RISK ALLOCATION AND MISPLACED EMOTION: THE U.S.'S SUBPRIME CRISIS

by

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Abstract

This paper contends that an important but under-explored cause of the United States' subprime mortgage crisis is contract law's derisory response to emotion and the defective risk allocation model that it helped to generate. Contract law cannot deal proactively or fairly with emotions – including irrational public enthusiasm and the deep desire for home ownership – because it views the world through the steely eyes of the reasonable man. As a countermand, the law must work to stave off disastrous subprime loans, especially for the honest, first-time buyer, by acknowledging that housing contracts have a concentrated emotional overlay. Beyond this, legislative reform is needed to re-establish the financial link between originating lender and borrower (which securitization has recently disrupted) as well as require enhanced and meaningful mortgagee disclosure.

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I. INTRODUCTION

This paper advances the view that an important – though by no means singular – cause of the United States' subprime mortgage crisis is contract law's derisory response to emotion and the defective risk allocation model that it helped to generate. As is well known, the subprime mortgage crisis refers to the international financial collapse which was triggered when U.S. subprime borrowers (that is, borrowers with a poor or otherwise problematic credit history[1]) defaulted en masse on their mortgage obligations.[2] The huge housing bubble that fuelled the rush to place subprime mortgages began to burst in 2006[3] and has since generated upheaval worldwide,[4] including in Canada.[5] The fallout from these foreclosures has caused the near collapse of major banking institutions,[6] the actual failure of several investment banks,[7] large declines in the stock market,[8] and an increase in homelessness due to personal foreclosure or landlord mortgage defaults which literally leave tenants out in the cold.[9] Foreclosures have also precipitated a government bailout and takeover of the mortgage giants Fannie Mae and Freddie Mac.[10] Ironically, there has been no comparable assistance for the honest mortgagors who lost their homes and saw their credit rating left in ruins.[11] Recent federal legislation to assist homeowners in default has failed dramatically.[12] However, some states have passed laws temporarily halting home repossessions[13] while both Fannie Mae and Freddie Mac are seeking to lower monthly payments for financially overwhelmed homeowners, thereby reducing potential foreclosures.[14] In addition, mortgage lending reform is being widely explored.[15]

The multiple causes of the subprime crisis are still being uncovered and, to date, include: corrupt mortgage lenders;[16] fraudulent brokers;[17] lax credit evaluations by underwriters;[18] naïve borrowers;[19] dishonest borrowers, including those taking out 'liar's loans'; [20] under-regulated financial institutions;[21] 'teaser' and variable interest rates;[22] compliant appraisers;[23] unrealistic rating agencies;[24] conflicts of interest attaching to how credit rating agencies are paid;[25] securitization of mortgage debt;[26] "Wild West investor/risk-takers;"[27] and historically low interest rates.[28] Also tremendously important in the mix was a certain economic and social zeitgeist leading up to the crisis which Yale economist Robert Shiller describes as an "irrational public enthusiasm for housing investments"[29] or "infectious exuberance"[30] – a contagious optimism accompanying real estate price increases and one that is not tempered by facts. Because US housing prices had been rising dramatically since the late 1990s, people came to regard a house purchase as being an essentially risk-free way of achieving financial security and perhaps even prosperity.[31] The fear of 'missing out' on the American dream of home ownership also fuelled the market.[32] When housing prices inevitably collapsed, foreclosures reached record rates[33] and were driven in particular by subprime mortgages which defaulted at an even greater pace than prime mortgages did.[34]

The purpose of this paper is to show that contract law's perspective on emotion is a ranking but under-explored cause of the subprime mortgage crisis because, *inter alia*, it contributed to the creation of an erroneous risk allocation model in relation to mortgage contracts. Contract law cannot deal proactively or fairly with emotions – including irrational public enthusiasm and the deep desire for home ownership – because it views the world through the steely eyes of the reasonable man. In this stylized and robust universe, emotion has no place; it is illegitimate. Those borrowing money for a home and giving a mortgage back as security are expected to keep their feelings in check, look out for their own best interests, and only buy what they can afford. Any other strategy is irrational and, from this perspective, deservedly brings with it foreclosure, displacement, and financial loss. If the borrower chooses to be 'emotional' or unrealistic as to what he can afford, he will receive the adverse economic consequences that contract law concludes he so richly deserves. In this way, the law punishes those emotions, even when they lead to an utterly ruinous contract.[35] Likewise, lenders are expected to be rational and lend only in proportion to the borrower's ability to repay. Any other strategy generates borrower default and financial loss by the lender. Given this downside, the lender takes on the role of the rational, self-interested gatekeeper, assessing the borrower and reining in her loan expectations as necessary. But the subprime crisis demonstrates that assumptions regarding lender incentives and who actually bears the risk of emotion were tremendously misplaced. As we will show, this is because, *inter alia*, the originate-to-distribute (OTD) model of subprime lending sheltered the lender from most or all of the effects of borrower default. That is, and contrary to the law's assumption, the lender *did* have incentives to manipulate borrower emotion. More specifically, the subprime mortgage industry took advantage of the borrower's "imperfect rationality"[36] or emotionalism and designed subprime mortgage contracts with the express objective of burying the long-term cost of the loan

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while juicing up its seemingly attractive "deferred-cost" characteristics.[37] And for their part, regulators -- infected by contract law's laissez-faire perspective on emotion -- failed to do enough to protect the vulnerable subprime borrower.

The following paper is divided into several parts. Part II establishes the emotional context of homeownership and provides a brief account of the subprime borrower. The section concludes by discussing how and why contract law misunderstands emotion. Part III describes the risk allocation of emotion in the mortgage contract and why that allocation proved to be so disastrously misguided. Part IV advances a better way to allocate the risk of emotion in the mortgage contract and is based on the view that mortgagor emotion does not *inherently* deserve market discipline and other forms of punishment. Put another way, contract law's intense focus on contract enforcement is misplaced. Instead, Part IV asks the law to acknowledge what should be obvious, namely that housing contracts have a concentrated emotional overlay, and to place more responsibility on the lender to stave off a disastrous loan. The subprime crisis proves that an expressly preventative strategy is in order and one that more appropriately allocates the risk of emotion. This would include enhanced mortgagee disclosure so that borrower emotion is less likely to be hyped. In addition, the law must mandatorily re-establish the link between originating lender and borrower[38] to further remove lender incentives to emotionally manipulate the borrower.

