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Introduction

There is a neighborhood in South Bend, Indiana, a short distance from large, affluent homes and a major university. A school stands on the corner, yet no children play in the street. House after house is boarded up. Occasionally, through an open door, you can glimpse a bedroll on the floor, suggesting someone has claimed the house, at least for now. Newark, New Jersey – far away from South Bend – has similar blocks with jerry-rigged electrical wires strung to boarded-up homes next door to burnt-out husks of buildings. You probably have a neighborhood like this in your community. Scattered across America, they are the legacy of the great foreclosure crisis that began in 2008.

In *The Foreclosure Echo*, we examine the long-term consequences of this crisis through the eyes of our clients.[1] We are both law professors whose work includes supervising law students as they represent real people with real legal issues. The book includes historical and policy discussions, but it also recounts the stories of our clients, people who have experienced housing calamity firsthand. To really appreciate the upheaval our clients experienced – and continue to endure – readers need to follow the everyday lives of real people attempting to achieve stable housing arrangements for their families amid the chaos, both bureaucratic and personal.

Our clients are largely lower middle class, often the first in their families to have owned their own homes. They are black, white and Latino. They have worked hard at blue-, pink- or low-level white-collar jobs – at least until they were laid off, got sick or were scammed. Like many others, the bulk of their wealth was the equity in their homes. Many had mortgages, credit cards and car loans. In fact, immediately before the financial crisis, the poorest homeowners in America were highly leveraged, with

[1] Throughout the book, we will use the pronoun "we" or "our client" regardless of which one of us represented the client. All the narratives in this book are taken from real people, most of whom are our clients. Although we have permission to tell our clients' stories, we have opted to change many of their names to protect their privacy.

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debt-to-income ratios of nearly 80 percent. At the other end of the spectrum, wealthy homeowners had very little debt – around 7 percent of their income.[2] Their wealth was diversified in stocks, bonds and other savings in addition to homes. "While the poor had $4 of home equity for every $1 of other assets, the rich were exactly the opposite with $1 of home equity for $4 of every other asset."[3]

The financial crisis wiped out the wealth of low- to moderate-income homeowners and ended their quest for the American dream. As Nobel Laureate Robert Shiller posited in his recent address to the National Economics Society, to truly understand what happens in an economic crisis, we need to "replicate in ourselves as best we can the feelings" of the people who experienced it.[4] In order to do this, we need to know and understand their stories. This book tells those stories, but it also helps explain the importance of narratives in understanding what happens after a financial crisis.

The long-term consequences of the financial crisis are only beginning to emerge. Even as certain higher-income, predominantly white neighborhoods across the country have largely recovered, other communities continue to suffer, with no end in sight. Communities of color, originally targeted for the worst loans, remain in crisis. The ever-increasing wealth inequality in this country is one obvious result. This book introduces you to the people who bore the brunt of the crisis and illustrates how the governmental response protected the assets of the wealthy while neglecting a newly emerging middle class. This version of *A Tale of Two Cities* has also exacerbated patterns of resegregation, as displaced homeowners tend to move to poorer, more segregated neighborhoods after foreclosure.

Economists have only recently begun to explore how narratives can influence and, as some suggest, affect economic fluctuations. While we are lawyers, not economists, our clients and their experiences can add to that understanding. By retelling the story of the housing crisis from the perspective of our clients who experienced it, we hope to better understand what happened and suggest ways to improve the response to the next crisis. More importantly, we hope to provide evidence that the lingering effects of that crisis remain for real people, even while the economic indicators tell us the crisis has passed. Those lingering effects, or the "foreclosure echo," as we have named it, continue to feel like a crisis to the individuals and communities that have been left behind.[5]

[2] Atif Mian & Amir Sufi, House of Debt: How They (and You) Caused the Great Recession, and How We Can Prevent It from Happening Again 20 (2015).
[3] *Id.*
[4] Robert J. Shiller, *Narrative Economics*, Cowles Foundation, Discussion Paper No. 2069 (2017), https://ssrn.com/abstract=2896857.
[5] The phrase "foreclosure echo" was derived from an early article on the subject written. Judith Fox, *Foreclosure Echo: How Abandoned Foreclosures Are Re-Entering the Market through Debt Buyers*, 26 Loy. Consumer L. Rev. 25 (2013). It later became the theme of the National Consumer Law Center's annual mortgage conference entitled, "The Foreclosure Echo: Addressing the Ongoing Consequences of the Foreclosure Crisis," July 10, 2015.

