# Surging Inequality and the Foreclosure Crisis

*Gregory D. Squires*

The dramatic rise in inequality over the past three decades is no longer contested as indicated by the attention paid to this issue by publications ranging from the *Wall Street Journal* to *Mother Jones*. Another issue that continues to grab headlines today is the foreclosure crisis and the associated economic challenges facing many households and communities. Lost in much of this discussion, however, is the central role that inequality in general and residential segregation in particular play in the flood of foreclosures and their costs.

According to the Joint Center for Housing Studies, 4.9 million families lost their homes to foreclosure between 2008 and 2013. And while the foreclosure rate has declined in recent months, at the end of 2013 9.8 million households were underwater, meaning they owed more on their mortgage than their homes were worth according to Zillow, an on-line data base that records national mortgage information. Homeowners have lost $1.86 trillion in home equity, about $20,000 per household. While this crisis has reached almost all parts of the nation, these problems began in low-income communities of color and that is where the greatest damage has been done. Economic inequality and racial segregation have been major contextual factors framing the developing crises but missing from most of the policy debates. This article takes a closer look at these factors. Following a brief review of prevailing accounts of the crisis, I provide an overview of trends in inequality, its role in the foreclosure crisis and the policy implications that stem from bringing inequality into the debate.

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#### Causes of the Crisis

Explanations for the foreclosure crisis are varied and complex, but most reflect one of two narratives – one focusing on irresponsible borrowers and bad government policy and the other focusing on the behavior of lenders and their regulators. Perhaps the most popular, if flawed, account focuses on the role of misinformed, if not greedy, borrowers trying to purchase more home than they could afford, nurtured by faulty government fair lending policy (e.g., the Community Reinvestment Act (CRA) which is a federal law prohibiting redlining, affordable housing goals for Fannie Mae and Freddie Mac, fair housing laws). By "forcing" lenders to make loans to borrowers in low-income and minority communities who actually could not afford to pay them back, a dynamic was set up to create a housing bubble that finally burst. As *Fox News* television reporter Neil Cavuto told his audience on September 18, 2008, "Loaning to minorities and risky folks is a disaster."

In fact, the foreclosure crisis was brought on by a range of aggressive, predatory and often fraudulent practices by mortgage lenders, various investors and other financial service providers and regulators. High-priced loan products – often with predatory features like variable interest rates, pre-payment penalties and balloon payments – were disproportionately marketed to unsuspecting borrowers in low-income and minority communities. Originators were often less than scrupulous in their underwriting practices, frequently falsifying income and other financial characteristics of borrowers in loan applications. Investment banks purchased the loans and packaged them into mortgage-backed securities that they sold to other investors – often with inflated investment grades from rating companies – and regulators were slow to respond as problems emerged. Assuming housing prices would keep rising, it was expected all parties were protected. If borrowers could not in fact make the payments, they could always sell the home. But when borrowers started to default, home values declined. Many borrowers found themselves "underwater." Not able to sell, some walked away from their homes, while others were foreclosed on and forced out of their homes.

As for federal policy, the CRA only applied to depository institutions which made a tiny share of the problematic subprime loans; most were originated by independent mortgage bankers and brokers not covered by the law. And while the CRA did call for lenders to be responsive to the credit needs of their entire service areas, including low-and moderate-income communities, it also required lenders to do so consistent with safe and sound lending practices. Fannie Mae and Freddie Mac, for instance, did not begin to purchase and sell the problematic loans until the crisis was well under way. According to the National Community Reinvestment Coalition, the CRA has generated more than $6 trillion in lending to traditionally underserved low-income and minority communities thanks in large part to grassroots community organizing efforts since the law was enacted in 1977.