II: EMOTION IN THE MORTGAGE CONTRACT

A. The American Dream

The dream of homeownership is a long-standing part of America's cultural fabric. But this is not merely because homeownership is understood to promote economic security. Land ownership was a founding principle of the early colonists and came with such civic rights as voting, holding office, and otherwise participating in citizenship. When the country was urbanized in the 19th century, homeowners – being full citizens – were regarded as 'better' people than renters and in this way, home ownership evolved into a sign of moral superiority.[39] For example, two 19th century urban critics (Jacob Riis and Lawrence Veiller), associated owning a private home with individualism.[40] As summarized by historian Laurence Vale, these urban critics were envisioning "a very clear alternative to the slum: they wished to transform it into a district of private homes. Each believed that good American citizenship could come only with living in a single-family dwelling."[41] Put in the negative, tenement life tore the moral fiber of each inhabitant. In Riis's words, "the tenement itself, with its crowds, its lack of privacy, is the greatest destroyer of individuality, of character. As its numbers increase, so does the element that becomes criminal for lack of individuality and the self-respect that comes with it."[42]

Herbert Hoover, when he was Secretary of Commerce (1921-1928), further revived and advanced the project of increasing homeownership in part by continuing to link homeownership, citizenship, and morality.[43] When he went on to become President, Hoover remained of the same mind, noting in one speech that the aspiration of homeownership "penetrates the heart of our national well-being. It makes for happier married life, it makes for better children, it makes for confidence and security…it makes for better citizenship."[44]

In summarizing Hoover's perspective and initiatives, Vale notes that:

> government and industry had transformed homeownership into an ideological necessity and installed it at the very center of American housing policy where it has remained enshrined. The homeownership ideology is woven from multiple interconnected strands. First is the strand of property ownership itself…. This ownership impulse is traced back to the founding of the Republic through a Revolution viewed as a triumph of individual landownership. Second, homeownership draws strength from a wider identification with rose-tinted American traditions; the owned home could be touted as a metonym for "the American Dream," the codified symbolic evidence of proper socioeconomic advancement encumbered by assumptions about gender roles and racial separation. Third, the ideological fabric of homeownership features thick bands of red, white, and blue—patriotism mixed with nationalism.[45]

Under Franklin D. Roosevelt's New Deal, government continued with policies supporting home ownership[46] the momentum of which continues today. Among others, Mark Zandi notes that current public policy promotes home ownership through, for example, mortgage interest deduction and favorable capital gains treatment.[47] Other stimuli come from federal mortgage insurance, government owned enterprises like Freddie Mac and Fannie Mae, mortgage revenue bonds, down payment grants, and subsidized loans,[48] to name several more examples. Beyond this, federal legislation intended to advance home ownership (and enacted just prior to the subprime crisis) is encapsulating both for its name – the *American Dream Downpayment Act (2003)*[49] – and for then-President Bush's comments on signing this legislation. He stated:

> We want more people owning their own home [*sic*]. It is in our national interest that more people own their own home…. The rate of homeownership amongst minorities is below 50 percent. And that's not right, and this country needs to do something about it. …We need to close the minority homeownership gap in America so more citizens have the satisfaction and mobility that comes from owning your own home, from owning a piece of the future of America.[50]

A clear message, with varying emphases, has resonated for more than 100 years in America: homeownership is a symbol of one's moral superiority, moral rectitude, and moral fitness. It represents societal participation and belonging[51] as well as respectability and identity.[52] Homeownership is the shiny avatar of success, status and stability. By the inevitable contrast driven by ideology, renters remain the poor, morally inferior, stagnant and disreputable cousins of those who own a

piece of the American Dream.

B. Emotion in Home Acquisition

Buying a house is a demonstrably emotional experience. A recent U.K. study regarding emotion in the rising housing market of Edinburgh, Scotland shows the emotions experienced by respondents when searching for a house and their emotions upon buying one.[53] During the purchasing period, first time buyers in low-priced neighborhoods were fearful about "losing a place on the housing ladder"[54] and not being able to secure a property at all.[55] Others expressed anxiety to quickly acquire a property so as to exit the "crazy" market.[56] And desperation was experienced by those who wanted to escape the problems in their current neighborhoods or accommodations.[57] Upon success in securing a home, the respondent households spoke of their "'love' of and 'feelings' for the properties, of knowing that 'this is it, this is the one.'"[58] They spoke too of the "emotional values they hoped to extract from the property – of their new home as embodying desirable social and cultural identifiers."[59] According to the authors, property ownership was emotionally valued for the "appeals to the status and identity"[60] that came with it.

These commonly experienced emotions—the fear of missing out in a rising market; the wish to participate in the status and prestige of homeownership—are enormously significant and motivating. Indeed, the benefits of *successful* homeownership are tangible and significant, including an overall increased satisfaction with the quality of their life as compared to renters,[61] enhanced economic security, as well as a greater propensity to vote and participate in local politics.[62] However, homeownership *per se* is not a panacea.[63] Especially for those who have a low income, homeownership does not necessarily provide wealth, security or neighborhood quality.[64] As the subprime crisis showed, it often leads to foreclosure and financial ruin. Nicholas Retsinas, who is director of Harvard University's Joint Center for Housing Studies, captures the heartbreak perfectly when he writes: "As this [subprime] empire crumbles, the people at the base – the waitress in Detroit, the laborer in Sacramento, the daycare worker in Boston – will lose not just the dream and security of a financial asset, but their homes."[65]

C. Background to the Subprime Borrower

Subprime borrowers have various back-stories. Most commonly, the borrower was refinancing an existing home mortgage due to credit card debt.[66] Others were "trade-up buyers" – people in their 40's, many of whom had children and wanted the opportunity of owning a bigger house.[67] Flippers were another category of subprime borrower – that is, investors who would own the property for the short term, hoping to quickly cash in at a higher price as the market rose.[68] Others still were first time buyers who saw a unique chance to acquire a home due to the toppling of the traditional barriers to home ownership – such as low credit scores, the requirement of a down payment, and high monthly mortgage payments.[69] As noted by the Chief Economist of Moody's Economy.com, Mark Zandi:

> All of this was too much for many first-timers to pass up. Many saw it as a rare opportunity. With mortgage rates on the rise and housing prices appreciating rapidly, if they didn't walk through the proverbial door now, wouldn't they be locked out for good?[70]

First time buyers were the group most likely to be motivated by the American Dream. They wanted to seize their moment to join the homeowner ranks, the ranks of the moral, the responsible, the successful and the secure. First time buyers were also least likely to understand the full extent of the transaction in question. Federal Reserve[71] surveys showed that borrowers with teaser rate adjustable rate mortgages did not realize that their mortgage payments would rise dramatically at some point and some even thought that their payments would never rise.[72] Other first time buyers understood their mortgages but were fortified by two apparent safety valves: they could refinance down the road[73] or sell the property in an ever-rising market.[74] As Shiller summarizes the matter: "Subprime borrowers wanted… [adjustable-rate] mortgages in disproportionate numbers because they were less quantitatively sophisticated and because they were consumed by the mere thought of somehow gaining a foothold in the housing market."[75]

One example of a first time subprime buyer is Christina Natale, whose profile was reported in the *New York Times*.[76] According to the *Times*, Natale bought a house for $385,000 with a down payment of $185,000 which she raised from the sale of her grandfather's home. The loan to bridge the difference (including closing and insurance costs, fees, and taxes) required a $1873.96 monthly payment. Since this was only about $100 less than Ms. Natale's entire monthly net income, the transaction was doomed to fail. Nonetheless, both the bank and the broker seemed unconcerned by such a tight margin and when her loan was approved (without even attempts to confirm her income), Natale felt encouraged to attempt it. Though the adjustable interest rate was a source of concern for Natale, the broker assured her that refinancing was possible. Since she had $20,000 in savings, Natale thought she could really make a go of it. In her words, "I was hoping for a second job. I was hoping for a Prince Charming. I was just hoping things would get better."[77] But with her savings eventually gone, Natale refinanced once in June 2007 and again in July 2008. When a third attempt to refinance was turned down, Natale arranged a short sale, with her lender's approval. She was therefore never foreclosed on but lost her $185,000 down payment. Natale then turned to Children's Aid Society to help her and her children get on their feet again. This is because Natale had no money left whatsoever – not even for a security deposit for interim shelter. In speaking to the *Times*, Natale explained her emotions. Her house made her "feel good."[78] She wanted a better place for her children. In Natale's words, "I wanted the white picket fence."[79]

With the 20/20 hindsight provided by a post-bubble world, Natale's foray into subprime home ownership may seem particularly foolhardy. How could Natale have possibly imagined that her decision to borrow, given her circumstances, could ever have ended well? But when her narrative is assessed in context, Natale is an entirely more sympathetic figure. Caught up in bubble thinking, Natale simply hoped for the best. The presumed experts – lender and broker – expressed no reservations about her ability to repay the loan. In the pre-crash economy, Natale's optimism and the ever-rising housing market carried the day.

Though the loan never should have been made, it is most unlikely that Natale would have recourse against the originator -- whether through the doctrines of undue influence or unconscionability or via predatory lending statutes. Undue influence offers Natale no help because her relationship with the originator is neither fiduciary nor one of confidence or personal or familial trust,[80] as American law requires. An allegation of unconscionability holds little promise because it requires some showing of "an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party."[81] Natale presumably had choice as there were multiple lenders willing to extend credit to borrowers like her. She was certainly not boxed in from that perspective. Nor was she boxed in as to *what* home to purchase. Beyond this, the judicial remedy for unconscionability under the Uniform Commercial Code is most generally applicable to contracts for goods as opposed to credit or real estate.[82] Even if a court were willing to extend unconscionability to a non UCC contract such as Natale's, it would still be of no assistance since unconscionability is only a defense to non-payment -- it cannot be raised as an affirmative claim to rescind or reform a contract.[83] Since Natale's mortgage contract has already come to an end and she is no longer making payments, unconscionablity – even it were present – does not offer her any recourse. Regardless of the angle, the legal response appears to be that Natale should have purchased a less expensive home or even none at all.

Another avenue of redress for some subprime borrowers is through legislative prohibitions on abusive or predatory loans. Thirty-six states have such laws,[84] including New York State where Natale purchased her townhouse. State laws variably include provisions that prohibit abusive practices which in the mortgage market can include:

- Loan flipping --repeatedly refinancing loans, charging high fees each time.
- Excessive fees and 'packing' -- adding fees far exceeding those justified on economic grounds, often through loan terms, such as the financing of points, fees and pre-payment penalties, single-premium insurance (to cover the balance of the loan should a borrower die, paid in one sum and added to the amount financed) and balloon payments (those due at the end of a loan that are significantly higher than monthly payments).
- Asset-based lending-lending based on a borrower's overall assets, rather than income and ability to repay.
- Outright fraud and abuse."[85]

In addition, several federal statutes regulate aspects of predatory loans.[86]

There is no overt evidence revealed in the *New York Times* to suggest that Natale's loan exhibited predatory earmarks noted above.[87] For example, Natale was apparently not misled by the originators *per se* – she knew that her mortgage payment was only $100 less than her take home pay. Natale was simply hoping for the best, felt buoyed by the originator's lack of concern over her ability to make payments, and expected the housing market to continue to rise. Her loan was tremendously ill-advised but probably not abusive in the statutory sense.

Though it is beyond the scope of this paper to comprehensively assess remedies, subprime borrowers like Natale would seem to be without legal recourse even though -- absent extraordinarily positive personal and market developments – their loans were almost certainly doomed to founder. This makes the law's failure to properly allocate the risk of emotion at the outset even more egregious because the failure is so costly and final to the borrower. Proper risk allocation -- backed by an accurate assessment of lender incentives -- would have kept many subprime borrowers away from the financial precipice. Instead of facing foreclosure and ruin, they would have remained renters or have entered into more modestly-sized mortgage loans.

