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FORECLOSING ON THE FREE MARKET

How to Remedy the Subprime Catastrophe

IT'S NOW OFFICIAL. IN JANUARY 2008, THE AMERICAN DIALECT SOCIETY SELECTED “subprime” as 2007’s Word of the Year. “Everyone is talking about subprime,” said Wayne Glowka, a society spokesman. “It’s affecting all kinds of people in all kinds of places.”¹

The word is likely to gain even more currency in the next few years with the accelerating number of foreclosures creating chaos in the housing and stock markets, the banking industry, and the global money markets, triggering skyrocketing consumer debt, tight credit, massive lay-offs, neighborhoods in decline, serious fiscal woes for states and cities, and families and neighborhoods upended by the turmoil.

Business leaders, activist groups, and politicians are calling for our government to do something before the situation worsens. The

Bush administration proposed a bail-out for big Wall Street firms, but as of this writing (May 2008) has done little for homeowners except asking banks to voluntarily restructure troubled loans. The subprime crisis has been a hot-button issue during the 2008 presidential campaign. The Republican candidates were conspicuously silent, while the Democrats offered reasonable ideas for coping with the symptoms (especially regarding homeowners facing foreclosure), but no major candidate proposed the sweeping reforms needed to address the root causes—four pillars of which are outlined below.

Make no mistake—it *is* a crisis. More than seven million borrowers now hold subprime loans, according to the Center for Responsible Lending (CRL). Most of them involved adjustable-rate mortgages (ARMs) that include an initial low interest rate that quickly “balloons” to a higher rate. The Federal Reserve reported that 2.1 percent of residential mortgage loans held by banks were delinquent at the end of 2006.

In 2007, 405,000 households lost their homes, an increase of 51 percent over 2006. CRL projects that two million families are likely to lose their homes in the next few years. More than 80 mostly subprime mortgage lenders went bankrupt by the end of 2007. Regulators anticipate that between 100 and 200 banks will fail over the next two years.²

But it isn't just borrowers and lenders who are losing. Home prices dropped by over 12 percent during a 12 month period beginning in February 2007. A Congressional committee projected a loss of \$71 billion in housing wealth as a result of the mortgage meltdown. The U.S. Conference of Mayors projected that ten states alone would lose \$6.6 billion in local tax revenue.³

This mortgage crisis was preventable. Like most economic problems, it was due to corporate greed. Top executives at major banks, mortgage companies, and rating agencies saw an opportunity to increase corporate income and their own compensation by engaging in risky practices. In the short term, their personal compensation was not connected to corporate performance, so they could get away with irresponsible behavior. Eventually, however, these perverse incentives caught up with them. Several CEOs—Countrywide's Angelo Mazilo, Citicorp's Charles

Prince, and Merrill Lynch's Stanley O'Neill—were forced out or faced criminal investigations, but not before their firms suffered huge losses. Indeed, they put the entire financial system in jeopardy.⁴

Government is necessary to make business act responsibly. Without it, capitalism becomes anarchy. In the case of the financial industry, government failed to do its job, for two reasons—ideology and influence-peddling. The federal government was dominated by people who didn't believe in the regulation of business. Rather, they preferred the burdens of economic change to fall on individuals and families—what Hacker terms “the great risk shift.”⁵ In addition, the financial services industry—utilizing campaign contributions and lobbyists—wielded influence to weaken regulations and oversight. While federal regulators looked the other way, banks engaged in an orgy of risky loans and speculative investments. Every aspect of the financial industry was so short-sighted and greedy that they didn't see the train wreck coming around the corner.

IT STARTED WITH DEREGULATION

AT THE HEART OF THE CRISIS ARE THE CONSERVATIVE free-market ideologists whose views have shaped public policy since the 1980s, and who dominated the Bush administration. To them, government regulation is a misguided interference with the free market. In 2000, Edward Gramlich, a Federal Reserve Board member, urged Federal Reserve Chair Alan Greenspan to crack down on subprime lending by increasing oversight, but his warnings fell on deaf ears.⁶

By the early 1980s, the industry used its political clout to push back against govern-

ment regulation. In 1980, Congress adopted the Depository Institutions Deregulatory and Monetary Control Act, which eliminated interest-rate caps and made subprime lending more feasible for lenders. The savings and loan institutions (S&Ls) balked at constraints

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on their ability to compete with conventional banks engaged in commercial lending. They got Congress—Democrats and Republicans alike—to change the rules, allowing S&Ls to begin a decade-long orgy of real-estate speculation, mismanagement, and fraud.

