthiness rather than trust."[116] They also implied from these findings that, in order to find out if someone is trustworthy, one should ask the person whether he or she trusts others.[117]

Lest we think these findings are relevant in ivory tower settings only, a similar study of residents of rural Bangladesh reached simi-

ALONE DATA], *available at* http://www.bowlingalone.com/data.htm. For the delinquency data used, see MBA DATA, *supra* note 47, at 4. States excluded above are states for which the GSS Data is not available. Admittedly, the P-Value for this graph shows a roughly one in fourteen chance that this data could appear randomly (i.e., a P-Value of .07), which is considered in the range of P-Values that are "marginally statistically significant," that is, having a P-Value between .1 and .05. On marginal statistical significance, see Kimberly West-Faulcon, *The River Runs Dry: When Title VI Trumps State Anti-Affirmative Action Laws*, 157 U. PA. L. REV. 1075, 1136 n.211 (2009).

113. *See* Glaeser et al., *supra* note 12, at 812. For an earlier version of this type of study, see Joyce Berg et al., *Trust, Reciprocity, and Social History*, 10 GAMES & ECON. BEHAV. 122 (1995).

114. Glaeser et al., *supra* note 12, at 812.

115. *Id.* at 826.

116. *Id.* at 833.

117. *Id.*

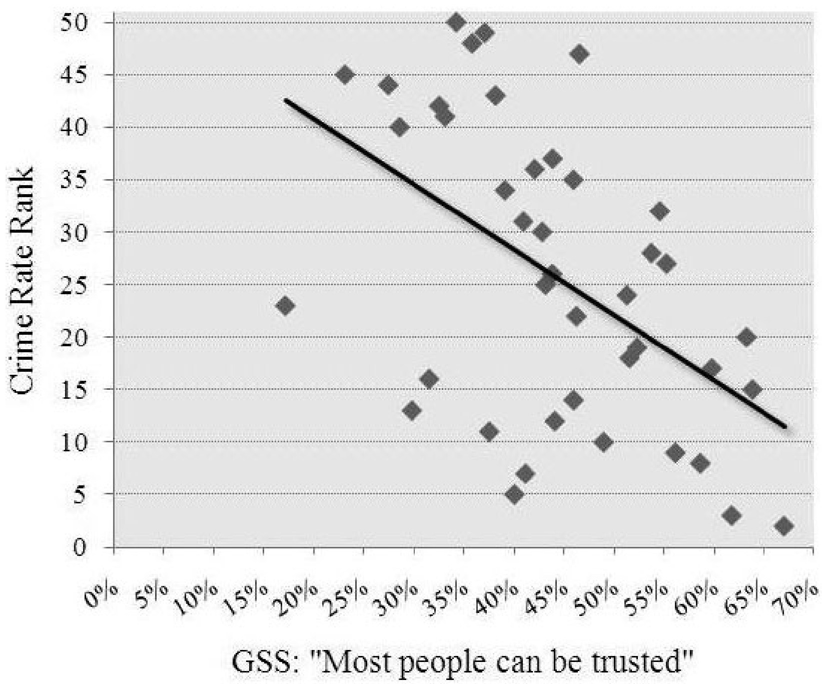
lar outcomes, leading the researchers there to conclude that "stated trust is a better predictor of the amount sent back by the receivers, than of the amount sent by the senders in the trust game."[118] Similarly, analyzing cross-country "lost wallet experiments," research concluded that residents of countries with high levels of generalized trust were more likely to return lost wallets than residents of nations with lower levels of generalized trust.[119] These findings show that people are more trustworthy—i.e., they return lost wallets with greater frequency—in countries where trust is high. Thus, trustworthy conduct can be found in nations with high levels of trust. In other words, when one finds high levels of trust somewhere, one is also going to find high levels of trustworthiness.[120] Going further, one indicator of trustworthiness—the level of crime in a community—corresponds to levels of trust in a particular community, as Table 11 implies. Lower levels of trust correspond to a higher crime rate.

118. Olof Johansson-Stenman et al., *Trust, Trust Games and Stated Trust: Evidence from Rural Bangladesh* 22 (Goteborg Univ. Dep't of Econ., Working Paper No. 166, 2005), *available at* http://gupea.ub.gu.se/bitstream/2077/2758/1/gunwpe0166.pdf.

119. Stephen Knack, Trust, Associational Life and Economic Performance 18–22 (Mar. 19, 2000) (prepared for the HRDC-OECD International Symposium on the Contribution of Investment in Human and Social Capital to Sustained Economic Growth and Well-Being), *available at* http://www.oecd.org/dataoecd/6/31/1825662.pdf (analyzing Readers Digest study involving lost wallets in several nations and U.S. cities, and showing that rate of return of such wallets corresponded to levels of generalized trust in those areas).

120. There is an obvious feedback loop between trust and trustworthiness; one is more likely to be trusting the more one observes trustworthy behavior. Conversely, the more one is the victim of predatory conduct, the less likely he or she is to trust others. This phenomenon poses particular challenges in the wake of the financial crisis in terms of rebuilding trust in financial institutions. Those burned by such institutions are less likely to be trusting of those institutions, and others like them, in the future. In a fascinating study of the effects of the Bernie Madoff scandal on trust in financial institutions, researchers found a drop in trust in such institutions in communities hardest hit by Madoff's Ponzi scheme. Luigi Guiso, *A Trust-Driven Financial Crisis: Implications for the Future of Financial Markets* 8–10 (Eur. Univ. Inst., Working Paper No. 2010/07, 2009), *available at* http://Cadmus.eui.eu/bitstream/handle/1814/13657/ECO_2010_07.pdf?sequence=3.

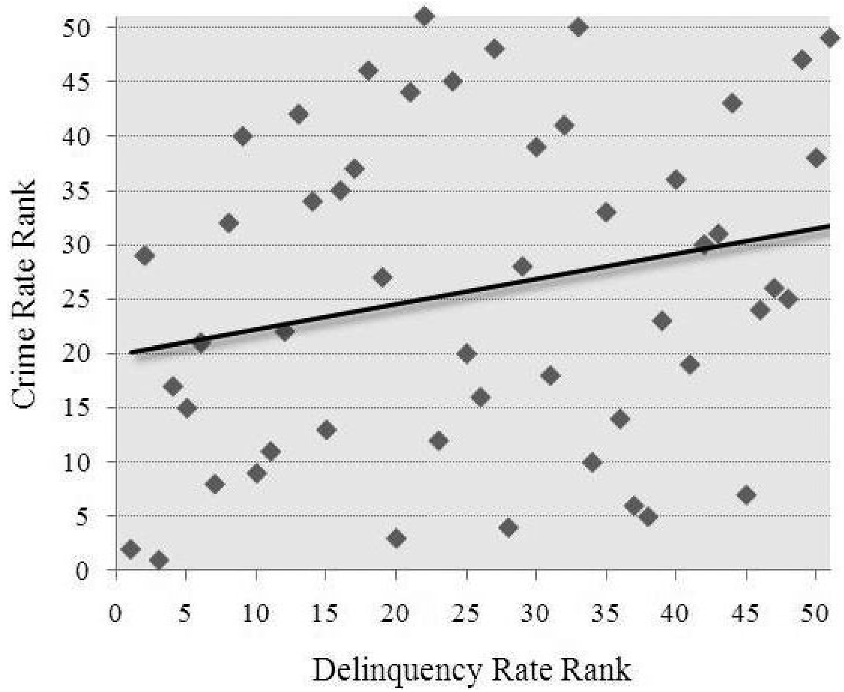
Table 11: Trust and Crime Rate Rank[121]



If indicators of trust are also (or perhaps actually) indicators of trustworthiness, then it makes sense that states with lower levels of trust have a greater prevalence of delinquencies—that is, states where people are less trustworthy are also states in which uncooperative and predatory conduct is more likely to take place. As Table 12 reveals, taking general crime rates, set forth in the previous table, and comparing them to delinquency rates, there is a similar correlation between the two data sets. This makes sense since, as shown before, lower levels of trust correspond to higher delinquency rates.

121. The P-Value for this graph is particularly strong. *See infra* Appendix, Data Set 3. For the GSS data on trustworthiness, see BOWLING ALONE DATA, *supra* note 112. For crime rate data, see U.S. DEP'T OF JUSTICE, 2008 CRIME IN THE UNITED STATES, tbl.5 (2008), *available at* http://www2.fbi.gov/ucr/cius2008/data/table_05.html.

Table 12: Delinquency Rate Rank and Crime Rate Rank[122]



This potential correlation between crime rates, levels of trust and trustworthiness, and delinquencies suggests that the presence of low trust/trustworthiness, which brings with it higher crime rates, may be correlated with high delinquencies and a greater likelihood of predatory conduct. This correlation implies the possibility that such predatory conduct may have been one of the driving forces behind such delinquencies. States with higher crime rates, by definition, are states in which predatory conduct is more prevalent. It is not a stretch to suggest then that such states were also states where predatory *lending* was likely to flourish. Since there is a possible correlation between trust, trustworthiness, crime rates, and delinquencies, it is also not a stretch to presume that such predatory conduct is likely to have helped to fuel some of the behavior behind the delinquencies that are at the root cause of the foreclosure crisis.

122. For the P-Value of this Table, see *infra* Appendix, Data Set 3. As with Table Ten, *supra*, the P-Value for this table is within the range of "marginal statistical significance." For delinquency rate ranks, see MBA DATA, *supra* note 47, at 4. For crime rate data, see U.S. DEP'T OF JUSTICE, *supra* note 121.

Another way that social scientists determine the level of trust within a given community is to look at the relative level of "social capital" within that community.[123] As Robert Putnam, the author of the landmark work "Bowling Alone," describes it, social capital is manifest in the "social networks and the . . . norms of reciprocity and trustworthiness" associated with such networks.[124]

These networks and norms facilitate cooperative behavior by generating feelings of mutual obligation towards other members of a network.[125] Communities that have high levels of social capital are better off economically and have lower crime rates; the residents of those communities report higher levels of life satisfaction.[126] Levels of social capital also tend to correspond with levels of trustworthiness because of the symbiotic relationship between trust, trustworthiness and social capital.[127]

Returning to the foreclosure crisis, according to commentators from different points on the political spectrum—from Nobel Prize-winning economist Joseph Stiglitz[128] and Nobel Peace Prize recipient Muhammad Yunus,[129] to Federal Deposit Insurance Corpora-

123. The level of social capital within a community is sometimes considered a "proxy" for the level of trust in that community, and vice versa. *See, e.g.*, Francis Fukuyama, *Social Capital and Civil Society* 4–5 (Int'l Monetary Fund, Working Paper No. 00/74, 2000), *available at* http://www.imf.org/external/pubs/ft/wp/2000/wp0074.pdf (describing interplay between trust and social capital); PIPPA NORRIS, DEMOCRATIC PHOENIX 166 (2002) (describing the same); Luigi Guiso et al., *The Role of Social Capital in Financial Development*, 94 AM. ECON. REV. 526, 528 (2004) (characterizing "high-social-capital areas as those with high levels of generalized trust").

124. Robert D. Putnam, E Pluribus Unum*: Diversity and Community in the Twenty-first Century*, 30 SCANDINAVIAN POL. STUD. 137, 137 (2007).

125. On the ways in which social capital develops trust among the members of a network, see James S. Coleman, *Social Capital in the Creation of Human Capital*, 94 AM. J. SOC. S95, S119 (Supp. 1988).

126. For an overview of the benefits of social capital, see Michael Woolcock, *The Place of Social Capital in Understanding Social and Economic Outcomes*, 2 ISUMA: CAN. J. POL'Y RES. 1 (2001).

127. *See* Robert D. Putnam, *Bowling Alone: America's Declining Social Capital*, 6 J. DEMOCRACY 65 (1995), *reprinted in* CULTURAL METAPHORS: READINGS, RESEARCH TRANSLATIONS, AND COMMENTARY 109, 111 (Martin J. Gannon ed., 2001).

128. JOSEPH E. STIGLITZ, FREEFALL: AMERICA, FREE MARKETS, AND THE SINKING OF THE WORLD ECONOMY 14 (2010).

129. When asked why Grameen Bank is expanding and its microlending portfolio has a 99% success rate when, in the wake of the financial crisis, other financial institutions are pulling back on credit, Yunus attributed this to the relationship between the bank and its customers:

> One thing I would say [sic] that very close relationship between the lender and the borrower. That relationship disappeared in a conventional bank. You lend the money to borrower, you know her or you came to know here [sic].

tion (FDIC) Chair Sheila Bair[130]—one of the root causes of the financial crisis was the breakdown of the traditional borrower-lender relationship. In the traditional relationship, the lender was concerned with the long-term viability of the borrower because bank income and profitability hinged on the dependability of the borrower over the long run.[131] These long-term bonds and commitments were likely infused with aspects of social capital.[132] With securitization came the breakdown of the traditional borrower–lender relationship, as lenders were looking to "originate to securitize," keeping loans on their books for days, or even hours, just until they could sell them to investment banks to be packaged and sold off as securities.[133] Stiglitz describes this transformation as follows:

> Securitization, the hottest financial-products field in the years leading up to the collapse, provided a textbook example of the

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> And you give the loan. And then you sell the document to somebody else. The person who is now owning it doesn't know this person anymore. And this has been sold, and sold, many times, with nothing to do with the person who still owes the money.
>
> So, the relationship has disappeared completely. So we have to go back to the original concept of banking. They stole that relationship. I think that is a very important element that we have to com [sic] back to.

Quest Means Business (CNN television broadcast May 19, 2010) (transcript available at http://transcripts.cnn.com/TRANSCRIPTS/1005/19/qmb.01.html) (interview by Maggie Lake with Muhammad Yunus, Founder, Grameen Bank, in New York, NY).

130. Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp., Possible Responses to Rising Mortgage Foreclosures Before the Committee on Financial Services, U.S. House of Representatives (Apr. 17, 2007) [hereinafter Blair Testimony], *available at* http://www.fdic.gov/news/news/speeches/archives/2007/chairman/spapr1707.html.

131. Frank A. Hirsch, Jr., *The Evolution of a Suitability Standard in the Mortgage Lending Industry: The Subprime Meltdown Fuels the Fires of Change*, BNET (Mar. 2008), http://findarticles.com/p/articles/mi_6779/is_12/ai_n28511999/ (asserting that "most lenders, prior to the recent increase in subprime mortgages, were unwilling to make a loan in which they doubted the borrower's ability to repay").

132. Of course, these bonds could easily have their down side, and bankers could play favorites, give in to stereotypes, and discriminate with impunity. At the same time, such character assessment could come with close and frequent contact with one's banker. In Frank Capra's classic film, the community banker's bedtime story, "It's a Wonderful Life," Lionel Barrymore's Potter, the model of a corrupt, profit-driven banker, criticizes what he sees as the Bailey Building & Loan's favoritism in its underwriting approach: "You see, if you shoot pool with some employee here, you can come and borrow money." IT'S A WONDERFUL LIFE (Liberty Films 1946).