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Prevailing narratives from previous financial crises, whether true or not, are also instructive. They drive not only the public's perceptions about the crisis but also, at times, the government's reaction to it. One of the most striking examples is the narrative of the bank runs of the Great Depression, so famously portrayed by Jimmy Stewart in *It's a Wonderful Life*. At the time, the government correctly determined that it had a responsibility to prevent such incidents in the future. In 1933, Congress passed the Glass-Steagall Act, which, among other things, created the Federal Deposit Insurance Corporation (FDIC). The FDIC insures deposits and thus removes the incentive to grab your money from the bank before it is gone. As added protection, the Federal Reserve was empowered to make low-interest loans to otherwise solvent banks to provide liquidity. These protections worked fairly well to shore up the banking industry. Between 1934 and 1980, only 243 banks failed.[6]

Despite all these efforts, 465 banks failed between 2008 and 2012.[7] Washington Mutual (WaMu) was one of the first and most public of these failures. Lines of people outside the bank brought back narratives of the Great Depression bank runs. In response, FDIC insurance on deposits was raised from $100,000, where it had been for nearly three decades, to $250,000.[8] In addition, the government took the unprecedented step of expanding deposit insurance to previously uninsured money market accounts for a year.[9] Economists have questioned the efficacy of these moves, but both are examples of how the response to the crisis of 2007–08 was driven not just by current realities but also by memories of previous crashes. Your bank deposits were never in real danger in 2008 – your house was.

Between the Great Depression of the 1930s and what is now called the Great Recession of 2007–09 was the Savings and Loan crisis of the 1980s. Three thousand banks or savings and loans failed, many more than had failed in any prior economic downturn. In fact, "[b]y 1994, one-sixth of federally insured depository institutions had either closed or required financial assistance, affecting 20% of the banking system's assets."[10] Why did an unprecedented number of savings and loan institutions and banks fail? In the years running up to the crisis, savings and loans and thrifts had moved away from their usual safe lending practices into riskier, higher-interest loans. A housing bubble developed, largely in the West and Southwest, and then it popped. The result was a crisis in the financial markets, but it was more localized than either the Great Depression or the recession that developed in 2008.[11]

6 The Fin. Crisis Inquiry Rep.: Final Rep. of the Nat'l Commission on the Causes of the Fin. and Econ. Crisis in the United States 36 (authorized ed. 2011).
7 Fed. Deposit Ins. Corp., Failed Ban List, https://www.fdic.gov/bank/individual/failed/banklist.html.
8 *Id.*
9 Shiller, *supra* note 4, at 44.
10 Fin. Crisis Inquiry Rep., *supra* note 6, at 36.
11 *Id.* at 35–36; *see generally* Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. Econ. Persp. 93 (2004).

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The savings and loan crisis helped create the belief that housing crises are both caused by and preceded by a housing bubble. It follows that where there has been no bubble, there will be no crisis. Ironically, prior to 2008, policymakers spent a lot of time arguing that there was no bubble and, therefore, would be no crisis. Shortly before his nomination as chairman of the Federal Reserve in 2005, Ben Bernanke famously testified that rising house prices "reflect strong economic fundamentals" and not a housing bubble.[12] But advocates on the ground, including both of us, were seeing a very different picture and issuing warnings.

The noted economists Atif Mian and Amir Sufi make a very convincing argument in *House of Debt* that housing bubbles alone do not create financial crises. The debt burdens our clients were taking on, along with the predatory loan products targeting them, were warning signs of a problem to come. These warnings were ignored. Ben Bernanke eventually acknowledged that a housing bubble had preceded the crisis but insisted regulators bore no responsibility for it or the crisis that followed. He may be at least half right. We can see that burgeoning consumer debt combined with the housing bubble to foment the crisis.[13] By relying on the narrative of a market and culture that no longer existed, policymakers missed the warning signs. That narrative persists with some policymakers, making it likely they will miss the next crisis as well.