As noted in the Introduction, though the law allocates the risk of emotion to both parties, it also assumes, *inter alia*, that the lender would have no incentives to manipulate borrower emotion—on the contrary, the lender would act as gatekeeper seeking solid assurances regarding the borrower's ability to repay. In fact, this assumption regarding lender incentives proved to be completely and utterly wrong. Subprime mortgages were designed by the industry to actively appeal to borrower emotion, including optimism however misplaced. Such mortgage products intentionally emphasized cost deferral[88] and buried the long term costs in mounds of complexity.[89] The mortgage industry wanted to place as many subprime mortgages as it could and, due to securitization, had no concern about the borrower's prospects of repaying. And borrowers took the bait. In short, the emotionally manipulative features of the subprime mortgage must count as a cause of the subprime crisis and are discussed in more detail in Part III. Before turning to this matter, however, the following section explains why emotional manipulations – short of triggering undue influence, unconscionablity, and predatory lending statutes – are tolerated by contract law.

D. Contract Law's Response to Emotion

Contract law tends to ignore emotion or punish it, which may come to the same thing. In part, this is because modern contract law's development over the course of the 19th century adopted antiquity's hierarchies in duality, including reason over emotion, objectivity over subjectivity, and male over female.[90] Even more specifically, emotion in the 19th century was

directly associated with widespread hysteria, a disease typically attributed to women and understood as being caused by a failure to keep one's emotions under control.[91] Contract law reflected an impoverished and even hostile understanding of emotion given the latter's historical and symbolic patina.[92]

Contract law strips emotion out of contracts and chooses male abstraction instead.[93] This accounts for why contract law is premised on the generic example of "A" selling widgets to "B" such that the biographies of each party to the contract and indeed, the subject matter of the contract itself, are irrelevant. As Friedman notes: "Contract law is abstraction – what is left in law relating to agreements when all particularities of person and subject-matter are removed."[94] He states:

> "Pure" contract doctrine is blind to the details of subject matter and person. It does not ask who buys and who sells, and what is bought and sold. In the law of contract it does not matter whether the subject of the contract is a goat, a horse, a car load of lumber, a stock certificate, or a shoe. As soon as it matters -- e.g., if the sale is of heroin, or of votes... or labor for 25 cents an hour -- we are in one sense no longer talking about pure contract. In the law of contract it does not matter if either party is a woman, a man, an Armenian-American, a corporation, the government, or the church. Again, as soon as it does matter... we are no longer talking pure contract.
>
> ….The abstraction of classical contract law is not unrealistic; it is a deliberate renunciation of the particular; relinquishment of the temptation to restrict untrammeled individual autonomy or the completely free market in the name of social policy. The law of contract, therefore, is roughly coextensive with the free market.[95]

The inclination of contract law to erode biographical and subject matter detail causes contract law to have a bias against transactions which, and transactors who, do not fit the idealized, generic norm. In this way, contract law orients itself around the expectations of the reasonable business man. The concerns or vulnerabilities of those who do not fit this profile – including those of the honest but unsophisticated subprime borrower – are submerged.

The will theory and bargain theory also work to bury the emotional content of a contract because they focus instead on individual freedom and rationality. These theories, too, help explain why emotion has historically gone missing in contract law.

Briefly, the will theory, upon which contract law is founded,[96] regards parties to a contract as free agents[97] and is typically unconcerned about the actual content of the contract or specific background of the parties. The emphasis is on individuality and choice,[98] not on what the parties actually chose. The will theory is singular: it looks only for a meeting of the minds[99] and "does not speak to the content."[100] Accordingly, it regards consideration not as a conceptual cornerstone of enforceability but as being simply *evidential* of an intention to be bound.[101] Beyond this, and as Beverly Brown points out,

> The logic of the will theory, mimicking political theory of freedom of the individual, would in principle allow potentially *any* agreement to count as a contract, however, risky, however ruinous. The only concern, this being based on the theory of freedom, would be undue influence and the forces of duress or sentiment.[102]

This echoes Hugh Collins's account of 19th contract law ideology. According to Collins:

> The latent social ideal of the nineteenth-century law of contract embodies a libertarian state, in which the law maximizes the liberty of individual citizens, encourages self-reliance and adopts an avowedly neutral stance with regard to permissible patterns of social life. The law of contract secures these goals ….by facilitating the creation of legal obligations on any terms which individuals freely choose.[103]

For these kinds of reasons, the will theory is standoffish and even castigatory when it comes to emotion. As noted by Peter Nygh, the will theory expects people to "look after their own interests and calculate their own risks. The protective role of law to guard against fraud, misrepresentation, or duress is narrowly construed….The rights of the parties and their enforcement are paramount."[104] In short, freedom to choose a bad bargain is itself a manifestation of personal freedom and autonomy. If the contracting party was carried away by emotion or 'irrational exuberance' or bubble thinking, he gets to own the result of that.[105]

A related theory, the bargain theory, also submerges emotion but for a different reason: it focuses on the contracting parties as rational agents (*versus* the free agents who populate the will theory).[106] The bargain theory emphasizes exchange or consideration,[107] as opposed to individual freedom, but, just like the will theory, it elevates contract enforcement. As Robert Hillman summarizes this perspective, "if a party made a bargained-for promise the party had to perform the promise or pay damages. Courts would not entertain excuses."[108]

Embedded in the bargain theory's focus on exchange is, in Brown's words, the view that "no rational person would do something for nothing, or, in market-theory terms, groups behave on the premise that members act rationally (which is not incompatible with the knowledge that not all of them do.)"[109] Rational actors drive the best bargain they can but, on the flipside, also carry the risk of miscalculation.