133. On the "originate to securitize" or "originate to distribute" model, see Kiff & Mills, *supra* note 24, at 11–16.

> risks generated by the new innovations, for it meant that the relationship between lender and borrower was broken . . . . In the Frankenstein laboratories of Wall Street, banks created new risk products (collateralized debt instruments, collateralized debt instruments squared, and credit default swaps . . .) without mechanisms to manage the monster they had created. They had gone into the moving business—taking mortgages from the mortgage originator, repackaging them, and moving them onto the books of pension funds and others—because that was where the fees were the highest, as opposed to the "storage business," which had been the traditional business model for banks (originating mortgages and then holding on to them).[134]

While the initial assessment of creditworthiness was likely colored by the depth of the relationship between the prospective borrower and his or her bank, once the deal was consummated, a temporary economic setback would be forgiven more easily when the borrower could communicate with his or her banker and seek forbearance directly, as opposed to dealing with a servicer call center in another state or country.[135]

134. STIGLITZ, *supra* note 128, at 14.

135. Caroline Baum, *Paulson Goes to Washington, Loses Way*, BLOOMBERG (Dec. 4, 2007), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aFLLy4LlxCmc. As Sheila Bair has explained: "[T]he increased complexity of the structure and the different interests of the various securitization parties can make credit workout strategies more complicated than in a direct borrower/lender relationship." Bair, *supra* note 130. Stiglitz describes the transformation of mortgage renegotiation dynamics as follows:

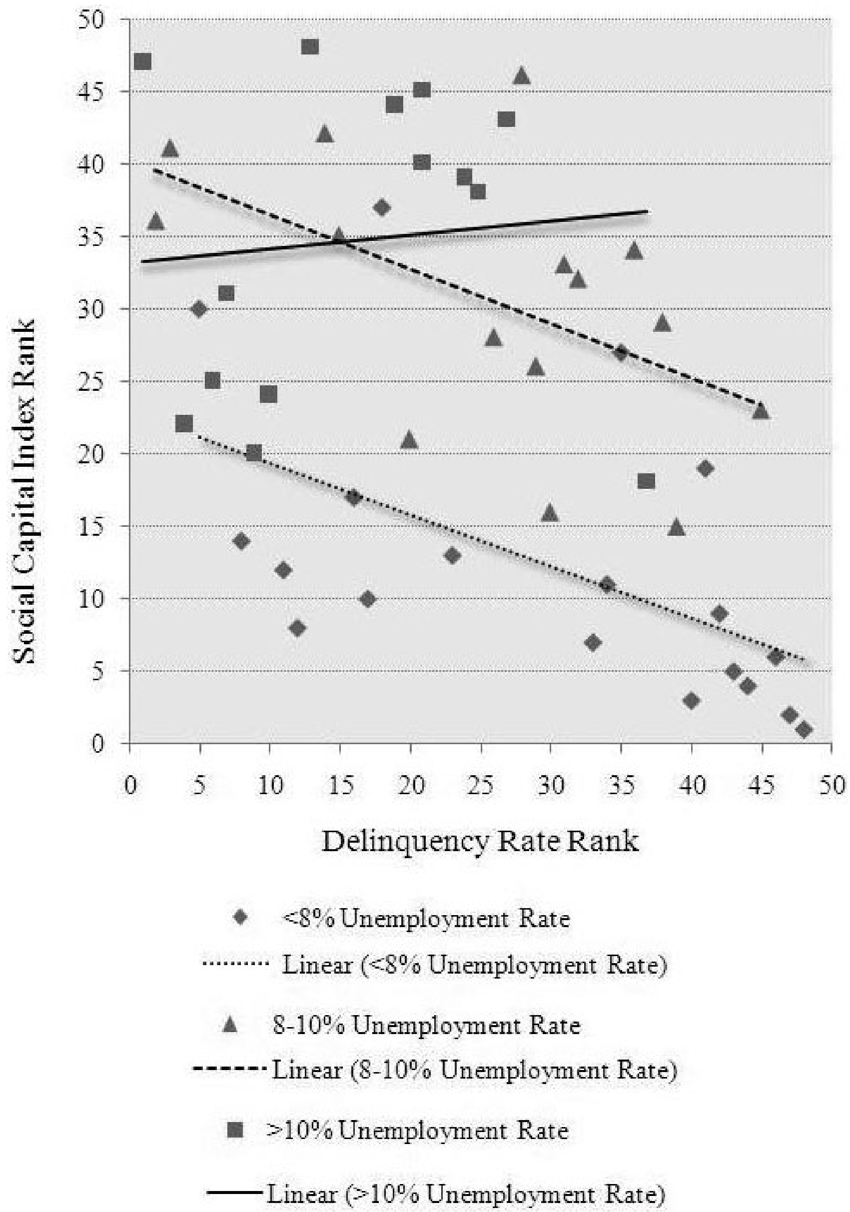
> Banks with long-standing relations with the community had an incentive to treat borrowers who got into trouble well; if there was a good chance that borrowers would catch up on their payments if they were given some time, then the bank would give them the time they needed. But the distant holders of the mortgages had no interest in the community and no concern about having a reputation as a good lender.

STIGLITZ, *supra* note 128, at 95.

If there is a connection between social capital and delinquency rates, the level of social capital in a community will also impact delinquency rates. Comparing a state's relative social capital rank, using Putnam's social capital index,[136] with delinquency rate rank by state, reveals a correlation between high levels of social capital and low delinquency rates, at least with respect to states that are not experiencing above-average unemployment rates, as Table 13 indicates.

136. Putnam's social capital index includes fourteen indicators, including those that measure the level of participation in civic organizations, the level of trust in a community, and the number of non-profit organizations per 1000 residents in a community. *See* BOWLING ALONE DATA, *supra* note 112. Admittedly, this social capital index was generated when *Bowling Alone* was published, and has not been updated. Using this data is helpful, though, to show that social capital was high or low in a particular state prior to the changes in the economy, most notably, the rise in home values, which marked the middle part of the last decade.

Table 13: Social Capital and Unemployment Data[137]



137. For the social capital data, see BOWLING ALONE DATA, *supra* note 112. For the delinquency data used, see MBA DATA, *supra* note 47, at 4. For unemployment data, see U.S. Dep't of Labor: Bureau of Labor Statistics, *Unemployment Rates for States*, LOCAL AREA UNEMPLOYMENT STATISTICS, http://www.bls.gov/lau/lastrk09.

For the most part, the higher the social capital, the lower the delinquency rate. Here, the data is separated for states with similar unemployment rates. In states with average or below-average unemployment rates, we see a strong negative correlation between social capital and foreclosure rates. In states with above-average unemployment rates, there is a slight positive correlation. This may either be a statistical anomaly, or social capital may have no positive effects on foreclosure rates in the face of extreme economic distress, like having double-digit unemployment within a state.

The findings with respect to a generally negative correlation between foreclosure rates and social capital correspond to similar findings reached by the Corporation for National and Community Service (CNCS) in its study of foreclosure rates and volunteering (another reflection of social capital) in large U.S. cities in 2008 and 2009. "Looking at the relationship between foreclosure and volunteer rates, [CNCS] found that cities with higher foreclosure rates tended to have lower volunteer rates. [The] findings show that a one percent decrease in foreclosure rates would be associated with a 1.2 percent increase in volunteer rate."[138]

If these correlations are present, then it is worth discussing whether the absence of social capital may have been one of the driving forces behind the foreclosure crisis.

C. Racial Distance and the Foreclosure Crisis

Another type of social distance can come about as a result of distinctions based on race. Again, according to the theory, racial differences can lead to the same sort of predatory conduct that occurs where there is greater income inequality.[139] For this to hold true in the financial crisis, we would have to see an increase in the occurrence of predatory conduct in communities of color.

Looking at lending during the heart of the subprime mortgage frenzy in 2006, the Federal Reserve's analysis of Home Mortgage Disclosure Act (HMDA) data reveals that nearly 54% of the home

htm (last modified Mar. 8, 2010). For the P-Values for this chart, see *infra* Appendix, Data Set 3. As stated above, there is no statistically significant impact of social capital on delinquencies in states with high unemployment.

138. CORP. FOR NAT'L & CMTY. SERV., ISSUE BRIEF, VOLUNTEERING IN AMERICA 2010: NATIONAL, STATE AND CITY INFORMATION 8–9 (2010), *available at* http://www.volunteeringinamerica.gov/assets/resources/IssueBriefFINALJune15.pdf.

139. *See supra* text accompanying notes 94–98. For an overview of research on social distance and race relations, see Ralph Richard Banks & Richard Thompson Ford, *(How) Does Unconscious Bias Matter?: Law, Politics, and Racial Inequality*, 58 EMORY L.J. 1053, 1069–72 (2009), and sources cited therein.

purchase loans made to African Americans in that year had subprime features, compared to just under 18% for Whites, a nearly three-to-one ratio.[140]

Controlling for borrower characteristics,[141] the Fed found that in 2006, over 30% of African American borrowers and 24% of Latino borrowers, compared to just under 18% of White borrowers of comparable creditworthiness, received subprime loan products.[142] Thus, an African American borrower of similar creditworthiness to a White borrowers was 75% more likely to receive a subprime loan product than the White borrower, and a Latino borrower was 36% more likely to take out a subprime loan than a White borrower with a similar economic profile.

A study done by the New York Times on lending in the New York City metropolitan region found the prevalence of lending patterns even more striking, particularly as it related to working-class

140. *See* Robert B. Avery et al., *The 2006 HMDA Data*, 93 FED. RES. BULL. A73, A95 (2007) [hereinafter 2006 HMDA Data], *available at* http://www.federalreserve.gov/pubs/bulletin/2007/pdf/hmda06final.pdf.

141. The authors controlled for borrower characteristics by utilizing a "matching procedure" in assessing the 2004 and 2005 HMDA data. *Id.* This procedure allowed the Fed to measure "differences in denial rates by comparing applications for a specific loan product filed by applicants who differ by race, ethnicity, or sex but who are matched on the basis of the limited set of items in the HMDA data." Robert B. Avery et al., *New Information Reported under HMDA and Its Application in Fair Lending Enforcement*, 91 FED. RES. BULL. 344, 387 (2005) (emphasis omitted), *available at* http://www.federalreserve.gov/pubs/bulletin/2005/3-05hmda.pdf. The HMDA data can be manipulated, allowing

> individuals to be matched by loan type and purpose, type of property securing the loan, lien status, owner-occupancy status, property location (for example, same MSA or even same census tract), income relied on for underwriting, loan amount, and time of year when the loan was made as well as by whether the loan involved a co-applicant.

Id. at 372. In 2006, a control for lender was also added. 2006 HMDA Data, *supra* note 140, at A95.

142. *Id.* at A96 tbl.11. A subprime loan is a loan made to a borrower who possesses certain features:

> Subprime borrowers typically have weakened credit histories that include payment delinquencies, and possibly more severe problems such as charge-offs, judgments, and bankruptcies. They may also display reduced repayment capacity as measured by credit scores, debt-to-income ratios, or other criteria that may encompass borrowers with incomplete credit histories. Subprime loans are loans to borrowers displaying one or more of these characteristics at the time of origination or purchase.

OFFICE OF THE COMPTROLLER OF THE CURRENCY ET AL., EXPANDED GUIDANCE FOR SUBPRIME LENDING PROGRAMS 2 (2001), *available at* http://www.federalreserve.gov/boarddocs/press/boardacts/2001/20010131/attachment.pdf.

African Americans.[143] Indeed, after studying lending patterns in the city and comparing borrowers of similar incomes, the researchers concluded as follows: "[T]he hardest blows rain down on the backbone of minority neighborhoods: the black middle class. In New York City, for example, black households making more than $68,000 a year are almost five times as likely to hold high-interest subprime mortgages as are whites of similar — or even lower — incomes."[144]

Deeper analysis of HMDA data reveals that 169 mortgage lenders failed in 2007, following the collapse of the housing market.[145] With these lenders, who were most likely engaged in the riskiest lending (hence their closing their doors in 2007), a disproportionate share of their subprime lending in 2006 was directed towards African American borrowers when compared to lending in the industry as a whole. Indeed, 74% of the loans made by these lenders to African Americans in 2006 were subprime loans, and 63% of the loans to Latinos were subprime, compared to an industry average of 54% and 47% respectively, as Table 14 indicates.[146] Thus, it appears that the riskiest subprime lending in 2006 was carried out by lenders that focused such lending on borrowers of color.

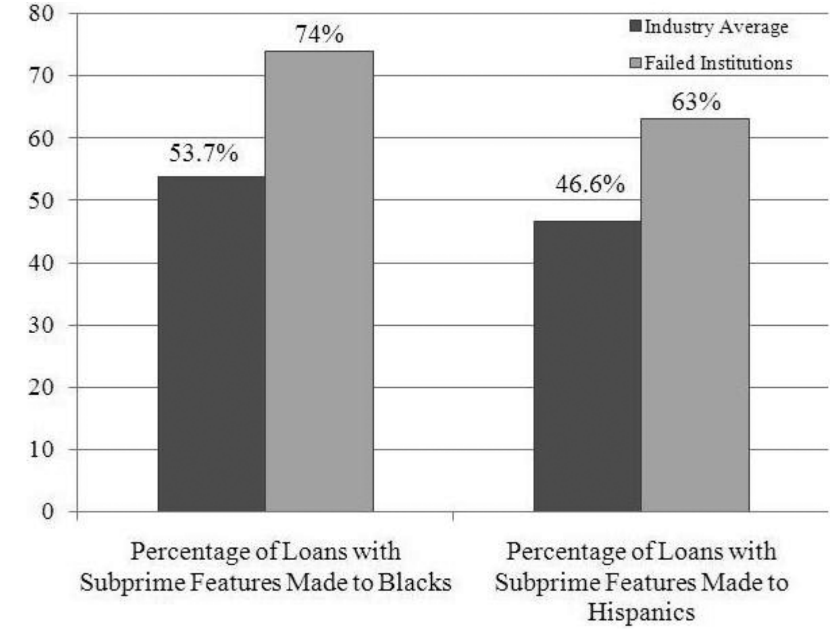
143. Michael Powell & Janet Roberts, *Minorities Hit Hardest as New York Foreclosures Rise*, N.Y. TIMES, May 16, 2009, at A1.

144. *Id.*

145. Robert B. Avery et al., *The 2007 HMDA Data*, 94 FED. RES. BULL. A107, A109 (2008), *available at* http://www.federalreserve.gov/pubs/bulletin/2008/pdf/hmda07final.pdf.

146. For the failed institutions data, see *id.* at A126 tbl.12. For the industry average data see 2006 HMDA Data, *supra* note 140, at A95–96.