The deregulation of banking led to merger mania, with banks and S&Ls gobbling each other up and making loans to finance shopping malls, golf courses, office buildings, and condo projects that had no financial logic other than a quick profit. When the dust settled in the late 1980s, about a thousand S&Ls and banks—including Lincoln Savings—had gone under, billions of dollars of commercial loans were useless, and the federal government was left to bail out depositors whose money the speculators had looted to the tune of about \$125 billion. The icing on the cake was the Gramm-Leach-Bliley Act of 1999, which tore down the remaining legal barriers

to combining commercial banking, investment banking, and insurance under one corporate roof.

The industry consolidated. Between 1984 and 2004, the number of FDIC-regulated banks declined from 14,392 to 7,511. The proportion of industry assets held by the ten largest banks increased from 21 percent in 1960 to 60 percent in 2005.⁷

The stable neighborhood S&L became a thing of the past. Banks, insurance companies, credit card firms, and other money-lenders became part of a giant financial services industry, while Washington walked away from its responsibility to protect consumers with regulations and enforcement. Into this vacuum stepped banks, mortgage lenders, and scam artists, looking for ways to make big profits from consumers desperate for the American Dream of homeownership. They invented new “loan products” that put borrowers at risk. Thus was born the subprime market.

Wall Street financed many of these mortgages by purchasing loans from originators, packaging them into mortgage-backed securities and selling them to investors who stood to make substantial profits as long as home values kept rising and borrowers paid their mortgages. Because originators sold most of these mortgages, they were less concerned with borrowers' ability to repay than with access to investors to whom they could sell. In effect, the interests of borrowers and lenders were no longer aligned; underwriting standards became much looser (that is loans were made to borrowers who could not afford them). Everyone profited until the housing bubble burst and loans starting “nonperforming.”

SURGING INEQUALITY AND PERSISTENT SEGREGATION: INCUBATOR FOR THE MORTGAGE MELTDOWN

THE MORTGAGE CRISIS IS BEST UNDERSTOOD IN the context of rising inequality and persistent racial and economic segregation. America is experiencing a new Gilded Age—a frenzy of corporate mergers, widening economic disparities, and deteriorating social conditions. It now has the biggest concentration of income and wealth since 1928. Under the Bush administration, the incomes of most Americans fell, but the average income of top wage earners (those above the 95th percentile) increased from \$324,427 in 2001 to \$385,805 in 2006. Wealth has long been much more unequally distributed than income; that inequality has recently increased.

The American Dream—the ability to buy a home, pay for college tuition and health insurance, take an annual vacation, and save for retirement—has become increasingly elusive. American workers face declining job security. The cost of food, health care, and other necessities is rising faster than incomes. Between 2000 and 2006, for example, the median worker's weekly earnings increased by 0.7 percent, while the cost of a typical home grew by 80.6 percent.⁸ A growing number of families are in debt.⁹

Economic and racial inequality is also reflected by where people live. Between 1970 and 2000, the number of high poverty census tracts (where 40 percent or more residents are poor) grew from 1,177 to 2,510. The number of people in those tracts grew from 4.1 million

to 7.9 million.^{10,11} The isolation of rich and poor families is also reflected by the declining number of middle-income communities. Between 1970 and 2000, the number of middle-income neighborhoods (census tracts where median family income is between 80 percent and 120 percent of that for the metropolitan area) dropped from 58 percent to 41 percent of all neighborhoods. More than half of lower-income families lived in middle-income neighborhoods in 1970; only 37 percent of such families did so in 2000. The share of low-income families in low-income areas grew from 36 percent to 48 percent.¹²

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Longstanding patterns of racial segregation persist, the result of decades of discrimination by banks, real estate agents, homebuilders, and landlords. Few blacks live in predominantly white neighborhoods. Middle-income blacks are almost as segregated from whites as lower-income blacks. Poor black families are much more likely than poor whites to live in high-poverty neighborhoods. The median census tract income for the typical black household in 1990 was \$27,808 compared to \$45,486 for whites. A similar pattern exists for Latinos.¹³