### Surging Inequality

Ignored in much of the current discourse and policy debate is the role of inequality generally and racial segregation in particular in fomenting the crisis and undercutting reform efforts. This is despite the fact that economic inequality has increased dramatically over the past 30 years contrary to the egalitarian trends from the end of World War II through the 1960s. To illustrate, the Brookings Institution reported that the top one percent increased their income by 275 percent between 1979 and 2007 compared to 65 percent for others in the top fifth and just 18 percent for those in the bottom fifth. The ratio of the compensation of chief executive officers to typical workers grew from 42-1 in 1982 to 354-1 in 2012 according to an April report by the AFL-CIO. The Federal Reserve Board recently reported that between 2010 and 2013 the income of the wealthiest 10 percent grew by 2 percent while the income of the bottom 60 percent declined. And between 2002 and 2013 the Census Bureau reports that black household income as a percentage of white household income declined from 61.9 percent to 59.7 with the Hispanic/white ratio dropping from 70.6 percent to 70.3 percent.

Wealth has long been more unequally distributed than income and wealth disparities have increased in recent years as well. The ratio of the wealth controlled by the top one percent of families compared to the median grew from 125 to 225 between 1962 and 2009 according to the Economic Policy Institute. In October 2014, Janet Yellen, Chair of the Governing Board of the Federal Reserve System, reported that the wealthiest 5 percent increased their share of total wealth from 54 percent in 1989 to 63 percent in 2013, while those in the lower half saw their share drop from 3 percent to 1 percent.

Economic disparities map on to residential ones. As Pew researchers Richard Fry and Paul Taylor concluded in 2013: "Despite the long-term rise in residential segregation by income, it remains less pervasive than residential segregation by race, even though black-white segregation has been falling for several decades." While segregation peaked in the 1970s, Blacks and whites continue to live in highly segregated neighborhoods. According to John Logan and Brian Stults' analyses of recent census data, nationwide, the share of white residents in the census tract of a typical Black resident changed little between 1940 (40 percent) and 2010 (35 percent). Another indicator of the ongoing reality of segregation is the persistence, if not slight increase, in the segregation of Hispanics and Asians from whites during these years.

Racial wealth inequalities have also skyrocketed in recent years and can be largely accounted for by changes in home equity. For whites median home equity declined between 2005 and 2009 from $115,364 to $95,000 compared to a drop from $76,910 to

$59,000 for Blacks, and from $99,983 to $49,145 for Hispanics according to Pew researchers.*

### The "Contribution" of Inequality to the Crisis

In an April 2014 speech at a Conference on the State of the U.S. and World Economies in New York, then Federal Reserve Board Governor Sarah Bloom Raskin (who has since moved on to become Deputy Secretary of the Treasury Department) argued that macroeconomic analyses and policies have missed the mark because such patterns of inequality have been ignored. She noted that lower-income families have less wealth to fall back on to cushion hard times. As more of their wealth is accounted for by equity in their homes, when the housing bubble burst, they lost a disproportionate share of their wealth. For lower- and middle-income families, about 70 percent of their wealth was tied up in their homes compared to 15 percent for families in the top quintile. So when the crisis hit, lower- and middle-income families lost about 15 percent of the net worth of their housing assets but 40 percent of their net worth overall. Among mortgages originated between 2004 and 2008, 25 percent of those in low-income neighborhoods were foreclosed on or in serious delinquency in 2011 compared to less than half the rate in high-income neighborhoods. As Raskin concluded, combining the job loss, income stagnation and loss of benefits also disproportionately affecting lower- and middle-income households with the loss of home equity brings inequality to the center stage of the crisis.

Inequality also contributed to the crisis and undercuts the recovery through traditional political channels. As Joseph E. Stiglitz argued in his book *The Price of Inequality,* inequality in economic and political spheres has mutually reinforcing and problematic outcomes. Those at the top are more able to enact policies that reflect their interests rather than the interests of the majority of the population or the economy and polity generally. For example, he points out if we were serious about deficit reduction, we would increase tax rates on the top earners and eliminate loopholes that only benefit the wealthy. But, he argues, "Because so many in the 1 percent derive too much income from the sectors that get these gifts . . . these proposals have not been focal points of the standard deficit reduction agenda." Several political scientists, including Larry M. Bartels, Martin Gilens, Benjamin Page, Paul Pierson, Jacob Hacker and others have provided a wealth of empirical evidence demonstrating that elected officials respond far more effectively to views of affluent constituents than those of poor people.