These prevailing narratives, as economists have named them, have a great deal of influence on decision-makers. Many new such narratives have been developed during the more recent financial crisis that is the subject of this book. Two of the most popular depicted as villains the irresponsible homebuyers who bought bigger homes than they could afford or who tried to benefit from the crisis by strategically defaulting on their mortgages. Neither narrative is based on fact. The poor and working-class neighborhoods of cities like South Bend, Indiana, and Newark, New Jersey went from credit deserts to credit oceans in the years running up to the crisis. As Mian and Sufi point out, the banking industry was deliberately targeting these areas for mortgages, but not for any altruistic reason or to satisfy community investment obligations, as some have alleged.[14] They were fueling the securitization craze that will be discussed in more detail in Chapter 1 of this book. In a three-year period before the crisis, mortgages for new homes in zip codes with low credit scores grew by a remarkable "30 percent *per year*, compared to only 11 percent in high credit score areas."[15] Many naive buyers were pulled into the market by brokers and lenders bent on making a quick buck.[16]

Most of our clients did not lose their homes because they bought big and overly expensive properties. In fact, many of them did not buy properties at all. Instead,

[12] Neil Henderson, *Bernanke: There's No Housing Bubble to Go Bust*, WASH. POST, Oct. 27, 2005.
[13] Mian, *supra* note 2, at 76.
[14] *Id.* at 78–91.
[15] *Id.* at 77.
[16] *See*, RICHARD BITNER, CONFESSIONS OF A SUBPRIME LENDER: AN INSIDER'S TALE OF GREED, FRAUD AND IGNORANCE (2008).

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they were convinced by slick and often very aggressive mortgage brokers to refinance their existing properties, sometimes for more than they were worth. It was common at that time to refinance for 100 or even 110 percent of home value, based on the belief that property values would perpetually rise. During the height of the subprime boom, mortgage brokers were literally going door to door in working-class neighborhoods. The plight of Eleanor Stames, an elderly client of the Notre Dame Clinical Law Center, was not uncommon. A broker knocked on her door, telling her he had "inspected her roof," which needed to be repaired. She was advised to take out a home equity loan. Initially, she refused, but he persisted. At one point, he stood on her porch, threatening her on his cell phone: "I know you are in there," and "You had better let me in." Eventually, she agreed to refinance her mortgage. The new loan was supposed to pay off her credit cards and give her money to fix the roof. Although she did receive the money to fix the roof – which arguably did not need fixing – the broker never paid off the credit cards. Instead, he pocketed the money and left town. Ms. Stames did not discover this until the credit card company began dunning her for unpaid bills.

Another elderly client of the clinic was in the process of moving to an assisted living facility when a mortgage broker drove her to his office to refinance her home, pulling $10,000 in equity out of the property. She was so obviously senile at the time that she kept asking anyone she encountered, included the judge in the resulting legal case, "Are you the dentist? I don't like dentists." Proving she was not competent to make the loan was easy; returning her money was not. As in the previous case, the money had disappeared along with the broker. The Notre Dame Clinical Law Center was able to rescind this obviously illegal loan, but the money was never recovered.

The Seton Hall Law Center for Social Justice represented many such clients in the greater Newark area. Some were victims of foreclosure rescue scams, which preyed on unwitting homeowners in foreclosure. The masterminds and their coconspirators – prominently including subprime mortgage brokers and appraisers – offered to take title to the home for a year or two while the homeowners improved their credit scores. The scammers explained that this would allow the borrowers to then refinance and retake title. In the meantime, the homeowners would pay "rent" to the fraudsters, who said they would use the money to make payments on a new mortgage. Of course, these schemes never worked out and the perpetrators always disappeared, leaving the original homeowners worse off than ever. One such client, Jim Colson, was even driven out of his home by five hammer-wielding thugs, associates of the mortgage broker. He remained homeless for some time thereafter, but we kept litigating for six years and eventually recovered a sizeable settlement. The primary defendant was an insurance company involved in securitizing mortgages, including the one taken out by the scammer's straw man. There were red flags indicating fraud that the company ignored. Eventually, the insurance company filed bankruptcy and the court discovered the debtor had defrauded thousands of

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elderly people who had invested their life savings in it.[17] After his case was resolved, Mr. Colson and his children were able to get back on their feet – his daughter even went to law school.