UNEVEN DISTRIBUTION OF FINANCIAL SERVICES

THese patterns have adverse consequences. Residents of low-income and minority communities live the greatest distance from areas of major job growth. They live in areas with fewer health care services and physicians, lower quality public schools, fewer retail services such as supermarkets and pharmacies, higher prices, and poorer air quality.¹⁴

Class, race, and geography compound the uneven distribution of financial services and access to credit. Some of these disparities are visible—such as the concentration of such “fringe bankers” as check-cashers, payday lenders, pawnshops, and others located in low-income and predominantly minority urban communities. Some disparities are less obvious—such as the kinds of loans targeted to low-income and minority residents who live in these neighborhoods.

In fact, a two-tiered system of financial services has emerged, one featuring conventional products distributed by banks and savings institutions primarily for middle- and upper-income, disproportionately white suburban markets and the other featuring high-priced, often predatory products, offered by “fringe” lenders as well as mainstream banks to borrowers in disadvantaged neighborhoods. In addition to what was formerly a conventional fixed-rate 30 year loan, in recent years there have been many options including interest only, payment optional, variable rate, and many other types of loans.¹⁵ This two-tiered system is the result, in part, of the failure of government to adequately regulate the evolving financial services industry.¹⁶

The mortgage meltdown is the result of the

dramatic growth in subprime lending and the wave of predatory lending. The media has typically confused these two phenomena.

Responsible subprime lending can help families who would otherwise be considered too risky for a conventional loan to become homeowners. These include middle-class families who have accumulated too much debt and low-income working families who want to buy a home in what was an inflated housing market. These loans have higher interest rates and other fees to compensate lenders for the increased risk posed by such borrowers. But the costs are not excessive.

Predatory lending involves an array of abusive practices, targeting those least likely to be able to repay. Predatory loans typically charge excessive fees relative to the risk involved, are aggressively marketed to unsophisticated buyers, and are frequently unaffordable to the borrowers, often resulting in default and foreclosure. Predatory loans have some or all of the following characteristics: interest rates and fees that far exceed the risk posed by the borrower; loans with low initial “teaser” rates that adjust rapidly upward within two or three years and quickly become unaffordable for borrowers; high pre-payment penalties that make it difficult or impossible for borrowers to refinance when interest rates decline, trapping borrowers in unaffordable loans; loans based on the value of the property with little regard for the borrower’s income and, therefore, ability to repay; loan flipping whereby a loan is frequently refinanced, generating fees for the lender but no financial benefit for the borrower; and negative amortization whereby the loan balance increases as borrowers make payments that are sufficient to cover only a portion of the interest but none of the principal that is due.¹⁷ Borrow-

ers face hidden fees masked by confusing terms such as “discount points,” erroneously suggesting that the fees will lower the interest rates.

Banks were so eager to profit on these loans that they often failed to require the documentation needed to evaluate the risks, sometimes not even requiring borrowers to report their income or failing to verify it when this information was provided.

Many borrowers who were eligible for conventional fixed-rate loans got snookered into taking subprime loans. Other borrowers were talked into taking loans whose terms they barely understood because the documents were confusing. In many cases, lenders simply lied about the costs of the loans and whether borrowers could really afford them.

Only a decade ago, subprime loans were rare. But, starting in the mid-1990s, led by the Household Finance Corporation, subprime lending began surging. Between 1994 and 2005, the annual dollar volume of such loans grew from \$35 billion to more than \$600 billion. They comprised 8.6 percent of all mortgages in 2001, soaring to 20.1 percent by 2006. Since 2004, more than 90 percent of subprime mortgages came with exploding adjustable rates.¹⁸

By 2005, the nation’s homeownership rate reached a record level of 69.1 percent. But the argument that subprime lending increased homeownership is misleading. Most subprime loans are for *refinancing* rather than purchase, and the number of families losing their homes as a result of default and foreclosure on these loans, which are often predatory, far exceeds the number who became homeowners. The CRL reported that between 1998 and 2006, approximately 1.4 million first-time homebuyers

purchased their homes with a subprime loan but projected that 2.2 million borrowers who took out subprime loans have or will lose their homes as a result of foreclosure.¹⁹ By 2006, the homeownership rate was declining as a result of the spiralling wave of foreclosures; the rate had fallen to 67.5 percent by the first quarter of 2008.²⁰