Reinforcing this perspective, Thomas Piketty argued in his widely celebrated book *Capital in the Twenty-first Century:*

> In my view, there is absolutely no doubt that the increase of inequality in the United States contributed to the nation's financial instability. The reason is simple: one consequence of increasing inequality was virtual stagnation of the purchasing power of the lower and middle classes in the United States, which inevitably made it more likely that modest households would take on debt, especially since unscrupulous banks and financial intermediaries, freed from regulation and eager to earn good yields on the enormous savings injected into the system by the well-to-do, offered credit on increasingly generous terms.

Not surprisingly, longstanding racial inequalities also contribute to the ongoing foreclosure and related economic crises. To illustrate, Federal Reserve Board researchers reported when subprime lending peaked in 2006, 53.7 percent of Blacks, 46.6 percent of Hispanics, and just 17.7 percent of whites received high-priced loans. In minority neighborhoods, 46.6 percent received such loans, compared to 21.7 percent of borrowers in white areas. These gaps did not close when various credit and financial characteristics of borrowers were taken into consideration. When Wells Fargo loan officers referred to these high-priced products as "ghetto loans" for "mud people," it was fairly clear to whom they were targeted.

The foreclosures that followed reflected these racial disparities. Among borrowers who received loans between 2004 and 2008, 11 percent of African

* As Melvin L. Oliver and Thomas M. Shapiro revealed in their classic book *Black Wealth/White Wealth,* housing accounts for approximately 62.5 percent of the assets of black families compared to 43.3 percent of white wealth. So, not surprisingly, blacks, and other non-whites, are more vulnerable when the housing market declines.

Americans, 14 percent of Latinos and 8 percent of Asians have lost their homes compared to 6 percent of non-Hispanic whites as reported by CRL. The consequences are also captured in the decline in home equity cited above.

Perhaps more revealing, but also hidden from public view and public debate, is the role of segregation. Studies appearing in the *Fordham Urban Law Journal* and *Housing Policy Debate* revealed that racial segregation is a significant contributor to high-cost and predatory lending. More significantly, in the A*merican Sociological Review,* Jacob S. Rugh and Douglas S. Massey demonstrated that racial segregation is a powerful predictor of foreclosures even after a range of other presumed predictors are taken into consideration including creditworthiness, coverage under the CRA, overall subprime lending rate and other socioeconomic and demographic factors. In fact, segregation was the single most powerful predictor. It would be surprising, actually, if this were not the case. In highly segregated communities – economically and racially – it is simply easier to identify the target markets to which predatory loans were most aggressively marketed.

### Raising Our Sights

What does this overview suggest for policies to address the crisis? Bank reform remains a critical domestic policy issue, but the focus of those efforts must go beyond individual financial institutions and their regulators. Policies aimed at ameliorating economic inequality and segregation should become part of the bank reform toolkit.

The Dodd-Frank Wall Street Reform and Consumer Protection Act signed into law in 2010 was aimed at minimizing risky behavior that threatened not just the life of particular banks but the financial system and the global economy generally. The use of certain predatory loan products was restricted. An oversight council was created to act should "systemic risk" be in the offing to assure that taxpayers would not be on the hook for more bailouts and calling for the breakup of large financial institutions if necessary. A "say on pay" was granted to corporate boards to reign in excessive compensation. A Consumer Financial Protection Bureau (CFPB) was created whose sole function was to protect consumers in the financial services marketplace by writing new regulations, investigating complaints and enforcing key fair lending rules. Independent mortgage bankers and brokers not previously regulated by federal law would come under the jurisdiction of the CFPB. And in a nod to inequality, financial institutions are required to disclose the ratio of the compensation of their CEOs to a typical employee.