These are just a few examples of the millions of people unwittingly drawn into this crisis. Neither of the two women represented by Notre Dame lost their homes, but others were not so fortunate. Still, the purpose of this book is not to retell stories from the buildup to the crisis. Instead, we are telling the stories of those left behind after the government declared the recession over. Chapter 1 will provide some necessary background information about the boom in predatory and subprime lending that victimized moderate- and low-income homeowners and prospective homebuyers. To add perspective to the discussion, however, one must review the history of the government's role in and influence on housing markets.

HISTORICAL BACKGROUND OF HOUSING POLICY

Homeownership is built into the American psyche. President Franklin D. Roosevelt identified "the right to decent housing" as part of his Economic Bill of Rights.[18] For much of our history, however, only wealthy white men owned property. According to the United States Census Bureau, in 1900, fewer than half of all Americans owned their own homes. Homeownership peaked in 2005, right at the height of the subprime mortgage frenzy, at just under 70 percent. By the end of 2015, it had fallen to just under 64 percent, a number last seen in the 1980s. The numbers for African-American and Hispanic homeowners are much lower and fell much further. The rates of homeownership for these groups were just under 50 percent at the height of the bubble and have now fallen into the low 40s.[19]

As noted by Mechele Dickerson in her incisive book *Homeownership and America's Financial Underclass*, our culture has been saturated with the myth of the Happy Homeowner who has realized the promise of America. This narrative connected homeownership to the American dream, and made non-homeowners feel left behind.[20] As a country, we have come to believe that homeowners are more stable, and homes provide economic stability.[21] As a result, government policies have been developed to assist and encourage homeownership. While that is not

[17] *See*, Bert Caldwell, *'Loan to Own' Part of Met's Legacy*, THE SPOKESMAN-REV. (Feb. 17, 2005), http://www.spokesman.com/stories/2005/feb/17/loan-to-own-part-of-mets-legacy.

[18] UShistory.org, Economic Bill of Rights, http://www.ushistory.org/documents/economic_bill_of_rights.htm.

[19] U.S. CENSUS BUREAU, QUARTERLY RESIDENTIAL VACANCY AND HOMEOWNERSHIP, SECOND QUARTER 2018 (July 26, 2018), https://www.census.gov/housing/hvs/files/qtr416/hown416.png.

[20] A. Mechele Dickerson, HOMEOWNERSHIP AND AMERICA'S FINANCIAL UNDERCLASS (2014); *see also* Mechele Dickerson, *The Myth of Homeownership and Why Homeownership Is Not Always a Good Thing*, 84 IND. L. J. 189, 190 (2009).

[21] *Id.* at 190–91.

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necessarily an imprudent policy, it did contribute to changes in the market, some of which have had unintended consequences.

Responses to the housing crisis of the late 1920s and 1930s formed the bedrock of United States housing policy for decades to come. Home loans before the Great Depression were very different than the loans available in the subprime boom of the early 2000s. The loans of the 1920s and 1930s were short term – usually less than ten years – and had variable interest rates. Loans were rarely given for more than 50 percent of a home's value. When they came due – or when borrowers experienced financial strain – they were often refinanced or renegotiated. The Great Depression changed all that. Home prices fell drastically, turning these once-safe loans into unsustainable liabilities. Homeowners found themselves owing more than their homes were worth and unable to refinance. As many as 250,000 foreclosures occurred per year between 1931 and 1935.[22] In the spring of 1933, up to 1,000 foreclosures were occurring per day.[23]

Across America, homeless people began building shantytowns, later known as Hoovervilles, in reference to then-President Hoover. After Franklin Roosevelt was elected, his administration moved quickly to respond to the high number of foreclosures and the resulting homelessness crisis by creating the Home Owners' Loan Corporation (HOLC).[24] The corporation purchased and refinanced defaulted mortgage loans as well as offering loans to homeowners who had been foreclosed upon. During its short tenure, the HOLC provided over a million mortgages to homeowners.[25] This model became the template for future governmental intervention including during the foreclosure crisis that is the subject of this book, with one significant difference: HOLC mortgages allowed principal reductions, something that was opposed at all levels of the government during the most recent crisis. We will discuss the implication of this decision at length throughout the book. HOLC not only set the narrative for interventions for distressed mortgages, it also changed the nature of the mortgage instrument itself. HOLC mortgages were fully amortized, fixed-rate, twenty-year loans as opposed to the shorter-term, non-amortizing loans they replaced. HOLC loans thus became the model for future mortgage lending until the subprime boom of the 2000s.[26]