Federal Reserve Board researchers found that in 2006, 53.7 percent of blacks, 46.6 percent of Hispanics, and 17.7 percent of whites received high priced loans. In minority areas, 46.6 percent obtained high-priced loans compared to 21.7 percent in white areas.²¹ Given current levels of economic and racial segregation, and the prevalence of “fringe” lenders in poor neighborhoods, it isn’t surprising that foreclosures have been concentrated in low-income and minority areas, although they have spread to working-class areas and even some affluent areas, such as Greenwich, Connecticut.²²

The costs are severe. Families can lose their homes and their life savings that went into purchasing the home. The costs are not restricted

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to unfortunate borrowers. However, many spill over into the neighborhood and metropolitan area. Houses become vacant, deteriorate into eyesores, and detract from the feeling of neighborhood well-being. Vacant houses attract

crime and make it more difficult for neighbors to purchase homeowner insurance. Property values, and thus local property-tax revenues, plummet.²³ A number of cities, including Baltimore and Cleveland, have recently sued lenders, contending that their practices discrimi-

Vacant houses deteriorate into eyesores, attracting crime and making it more difficult for neighbors to purchase homeowner insurance.

nated against black borrowers and led to a wave of foreclosures that has reduced city tax revenues and increased municipal costs.²⁴

The consequences are harshest in depressed communities, particularly the Gulf Coast and industrial Midwest. Subprime foreclosure rates in the fourth quarter of 2006 ranged from less than three percent in Washington, DC, Maryland, and Virginia, to over seven percent in Mississippi and over nine percent in Indiana, Michigan, and Ohio.²⁵ The weak housing market, lay-offs in the financial industry, and the reluctance of lenders to make loans are careening the nation into a recession.²⁶

Not all subprime borrowers are innocent victims. Some were speculators, seeking to profit from the real estate housing bubble with their eyes wide open. They expected to rent their houses or quickly flip them to another buyer in a rising housing market. Others were simply living dangerously above their means, taking on too much debt and occupying houses

that, by any reasonable standard, they couldn't really afford. But it would be a mistake to place the primary blame on families who were seeking shelter in what was becoming a financial storm.

WHO IS RESPONSIBLE?

WHO IS RESPONSIBLE FOR THE MORTGAGE meltdown? In addition to the large-scale economic and social forces—rising inequality, widening economic segregation, persistent racial segregation, stagnant wages, and rising home prices—there are also the key players that have played a role in this economic tsunami.

First, and at the bottom rung of the industry ladder, are the private mortgage brokers and bank salespeople who hound vulnerable families for months, soliciting and encouraging them to take out a loan to buy a house or to refinance. There are also independent mortgage brokers who operate in the netherworld of the lending industry, earning fees for bringing borrowers to lenders even if borrowers could not always afford the loans.

These street hustlers earned fees for bringing borrowers to lenders—the larger the mortgage, the larger the fee. They were often in cahoots with real estate appraisers, who inflated the value of homes (on paper) to make the loans look reasonable.

Second, big mortgage finance companies and banks cashed in on subprime loans. In 2006, ten lenders—HSBC, New Century, Countrywide, CitiMortgage, WMC Mortgage, Fremont Investment and Loan, Ameriquist, Option One, Wells Fargo, and First Franklin—accounted for 60 percent of all subprime loans, originating \$362 billion in loans. The top 20 lenders accounted for 90.4 percent of all

subprime loans.²⁷ Executives of some of these companies cashed out before the market crashed, most notably Angelo Mozilo, Countrywide's CEO, the largest subprime lender. Mozilo made more than \$270 million in profits selling stocks and options from 2004 to the beginning of 2007. Between 2004 and 2006, the three founders of New Century Financial, the second-largest subprime lender, together realized \$40 million in stock-sale profits.²⁸

Third are the investors—people and institutions that borrowers never see, but who made the explosion of subprime and predatory lending possible. Subprime lenders collected fees for making the transactions and sold the loans—and the risk—to investment banks and investors who considered these high-interest-rate loans a goldmine. By 2007, the subprime business had become a \$1.5 trillion global market for investors seeking high returns. Because lenders didn't have to keep the loans on their books, they didn't worry about the risk of losses.²⁹