Table 14: Data on 2007 Failed Institutions[147]



What does all of this information say about economic and racial inequality and the financial crisis? States with greater inequality are also states in which predatory conduct is likely to be more prevalent. Is it possible then, that in states with greater inequality, their higher delinquency rates may be a function of the fact that predatory conduct, in the form of predatory lending, was more prevalent? Similarly, mortgage lenders concentrated a disproportionate share of their subprime lending in African American and Latino communities. A fair number of these borrowers saddled with subprime loans would have qualified for prime loans, which they would have stood a better chance of paying back, sparing themselves the ordeal of foreclosure.[148] The lenders that pedaled toxic products in

147. The data on failed institutions by race was obtained from Avery et al., *supra* note 145, at A126 tbl.12. The data on the 2006 industry average was obtained from the 2006 HMDA Data, *supra* note 140, at A95–96.

148. Estimates place the number of subprime borrowers who would have qualified for prime loans between 35% and 61%. *See The Community Reinvestment Act: Thirty Years of Accomplishments but Challenges Remain, Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 4 (2008) (prepared testimony of Michael S. Barr, Professor, Univ. of Mich. Law Sch.), *available at* http://financialservices.house.gov/hearing110/barr021308.pdf (arguing that 35% of subprime borrowers would have qualified for prime loans); Rick Brooks & Ruth Simon, *Subprime Debacle Traps Even Very Credit-Worthy: As Housing Boomed, Industry Pushed Loans to a Broader Market*,

those communities are the ones who should be held largely responsible for what ensued, not their victims.

Indeed, as a growing body of evidence strongly suggests, the problem in the mortgage market was not risky borrowers but predatory loans. One study by the Center for Community Capital at the University of North Carolina compared the performance of risky subprime loans with loans where strong underwriting guidelines were used.[149] The Center identified borrowers of similar profiles that entered into either the risky loans or the more stable loans.[150] That study found that for loans made in 2004, the subprime loans were four times more likely to enter into default than the more stable loan products; in 2006, they were 3.3 times as likely.[151] Imagine the amount of suffering that could be alleviated if foreclosure rates were reduced by 67% or even 75%.

A critical aspect of the theory about social distance is that greater social distance leads to non-cooperative, predatory conduct. Is it possible, then, that the problem was borrower fraud and not just predatory lending? Were borrowers behaving in an untrustworthy fashion? Certainly some were, but according to FBI estimates roughly 80% of losses due to mortgage fraud involved lender and/or broker misconduct.[152] Indeed, an *internal study* from 2005 conducted by Washington Mutual of just one of its offices, in Montebello, California, revealed that 83% of the mortgages generated by that office involved some form of fraud on the part of bank officials.[153]

WALL ST. J., Dec. 3, 2007, at A1 (reporting that 61% of subprime loans originated in 2006 "went to people with credit scores high enough to often qualify for conventional[, i.e., prime,] loans with far better terms"). In his recent book, Gary Rivlin puts it succinctly: "The problem wasn't the people [receiving the loans] but the product they were being sold." GARY RIVLIN, BROKE USA: FROM PAWNSHOPS TO POVERTY INC.—HOW THE WORKING POOR BECAME BIG BUSINESS 133 (2010).

149. Lei Ding et al., *Risky Borrowers or Risky Mortgages: Disaggregating Effects Using Propensity Score Models* 1 (Univ. of N.C. Ctr. for Cmty. Capital, 2010), *available at* http://www.ccc.unc.edu/documents/Risky.Disaggreg.5.17.10.pdf.

150. *Id.* at 15–16.

151. *Id.* at 28.

152. U.S. DEP'T OF JUSTICE: FED. BUREAU OF INVESTIGATIONS, FINANCIAL CRIMES REPORT TO THE PUBLIC D1–D12 (2005), *available at* http://www.fbi.gov/stats-services/publications/fcs_report2005/financial-crimes-report-to-the-public-2005-pdf.

153. On April 13, 2010, the Permanent Subcommittee on Investigations, headed by Senator Carl Levin, began holding hearings aimed at examining "some of the causes and consequences of the recent financial crisis." Memorandum from Senator Carl Levin, Subcomm. Chairman, to Members of the Permanent Subcomm. on Investigations 1 (Apr. 13, 2010) [hereinafter Levin Memo], *available at*

In one recently filed lawsuit under the Fair Housing Act, former employees of the defendant Wells Fargo, an aggressive subprime lender,[154] alleged the following:

> Wells Fargo's Memphis branches targeted African Americans for subprime loans because employees held negative views of African Americans. [Former bank employee] Taylor explains that "[t]he prevailing attitude was that African American customers weren't savvy enough to know they were getting a bad loan, so we would have a better chance of convincing them to apply for a high-cost, subprime loan."

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http://levin.senate.gov/newsroom/supporting/2010/PSI.LevinCoburnmemo.041310.pdf.

In particular, the subcommittee focused on a case study involving Washington Mutual Bank (WaMu). The hearings revealed that, in 2005, WaMu itself had conducted an internal investigation that turned up a number of red flags regarding its lending practices. David Heath, *WaMu Executives Knew of Rampant Mortgage Fraud and Failed to Act*, HUFFINGTON POST (Apr. 12, 2010), http://www.huffingtonpost.com/2010/04/12/wamu-executives-knew-of-r_n_534800.html. The investigation uncovered that:

> [L]oans originated from two top loan offices in southern California contained an extensive level of fraud . . . . Despite fraud rates in excess of 58% and 83% at those two offices, no steps were taken to address the problems, and no investors who purchased loans originated by those offices were notified . . . of the fraud problem.

Levin Memo, *supra*, at 4. James Vanasek was one of the former WaMu executives who testified before the subcommittee. Despite assertions of other executives that they had not been aware of the impending housing crisis early on, Vanasek "said he realized in 2004 that 'the industry was in some degree of difficulty . . . .'" Kirsten Grind, *WaMu Hearing Begins*, PUGET SOUND BUS. J. (Apr. 13, 2010), http://seattle.bizjournals.com/seattle/blog/2010/04/wamu_hearing_begins.html.

Another 2007 internal investigation of one of the southern California WaMu offices uncovered a fraud rate of 62%. Levin Memo, *supra*, at 4. WaMu, along with its affiliate, Long Beach Mortgage Company, compounded this problem by "creating misplaced incentives that encouraged high volumes of risky loans but little or no incentives to ensure high quality loans that complied with the bank's credit requirements." *Id.* at 2, 4–5. In addition to the 2005 and 2007 internal investigations, a number of other documents were uncovered which included discussions among the Board of Directors as well as various emails, all of which clearly illustrated the higher risk lending strategies that were rampant throughout the company from 2003 to 2008. *Wall Street and the Financial Crisis: The Role of High Risk Home Loans, Hearing Before the S. Permanent Subcomm. on Investigations*, 111th Cong. at 2–9 (Apr. 13, 2010) (exhibit list), *available at* http://hsgac.senate.gov/public/_files/Financial_Crisis/041310Exhibits.pdf. One internal report did conclude that "[t]hroughout the process, red flags were over-looked, process requirements were waived, and exceptions to policy were granted." Heath, *supra* (internal quotations omitted).

154. Michael Powell, *Suit Accuses Wells Fargo of Steering Blacks to Subprime Mortgages in Baltimore*, N.Y. TIMES, June 7, 2009, at A16.

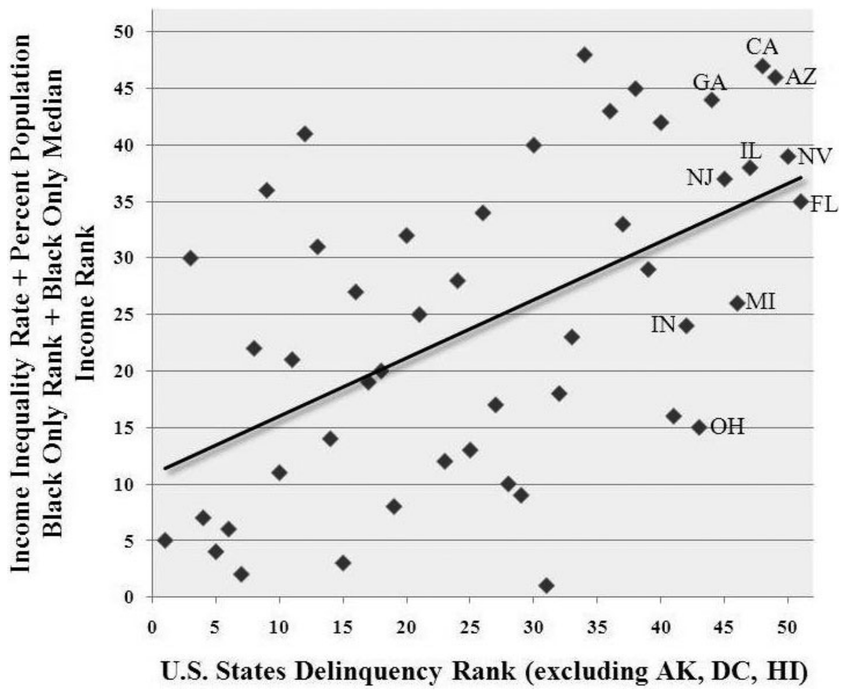
> Likewise, Thomas[, another former bank employee,] explains that "[i]t was generally assumed that African American customers were less sophisticated and intelligent and could be manipulated more easily into a subprime loan with expensive terms than white customers."[155]

Assuming these allegations are true, it appears likely that greater social distance, both in terms of economic and racial inequality, created the conditions in which predatory conduct flourished.

Finally, putting together a number of gauges of social distance caused by economic and racial inequality, Table 16 combines a number of factors outlined above that likely played out in harmful ways in the financial crisis: greater economic inequality, median income of the African American community in a state, and percentage of the African American community in a particular state. Putting these indicators together generates a graph that supports the theory that the African American middle class was targeted for subprime loans.

155. First Amended Complaint for Declaratory and Injunctive Relief and Damages at 32–33, City of Memphis v. Wells Fargo Bank (W.D. Tenn. Apr. 7, 2010) (No. 2:09-cv-02857x), 2010 WL 1506670. Similarly, a CitiFinancial branch manager described that lender's approach as follows: "'[t]he more gullible the consumer appeared . . . the more [additional costs] . . . I would try to include in the loan.' By 'gullible,' she explained, she meant the very young or the very old, minorities and those who 'appeared uneducated, inarticulate.'" Rivlin, *supra* note 148, at 152.

Table 15: Targeting the Black Middle Class[156]



This data analysis is consistent with the findings of a joint report by the U.S. Department of Housing and Urban Development (HUD) and U.S. Department of the Treasury issued in 2000 on predatory lending[157] and later studies conducted during the subprime mortgage market's heyday.[158] In the HUD–Treasury report, these agencies found that predatory lending was more prevalent in the subprime market than the prime market and that such sub-

156. This Table has the strongest P-Value of the tables generated for this study. *See infra* Appendix, Data Set 3. For the data on black middle class income, see US CENSUS BUREAU, *supra* note 109. The data on delinquency rate ranks by state can be found at MBA DATA, *supra* note 47, at 4. The P-Value for this graph as a whole, as well as for each of the separate data sets used and their relation to the delinquency rates with respect to each data set is set forth in the Appendix, Data Set 3, *infra*. In creating this index, these indicators were given equal weight. On the selection and weighting of criteria in the creation of an index, see Roodman, *supra* note 17, at 5–7.

157. U.S. DEP'T OF HOUS. & URBAN DEV. & U.S. DEP'T OF TREASURY, CURBING PREDATORY HOME MORTGAGE LENDING 47–48 (2000) [hereinafter HUD-TREASURY REPORT], *available at* http://www.huduser.org/Publications/pdf/treasrpt.pdf.

158. *See infra* note 163 and accompanying text.

prime lending was prevalent in communities of color.[159] Such communities, HUD and Treasury found, tended to be underserved by what the agencies called "traditional prime lenders," which they identified as banks, thrifts, and credit unions, all of which are subject to more federal oversight than mortgage finance companies.[160] In a later report, the National Community Reinvestment Coalition described the effects of a legacy of discrimination in communities of color as paving the way for subprime lenders to flourish in those communities:

> [M]inority borrowers and communities that received disproportionately high numbers of subprime loans had historically lower homeownership rates, as they were systematically excluded from home mortgages due to bank-redlining and discrimination until the early 1980s. Then, when financial institutions rapidly expanded their lending to minority households it was associated with the use of high-cost, or otherwise unfair and abusive products. The resulting high density of subprime loans "increases the risk of foreclosures and negative spillover effects like declines in property values and increasing crime rates." Hence, a larger proportion of homeowners are facing foreclosures in predominantly minority neighborhoods.[161]

A legacy of discrimination in certain communities,[162] that translated into a lower homeownership rate in those communities, meant such areas were fertile ground for the expansion of subprime lending that occurred in the last decade. With few prime banking alternatives, middle and lower-middle class borrowers of color were targeted for subprime loans and steered into loans with less favorable terms than they might have otherwise accessed had they had better credit alternatives available to them.[163] The thin

159. HUD-Treasury Report, *supra* note 157, at 16, 47–48.

160. *Id.* at 18.

161. Tamara Jayasundera et al., *Foreclosure in the Nation's Capital: How Unfair and Reckless Lending Undermines Homeownership* 19 (Nat'l Cmty. Reinvestment Coal., 2010) (citations omitted), *available at* http://www.ncrc.org/images/stories/pdf/research/ncrc_foreclosure_paper_final.pdf.

162. On the history of housing discrimination in the United States, see Dan Immergluck, Credit to the Community: Community Reinvestment and Fair Lending Policy in the United States 87–108 (2004); 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*, 115 Yale L.J. 186 (2005).

163. For an analysis of lending patterns in seven metropolitan areas, which showed 40% of the activities of subprime lenders concentrated in communities of

market for mainstream financial institutions in communities of color—the legacy of credit redlining—is precisely what narrowed the options available to the residents of such communities. The correlation between borrower median income and the size of the African American population with foreclosure rates in a state would suggest that the larger the African American middle class in a community, and the wealthier it was, the more likely that subprime lending was prevalent in that community and the more likely that the African American middle class was targeted for loans on less than favorable terms.[164] These less than favorable terms led to the foreclosure crisis now plaguing those very same communities, with devastating effects.

III.
AN ALTERNATIVE EXPLANATION AND A RESPONSE

As described above, Rajan and others have argued that government policies—most notably the demands of the CRA and the affordable housing goals of the GSEs—were responsible for the housing bubble and the financial collapse that followed the bursting of that bubble.[165] In order for these arguments to hold true, their proponents would have to show that it was CRA oversight that forced subprime lenders to engage in risky lending, that the GSE

color, while only 10% of their lending taking place in white communities, see CAL. REINVESTMENT COAL. ET AL., PAYING MORE FOR THE AMERICAN DREAM: THE SUBPRIME SHAKEOUT AND ITS IMPACT ON LOWER-INCOME AND MINORITY COMMUNITIES 5 (2008), *available at* http://www.woodstockinst.org/publications/download/paying-more-for-the-american-dream-%11-the-subprime-shakeout-and-its-impact-on-lower%11income-and-minority-communities.