Unfortunately, HOLC is also credited with creating the practice of redlining around African-American neighborhoods, a legacy that continues to afflict us today and is directly linked, decades later, to the crumbling communities we discuss herein. The highly descriptive term "redlining" refers to the lending industry's

[22] Richard K. Green & Susan M. Wachter, *The American Mortgage in Historical and International Context*, 19 J. Econ. Persp. 93, 94(2004).
[23] Amy E. Hillier, *Redlining and the Home Owners' Loan Corporation*, 29 J. Urb. Hist. 394, 416, note 1 (2009).
[24] *Id.* at 394.
[25] Green, *supra* note 22, at 94.
[26] Green, *supra* note 22, at 95.

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refusal to provide mortgage loans to minorities, predominately African Americans. HOLC created the infamous color-coded maps that birthed the term "redlining" by coloring African-American neighborhoods red.[27]

After addressing the immediate need to stem foreclosures in the 1930s, the government moved to shore up mortgage markets and provide a means for Americans to realize the American dream of homeownership that Roosevelt had envisioned. The Federal Housing Administration (FHA) was created in 1936 to provide insurance backing for mortgage loans, thereby encouraging financial institutions to lend to prospective homeowners. FHA charges homeowners a small insurance premium payment in addition to the loan to provide this insurance. As we will discuss later, these premiums would become a problem for homeowners in the aftermath of the latest crisis.[28]

Having encouraged home lending, the government now needed to create a market for these loans to allow banks to continue lending beyond their immediate capital reserves. The Federal National Mortgage Association (Fannie Mae) was created in 1938 to fuel mortgage lending by developing the secondary market in mortgages. Now, a remote investor could readily purchase and trade in mortgages. Fannie Mae provided a cushion for bankers to comfortably offer longer-term mortgages in what was a relatively calm time for mortgage lending.

After World War II, things changed once again. The Servicemen's Readjustment Act of 1944, more commonly known as the Veteran's Bill of Rights, guaranteed returning soldiers an education and a home loan. The Veterans Administration (VA) loan was born.[29] A new American middle class followed. Returning vets, largely subsidized by low down payments offered with VA loans, helped stimulate a housing boom. "Vet villages," as they were often called, sprang up across America. Unfortunately, not all returning vets were able to avail themselves of these benefits. African-American veterans returned to discover that no one would sell a home to them. Racial covenants – clauses in deeds that prohibited sales to African Americans and sometimes Jews, and other race-based lending practices – locked racial and ethnic minorities out of the American dream of homeownership. Governmental policies also suppressed lending in minority neighborhoods.[30] The history of racial discrimination plays a significant role in the run up to our recent foreclosure crisis, a topic we will return to in a moment.

The FHA used this period of expanding ownership to further standardize the mortgage, extending terms out to thirty years. The secondary market for mortgages was further incentivized by the creation of the Mortgage Guarantee Insurance

27 Richard Rothstein, The Color of Law: A Forgotten History of How Our Government Segregated America 64 (2017); *but see* Hillier, supra note 23, whose research disputes HOLC's responsibility for redlining.

28 Green, *supra* note 22, at 96.

29 *Id.*

30 For a history of discriminatory governmental housing policies, *see*, Rothstein, *supra* note 27.

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Corporation, which gave mortgage insurance guarantees outside of the strict FHA lending limits. To avail themselves of these insurance programs, lenders needed to standardize their products and their forms. The conventional American mortgage – the thirty-year, fixed-rate, fully amortized mortgage – would dominate the market for the next few decades.[31]

During this period, an investor in mortgage bonds could expect a healthy return of 5 to 6 percent. Treasury bonds, in contrast, paid only about 4 percent. Naturally, money flowed into the mortgage markets. When the rate on Treasury bonds increased, money began to flow out. The government sought to stimulate the mortgage markets again by splitting the Federal National Mortgage Association into the Government National Mortgage Association (Ginnie Mae) and Fannie Mae, which was now a private corporation. Ginnie Mae provided insurance and backing for FHA loans, while Fannie Mae provided backing for private mortgage loans made by banks. Freddie Mac, also private, was created several years later to insure loans made by the savings and loan industry.[32] These three – Ginnie Mae, Fannie Mae and Freddie Mac – are known as the GSEs, or Government Sponsored Entities. In 1970, Ginnie Mae became the first of the three to bundle loans into securitized loan pools, selling interests to investors.[33] Securitization, discussed at length in Chapter 1, is the process of putting hundreds or thousands of individual loans into a large pool, and then subdividing interests in the pool of loans into various grades of investment securities. Investors profit by receiving a stream of income each month from mortgage payments made by borrowers. Fannie Mae and Freddie Mac would play an important role in the foreclosure crisis to come, but securitization would play a larger one.