Wall Street investment firms set up special investment units, bought the subprime mortgages from the lenders, bundled them into "mortgage-backed securities," and for a fat fee sold them to wealthy investors worldwide. (For example, some towns in Australia sued Lehman Brothers for improperly selling them risky mortgage-linked investments).³⁰

When the bottom began falling out of the subprime market, many banks and mortgage companies went under, and major Wall Street firms took huge losses. They include Lehman Brothers (which underwrote \$51.8 billion in securities backed by subprime loans in 2006 alone), Morgan Stanley, Barclays, Merrill Lynch, Goldman Sachs, Deutsche Bank, Credit Suisse, RBS, Citigroup, JP Morgan and Bear Stearns. These investment banks are now ac-

cusing the lenders and mortgage brokers of shoddy business practices, but the Wall Street institutions obviously failed to do their own due diligence about the risky loans they were investing in.³¹

Fourth, the major credit agencies—Moody's and Standard & Poor's—made big profits by giving these mortgage-backed securities triple-A ratings. According to Roger Lowenstein, "by providing the mortgage industry with an entree to Wall Street, the agencies also transformed what had been among the sleepest corners of finance. No longer did mortgage banks have to wait 10 or 20 or 30 years to get their money back from homeowners. Now they sold their loans into securitized pools and—their capital thus replenished—wrote new loans at a much quicker pace." Almost all of the subprime loans wound up in securitized pools. But the credit agencies had little knowledge of how risky the original mortgages were. Their triple-A ratings were bogus. Moreover, they had a serious conflict of interest, because these ratings agencies get their revenue from these Wall Street underwriters.³²

The entire financial and housing food chain—brokers, appraisers, mortgage companies, bankers, investors, and credit agencies—participated in this greedy shell game. Some were honest and helped their clients. Some acted illegally. But most of it was simply business as usual.

THE JOB FOR THE NEXT CONGRESS

So, what to do now? Washington needs to put a short-term tourniquet on the banking industry to stem the damage, and to get back into the business of

protecting consumers, employees, and investors from corporate greed.

First, the federal government should help homeowners who have already lost their homes or are at risk of foreclosure. It should create an

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agency comparable to the Depression-era's Home Owners' Loan Corporation (HOLC), buy the mortgages, and remake the loans at reasonable rates, backed by federal insurance. Created in 1933, the HOLC helped distressed families avert foreclosures by replacing mortgages that were in or near default with new ones that homeowners could afford. A modern version of the HOLC would focus on owner-occupied homes, not homes purchased by absentee speculators.

Second, Washington should not bail out any investors or banks, including Bear Stearns and its suitor, JP Morgan, that do not agree to these new ground rules. The Fed brokered the deal between Bear Stearns and JP Morgan without any conditions for the consumers who were ripped off. There will be more Bear Stearns-like failures in the foreseeable future—institutions that the Fed considers “too big to fail.” But if the federal government is about to provide hundreds of billions from the Federal Reserve, as well as from Fannie Mae, Freddie Mac, and the Federal Home Loan Banks, to prop up Wall Street institutions, it should require the

industry to be held accountable for its misdeeds. Specifically, such lenders should agree to underwrite all loans for the full terms of the loan, not just for the initial teaser rate (this should apply to originators and purchasers), eliminate all pre-payment penalties, and recommend loan products that are suitable and in the financial interests of borrowers.

Third, Washington should consolidate the crazy-quilt of federal agencies that oversee banks and financial institutions into one agency. Federal oversight has not kept pace with the dramatic transformation of the financial services industry. Four federal agencies—the Federal Reserve, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Federal Deposit Insurance Corporation—have some jurisdiction over mortgage lending. States have jurisdiction over the growing number of non-bank mortgage lenders (which accounted for about 40 percent of new subprime loans) and have no agreed-upon standards for regulating them. States are responsible for regulating the insurance industry (including homeowner insurance), and do so with widely different levels of effectiveness. It is absurd to have so many competing and overlapping agencies involved in regulating these financial services institutions, often at cross purposes.

Fourth, the federal government should be a financial services industry watchdog, not a lapdog. Part of that effort involves supporting (financially and otherwise) initiatives currently being implemented or proposed by several advocacy groups.