164. Another potential explanation for the prevalence of foreclosures in communities with larger African American populations is the theory that communities with greater population heterogeneity have lower social capital. The logical conclusion to be drawn from such a theory is that this lowered social capital also tends to correspond with higher foreclosure rates, as we have already seen. If the correlation between social capital, trust, and cooperative behavior is well-founded, then the potential correlation between population heterogeneity and predatory conduct is certainly cause for alarm. This controversial issue is addressed in Robert Putnam's relatively recent work on the subject, Putnam, E Pluribus Unum, *supra* note 124. For a response to Putnam, see Casey J. Dawkins, *Reflections on Diversity and Social Capital: A Critique of Robert D. Putnam's "*E Pluribus Unum*: Diversity and Community in the Twenty-First Century the 2006 Johan Skytte Prize Lecture,"* 19 HOUS. POL'Y DEBATE 207 (2008). For a description of the ways in which mortgage lenders actually used social capital networks to gain entré into communities of color, see Creola Johnson, *The Magic of Group Identity: How Predatory Lenders Use Minorities to Target Communities of Color*, 17 GEO. J. POVERTY L. & POL'Y 165 (2010).

165. *See* RAJAN, *supra* note 83, at 34–37, 43–45.

policies were driving the subprime mortgage market, and that GSE underwriting standards were weaker than those of lenders acting on their own, selling bundled mortgages on the strictly private market. As the following discussion shows, not one of these factual suppositions enjoys much support.

A. *The CRA: Not Guilty*

Given our previous discussion of income inequality and its potential connection to financial crises, it is particularly salient to discuss the Community Reinvestment Act (CRA) because it was originally designed to protect the interests of low- and moderate-income communities.[166] As a result, it was originally crafted to combat income inequality, or at least the distortions that income inequality creates on credit markets.[167] If the previous information about income inequality and the foreclosure crisis suggests that the public should be concerned with the impact of such inequality on housing finance policy, then there is no better place to start than to look at the CRA to see its impact on causing or failing to prevent the financial crisis. That some have attempted to lay the blame for the crisis on the CRA only strengthens the need to analyze its purpose, scope, successes, and failures.

Under the CRA, federal bank regulators are to use their authority "to *encourage* [financial] institutions to help meet the credit needs of the local communities in which they are chartered," so long as this goal can be carried out "consistent with the safe and sound operation of such institutions."[168] The CRA was enacted to combat two practices that Congress found to undermine the economic health of low- and moderate-income communities: bank redlining (excluding certain communities from access to capital) and capital exportation (taking deposits from a community while refusing to lend within that community).[169] The policies of the CRA were also seen as a quid pro quo for the substantial benefits that

166. The original language of the CRA was amended during debates over its passage to include consideration of low- and moderate-income communities, as opposed to focusing on the needs of banks' "primary service area". H.R. REP. NO. 95-634, at 75-76 (1977) (Conf. Rep.).

167. On the distortions on credit markets affecting low- and moderate-income communities, see Michael S. Barr, *Credit Where It Counts: The Community Reinvestment Act and Its Critics*, 80 N.Y.U. L. REV. 513, 533–44 (2005).

168. 12 U.S.C. § 2901(b) (2006) (emphasis added).

169. 123 CONG. REC. 17,630 (1977) (statement of Sen. William Proxmire).

banks received: exclusive charter powers, deposit insurance, and discount loans.[170]

So, what is it about this law that makes it a favorite target of those who would lay the blame for the crisis on it and those minority communities which the CRA supposedly directs banks to serve? Under the CRA,[171] bank regulators grade the financial institutions the CRA covers on those institutions' success in meeting the credit needs of their communities, including low- and moderate-income neighborhoods, consistent with safe and sound banking practices.[172] Bank regulators are then supposed to take into account that grade when a bank makes an application to its regulators to take certain actions, like merging with another bank or opening a bank branch.[173] If the CRA were some kind of sword of Damocles hanging over the heads of banks, forcing them to make unwise loans, we would likely see two things: first, the regulators giving banks poor CRA ratings; and second, the regulators rejecting bank

170. *See* 123 CONG. REC. 1,958 (1977) (statement of Sen. William Proxmire). For a further discussion of the connection between government support for banks and the CRA, see Barr, *supra* note 167, at 616–24 (2005); Allen J. Fishbein, *The Community Reinvestment Act After Fifteen Years: It Works, but Strengthened Federal Enforcement Is Needed*, 20 FORDHAM URB. L.J. 293, 293 (1993) (citation omitted).

171. Under the CRA, the following federal banking agencies supervise different sectors of the banking industry: the Office of the Comptroller of the Currency oversees national banks; the Board of Governors of the Federal Reserve System oversees state chartered banks which are members of the Federal Reserve System and bank holding companies; the Federal Deposit Insurance Corporation regulates state chartered banks, savings banks that are not members of the Federal Reserve System and the deposits insured by the FDIC; and the Office of Thrift Supervision (OTS) with respect to savings associations, the deposits of which are insured by the FDIC and savings and loan holding companies. 12 U.S.C. § 2902(1) (2006). With the dissolution of the OTS through the Dodd-Frank financial reform legislation, it is likely that the OCC will assume CRA responsibilities over many of the former OTS-regulated entities. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 312, 124 Stat. 1376, 1521–23 (2010).

172. 12 U.S.C. § 2906(a)(1) (2006). Regulators issue one of four "grades" to the institutions they oversee based on those institutions' success in "meeting community credit needs" consistent with the CRA: "outstanding," "satisfactory," "needs to improve," or "substantial noncompliance." *Id.* § 2906(b)(2).

173. Under the CRA, a federal bank must take into account a covered bank's CRA record whenever the bank applies to its regulator for a "deposit facility." 12 U.S.C. § 2903(a)(2) (2006). The statute defines such an application to include a request seeking approval for any of the following: "a charter for a national bank or Federal savings and loan association; . . . deposit insurance in connection with a newly chartered . . . bank"; the establishment of a branch or other facility that will accept deposits; the relocation of a home or branch office; or the merger, consolidation, or acquisition of another regulated financial institution in certain circumstances. *Id.* § 2902(3).

applications on CRA grounds with great frequency. In reality, in the lead up to the financial crisis, neither of these occurred.

First, in terms of regulators issuing bank CRA grades, in 2005, a year in which many financial institutions engaged in risky lending practices, 99% of all banks covered by the CRA received a grade of "satisfactory" or "outstanding" in terms of meeting their CRA obligations.[174] Second, in terms of bank applications, during the 15 year span from 1985 to 1999, only eight bank applications were denied by bank regulators *on any grounds*, a figure that might seem significant until one learns that there were over 92,000 applications subject to CRA review that were filed during that period.[175] Analysis of the Federal Reserve's record shows that, from 1988 through 2007, the Federal Reserve denied only eight bank applications of the more than 13,000 filed with it for unsatisfactory efforts to meet community needs or to provide consumer protection.[176]

It is hard to imagine that the enforcement mechanisms, as applied by the regulators, were a meaningful check on bank behavior. Putting aside whether the CRA, as structured and enforced, was a serious check on the behavior of the banks to which the CRA applied, the truth of the matter is that the overwhelming majority of the riskiest bank behavior during the subprime mortgage market's heyday took place beyond the CRA's reach. As stated previously, the legislative history of the CRA reveals that it was enacted as a response to two forces in the market: redlining and credit exportation. As a result, the CRA covers only depository institutions and concerns itself with the geographic focus of bank activities as they relate to those places where a covered financial institution does the bulk of its business.[177] The CRA was thus conceived in a very different time, before internet and global banking, when the neighborhood bank was where one deposited one's money and sought access to credit. Given this history, the CRA was ill-equipped to handle the subprime tsunami that hit in the early part of this decade. A review of its scope reveals that the CRA exempted much of the riski-

174. *The Community Reinvestment Act: Thirty Years of Accomplishments, but Challenges Remain: Hearing Before the H. Comm. on Fin. Servs.*, 110th Cong. 194 (2008) (statement of John Taylor, President and CEO, Nat'l Cmty. Reinvestment Coal.).

175. *See* Barr, *supra* note 167, at 586 (citing TREASURY DEP'T, APPLICATIONS SUBJECT TO CRA THAT WERE SUBJECT TO CRA THAT WERE PROTESTED ON CRA GROUNDS (2000)).

176. *Foreclosures at the Front Step of the Federal Reserve Bank of Cleveland: Hearing Before the Subcomm. on Domestic Policy of the H. Comm. on Oversight and Gov't Reform*, 110th Cong. 63–64 (2007) (statement of Sandra Braunstein, Director, Div. of Consumer and Cmty. Affairs, Fed. Reserve Sys.).

177. *See infra* notes 178–84 and accompanying text.

est lending that took place in this time from its coverage in a number of ways. As a result of this narrow CRA scope, it is hard to argue that the CRA forced financial institutions that it did not even cover to do anything.

According to the statute, the CRA only applies to "regulated financial institutions,"[178] which the statute describes as "insured depository institution[s]."[179] This is the largest exemption, which, according to Fed Chairman Bernanke, excluded during the recent expansion of the market as much as two-thirds of mortgage lending from the CRA's reach.[180] That is the share of mortgage lending during that time that was carried out by standalone mortgage companies, companies that did not take deposits and thus were not covered by the CRA.[181] A second exemption permits depository institutions, at their discretion, to exempt the lending of their non-bank affiliates from CRA coverage, even if they are themselves covered by the law.[182] Thus, a bank like Bank of America can exempt its subsidiary, Countrywide, from CRA coverage if it chooses.

Third, the requirements of the CRA only apply to bank activities within each bank's "assessment areas" and regulators assess a bank's lending in low- and moderate-income communities only within those assessment areas.[183] A bank's assessment area includes where it has offices and branches, and where a "substantial" portion of a bank's lending occurs.[184] Regulators do not review lending for

178. 12 U.S.C. § 2901(a)(1) (2006).

179. *Id.* § 2902(2). Under the CRA, the definition of "insured depository institution" is that set forth in 12 U.S.C. § 1813, which provides that such an institution is "any bank or savings association the deposits of which are insured by the [Federal Deposit Insurance] Corporation . . . ." *Id.* § 1813(c)(2).

180. Ben S. Bernanke, The Community Reinvestment Act: Its Evolution and New Challenges, Speech at the Community Affairs Research Conference 5 (Mar. 30, 2007), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20070330a.htm; *see also* ROBERT E. LITAN ET AL., THE COMMUNITY REINVESTMENT ACT AFTER FINANCIAL MODERNIZATION: A BASELINE REPORT 70–72 (2000), *available at* http://www.novoco.com/low_income_housing/resource_files/research_center/crareport.pdf (analyzing lending data from 1992 and 1998, and finding that two-thirds of the increase in lending by institutions not covered by the CRA to low- and moderate-income communities was attributable to lenders specializing in subprime, while only 15% of these loans were originated by CRA-covered institutions).

181. Bernanke, *supra* note 180 (noting that companies owned by banks or bank holding companies can be nondepository institutions).

182. *See* Richard D. Marsico, *Subprime Lending, Predatory Lending, and the Community Reinvestment Act Obligations of Banks*, 46 N.Y.L. SCH. L. REV. 735, 738–39 (2003) (citing 12 CF.R. § 25.22(a)(1), (c)(1) (2010).

183. *See* 12 C.F.R. §§ 25.22, 25.41 (2010).

184. *See id.* § 25.41 (2010).

its consistency with CRA goals when lending activity is conducted by covered financial institutions and occurs outside their assessment areas. Thus, even a covered institution can engage in predatory practices beyond the reach of the CRA simply by doing a less than substantial amount of lending in communities where they have no branches. Given the age of internet banking, this is fairly easy to do. Another way of looking at this is to say that the CRA was irrelevant to lending that took place outside of covered financial institutions' designated CRA assessment areas; as a result, risky lending that occurred outside of these areas could not have been driven by the CRA simply because the CRA did not cover such lending.

These exclusions from the CRA—i.e., that it covers only financial institutions that take deposits, bank subsidiaries that do not themselves take deposits at those parent banks' discretion, and lending in a covered bank's assessment area—leave gaping holes in CRA coverage. These gaps in coverage were particularly relevant to the expansion of subprime lending in the lead up to the financial crisis. In fact, a study by the Federal Reserve showed that at least 94% of all subprime lending during the height of the mortgage mania was outside the scope of the CRA.[185] Moreover, numerous studies have shown that CRA lending was actually as profitable and viable as other stable loans on banks' ledgers, and potentially less likely to enter into foreclosure than subprime loans.[186]

185. Memorandum from Glenn Canner & Neil Bhutta, Div. of Research and Statistics, Bd. of Governors of the Fed. Res. Sys., to Sandra Braunstein, Dir., Consumer & Cmty. Affairs Div., Bd. of Governors of the Fed. Reserve Sys. 3 (Nov. 21, 2008), *available at* http://www.federalreserve.gov/newsevents/speech/20081203_analysis.pdf. It is also important to note that the 94% figure might actually *underestimate* the number of subprime loans that the CRA covered during the buildup of the subprime mortgage market: i.e., that figure might be lower than 6%. The Canner & Bhutta report did not differentiate between loans made by CRA-covered institutions and loans made by their affiliates. Thus, this percentage includes the lending carried out by affiliates of CRA-covered entities, which, as mentioned above, would only have been covered by the CRA at the discretion of the parent institution.

186. *See* Canner & Bhutta, *supra* note 185, at 10 tbl.7. A study by the Federal Reserve Bank of San Francisco of the loans issued in California from 2004 through 2006, the height of the boom in that state, revealed that mortgage loans made to borrowers of similar creditworthiness by financial institutions covered by the CRA, in those institutions' assessment areas, were half as likely to enter foreclosure as loans made by independent mortgage lenders not covered by the CRA. Elizabeth Laderman & Carolina Reid, *CRA Lending During the Subprime Meltdown*, *in* FED. RESERVE BANKS OF BOS. AND S.F., REVISITING THE CRA: PERSPECTIVES ON THE FUTURE OF THE COMMUNITY REINVESTMENT ACT 115, 118, 122 (2009), *available at* http://www.frbsf.org/publications/community/cra/revisiting_cra.pdf. On the profitability of lending covered by the CRA prior to the buildup of the subprime mortgage

In the end, the indictment against the CRA is not that it was too strong, but that it was too weak. Built to fight the civil rights battles of the twentieth century, in which communities were redlined and excluded from traditional bank services and access to capital, it was ill-equipped to withstand the cascade of subprime lenders that flourished in certain communities. Such lenders succeeded precisely because of a legacy of discrimination in those communities that meant fewer legitimate bank options were available there.[187] Remember those 169 failed lending institutions discussed above?[188] One hundred sixty-seven of them, roughly 99%, were beyond the reach of the CRA because they were non-depository institutions and thus not covered by the CRA.[189] It is hard to lay the blame on the CRA when 94% of subprime lending took place outside its scope, and 99% of the riskiest lenders were not even covered by it.