Brown's view that the concept of the rational agent dominates the bargain theory but not the will theory is, of course, subject to challenge. It could also be said, for example, that parties, as free agents, choose a bargain they think will be beneficial to them.[110] But such a response does not undermine Brown's analysis for the purposes of this paper. The shared outcome – regardless of theory or how that theory is precisely delineated – is that the individual bears the risk of entering into a ruinous contract. This is either because the party *chose* the agreement and must live with it or because the bargain arose on

the basis of both parties being rational actors and entering into an exchange. As the court in *Gray v. American Express Co.* observes,

> It is certainly true that, from the common law immemorial, parties have been free to include whatever conditions and limitations that they may desire in a contract. *See* Restatement (Second) of Contracts, Introductory Note, ch. 8, at p. 2 (1981); *see also id.* § 72 comment b **(contract provides opportunity for freedom of action and exercise of judgment)**. Absent a statutory prohibition or some public policy impediment, *id.* § 178, **the very essence of freedom of contract is the right of the parties to strike good bargains and bad bargains**. [Emphasis added].[111]

Because contract law is driven by highly abstracted notions of autonomy and reason, it is unable to develop a robust or useful understanding of emotion.[112] Instead, the law punishes emotion by enforcing contracts which possess minimum thresholds of voluntariness. Contract enforcement is, of course, essential to market certainty. And making people responsible for their own decisions is a defensible default rule. However, contract law's overwhelming bias against emotion also leads to huge miscalculations and misapplications,[113] with the subprime crisis being a poignant example. In short, as the next part will develop in more detail, contract law allocated the risk of emotion to the borrower and the lender (as in 'a pox on both your houses') but did not understand how the lender might develop incentives to manipulate borrower emotion. Beyond this, the law did not actually *care* if the lender somehow developed these incentives since the borrower is expected to fend for herself.

III. ERRONEOUS RISK ALLOCATION OF EMOTION IN THE MORTGAGE CONTRACT

A. The Nature of Originate- to-Distribute Subprime Loans

As noted above, contract law places the risk of borrower emotion on both the subprime lender and borrower – with the situation supposedly covered off no matter what actually transpires. On the one hand, the risk allocation model assumes that the lender has no incentive to manipulate borrower emotion since it would have a strong stake in carefully assessing the borrower's underlying resources and repayment prospects. On the other hand, even if incentives somehow emerged whereby the lender would choose to play upon borrower emotion, the borrower is properly regarded as his own best last line of defense. The borrower is expected to take care of himself, keep his feelings in check, and only borrow what he can afford to pay back. As the previous section notes, the law focuses on individual autonomy, exchange, and the freedom to make a bargain, for good or ill. If people let their emotions rule, contract law says that they deserve whatever consequences follow.

The assumption that the lender has no incentives to hype borrower emotion is the model's most egregious miscalculation but there other errors connected to it. The model further assumes that informational asymmetries between the subprime borrower and lender are not important; that, beyond this, the lender would not do anything to actually *increase* those informational asymmetries. The purpose of this part of the paper is to describe in more detail these misapprehensions and how they gave the lender even more room to manipulate borrower emotion. It will also show that the roots of such miscalculations and misallocations can be traced to contract law's impoverished understanding of emotion.

The risk allocation model mistakenly and fatally assumes that the subprime lender had no incentives to manipulate borrower emotion since it would otherwise risk holding a worthless mortgage on its books. As Nicholas Retsinas notes, while this was originally a correct assumption, innovation sparked by capital markets shifted the risk of default to international investors[114] who, "motivated by the promise of endless double digit returns"[115] acquired subprime structured finance products. That is, based on an originate-to-distribute model (OTD), the subprime lender would originate loans with the intention of distributing them to the market thereby transferring to others all or most of the associated risk of borrower default.[116] This process removed, or at least drastically weakened, crucial incentives in the lender to ensure that the borrower kept emotions in check and only borrowed what she could reasonably be expected to repay.

More specifically, securitization is a process whereby the originating lender sells its mortgages (including subprimes) to another entity, known as a special-purpose vehicle or "SPV".[117] This entity transforms them into mortgage-backed securities which, in turn "are divided and sold again to a global network of investors."[118] These securitized products, as Steven Schwarcz explains, are classified as MBS, ABS, CDO, or ABS CDO:

> MBS means mortgage-backed securities, or securities whose payment derives principally or entirely from mortgage loans owned by the SPV. ABS means other asset-back securities, or securities whose payment derives principally or entirely from receivables or other financial assets – *other than mortgage loans*— owned by the SPV. Industry participants refer to transactions in which SPVs issue MBS or ABS as securitization.
>
> The term "securitization" also technically includes CDO and ABS CDO transactions. CDO, or "collateralized debt obligation," securities are backed by – and thus their payment derives principally or entirely from – a mixed pool of mortgage loans and/or other receivables owned by an SPV. ABS CDO securities, in contrast, are backed by a mixed pool of ABS and/or MBS securities owned by the SPV, and thus their payment derives principally or entirely from the underlying mortgage loans and/or receivables ultimately backing the ABS and MBS securities. For this reason, ABS CDO transactions are sometimes referred to as 're-securitization.'[119]

Schwarcz makes a very strong case that the securitization process described above created moral hazard in the subprime lender "to the extent that mortgage lenders did not have to live with the credit consequences of their loans."[120] In short, absent the lender retaining at least some risk of loss, its interest became "misaligned with that of the investors in these securities."[121] And, even more germane for the purposes of this paper, lender interests *also* became misaligned with those of the borrower.

This means that – contrary to assumptions in the risk allocation model – the subprime lender actually *did* have incentives to manipulate the subprime borrower into assuming a mortgage he could not actually afford. Brokers thoroughly assisted in this endeavor.[122] The lender (and broker) could and did hype emotion, a matter recently acknowledged by the Board of Governors of the Federal Reserve. According to the Board, with implicit concern about the practice:

> originators may sometimes encourage borrowers to be excessively optimistic about their ability to refinance should they be unable to sustain repayment. For example, they sometimes offer reassurances that interest rates will remain low and house prices will increase; borrowers may be swayed by such reassurances because they believe the sources are experts.[123]

Because default was not the lender's problem,[124] market discipline[125] and lending standards[126] went out the window. This meant that borrowers ended up with mortgages that they had no likely prospect of repaying – just like the subprime borrower whose story is recounted in the previous part of this paper. Alluding to the 'tragedy of the commons' component of the subprime market, Schwarcz states: "a firm that exercises market discipline by reducing its leverage will marginally reduce the overall potential for systemic risk; but if other firms do not also reduce their leverage, the first firm will likely lose net asset value relative to the other firms."[127] In short, there was no coin for the lender or broker to be cautious or even reasonable in assessing the risk of borrower default.