The Community Reinvestment Act (CRA), a federal ban on redlining, should be strengthened to sanction institutions that engage in predatory practices and to reward those that

engage in responsible lending. The CRA now applies only to federally-chartered depositories (e.g. banks and thrifts). This statute should be expanded to cover credit unions, independent mortgage bankers, insurers, and other entities that now account for well over half of all mortgage loans. The Community Reinvestment Modernization Act of 2007, introduced by Eddie Bernice Johnson (D-TX) and Luis Gutierrez (D-IL) would accomplish this objective. In addition, the Home Mortgage Disclosure Act (HMDA), which facilitates enforcement of the CRA, should be expanded to include pricing information on all loans.

A strong national anti-predatory lending law should also be enacted. Currently 36 states and Washington, D.C., along with 17 other local jurisdictions have such laws, leaving most consumers in other states less protected.³³ Again, this statute should apply to those who originate loans and those who purchase loans and mortgage-backed securities for investment purposes.

As of this writing (May 2008), the Fed had issued proposed regulations and Congress has debated several bills to address the immediate foreclosure problems and mitigate their recurrence, but so far no final regulations have been issued and no legislation has been passed.

Congressman Barney Frank and Senator Chris Dodd (chair of the Senate Banking Committee) introduced legislation to address some but not all of these concerns. In May, the House voted 266-154 in favor of Frank's bill. Although the vote went mostly along partisan lines—all 227 Democrats voted "yes" and 154 Republicans voted "no"—39 Republicans bucked pressure from their party leaders and from the

White House and voted "yes." (Thirteen members didn't vote.) Most of the Republicans who supported the bill represent districts that have been particularly hard-hit by the mortgage meltdown. The bill would allow homeowners to shift from subprime mortgages they can no longer afford to federally backed mortgages. It would provide \$300 billion in federal loan guarantees to lenders who agree to reduce the outstanding principal on loans. In exchange for a new mortgage, backed by the FHA, homeowners must share profits on a subsequent sale of their home with the government. The bill also includes a one-time \$7,500 tax credit for new homeowners to be paid back over 15 years, and \$15 billion for states and localities to buy and rehabilitate foreclosed properties.

Frustrated with the delayed federal response, many states have acted on their own. Nine states have created refinance funds to help borrowers avoid foreclosure. Ten have banned or limited pre-payment penalties. Twenty have

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created consumer counseling programs. Nine require lenders to represent the interests of borrowers. And 14 states have created foreclosure

task forces bringing together lenders, consumers, regulators, and other experts to develop solutions.³⁴ There is a critical role for state and local governments to play. But an effective, comprehensive solution will require a far more active federal government.

FROM UNEVEN TO EQUITABLE DEVELOPMENT

GETTING CONGRESS TO ADOPT REGULATIONS TO require the financial services and real estate industries to act more responsibly is an important part of the solution. But Congress also needs to address the underlying causes that made so many Americans unable to afford decent housing and vulnerable to the practices of brokers, banks, and others. These include raising the federal minimum wage to the poverty threshold (about \$9.50 an hour) and indexing it to inflation; expanding the Earned Income Tax Credit by adding a housing component to it in order to account for the significant difference in housing costs in different parts of the country; enacting the Employee Free Choice Act, which would strengthen workers' rights to unionize; adopt the Income Equity Act, sponsored by former Minnesota Rep. Martin Sabo, which would deny corporations tax deductions on any executive compensation exceeding 25 times the pay of the firm's lowest paid workers. Congress should also reverse the almost three decade decline in federal housing assistance to

low- and moderate-income families. It could also use a variety of carrots, such as rent vouchers, and sticks, such as mortgage subsidies, to encourage states and localities to build more rental units and mixed-income housing developments in the suburbs where jobs are expanding. States and localities could require the adoption of inclusionary zoning laws that require developers to set aside a specific share of housing units to meet affordable housing objectives. Such laws have already been implemented in hundreds of localities, particularly in California, but also in Maryland, New Jersey, and several other states.

The success of any of these proposals will depend on the capacity of community organizations, labor unions, and consumer groups to

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mobilize Americans in the political arena. As Frederick Douglass famously observed, "Power concedes nothing without a demand. It never did, and it never will." ■

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