B. The Role of Government Sponsored Entities

Turning to the GSEs, the theory goes that politicians drove those entities to increase their share of the subprime securitization pool, which led to an unsustainable expansion of the mortgage market, reaching borrowers that were poor credit risks.[190] But the facts concerning the GSEs' share of the market do not bear this out. Indeed, as the securitization market expanded in 2004 and 2005, both the size and the share of the GSEs' stake in that market actually declined. As the market started to dry up in 2006, their share got even smaller, as Table 17 reveals.

market, see BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE PERFORMANCE AND PROFITABILITY OF CRA-RELATED LENDING 45–51 (2000), *available at* http://www.federalreserve.gov/boarddocs/surveys/craloansurvey/cratext.pdf.

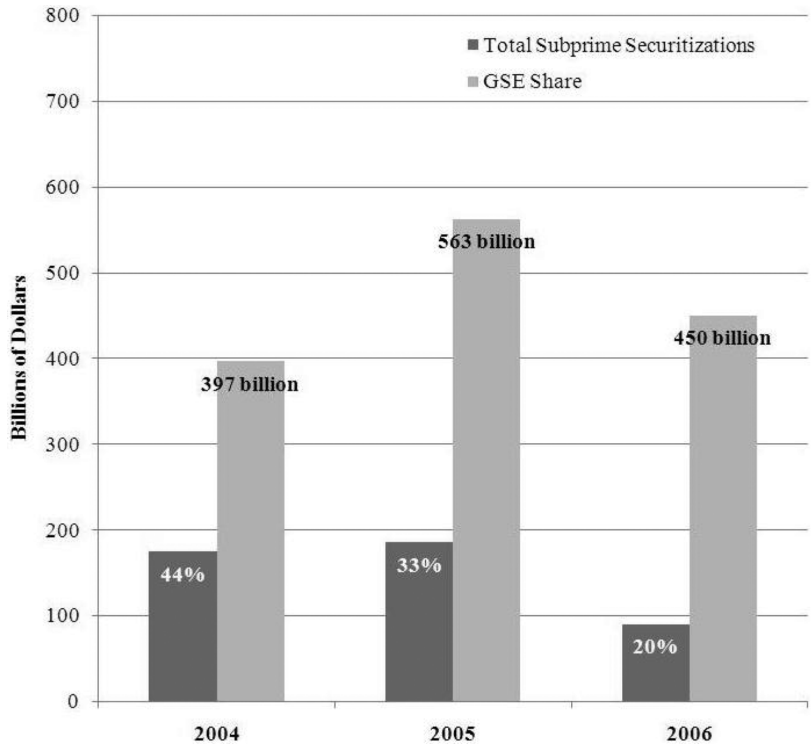
187. *See*, *e.g.*, Kathleen C. Engel & Patricia A. McCoy, *The CRA Implications of Predatory Lending*, 29 FORDHAM URB. L.J. 1571, 1583–84 (2001) (noting that failure of traditional lenders to serve communities of color allows predatory lenders to charge supracompetitive rates); *see also* Barr, *supra* note 167, at 534–40 (2005) (providing economic reasons for failure of mortgage market to serve certain communities).

188. *See supra* text accompanying notes 145–46.

189. *See* Avery et al., *supra* note 145, at A123.

190. *See* RAJAN, *supra* note 83, at 32–45.

Table 17: GSE Share of All Subprime Securities, 2004–2006.[191]



Furthermore, although the GSEs *did* lower their underwriting standards in the early part of this decade, recent research by the National Community Reinvestment Coalition reveals that securitized subprime loans on the books of private investors, as compared to those on the GSEs' ledgers, were more than twice as likely to go into default.[192] Thus, if risky lending and poor underwriting standards are to blame for the present foreclosure crisis, then had the underwriting standards of the securitizations that the GSEs invested in been utilized across the board, foreclosure rates may have been significantly reduced.[193]

191. *See* Carol D. Leonnig, *How HUD Mortgage Policy Fed the Crisis: Subprime Loans Labeled 'Affordable'*, WASH. POST (June 10, 2008), http://www.washingtonpost.com/wp-dyn/content/article/2008/06/09/AR2008060902626.html.

192. *See* Jayasundera et al., *supra* note 161, at 3, 18 tbl.6.

193. *See id.* at 20. A related issue recently reached the Supreme Court, where the Court upheld the authority of state attorneys general to enforce their respective states' fair lending laws. Cuomo v. Clearing House Ass'n, 129 S. Ct. 2710, 2717, 2722 (2009) (holding that National Bank Act only preempts sovereign's "vistorial powers" and not its ability to enforce its own fair-lending laws).

It seems likely that non-depository institutions and private investors were driving the riskiest lending, not a political push generated by Washington through either the CRA or the GSEs.

IV.
MOVING FORWARD: SOCIAL DISTANCE AND FINANCIAL REFORM

The preceding analysis raises important questions about the impact of racial and economic inequality on the health of national economies and the sustainability of certain economic practices. Given these impacts, efforts to rein in risky practices should take into account the way social inequalities, and the social distance they engender, can increase predatory conduct and weaken markets. There are several straightforward, macroeconomic approaches that could help to reduce social distance. Recalibrating marginal tax rates so as to increase taxes on the wealthy as a way to flatten differences between the haves and have-nots is one obvious way to reduce the social distance that comes from greater economic and social inequality. If economic inequality itself is not subject to direct assault, given political realities, the gravity of Judson's "governance problem" can be reduced by reducing the influence of money on the political process, though the present makeup of the U.S. Supreme Court holds a firm line against campaign finance reform.[194] Short of a constitutional amendment, the outsized influence of money on politics seems firmly in place. Similarly, governmental affirmative action strategies aimed at reducing economic inequality between Whites and people of color have raised fatal constitutional questions.[195] Yet with respect to racial inequality and the way it has

194. André Douglas Pond Cummings, *Procuring "Justice"?:* Citizens United, Caperton, *and Partisan Judicial Elections*, 95 IOWA L. REV. BULL. 89 (2010), *available at* http://www.uiowa.edu/~ilr/bulletin/ILRB_95_cummings.pdf. The author notes that especially since the holding in the *Citizens United* case, the Court has "[made] permissible a corporations direct expenditure of general treasury funds to explicitly endorse or malign a candidate for public office immediately prior to an election." *Id.* at 97 (citing Citizens United v. Fed. Election Comm'n, 130 S. Ct. 876, 964 (2010) (Stevens, J., concurring in part and dissenting in part)). This unwillingness to tighten campaign financing practices has been an identifiable trend in the U.S. Supreme Court since Chief Justice Roberts took his position. *See* Richard Briffault, WRTL *and* Randall*: The Roberts Court and the Unsettling of Campaign Finance Law*, 68 OHIO ST. L.J. 807, 807–08 (2007) (stating that two decisions made in Roberts' first year as Chief Justice "may constitute a pivotal moment in the Court's evolving campaign finance jurisprudence").

195. For a discussion of the constitutional barriers to public affirmative action strategies, see Jed Rubenfeld, *Affirmative Action*, 107 YALE L.J. 427, 428–30 (1997). The author asserts that "[t]he ultimate constitutional question presented by race-

played out in the mortgage arena, the legal infrastructure that might combat reverse redlining exists, but application of the laws against discrimination in lending during the last decade seems slow to catch up to invidious practices. This is due not only to the inadequacy of enforcement mechanisms and resources, but also to the fact that securitization permits downstream investors to claim protection from charges of discrimination in the origination of the underlying mortgages by invoking the "holder in due course" doctrine.[196]

Since economic and racial inequality seem to bear some relation to financial crises, short of direct efforts to reduce such inequality—efforts that might seem politically infeasible or constitutionally suspect—to what extent does the recent financial reform legislation that Congress passed in the summer of 2010 address these forms of social inequality, if at all? The remainder of this section is devoted to this question, as well as to the question of whether there are additional legislative or market-oriented fixes, not covered in this legislation, that might rein in the effects of social inequality.

In July 2010, by a close—yet bi-partisan—vote, Congress passed what became known as the Dodd-Frank bill, named for Connecticut Senator Chris Dodd and Massachusetts Representative Barney Frank, both Democrats. Formally known as the "Dodd-Frank Wall Street Reform and Consumer Protection Act," the legislation runs over 2000 pages and covers a wide range of topics, including increasing transparency in derivatives trading, improving regulatory oversight over financially important institutions, and strengthening regulatory authority to wind down institutions that pose systemic risks to the financial system.[197] At the same time, few in the general

based affirmative action—by no means an easy question—is whether whites' equal protection rights are violated when the government purposefully acts to assist blacks and other minorities by granting them special opportunities." *Id.* at 429.

196. Put in its most basic form, the holder in due course doctrine protects a purchaser of a financial instrument who buys that instrument for value without notice of any defects in prior transactions related to that instrument. For a description of the holder in due course doctrine, see Vern Countryman, *The Holder in Due Course and Other Anachronisms in Consumer Credit*, 52 TEX. L. REV. 1, 2–3 (1973). For criticisms of the doctrine, specifically as it relates to the securitization of subprime mortgages, see Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503 (2002); Siddhartha Venkatesan, Note, *Abrogating the Holder in Due Course Doctrine in Subprime Mortgage Transactions to More Effectively Police Predatory Lending*, 7 N.Y.U. J. LEGIS. & PUB. POL'Y 177 (2003).

197. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

public appear to have faith in the legislation to prevent future financial crises from occurring.[198] Moreover, the legislation does little to address the problem of economic and racial inequality and the social distance they create. In this section, those aspects of the Dodd-Frank legislation that appear to relate in some way to the inequalities discussed in previous sections are analyzed.

What follows is an exploration of some of the issues implicated by the analysis set forth above, and an attempt to identify potential areas of focus for regulators as they begin the difficult process of developing the regulations necessary to implement Dodd-Frank, as well as continue the investigation of predatory conduct that occurred during the lead up to the financial crisis. This analysis also identifies potential areas of focus for the new Consumer Financial Protection Bureau. Each of these topics will be discussed, in turn, below.

In addition, as this Article goes to print, Congress is expected to consider what could amount to wide-ranging amendments to the CRA, changes that would expand its coverage and close the loopholes that left much of the riskiest lending outside its coverage. This Article discusses these proposed amendments below. Finally, this section concludes with a discussion of the role that social capital can play in improving financial industry practices, with particular emphasis on its ability to serve as a consumer-driven lever for reform of the financial sector, regardless of the relative effectiveness of Dodd-Frank to rein in the riskiest, crisis-inducing practices of the shadow banking system.

A. *Social Distance, Dodd-Frank, and a New Regulatory Framework*

Not surprisingly, perhaps, Dodd-Frank explicitly says next to nothing about social inequality. Only in section 1204, entitled "Expanded Access to Mainstream Financial Institutions," is any reference made to low- and moderate-income individuals. This section authorizes the Secretary of the Treasury to undertake the following:

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198. A Bloomberg poll conducted on the eve of the passage of the Dodd-Frank legislation found the following:

> Almost four out of five Americans surveyed in a Bloomberg National Poll this month say they have just a little or no confidence that the measure being championed by congressional Democrats will prevent or significantly soften a future crisis. More than three-quarters say they don't have much or any confidence the proposal will make their savings and financial assets more secure.

Rich Miller, *Wall Street Fix Seen Ineffectual by Four of Five in U.S.*, BLOOMBERG, July 13, 2010, http://www.bloomberg.com/news/2010-07-13/wall-street-fix-from-congress-seen-ineffectual-by-four-out-of-five-in-u-s-.html.

> to establish a multiyear program of grants, cooperative agreements, financial agency agreements, and similar contracts or undertakings to promote initiatives designed—
>
> (1) to enable low- and moderate-income individuals to establish one or more accounts in a federally insured depository institution that are appropriate to meet the financial needs of such individuals; and
>
> (2) to improve access to the provision of accounts, on reasonable terms, for low- and moderate-income individuals.[199]

Apart from this lone explicit mention, there are also other provisions in the legislation that will assist low- and moderate-income communities. For example, the legislation authorizes the Treasury Secretary to assess the risk to consumers from consumer financial products and services[200] and to promote programs that will offer alternatives to high-cost, small dollar loans;[201] adopts mortgage protections geared towards ensuring that mortgage originators offer loan products that are appropriate for the borrowers they serve;[202] and places limits on mortgage broker compensation to ensure that brokers are not given incentives to steer borrowers into higher cost and less favorable loans.[203] Each of these provisions will undoubtedly assist lower-income Americans. Moreover, the Bureau of Consumer Financial Protection will likely be inclined towards ensuring that lower-income Americans are not preyed upon by financial institutions using opaque and predatory products.[204] The creation of this entity is probably the most significant aspect of the Dodd-Frank legislation that will impact social inequality, and the following section provides an overview of the bureau's powers and functions.

At the same time, Dodd-Frank does little to rein in executive compensation at regulated financial institutions. It is hard to think of a practice that did more to spur economic inequality, and the

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199. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1204(a)(2).

200. *Id.* § 1024(b)(1)(C).

201. *Id.* § 1205(a).

202. *Id.* § 1402–33.

203. Such incentives, typically called "Yield Spread Premiums," often encouraged brokers to try to convince borrowers to accept more expensive loan terms because the broker was paid a higher commission for doing so. On the operation of these premiums, see Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN. J.L. BUS. & FIN. 289 (2007).

204. A discussion of the Consumer Financial Protection Bureau follows *infra* Part IV.A.1.

Judsonian governance problem mentioned earlier,[205] than the growth of financial compensation for financial industry executives.[206] What Dodd-Frank does do in this area is direct the development of regulations that will prohibit "excessive compensation" that could lead to excessive risk-taking at a large percentage of financial sector institutions.[207] These regulations will cover a range of institutions, including bank holding companies, registered broker dealers, and credit unions, among others.[208] In many ways, these new standards adopt similar controls to provisions already in existence related to excessive compensation controls on insured depository institutions.[209]

Other provisions of the legislation related to compensation include non-binding "say on pay" votes for shareholders,[210] disclosure requirements on public companies,[211] and compensation clawback provisions for companies that must restate earnings.[212] It is too early to determine whether these regulations will have teeth and whether regulators will enforce them vigorously.

The following discussion provides an overview of those other aspects of the Dodd-Frank legislation, beyond the modest compensation controls described above, that relate most directly to social inequality. In this discussion, this Article attempts to provide an overview of both the legislation's specific provisions as well as the critical issues that will face regulators, the financial industry, and consumers as the legislation moves from passage to implementation.

1. The Bureau of Consumer Financial Protection

Dodd-Frank calls for the creation of an independent subagency within the Federal Reserve System that will have as its primary function maintaining oversight of federal consumer protection laws and monitoring the financial system for abusive and unfair practices. To be known as the "Bureau of Consumer Finan-

205. *See supra* text accompanying notes 65–67.