Enforcement of all of these regulatory requirements remains vital to ameliorate the consequences of the foreclosure crisis and move towards the goal of fair and equitable access to appropriate credit products. Other potentially beneficial reforms would include the following:

- modifying CRA to cover non-depository financial institutions,
- allowing homeowners to utilize bankruptcy laws as an alternative to foreclosure which is now prohibited,
- establishing a duty of suitability for lenders, similar to what stock brokers have, requiring them to recommend products that are in the clients' financial interests and
- encouraging more municipalities to utilize eminent domain authority to purchase loans and modify them so families can stay in their homes.

But other steps to combat rising levels of economic inequality and the persistence of racial segregation are essential as well if the costs of the foreclosure crisis are to be mitigated and the likelihood of future crises is to be reduced. Policies to reduce economic inequality include:

- raising the minimum wage and indexing it annually to keep up with inflation,
- expanding the earned income tax credit to lift more families out of poverty,
- implementing a transaction tax on all sales of stocks, bonds, and related financial instruments and
- reducing the disparity in the income tax rates for earnings derived from investments (e.g., capital gains) and labor.

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with NAMA when threatened with eviction. Spain's SAREB takes a similar hands off approach.

Indeed, NAMA's attempt to sidestep the urban planning implications jars with the view expressed by the Irish Minister for Finance (Michael Noonan), who has ultimate responsibility and oversight for NAMA. In a recent statement to the press about the proposed development of Dublin's Docklands, he made it very clear that AMCs can have a decisive impact on the city:

> The Dublin Docklands area presents a unique opportunity for NAMA and the Irish taxpayer. It is rare that such large swathes of prime waterfront land in a modern city such as Dublin has remained undeveloped. It is even rarer that the ownership of such land rests in a State organisation providing the opportunity for truly joined up planning, development and construction of such a large and important area. NAMA now has the opportunity to bring this area to life and create a Dublin Docklands that will rival the likes of London's Canary Warf, Boston's Seaport and Singapore's Marina Bay.

NAMA and SAREB are indicative of the role of financial entities in shaping urban outcomes, but they also show the part played by the state in extending and deepening the financialization of the city. The experience of both AMCs also suggests that governments, in setting up AMCs, tend to ignore the planning and urban development implications, focusing instead on the solvency of banks and rebooting financialized real estate markets. As we have seen in the case of NAMA, planning regulations are weak, vague and ineffective, permitting it to prioritize the maximization of asset values. Here it seems we have much to learn from the PAH and its struggle against SAREB. Those on the frontline of Spain's housing crisis have politicized SAREB. And by doing so, they draw out not only the injustice involved in bailing out banks with public funds, but also the potential to harness real estate assets which fall under the control of state agencies in order to respond to the urban catastrophe set in motion by the global financial crisis. P²

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Further steps to combat segregation include the following:

- providing greater public and foundation support for grass roots advocacy organizations,
- expanding and strengthening inclusionary zoning rules, now in place in hundreds of communities, requiring more developers to set aside a share of homes in new developments for low-income families,
- banning the mortgage tax deduction in segregated communities, making the absence rather than the presence of racial and ethnic minorities the problem to be solved and
- changing the mortgage tax deduction to a credit so families at all income levels can participate.

Even if we took all these steps, challenges would persist. Free market ideology and the political power of industry and capital continue to play a critical role in shaping how wealth is controlled and distributed. Thus, progressive movement building to democratize the economy must continue alongside 'technical' fixes.

Nonetheless, bringing economic inequality and racial segregation onto the agenda is a critical first step. These structural factors present far more fundamental and problematic challenges to the nation's economy and overall well-being than banking practices alone. Raising our sights and addressing these broader patterns of inequality must also become part of the foreclosure and financial services industry policy debates. P²