But not only did lenders and brokers directly hype borrower emotion by encouraging, for example, excessive optimism as noted by the Federal Reserve described above. The subprime mortgage industry actually designed mortgage contracts which intentionally buried the long-term cost of the loan while enhancing its seemingly attractive "deferred-cost"[128] characteristics. This took strategic advantage of borrower emotion and the wish to live the American Dream.

As Oren Bar-Gill demonstrates, the subprime mortgage design features involved two "suspect features"[129]: unusually high cost deferral and unusually high complexity of terms.[130] Bar-Gill identifies these mortgage characteristics as a rational – though problematic – market response to borrowers who were myopic, overly-optimistic and imperfectly rational.[131] In the next two sections, we show how these troubling mortgage characteristics appealed to the emotions of the honest first time buyer and encouraged her down the garden path. We thereby illustrate the law's miscalculation regarding lender incentives as well as who actually bears the risk of borrower emotion.

B. High Cost Deferral in the Subprime Mortgage Contract

The unusually high cost deferral of the subprime mortgage arises because borrowers gave low down-payments and carried a high loan-to-value (LTV) ratio – up to 100%.[132] Put another way, the subprime borrower frequently borrowed the entire purchase price of the house.[133] On a related front, subprime borrowers typically agreed to adjustable-rate mortgages (ARMs) whereby initially low monthly payments (generally for two years) were replaced with a steeper interest rate for the balance of the term.[134] As Bar-Gill summarizes the matter: "A direct implication of an escalating-payments contract is 'payment shock,' which occurs when a rate reset leads to a significant, up to 100 percent, increase in the monthly payment."[135] Another final cost deferral characteristic of the subprime mortgage is the prepayment penalty imposed on the borrower for repaying the loan prior to its maturity date.[136] Among other features, loans with prepayment penalties have lower interest rates and, by extension, lower monthly payments.[137] They thus "produce the temporal shift characteristic of deferred-cost contracts: pay less now, pay more later."[138]

The borrower was attracted to the cost deferral aspect of subprime mortgages because it lifted traditional barriers. Little or no money down, combined with low initial mortgage payments, got the borrower into the real estate market and, for at least a while, made them a member of that illustrious group living the American Dream. The emotional appeal of homeownership, and the fear of never perhaps having another opportunity to buy, motivated at least some subprime borrowers to simply hope for the best. Those who understood that the mortgage[139] would eventually reset to a higher rate were either propelled by a perhaps irrational anticipation that their incomes would rise in time or intended take advantage of the mortgage's prepayment option.

Prepaying or refinancing the mortgage on attractive terms is only possible, as Bar-Gill notes, in three circumstances: "(1) the borrower's credit score improves, (2) market interest rates fall, or (3) house prices increase."[140] For many subprime borrowers, any practical hope for refinancing was tremendously misplaced.

Of course, some first time subprime borrowers were, as Bar-Gill notes, simply speculators who reasoned that if housing prices went up at the time the mortgage reset, they would simply sell and take the profit.[141] Conversely, if housing values declined, mortgage default was the solution. As Bar-Gill notes: "default is not a cost-free proposition but as long as the probability of a price increase is high enough, the upside benefit will offset the downside risk. Some subprime borrowers were surely speculators. Many others, however, were not."[142]

As Bar-Gill observes, subprime borrowers displayed imperfect rationality, or, as we would express the matter, are more

liable to have their emotions manipulated by the originator:

> Myopic borrowers unduly focus on the short-term dimensions of the loan contract and pay insufficient attention to long-term dimensions. Optimistic borrowers underestimate the future costs of a deferred-cost transaction. They overestimate future income. They expect to have unrealistically attractive refinancing options. Or they overestimate the expected value of the real estate market, perhaps because they irrationally expect that the 10% price increase last year will be replicated next year. If myopic and optimistic borrowers focus on the short-term and discount the long-term, then lenders will offer deferred-cost contracts with low short-term prices and high long-term prices.[143]

In short, the originator actively designed mortgage products to appeal to the borrower's aspirations to home ownership. Due to securitization, the lender suffered no market discipline from being reckless and manipulative -- a poignant irony since the borrower would be expecting precisely the opposite attitude. The largest risk of emotion was therefore borne by the borrower who stood to lose everything. A more diffuse risk of borrower emotion was borne those who invested in mortgage-backed and related securities.[144] The lender, however, had no risk of borrower emotion at all.[145]

C. Informational Asymmetry and Undue Complexity in the Subprime Mortgage Contract

Informational asymmetries are common in the credit market and in the context of commercial lending, it is typically the borrower who has more information.[146] This places incentives on lenders to assess creditworthiness.[147] However, as Donald Morgan of the Federal Reserve Bank of New York argues, the opposite asymmetry operates in the consumer lending context.[148] This asymmetry is exacerbated in the subprime market because 'fringe' or subprime borrowers are less educated than 'mainstream borrowers'[149] and are often borrowing for the first time or 'rebounding from a failed first foray into credit".[150] But instead of being met with loans that would acknowledge and compensate for their lack of financial sophistication, borrowers were faced with mortgage contracts whose complexity increased as the borrower's creditworthiness decreased.[151] Simply stated, the most complex loans are presented to the group who is least able to understand their terms. As Morgan notes:

> Lenders know from experience with large numbers of borrowers, whereas the borrower may only have their own experience to guide them. Credit can also be confusing; after marriage, mortgages are probably the most complicated contract most people ever enter. Given the subtleties involved with credit, and the supposed lack of sophistication of sub-prime borrowers, our assumption that lenders know better becomes plausible.[152]

Indeed, a second feature of the subprime mortgage is that it is uniquely and strategically complex. As Bar-Gill states:

> The subprime market boasted a broad variety of complex loans with multidimensional pricing structures. Hybrid loans, combining fixed and variable rates, interest-only loans, and option-payment adjustable-rate mortgages (ARMs), each product type with its own multidimensional design, were all common in the expanding subprime market. Many of these contractual designs were not new; they were known in the prime market since the early 1980's. But it was in the subprime market where they first took center stage.[153]

He goes on to note that the subprime mortgage features:

> a proliferation of fees and other price dimensions combined with elaborate rules governing the application of these multiple prices. Beyond multidimensional pricing, the prepayment option, and the (implied) default option, increase the complexity of valuing these mortgage products. Finally, since complexity should be measured at the market level, and not at the contract level, the existence of numerous complex products exponentially increases the complexity of the choice problem that a borrower faces.[154]

In short, originators exploited the subprime borrower's informational asymmetry so as to more easily take advantage of the borrower's wish to participate in homeownership. The emotional or "imperfectly rational" borrower ignores complexity [155] and becomes unable to choose well: "limited attention and limited memory might result in the exclusion of certain price dimensions from consideration."[156] In short, enticing a subprime borrower into a disastrous mortgage was easier than shooting fish in a barrel. According to Congressional Budget Office testimony by its then-director, Peter Orzag:

> some [subprime] borrowers lacked a complete understanding of the complex terms of their mortgages and assumed mortgages that they would have trouble repaying. (Certain ARMs may have been among the more difficult mortgages for first-time borrowers to understand.) Many of those mortgages made in recent years included teaser rates, which may have confused some borrowers about the eventual size of their mortgage payments when their mortgage rates were reset."[157]

The subprime borrowers' vulnerabilities are widely acknowledged, including by Shiller who observes: "Many households have access to very little financial insight… the only financial professionals they come in contact with are trying to sell them something." [158] Beyond this, first time buyers, according to Shiller, are less sophisticated and more "susceptible to irrational optimism"[159] about the economy in general and their own personal financial situations. As such, borrower's knowledge deficits combined with adverse lender incentives contribute to the borrower assuming liabilities that she can ill afford.[160]

But even for the motivated borrower, subprime information was inherently difficult to locate. The Federal Trade Commission conducted an empirical study of the efficacy of required mortgage disclosures. The study compared how well borrowers in both prime and subprime markets were able to understand the terms of their loans after being given loan

disclosures required by law.[161] In the press release accompanying the study, FTC Chairwoman Deborah Platt Majoras observed that "Mortgage disclosures designed more than 30 years ago can be confusing even for simple loans, and they do not address the variety and complexity of today's mortgage products".[162] The study found woefully inadequate the industry practice of applying disclosures designed for fixed term, fixed rate mortgages to the subprime context. This practice was found to be deficit for its failure to disclose at least twelve basic loan provisions which the subprime borrower would need in order to decode her mortgage.[163]

Risk allocation in the mortgage contract assumes that each party will rationally assess risk and then, in the bargaining process, each party will attempt to shift as much risk as possible to the other. Where there is significant information asymmetry, the party with greater knowledge will use it to shift as much risk as possible to the other. According to Michael Meyerson, "[t]he incentive for inefficient contract terms is similar to the incentive for fraud. When there are substantial information costs associated with uncovering deception, fraud is more likely to occur. The marginal revenue from the fraud will likely exceed the marginal loss of revenue from the loss of business of dissatisfied customers."[164] As the FTC study suggests, borrowers who are able to understand key terms are more likely to be able to comparison shop and make choices based on terms that are more favorable,[165] and ultimately affect the quality of loans that are offered in the subprime market. In the absence this understanding, however, lenders are free to exploit borrowers' desire to own a home, and, like the borrowers, they need not take a rational view of the riskiness of the loan. But unlike borrowers, lenders will pass their irrational risk on in the securitization process, while borrowers will suffer the full brunt of theirs.

Contract law's risk allocation model attaches no meaningful significance to informational asymmetries between borrower and lender. Not only does it assume that the subprime mortgagor has assessed the risk rationally; more fundamentally, it assumes that the subprime borrower has relatively equal access to the information necessary to understand the terms that underlie the risk in the first instance. As has been shown, neither of these assumptions is correct. Many subprime buyers were not equipped with the knowledge and financial where-with-all to understand the real risks they were assuming. This made emotional appeals by the originator and the market's irrational exuberance at large even more likely to hit their mark. Though the law allocated the risk of emotion to both lender and borrower, securitization meant that only the borrower truly carried it. This is tremendously unjust since the borrower was the party with the least information to bring to bear on her emotions and the originator was the party who actively exploited this asymmetry.

The photograph below, by Globe and Mail photographer Fernando Morales, shows a message written left on the wall of a foreclosed upon house in Toledo, Ohio. The sentence written on the wall above a dismantled smoke detector – "I feel like dying" – is poignant but also inadvertently à propos since the word 'mortgage' is derived from the French word 'mort' (death) and 'gager' (to pledge). A mortgage is a 'dead pledge' because in the event of default, the property is dead to the borrower while if the lender is repaid, the pledge is dead to the lender.[166] In this case, the property is dead to the borrower and the borrower wishes that he/she could be. The image also demonstrates the emotional nature of foreclosure and – by extension— of homeownership.

Fernando Morales (October 1, 2008) G*lobe & Mail* at page 1[167] Reproduced with permission.

D. The Link between Risk Misallocation and Contract Law's View of Emotion

As previously noted, contract law has a bias against emotion. Instead, it is driven by highly abstracted notions of autonomy and reason, examples of which are found in the concept of the reasonable man as well as in the will theory and bargain theory of contract, discussed in Part II above. This focus on autonomy inevitably orients contract law around enforcement because the freedom to contract brings with it the freedom to contract badly.

A focus on autonomy also means that contract law unreflectively allocates the risk of emotion on both the mortgagor and mortgagee. If the borrower becomes emotional and assumes too large a mortgage, she must also accept the risk of foreclosure, displacement, and other financial consequences. If the lender fails to keep borrower emotion in check and lends more than the borrower can repay, the mortgagee too gets what it deserves—namely, a bad loan. In this way, contract law regards emotion with implicit derision and punishes it through enforcement of an ill-considered agreement.