206. For a discussion of the potential impacts of executive compensation structures on the financial crisis, see Mark Hulbert, *Did Bankers' Pay Add to This Mess?*, N.Y. TIMES, Sept. 27, 2009, at BU6, *available at* http://www.nytimes.com/2009/09/27/business/27stra.html, and the sources cited therein.

207. Dodd-Frank Wall Street Reform and Consumer Protection Act § 956(b).

208. *Id.* § 956(e).

209. *See* 12 U.S.C. § 1831p-1(c) (2006).

210. Dodd-Frank Wall Street Reform and Consumer Protection Act § 951.

211. *Id.* § 953.

212. *Id.* § 954.

cial Protection"[213] (or, as it is more commonly referred to, the Consumer Financial Protection Bureau, or CFPB), the Bureau will draw its funding from the Federal Reserve System,[214] and its director will be nominated by the President and confirmed by the U.S. Senate.[215]

Section 1021 of Dodd-Frank lays out the CFPB's purpose, objectives, and functions. According to the legislation, the bureau shall "seek to implement and, where applicable, enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive."[216] The Bureau is tasked with enforcing a range of federal financial protection laws, including the Truth in Lending Act and the Equal Credit Opportunity Act.[217]

213. *Id.* § 1011(a).

214. *Id.* § 1017(a).

215. *Id.* § 1011(b)(3).

216. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1021(a).

217. According to Dodd-Frank, the consumer protection laws that the bureau has responsibility over include those laws designated as "enumerated consumer laws," which are the following:

(A) the Alternative Mortgage Transaction Parity Act of 1982 (12 U.S.C. 3801 et seq.);
(B) the Consumer Leasing Act of 1976 (15 U.S.C. 1667 et seq.);
(C) the Electronic Fund Transfer Act (15 U.S.C. 1693 et seq.), except with respect to section 920 of that Act;
(D) the Equal Credit Opportunity Act (15 U.S.C. 1691 et seq.);
(E) the Fair Credit Billing Act (15 U.S.C. 1666 et seq.);
(F) the Fair Credit Reporting Act (15 U.S.C. 1681 et seq.), except with respect to sections 615(e) and 628 of that Act (15 U.S.C. 1681m(e), 1681w);
(G) the Home Owners Protection Act of 1998 (12 U.S.C. 4901 et seq.);
(H) the Fair Debt Collection Practices Act (15 U.S.C. 1692 et seq.);
(I) subsections (b) through (f) of section 43 of the Federal Deposit Insurance Act (12 U.S.C. 1831t(c)–(f));
(J) sections 502 through 509 of the Gramm-Leach-Bliley Act (15 U.S.C. 6802-6809) except for section 505 as it applies to section 501(b);
(K) the Home Mortgage Disclosure Act of 1975 (12 U.S.C. 2801 et seq.);
(L) the Home Ownership and Equity Protection Act of 1994 (15 U.S.C. 1601 note);
(M) the Real Estate Settlement Procedures Act of 1974 (12 U.S.C. 2601 et seq.);
(N) the S.A.F.E. Mortgage Licensing Act of 2008 (12 U.S.C. 5101 et seq.);
(O) the Truth in Lending Act (15 U.S.C. 1601 et seq.);
(P) the Truth in Savings Act (12 U.S.C. 4301 et seq.);
(Q) section 626 of the Omnibus Appropriations Act, 2009 (Public Law 111–8); and

"The Bureau is authorized to exercise its authorities under Federal consumer financial law" to ensure that consumers are given effective information about consumer products and services,[218] and "consumers are protected from unfair, deceptive, or abusive acts and practices and from discrimination."[219] The Bureau is also empowered to address "unduly burdensome regulations . . . in order to reduce unwarranted regulatory burdens."[220] It should also ensure fair competition among depository and non-depository institutions and that "consumer financial products and services operate transparently and efficiently to facilitate access and innovation."[221] The "primary functions" of the Bureau will include engaging in consumer education; "collecting, investigating, and responding to consumer complaints;" monitoring markets to "identify risks to consumers and the proper functioning of such markets;" supervising compliance with and enforcing consumer protection laws; and issuing rules, orders, and guidance on consumer protection laws.[222]

With respect to rulemaking, the CFPB will have the primary enforcement authority over the federal consumer protection laws over which it has jurisdiction.[223] At the same time, the Financial Stability Oversight Council,[224] also created by Dodd-Frank,[225] has the ability to stay or set aside any rules promulgated by the Bureau

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(R) the Interstate Land Sales Full Disclosure Act (15 U.S.C. 1701).

Id. §§ 1002(12)(A)–(R), 1002(14), 1011(a).

218. *Id.* § 1021(b).

219. *Id.* § 1021(b)(2).

220. *Id.* § 1021(b)(3).

221. *Id.* § 1021(b)(4), (5).

222. *Id.* § 1021(c)(1)–(5).

223. *Id.* § 1025(c).

224. The Council will include the following voting members:

(A) the Secretary of the Treasury, who shall serve as Chairperson of the Council;

(B) the Chairman of the Board of Governors;

(C) the Comptroller of the Currency;

(D) the Director of the Bureau;

(E) the Chairman of the Commission;

(F) the Chairperson of the Corporation;

(G) the Chairperson of the Commodity Futures Trading Commission;

(H) the Director of the Federal Housing Finance Agency;

(I) the Chairman of the National Credit Union Administration Board; and

(J) an independent member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise.

Id. § 111(b)(1).

225. *Id.* § 111(a).

on an affirmative vote of two thirds of the members of the Council.[226]

In addition, the Bureau can hold hearings and adjudicative proceedings concerning alleged violations of consumer protection laws,[227] can file litigation in its own name,[228] and is to create a fund to collect penalties and fines for violations of consumer protection laws to help to compensate victims of such violations.[229]

It is apparent that the focus of the CFPB will be to minimize information asymmetries, monitor the functioning of markets and the use of dangerous financial products, enforce federal consumer protection laws, and prosecute violations of these laws. These powers will likely inure to the benefit of individuals of low and moderate income the most, or those most susceptible to deceptive practices and those most in need of assistance guarding against such practices. In this way, the Bureau has the potential to be a strong counterweight to the significant financial and informational advantages that well-heeled institutions and intermediaries have over less sophisticated consumers. With so much primary authority over federal consumer protection laws, for such things as rulemaking and enforcement, it is critical that the CFPB is staffed with individuals who will take their role seriously, and will be aggressive and conscientious in carrying out the mandate and mission of the entity. Resting such broad, primary and comprehensive consumer protection authority in a single entity runs the risk that such power will not be wielded well or, worse, will give consumers a false sense of security, leading the way for deceptive practices that are more effective in taking advantage of consumers. "Cognitive regulatory capture" of the CFPB by individuals inclined to favor industry interests could, in fact, do more harm than good.[230] Thus, ensuring that

226. *Id.* § 1023(c)(3)(A) (setting forth the two-thirds requirement). With respect to the specific authority to overturn a bureau's rule, Section 1023(a) provides as follows:

> Review of Bureau Regulations.—On the petition of a member agency of the Council, the Council may set aside a final regulation prescribed by the Bureau, or any provision thereof, if the Council decides, in accordance with subsection (c), that the regulation or provision would put the safety and soundness of the United States banking system or the stability of the financial system of the United States at risk.

Id. § 1023(a).

227. *Id.* § 1053(a).

228. *Id.* § 1054(b).

229. *Id.* § 1017(d).

230. For a discussion of cognitive regulatory capture, in which regulators adopt the mindset and interests of the entities they regulate, see WILLEM H.

the agency is staffed by individuals with independence and who possess the ability to navigate and coordinate the efforts of dozens of federal agencies will be an essential first step in guaranteeing the success of the CFPB in carrying out its purposes and helping to mitigate the effects of social distance. One aspect of this mission—the CFPB's fair lending enforcement powers—will obviously be essential in addressing the effects of social distance. This authority will now be considered.

2. Strengthened Fair Lending Enforcement

Dodd-Frank mandates that the Bureau create an Office of Fair Lending and Equal Opportunity.[231] The powers of this Office include any that the Bureau Director may delegate to it, including the following:

> (A) providing oversight and enforcement of Federal laws intended to ensure the fair, equitable, and nondiscriminatory access to credit for both individuals and communities that are enforced by the Bureau, including the Equal Credit Opportunity Act and the Home Mortgage Disclosure Act;
> (B) coordinating fair lending efforts of the Bureau with other Federal agencies and State regulators, as appropriate, to promote consistent, efficient, and effective enforcement of Federal fair lending laws;
> (C) working with private industry, fair lending, civil rights, consumer and community advocates on the promotion of fair lending compliance and education; and
> (D) providing annual reports to Congress on the efforts of the Bureau to fulfill its fair lending mandate.[232]

Along a similar vein, earlier this year the Department of Justice (DOJ) announced the creation of a new Fair Lending Unit within the Department's Civil Rights Division that will focus on discriminatory lending occurring now and in the lead up to the financial crisis.[233]

Given the fact that unfair lending was prevalent during the mortgage mania of the last decade, there is an obvious need for this

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BUITER, LESSONS FROM THE NORTH ATLANTIC FINANCIAL CRISIS 37 (2008), *available at* http://www.newyorkfed.org/research/conference/2008/rmm/buiter.pdf.

231. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1013(c)(1).

232. *Id.* § 1013(c)(2)(A)–(D).

233. Thomas E. Perez, Assistant Att'y Gen., Testimony Before the H. Subcomm. on the Constitution, Civil Rights, and Civil Liberties (Apr. 29, 2010), *available at* http://www.justice.gov/crt/speeches/2010/crt-speech-100429.html.

type of focus for the CFPB, as well as for the DOJ. These two entities should join forces with others both inside and outside the federal government to conduct a comprehensive assessment of lending practices during the lead up to the financial crisis. With the outstanding portfolios of Fannie Mae and Freddie Mac, those of the banks the FDIC has taken over in the last two years, and the records the Department of the Treasury has amassed through its mortgage modification program, there is a wealth of data available to the CFPB and the DOJ to identify discriminatory lending patterns. If many of the lenders responsible for the worst abuses have since dissolved, at least such investigations will help to uncover the extent to which discrimination may have played a part in the buildup of the mortgage market. Such information is critical to help develop a deeper appreciation for the causes of the crisis; to date, little has been done to root out such information, short of the efforts of a few plaintiff-side attorneys and intrepid state attorneys general.

Placing primary enforcement authority over such laws as the Equal Credit Opportunity Act and the Home Mortgage Disclosure Act with the CFPB means there is now a federal financial regulator with a primary focus on fair lending. This will help address one of the critical causes of social distance that played itself out with ferocity in the lead up to the financial crisis: economic inequality that falls along racial lines. In order to minimize the harshest consequences of this social distance, robust enforcement of the fair lending laws is necessary. Once again, in order for the CFPB to wield this authority in an effective way, it must be staffed by committed, competent and professional bureaucrats who will enforce both the letter and the spirit of the fair lending laws.

3. Reforming Mortgage Laws

Dodd-Frank imposes sweeping new restrictions on all home mortgage loans. Section 1411 of the legislation imposes the following requirement on residential mortgage lending:

> [N]o creditor may make a residential mortgage loan unless the creditor makes a reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan, according to its terms, and all applica-

ble taxes, insurance (including mortgage guarantee insurance), and assessments.[234]

This requirement is similar to the suitability requirement applied in the securities context.[235] A "reasonableness" requirement could go a long way towards offsetting the asymmetries of information that plagued the mortgage market during the last decade. Such asymmetries left borrowers at the mercy of mortgage brokers and originators who could mask the true import of mortgage terms, including critical interest rate adjustment formulas.

The mortgage context is one in which the design of the laws does not match the needs of many consumers. In this context, to date, we have relied heavily on a disclosure regime, one which places a great deal of somewhat murky information at the disposal of the borrower.[236] Such a regime clearly failed; it was and is ill-suited to the task of reining in the modern, at times exotic, mortgage market.

If one traces the history of the development of other areas of property law, the law has been transformed to take into account the realities of the day.[237] The warranty of habitability is perhaps the best example. In the landlord–tenant context, history shows that

234. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1411(a)(2) (amending Chapter 2 of the Truth in Lending Act, 15 U.S.C. § 1631 et seq. (2006)).

235. For an overview of the suitability requirement with respect to the securities industry, see *Suitability*, SEC. & EXCH. COMM'N, http://www.sec.gov/answers/suitability.htm (last modified Oct. 16, 2009).

236. For an analysis of the failure of the mortgage lending disclosure regime to protect against abuses in the subprime mortgage market, see Jeff Sovern, *Preventing Future Economic Crises Through Consumer Protection Law or How the Truth in Lending Act Failed the Subprime Borrowers* (St. John's Univ. Sch. of Law, Legal Studies Research Paper No. 10-0189, 2010) *available at* http://ssrn.com/abstract=1531781.

237. That our property laws are constantly evolving is beyond question, as Justice Stevens, in his dissenting opinion in *Lucas v. S.C. Coastal Council*, 505 U.S. 1003 (1992), made clear:

> The human condition is one of constant learning and evolution—both moral and practical. Legislatures implement that new learning; in doing so they must often revise the definition of property and the rights of property owners. Thus, when the Nation came to understand that slavery was morally wrong and mandated the emancipation of all slaves, it, in effect, redefined "property." On a lesser scale, our ongoing self-education produces similar changes in the rights of property owners: New appreciation of the significance of endangered species, see, *e. g., Andrus v. Allard*, 444 U.S. 51 (1979); the importance of wetlands, see, *e. g.*, 16 U. S. C. § 3801 *et seq.;* and the vulnerability of coastal lands, see, *e. g.*, 16 U. S. C. § 1451 *et seq.*, shapes our evolving understandings of property rights.

Id., at 1069–1070 (Stevens, J., dissenting).

the landlord–tenant relationship changed from one in which a jack-of-all-trades farmer entered into a relationship with a land owner, primarily for the use of farmland, to one in which an unskilled tenant rented property in an urban setting.[238] The law had to adapt to take into account the inability of the tenant to tend to the quality of his or her own housing and the inequity of bargaining power between the landowner and the tenant.[239]

In the mortgage context, the disclosure regime, one in which prospective borrowers received incomprehensible information with references to terms like "LIBOR" and the use of other methods to calculate the interest rate on an adjustable rate mortgage, clearly failed and many borrowers accepted loans that they could not understand with terms that were unsustainable.[240]

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238. *See* Javins v. First Nat'l Realty, 428 F.2d 1071, 1078–79 (D.C. Cir. 1970), *cert. den.*, 400 U.S. 925 (1970).