At first, only the GSEs securitized their loans. Private securitization began to develop in the period immediately before the savings and loan crisis of the early 1980s. As previously mentioned, this crisis caused a great number of financial institutions to fail. After the 1980s crisis, the federal government had a major problem to solve, having been left with "$402 billion in loans and real estate" from these failed institutions.[34] The Resolution Trust Corporation (RTC) was created to allow the government to sell these loans. Fannie Mae and Freddie Mac were able to buy a portion of them, but most did not meet their standards. Unable to sell them to the GSEs, the RTC instead securitized them, expanding the securitized mortgage market by some $25 billion. The marriage of subprime loan origination and private securitization had occurred, ironically, at the hand of the US government.[35]

[31] Green, *supra* note 22, at 99.
[32] Green, *supra* note 22, at 97–8.
[33] Judith Fox, *The Future of Foreclosure Law in the Wake of the Great Housing Crisis of 2007–2014*, 54 Washburn L. J. 496, 489–526 (2015).
[34] Fin. Crisis Inquiry Rep., *supra* note 6, at 68.
[35] *Id.* at 69–70.

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The negative impact of these emerging loan products and their subsequent private securitization will be a recurring theme throughout this book.

Securitization works well when people are able to make payments, but a brief history of the underlying loans begins to explain some of the problems that can occur when homeowners are unable to pay. As mentioned, prior to the Great Depression, a mortgage loan was generally of short duration. It was not uncommon for it to be renegotiated or refinanced at the end of that short term, because a large balloon (or lump-sum) payment remained. These negotiations also took place if a loan went into default. Prior to securitization, banks held their loans in their portfolio, so it was in their best interest to negotiate to continue to be paid after a loan defaulted. Selling a home in foreclosure virtually always results in further loss; holding and owning the property is an even bigger headache.

Once securitization became the norm, however, the situation changed dramatically. The originating mortgage lender had sold the loan to the securitized pool. It no longer had anything to lose if the loan failed. Renegotiating the loan was difficult due to the many parties and interests involved, the details of which we will discuss later in the book. The servicer of the loan – the entity taking payments – had no incentive to spend the time and money necessary to renegotiate. It was and is easier to simply foreclose. Or is it? The industry was never created with foreclosure in mind, and servicers lacked the expertise to do it right. The previous framework really did not provide much room for a homeowner to challenge a foreclosure. Securitization changed all that.

Unfortunately, the issues do not get any less complicated after foreclosure. When a lender sells a property at a foreclosure sale, the property generally sells for far less than the market value, resulting essentially in a fire sale. This is even more pronounced when many, many foreclosure sales are happening at once, as occurred in the financial crisis of 2008 and the Great Depression before it. When a property is sold, the proceeds are used to repay the mortgage debt. If the debt is larger than the selling price of the property, the homeowner is left with a "deficiency," a personal obligation that must be paid out of other assets or earnings if it is reduced to a judgment. During the Great Depression, policymakers became very concerned about the rise in foreclosures that was depressing sales prices and, as a result, dramatically increasing deficiencies.[36]

States reacted with a number of measures to stem the tide of foreclosures. The first was the foreclosure moratorium. California was an early adopter of this solution.[37] Many states enacted similar legislation that delayed foreclosures in ways ranging from extensions of the redemption period to delays in trials and sales. During the recent financial crisis, senators, congressmen and citizens called for a

[36] *See*, note, *Mortgage Relief during the Depression*, 47 Harvard L. Rev. 299 (1933).

[37] Stefan A. Riesenfeld, *California Legislation Curbing Deficiency Judgment*, 48 Cal. L. Rev. 705, 706 (1960).

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