239. For a history of the development of the warranty of habitability, see Mary Ann Glendon, *The Transformation of American Landlord-Tenant Law*, 23 B.C. L. REV. 503, 523–24 (1982). The sociological and economic forces at work that justified the warranty of habitability's transformation of the landlord-tenant relationship are perhaps best summed up by Judge J. Skelly Wright's opinion in the landmark *Javins v. First Nat'l Realty* case. 428 F.2d 1071 (D.C. Cir. 1970). In his opinion, Judge Wright explained those forces as follows:

> Today's urban tenants, the vast majority of whom live in multiple dwelling houses, are interested, not in the land, but solely in "a house suitable for occupation." Furthermore, today's city dweller usually has a single, specialized skill unrelated to maintenance work; he is unable to make repairs like the "jack-of-all-trades" farmer who was the common law's model of the lessee. Further, unlike his agrarian predecessor who often remained on one piece of land for his entire life, urban tenants today are more mobile than ever before. A tenant's tenure in a specific apartment will often not be sufficient to justify efforts at repairs. In addition, the increasing complexity of today's dwellings renders them much more difficult to repair than the structures of earlier times. In a multiple dwelling repair may require access to equipment and areas in the control of the landlord. Low and middle income tenants, even if they were interested in making repairs, would be unable to obtain any financing for major repairs since they have no long-term interest in the property.

Id. at 1078–79 (citations omitted).

240. Mortgage disclosure laws were ill-suited to prepare borrowers with little knowledge of sophisticated financial instruments to understand the terms of their mortgages. *See* Aaron Smith, Note, *A Suitability Standard for Mortgage Brokers: Developing a Common Law Theory*, 17 GEO. J. ON POVERTY L. & POL'Y 377, 389 (2010) ("The vast majority of consumers would likely be considered unsophisticated in the details of complex modern mortgages, with the possible exception of people who still get standard fixed rate mortgages. Modern circumstances demand that mortgage brokers not take advantage of this understandable reliance."). For example, some adjustable mortgage rates were pegged to the London Interbank Offered Rate (LIBOR), the floating rate at which banks borrow money from other banks on the London wholesale money market. *See* Alex M. Johnson, Jr., *Preventing a Return En-*

Moving forward, it is critical to recognize that a more robust body of laws is necessary to protect borrowers in the real world. The "reasonable ability to repay" standard embodied in Dodd-Frank requires that mortgage originators and brokers must ensure that a particular loan is appropriate for a particular borrower.[241] This is a logical and necessary step to ensure that the mortgage feeding frenzy fed by imbalances in the level of sophistication and knowledge between borrowers and lenders does not occur again. Admittedly, this would not protect any of the millions of borrowers presently underwater, but it might help prevent the type of predatory conduct that appears to have been so prevalent before the crisis.

4. Weakening Federal Preemption of State Consumer Protection Laws

Another important reform accomplished through Dodd-Frank is the partial rollback of efforts by several federal banking regulators to preempt state consumer protection laws. In the 1990s, the Office of Thrift Supervision (OTS) was authorized to promulgate regulations pursuant to the Home Owners' Loan Act (HOLA)[242] that could preempt any state laws affecting "the operations of federal savings associations."[243] The regulations could preempt any state law that imposed licensing requirements on OTS-regulated entities and attempted to regulate the interest rates such entities could charge.[244] In 2003, the OTS issued letters declaring that federal laws and regulations preempted state predatory lending laws as they affected OTS-regulated entities in a range of states.[245]

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gagement: Eliminating the Mortgage Purchasers' Status as a Holder-In-Due-Course: Properly Aligning Incentives Among the Parties, 37 PEPP. L. REV. 529, 572 nn.152–54 (2010) (providing relevant language present in Freddie Mac Single-Family Uniform Instrument for Multistate Initial Interest Adjustable Rate Notes). For a discussion of the connection between LIBOR and adjustable rate mortgages, see Bruce Yandle, *Lost Trust: The Real Cause of the Financial Meltdown*, 14 INDEP. REV. 341, 348 (2010); *see also* Olaf Clemens, *Accounting Discretion, Securitization, and the Subprime Crisis: An Accounting-based Analysis of the Subprime Market* 22 (Jan. 15, 2010), *available at* http://www.fma.org/NY/Papers/AccountingDiscretionSecuritizationandSubprimeCrisis.pdf.

241. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 1402–03, 124 Stat. 1376, 2038–41 (2010).

242. 12 U.S.C. §§ 1461–70 (2006).

243. 12 C.F.R. § 560.2(a) (2010).

244. *Id.* § 560.2(b).

245. Those states were: Georgia (*see* OFFICE OF THRIFT SUPERVISION, DEP'T OF THE TREASURY, P-2003-1, PREEMPTION OF GEORGIA FAIR LENDING ACT (2003), *available at* http://files.ots.treas.gov/56301.pdf); New York (*see* OFFICE OF THRIFT SUPERVISION, DEP'T OF THE TREASURY, P-2003-2, PREEMPTION OF NEW YORK PREDATORY

In January 2004, the Office of the Comptroller of the Currency (OCC) followed the lead of the OTS and issued its own regulations that preempted state laws that "obstruct, impair, or condition a national bank's ability to fully exercise its Federally authorized real estate lending powers . . . ."[246] This regulation preempted any state laws that related to such matters as the terms of mortgages, escrow account requirements for loans, loan-to-value ratios, and a host of other mortgage-related issues.[247] The OCC also strengthened its examination powers, declaring that it had the exclusive powers to visit, examine, and inspect the banks under its supervision.[248]

The question of regulatory preemption ultimately reached the Supreme Court in 2006, with the Court siding with the federal regulators, finding that "state regulators [could not] interfere with the 'business of banking' by subjecting [federally regulated] national banks or their OCC-licensed operating subsidiaries to [state] audits and surveillance under rival oversight regimes."[249] This decision of the Court, as one state attorney general pronounced, "took 50 sheriffs off the beat at a time when lending was becoming the Wild West."[250]

Even with a strong and independent consumer protection bureau, states should be authorized to regulate financial sector conduct within their borders. If the delinquency and other data discussed here shows anything, it is that predatory conduct occurred at different rates and with different virulence in different states. As such, states must have the tools at their disposal to regulate lending and other financial services when such services threaten their citizens' financial security.

Under Dodd-Frank, federal law as it relates to national banks will only preempt state law under certain pre-conditions. First, a state consumer law will be preempted if its application will discrimi-

LENDING LAW (2003), *available at* http://files.ots.treas.gov/56302.pdf); New Jersey (*see* OFFICE OF THRIFT SUPERVISION, DEP'T OF THE TREASURY, P-2003-5, PREEMPTION OF NEW JERSEY PREDATORY LENDING ACT (2003), *available at* http://files.ots.treas.gov/56305.pdf); and New Mexico (*see* OFFICE OF THRIFT SUPERVISION, DEP'T OF THE TREASURY, P-2003-6, PREEMPTION OF NEW MEXICO HOME LOAN PROTECTION ACT (2003), *available at* http://files.ots.treas.gov/56306.pdf).

246. 12 C.F.R. § 34.4(a) (2010).

247. *Id.*

248. *Id.* § 7.4000(a).

249. Watters v. Wachovia Bank, N.A., 550 U.S. 1, 21 (2007).

250. Jo Becker et al., *White House Philosophy Stoked Mortgage Bonfire*, N.Y. TIMES, Dec. 21, 2008, at A1 (quoting Roy Cooper, Att'y Gen. of N.C.).

nate against national banks in favor of state chartered banks.[251] Second, preemption will apply if the state law "prevents or significantly interferes with" the national bank's exercise of its charter powers.[252] In this way, the legislation returns federal preemption to its state prior to OCC and OTS preemption, consistent with the Supreme Court's decision in *Barnett Bank of Marion County, N.A. v. Nelson*.[253] Or, third, state law will be preempted as it applies to national banks if other federal laws expressly preempt the application of state laws to such national banks.[254] Thus, if a state law does not meet any of these criteria, state enforcement authorities can apply it to national banks. The law also exempts subsidiaries of national banks (unless those subsidiaries themselves are chartered as national banks) from the preemptive effect of Dodd-Frank.[255]

Curtailing the ability of federal regulators to preempt state laws will go a long way towards permitting state legislatures, and the state executive branch officials who enforce state laws, to adapt their laws and to provide oversight over their state's needs. Different markets call for different responses, as well as experimentation with different types of consumer protection regimes. States should be allowed to carry out consumer protection activities without facing the shielding effects of federal preemption unless important issues of federalism—like protecting federally chartered institutions from unfair competition from state-chartered institutions—are implicated by a particular state's practices towards national banks acting within its borders.

251. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1044(a), 124 Stat. 1376, 2015 (2010) (creating 12 U.S.C. § 5136C).

252. *Id.*

253. *See* 517 U.S. 25, 33 (1996).

254. Dodd-Frank Wall Street Reform and Consumer Protection Act § 1044(a). For an analysis of the preemption pre-conditions, see Linda Singer et al., *Breaking Down Financial Reform*, 14 J. CONSUMER & COM. L. 2, 10–11 (2010); *see also Barnett*, 517 U.S. at 31–33.

255. Dodd-Frank describes the application of preemption to subsidiaries of national banks as follows:

> Notwithstanding any provision of this title or section 24 of Federal Reserve Act (12 U.S.C. 371), a State consumer financial law shall apply to a subsidiary or affiliate of a national bank (other than a subsidiary or affiliate that is chartered as a national bank) to the same extent that the State consumer financial law applies to any person, corporation, or other entity subject to such State law.

Dodd-Frank Wall Street Reform and Consumer Protection Act § 1044(a).

B. The Community Reinvestment Modernization Act

After passage of the Dodd-Frank legislation, Congress considered addressing CRA reform. In March of 2009, Rep. Eddie Johnson introduced in the U.S. House of Representatives the Community Reinvestment Modernization Act of 2009 (CMRA).[256] The goals of the CMRA are to close the CRA's loopholes and to extend its coverage to a range of financial industry actors not currently covered by the CRA.[257] The changes proposed to the CRA are sweeping, and Congress is unlikely to adopt them without a serious clash over the purposes and goals of the CRA, as well as an airing of the accusations that it was to blame for the crisis. Indeed, Rep. Jeb Hensarling has introduced competing legislation that would repeal the CRA entirely.[258] While it is unlikely that CRA repeal could get through Congress or past a presidential veto, some form of CRA reform is possible, and the following is a description of the key elements of the CMRA.

The CMRA attempts to accomplish seven major changes to the CRA. First, it calls for the repeal of regulations enacted in the last decade that imposed a lighter CRA burden on mid-sized banks.[259] Second, it would overhaul the ratings process by adding to the range of ratings that can be assigned to institutions covered by the CRA (adding grades of "low satisfactory" and "high satisfactory"),[260] requiring the generation of a separate CRA grade for each financial institution's assessment area,[261] expanding the definition of CRA assessment area[262] and requiring regulators to downgrade banks found to have engaged in predatory lending and other unfair prac-

256. H.R. 1479, 111th Cong. (2009).

257. The CMRA has the following "purposes":

> (1) To enhance the availability of financial services to citizens of all economic circumstances and in all geographic areas.
>
> (2) To enhance the ability of financial institutions to meet the capital and credit needs, and needs for other banking and financial services of all citizens and communities, including and especially minority and low- and moderate-income communities and populations.
>
> (3) To ensure that community reinvestment keeps pace with developments in the financial industry and with the affiliation of banks, securities firms, and other financial service providers, as provided by the Gramm-Leach-Bliley Act.

Id. § 3.

258. Fair Access to Credit and Job Creation Act of 2010, H.R. 5038, 111th Cong. (2010).

259. H.R. 1479 § 101.

260. *Id.* § 103(a).

261. *Id.*

262. *Id.*

tices.[263] Third, it would require any financial institution receiving a failing CRA grade (i.e., "Low Satisfactory," "Needs to Improve," or "Substantial Noncompliance") in any assessment area to submit a corrective action plan to its regulator.[264] Fourth, it would expand the types of financial institutions covered by the CRA to include non-depository mortgage lenders,[265] insurance companies,[266] securities companies[267] and credit unions.[268] It would also make CRA coverage of affiliates of covered institutions mandatory.[269] Fifth, it would impose new reporting and disclosure requirements on covered institutions.[270] Sixth, it would make concern for communities of color an explicit purpose of the CRA, whereas now the CRA only addresses bank services to "low- and moderate-income communities" with no explicit mention of the race of those communities.[271] Seventh, it would enhance the regulators' ability to conduct public hearings on financial institution applications for which CRA review is appropriate.[272]

These changes are not only welcome, but are necessary if the CRA—perhaps the strongest federal legislation designed to lower barriers to credit for low- and moderate-income communities—is to serve its core purposes. Moreover, short of a progressive tax structure and funding for public education, the CRA serves as one of the few federal laws specifically designed to lower social distance, to the extent that such distance is created and strengthened by an entrenched financial system that remains resistant to overcoming a legacy of racial discrimination. As discussed above, the CRA's many loopholes, and its anachronistic focus on narrowly drawn assess-

263. *Id.* § 104(a).
264. *Id.* § 103(a).
265. *Id.* § 108(a), (b)(3).
266. *Id.* § 109(a).
267. *Id.* § 107(a).
268. *Id.* § 111.
269. *Id.* § 102, 110.
270. *See, e.g.*, H.R. 1479 § 105 (expanding Equal Credit Opportunity Act to include reporting requirements for small business lending); *see also id.* § 203 (requiring development of reporting methods for insurance companies).
271. *Id.* § 2(3).
272. *Id.* § 303. More recently, a bill was introduced in the House of Representatives, the American Community Investment Act of 2010, H.R. 6334, 111th Cong. (2010), which attempts to accomplish many of the same goals of the CRMA in a more streamlined fashion. *See* Press Release, Rep. Gutierrez et al., Rep. Gutierrez Initiates Effort to Modernize Community Reinvestment Act: In Introducing American Community Investment Reform Act of 2010 (Sept. 29, 2010), *available at* http://www.gutierrez.house.gov/index.php?option=com_content&task=view&id=617&Itemid=55.

ment areas and depository institutions, meant that it was ill-suited to prevent the rush of subprime lending in communities that the CRA was ostensibly designed to protect. In order to serve the CRA's purposes, and make it relevant to banking in the twenty-first century, the changes proposed through the CMRA seem wise and necessary.[273]

C. Social Capital, Social Distance, Regulatory Reform, and Financial Crises

Financial institutions that did not engage in risky lending or enter the market in exotic derivatives during the buildup to the crisis have weathered it much better than the large commercial and investment banks.[274] Without a massive infusion of Troubled Asset Relief Program (TARP) funds, many more banks would have certainly collapsed.[275] The faceless, nameless, opaque transactions that brought down some of the most venerable financial institutions were devoid of social capital—ties of trust and reciprocity that reduce the risk of non-cooperative or predatory conduct.

At the same time, financial transactions infused with social capital—the type of lending that occurred at community banks and other financial institutions that were "lower to the ground"—performed better than the innovators of high finance. One recent study of microlending revealed that increased contact between participants in meetings of borrowers decreased both social distance and default rates by participants in the program.[276] Is there a way to

273. For a further discussion of the CMRA and additional ways to strengthen the CRA, see Raymond H. Brescia, *A CRA for the 21st Century: Congress Considers the Community Reinvestment Modernization Act of 2009*, 28 BANKING & FIN. SERVICES POL'Y REP., Oct. 2009, at 1.

274. *See* Raymond H. Brescia, *Trust in the Shadows: Law, Behavior, and Financial Re-Regulation*, 57 BUFF. L. REV. 1361, 1419–22 (2009) (and citations contained therein).

275. *See* Donny Wise, *Rapid Reaction via TARP Diverts Collapse at the Cost of Accountability*, EXAMINER.COM (Apr. 11, 2010, 4:30 AM), http://www.examiner.com/consumer-and-banking-in-washington-dc/rapid-reaction-via-tarp-diverts-collapse-at-the-cost-of-accountability ("As the economic crisis spread rapidly in September 2008, the government intervention in the financial system via TARP was a necessity, and the quick action saved the economic and societal collapse of the United States.").

276. Benjamin Feigenberg et al., *Building Social Capital through Microfinance* 3–4 (Nat'l Bureau of Econ. Research, Working Paper No. 16018, 2010), *available at* http://www.nber.org/papers/w16018. Similarly, another study of microlending found that a high level of trust between borrower and lender improved repayment rates. Asif Dowla, *In Credit We Trust: Building Social Capital by Grameen Bank in Bangladesh*, 35 J. SOCIO-ECON. 102, 108 (2006). A study of domestic credit unions

take such lessons to scale and capture the benefits of social capital in financial transactions?

A grassroots movement is afoot that attempts to do just that. The "Move Your Money" campaign was hatched by Arianna Huffington and others in late 2009 as a way to bring community banking values back to retail banking.[277] This effort is designed to convince retail banking consumers to utilize the banking services of financial institutions with strong ties to local communities.[278] Using a risk assessment tool developed by Institutional Risk Analytics,[279] the Move Your Money Campaign claims that over 2 million participants, moving $5 billion in assets, have ended their relationship with their large banking institutions.[280] Institutional and governmental investors have also adopted similar tactics. Municipalities, universities, unions, and public pension funds have either pledged to invest and bank with community-based institutions or have attempted to exact compliance with demands for behavioral changes from the larger institutions, like improved performance in terms of modifying mortgages.[281]

found that longer-term credit union members had better repayment rates on micro-loans than new members. *See* Marva Williams, *Cooperative Credit: How Community Development Credit Unions are Meeting the Need for Affordable, Short-Term Credit*, WOODSTOCK INST., 17 (May 2007), http://www.economicintegrity.org/pdf/cooperativecredit_may2007_williams-1.pdf.

277. Arianna Huffington & Rob Johnson, *Move Your Money: A New Year's Resolution*, HUFFINGTON POST, Dec. 29, 2009, http://www.huffingtonpost.com/arianna-huffington/move-your-money-a-new-yea_b_406022.html. For a critique of the Move Your Money campaign, see Martha C. White, *Does Boycotting Big Banks Make Sense? No. (Sorry, Arianna)*, SLATE: THE BIG MONEY (Jan. 4, 2010), *available at* http://www.thebigmoney.com/articles/hey-wait-minute/2010/01/04/does-boycotting-big-banks-make-sense?page=full.

278. Huffington & Johnson, *supra* note 277 (The movement advocates that "[i]t's time for Americans to move their money out of these reckless behemoths . . . . [B]ig banks are the core of the problem. We need to return to the stable, reliable, people-oriented approach of America's community banks.").

279. *See Move Your Money, Special Report: Big Four Banks Deposits Change Survey*, INSTITUTIONAL RISK ANALYTICS, http://us1.irabankratings.com/MoveYourMoney/IRADeposits_MYM_TBTF.asp (last visited Dec. 29, 2010).

280. Dennis Santiago, *For Biggest Banks, Deposits Remain Sticky*, HUFFINGTON POST, May 10, 2010, http://www.huffingtonpost.com/dennis-santiago/for-biggest-banks-deposit_b_569655.html (dividing net deposit outflows for major banks by assumed average account value of $2,500).

281. *See, e.g.*, Steven Greenhouse, *New York Presses Banks on Foreclosures*, N.Y. TIMES, July 13, 2010, at B3, *available at* http://www.nytimes.com/2010/07/14/business/14foreclose.html (detailing efforts of elected official and union leaders to pressure banks to improve loan modification efforts); Steve Flynn, *A Proposal for New Thinking on University Endowments and Community Investment*, RESPONSIBLE ENDOWMENTS COALITION BLOG (July 20, 2010, 5:52 PM), http://www.endowment

Efforts to break up the large banks by putting asset caps on such banks—by, for example, pegging their size to no larger than a percentage of U.S. gross national product—failed during the creation of financial reform legislation.[282] Instead, a consumer movement—both individual and institutional—may stand a better chance than regulation of re-infusing financial transactions with elements of social capital, by driving the reform of institutions, both large and small, to take less risk, maintain better customer relations, reinvest in local communities and meet local priorities. Such efforts are well under way, yet it would be premature to attempt to gauge their success in meeting such goals.

V.
CONCLUSION

If we are to believe that a lack of trustworthiness and an excess of predatory conduct helped feed the subprime mortgage bonfire, it is essential to restore checks and balances to the financial system that would restrain such conduct and incentivize trustworthy behavior in mortgage lending and other financial practices. We also need to reduce social distance, both economic and racial. To do so would require both a greater enforcement of the laws on the books—the creation of the CFPB and the DOJ's recent announcement of the creation of a new fair lending unit are also helpful—as well as a strengthening of laws like the Community Reinvestment Act by closing loopholes that permitted predatory lenders to thrive.

We also have to recognize the role that law can play in fostering trustworthy conduct. Behavioral economists like Dan Ariely tell us that without rules, people cheat.[283] Members of the law and economics school, like Richard Posner, tell us that the microeconomic incentives in place in the lead up to the financial crisis helped to

ethics.org/news-media/archives/305 (urging investing university endowments with community banks).

282. *See Implications of the 'Volcker Rules' for Financial Stability: Hearings Before the S. Banking Comm.*, 111th Cong. 5 (2010) (testimony of Simon Johnson, Professor, MIT Sloan Sch. of Mgmt.), *available at* http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=98845464-f06e-4f20-b1bd-cbce9a87803c (opposing asset caps on banks pegged to GDP). The Brown-Kaufman amendment would have adopted such asset caps as part of Dodd-Frank, but the amendment failed. Tim Fernholz, *On the Death of Brown-Kaufman*, TAPPED: THE GROUP BLOG OF THE AM. PROSPECT (May 7, 2010, 4:16 PM), http://www.prospect.org/csnc/blogs/tapped_archive?base_name=on_the_death_of_brownkaufman&month=05&year=2010.

283. *See* DAN ARIELY, PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS 213 (revised ed. 2009).

encourage risky behavior and brought about the crisis.[284] The analysis presented in this Article suggests that an exploration of the role that greater social distance plays in decreasing trust and increasing predatory conduct deserves its place at the table in conversations about how to reform mortgage markets, and markets in general.

284. *See* POSNER, *supra* note 75, at 75–112.

APPENDIX A

Data Set 1:

	MEDIAN HOUSEHOLD INCOME	MEDIAN HOUSEHOLD INCOME BY RACE					
STATE	MHI by State (Thousands)	White	White Rank	Black	Black Rank	Latino	Latino Rank
Alabama	38,783	71,195	2	51,726	1	58,093	1
Alaska	59,393	61,616	7	49,486	2	55,909	2
Arizona	47,265	65,641	5	40,499	13	55,322	3
Arkansas	36,599	59,560	10	43,993	5	55,048	4
California	56,645	61,067	8	40,267	14	54,087	5
Colorado	52,015	47,970	28	0	51	45,899	6
Connecticut	63,422	55,225	15	43,027	6	45,392	7
Delaware	52,833	69,836	3	44,866	4	45,049	8
District of Columbia	51,847	56,379	12	33,151	24	43,877	9
Florida	45,495	60,415	9	40,709	11	43,805	10
Georgia	46,832	48,528	26	41,170	10	43,660	11
Hawaii	61,160	88,969	1	34,484	22	43,547	12
Idaho	42,865	47,749	30	32,554	25	40,510	13
Illinois	52,006	55,907	13	41,640	8	39,199	14
Indiana	45,394	46,691	35	23,986	46	38,776	15
Iowa	44,491	44,494	40	48,623	3	37,786	16
Kansas	45,478	53,936	19	33,563	23	37,692	17
Kentucky	39,372	35,454	51	21,554	50	37,631	18
Louisiana	39,337	47,412	31	27,140	38	37,439	19
Maine	43,439	49,566	23	41,198	9	37,288	20
Maryland	65,144	52,179	20	39,744	15	37,157	21
Massachusetts	59,963	55,724	14	30,120	29	36,850	22
Michigan	47,182	45,331	37	27,808	37	36,738	23
Minnesota	54,023	50,309	22	31,276	28	36,372	24
Mississippi	34,473	54,118	18	40,659	12	36,222	25
Missouri	42,841	67,852	4	41,648	7	36,217	26
Montana	40,627	57,021	11	37,107	18	36,147	27
Nebraska	45,474	40,521	49	26,595	40	36,098	28
Nevada	52,998	54,690	17	34,563	21	35,941	29
New Hampshire	59,683	45,222	38	27,017	39	35,789	30
New Jersey	64,470	47,036	33	29,293	31	35,744	31
New Mexico	40,629	46,525	36	28,423	35	35,639	32
New York	51,384	47,291	32	29,309	30	35,484	33
North Carolina	42,625	43,139	45	21,969	49	35,378	34
North Dakota	41,919	47,902	29	26,473	41	35,313	35
Ohio	44,532	50,794	21	26,161	42	34,332	36

Oklahoma	38,770	46,946	34	29,076	34	34,220	37
Oregon	46,230	43,731	42	38,006	17	33,789	38
Pennsylvania	46,259	49,207	24	32,159	26	33,354	39
Rhode Island	51,814	48,179	27	29,243	32	33,187	40
South Carolina	41,100	48,768	25	29,111	33	32,454	41
South Dakota	42,791	43,347	43	32,074	27	32,085	42
Tennessee	40,315	42,919	46	28,067	36	32,049	43
Texas	44,922	44,788	39	25,203	43	31,930	44
Utah	51,309	43,317	44	22,931	48	31,516	45
Vermont	47,665	43,915	41	35,941	19	31,343	46
Virginia	56,277	40,009	50	23,265	47	30,704	47
Washington	52,583	55,133	16	35,183	20	30,499	48
West Virginia	35,059	62,443	6	38,496	16	30,140	49
Wisconsin	48,772	41,741	47	24,119	45	29,838	50
Wyoming	47,423	41,604	48	24,365	44	27,165	51

Data Set 2:

	INCOME INEQUALITY		PERCENT OF STATE POPULATION: BLACK		TRUST	POVERTY
STATE	**Inequality Rate**	**Inequality Rank**	**% Black Pop.**	**% Black Pop. Rank**	**GSS: "Most people can be trusted"**	**Percentage of people in poverty**
Alabama	0.475	46	7.2	24	23%	16.6
Alaska	0.402	3	.	.	.	10.9
Arizona	0.45	29	37.3	48	47%	14.2
Arkansas	0.458	35	29.6	46	29%	17.3
California	0.475	42	26.2	43	43%	13.1
Colorado	0.438	28	31.5	47	46%	12
Connecticut	0.477	49	16.7	39	49%	8.3
Delaware	0.429	15	28.6	44	.	11.1
District of Columbia	0.549	51	.	.	.	19.6
Florida	0.47	43	3.2	13	37%	12.6
Georgia	0.461	38	21.2	42	38%	14.7
Hawaii	0.434	18	.	.	.	9.3
Idaho	0.427	6	7.3	25	.	12.6
Illinois	0.456	40	11.4	31	44%	12.3
Indiana	0.424	13	15.5	38	43%	12.7
Iowa	0.418	7	14.9	37	56%	11
Kansas	0.435	20	13.2	33	55%	12.4
Kentucky	0.468	35	14.8	36	32%	17
Louisiana	0.483	48	1.8	11	33%	19
Maine	0.434	10	19.4	40	.	12.9
Maryland	0.434	14	28.7	45	42%	7.8
Massachussetts	0.463	38	14.6	35	46%	9.9
Michigan	0.44	23	10.2	29	51%	13.5
Minnesota	0.426	11	6.0	23	63%	9.8
Mississippi	0.478	45	11.8	32	17%	21.1
Missouri	0.449	26	7.3	25	44%	13.6
Montana	0.436	9	8.7	27	64%	13.6
Nebraska	0.424	11	4.6	19	.	11.5
Nevada	0.436	15	20.4	41	.	10.3
New Hampshire	0.414	3	14.0	34	62%	8
New Jersey	0.46	33	3.2	13	41%	8.7
New Mexico	0.46	32	0.4	1	.	18.5
New York	0.499	50	11.3	30	40%	14.2
North Carolina	0.452	33	5.7	21	27%	14.7

North Dakota	0.429	15	9.2	28	67%	11.4
Ohio	0.441	26	5.5	20	41%	13.3
Oklahoma	0.455	35	3.6	16	39%	17
Oregon	0.438	23	0.8	5	55%	13.3
Pennsylvania	0.452	30	1.0	8	44%	12.1
Rhode Island	0.457	21	1.6	10	52%	11.1
South Carolina	0.454	40	5.8	22	34%	15.7
South Dakota	0.434	19	3.3	15	.	13.6
Tennessee	0.465	44	0.6	3	36%	16.2
Texas	0.47	47	1.0	8	33%	16.9
Utah	0.41	1	2.2	12	54%	10.6
Vermont	0.423	5	4.0	17	59%	10.3
Virginia	0.449	31	0.5	2	38%	9.6
Washington	0.436	22	4.4	18	46%	11.8
West Virginia	0.468	25	0.8	5	30%	17.3
Wisconsin	0.413	7	0.7	4	52%	11
Wyoming	0.428	2	0.9	7	60%	9.4

Data Set 3:

TABLE	**P-Value**
Table 6: Income Inequality and Delinquency Rates by State	0.011224
Table 7: Poverty Rate	0.800896
Table 8: Median Income by State	0.056502
Table 9: Median Income by Race	White: 0.061754
	Black: 0.048303
	Latino: 0.501179
Table 10: Trust and Delinquencies	0.070695
Table 11: Trust and Crime Rate Rank	0.000678
Table 12: Delinquency Rate Rank and Crime Rate Rank	0.097418
Table 13: Social Capital and Unemployment Data	<8 Unemployment Rate: 0.017062
	8-10 Unemployment Rate: 0.047184
	>10 Unemployment Rate: 0.752530
Table 15: Targeting the Black Middle Class	Overall: 0.0000583 or 5.83×10^{-5} State Level Inequality and Delinquencies: 0.011224 Percentage African American Population and Delinquencies: 0.039541 African American Median Income and Delinquencies: 0.048303