Though contract law apparently treats emotion even-handedly because it allocates its risk to *both* parties, this even-handedness is ultimately illusory. Contract fails to detect or attach significance to a reality which the subprime lender actively exploited, namely that the mortgage contract has a particularly concentrated emotional overlay for the subprime borrower. On a related front, contract law is largely indifferent to the background to the contracting parties. It therefore refuses to acknowledge the vulnerabilities of the subprime borrower -- including desperation in a rising housing market accompanied by a lack of financial sophistication. Indeed, and as previously discussed, contract law attaches no importance to the profound informational asymmetries between subprime originator and borrower. Likewise, contract law's assumption that the lender would have no incentives to exploit a borrower's naiveté to the point of financial ruin was also famously misplaced. As this paper has discussed, the originator actively played upon borrower emotion and made its products as complex as possible to hide the true cost of the mortgage in question. Securitization – by no means a recent phenomenon[168] – severed the link between originator and the loan itself such that there was no market discipline on the lender, even for egregious conduct. A collapse in lending standards ensued and brought many borrowers into the market who had nowhere near the financial resources to be there.

In short, contract law misallocated the risk of emotion because it is much more concerned about autonomy, contract enforcement, and abstraction. Everything untoward on the mortgage landscape, it seems, slipped by entirely and egregiously undetected. As a result, and contrary to what the risk allocation model anticipated, only the mortgagor – and those who purchased structured finance products backed by that mortgage – actually bore the risk of borrower emotion. The lender had exited long before.

Contract law's focus on autonomy, contract enforcement, abstraction, and concomitant tendency to see through the eyes of the imaged reasonable man also generated myopia in the regulators – yet another cause of the subprime crisis. Regulators were simply not alert enough to the ways in which borrower emotion could be manipulated by originators because, *inter alia*, they implicitly adopted a contract law paradigm.[169] This paradigm, driven by an impoverished, even derisory understanding of emotion, led to regulatory tepidity.

The solution to emotion in the subprime market lies in enhanced regulation. This is because contract law cannot easily develop principles to *prevent* the ruinous loan when it so otherwise focused on enforcement and autonomy. As well, the common law evolves too slowly to provide the robust and immediate protection that borrowers need from lenders. Though such market intervention would have the effect of assisting *all* subprime borrowers, not just those who are naïve but this is not inherently problematic. It is the essence of consumer protection measures not to parcel out those who require protection from those who do not.[170] In the next section of this paper, therefore, we join other commentators who call for further legislative interventions in the subprime market. The common law simply cannot easily remediate the errors in its model given its fixed world view.[171]

IV. THE WAY FORWARD

Commentators have offered a number of solutions to the abuses in the mortgage industry including imposing a suitability standard, [172] placing fiduciary duties on mortgage brokers, [173] and creating a real estate futures market.[174] A "reinvigorated" FHA mortgage program which would provide "a comparison and benchmark for evaluating predatory lending in primary housing and mortgage markets"[175] is also suggested. It is well beyond the scope of this paper to offer or evaluate solutions as to how the subprime borrower could have been better served at the point of origination but we offer some general thoughts. The policy goal, going forward, is to prevent subprime borrowers from assuming unrealistic mortgage obligations in the future.[176]

First and foremost is the need to regard emotion proactively and without derision. Emotion in the mortgage contract needs to be acknowledged and planned for from the outset instead of punished at the moment of foreclosure. Regulation must robustly ensure that the borrower's underlying ability to repay is properly assessed in order to stave off a disastrous loan.[177] In this regard, the President's Working Group on Financial Markets, for example, provides an obvious but also helpful recommendation: a nation-wide improvement in mortgage underwriting standards and a strengthened government presence in overseeing those entities that originate and fund mortgages.[178] As noted, such a recommendation looks to help ensure that those who do not having the underlying ability to repay a proposed loan are denied that loan. After all, only *successful*

homeownership has a chance of advancing the individual.

Second, the informational asymmetry between subprime borrower and lender must be mitigated by increasing the information available to the borrower.[179] This makes it less likely that the lender will succeed in hyping borrower emotion and less likely that a borrower will assume a disastrous mortgage. The President's Working Group also recognizes informational deficits when it calls for the Federal Reserve to put in place stronger consumer protection laws and improved disclosures to make "more transparent" the affordability of the loan over the long term and in a way that would "facilitate comparison of the terms with alternate products."[180] Beyond this, Shiller calls for subsidized financial advice for the subprime borrower as a crucial aspect of prevention.[181] Measures like these would encourage the mortgage industry to drop those mortgage design features that appeal to emotion – such as burying true costs in unfathomable complexity and hyping the mortgage's deferred-cost characteristics.[182] On a related front, the President's Working Group calls for better regulation of mortgage originators and more effective enforcement standards.[183] Enhanced disclosure requirements and better regulation of originators would help to ensure less borrower manipulation since the lender would bear the costs of regulatory non-compliance. Again, this works appropriately to keep the under-qualified buyer out of the market and out of harm's way.

And finally, at minimum, it is essential to re-establish a closer identity of interest between mortgage originator and borrower to provide incentives on the originator not to manipulate. This can be done by requiring the mortgage originator to retain some risk of loss when the mortgage is securitized.[184] Such a solution – offered by Schwarcz as a way of protecting investors and capital markets by reducing moral hazard – works equally well to protect the subprime borrower because it achieves the same goal. If the originator mandatorily owns some of the result of the mortgage it places, there are enhanced incentives to do the job non-exploitatively.[185]

This paper has endeavored to show how contract law's refusal to understand emotion generated an erroneous risk allocation model. This refusal is not merely of theoretical interest and is certainly not benign. The intense emotional overlay in a mortgage contract, hyped by a bubble market and actively manipulated by OTD lenders, left many honest but naïve borrowers victimized. Since OTD lending did not ordinarily violate contract law's minimum standards of voluntariness, borrowers like Natale whose story is recounted in Part II of this paper, lost their homes and their live savings. And unfortunately, the paradigm around which contract law is constructed (including stark conceptions of rationality, objectivity, autonomy, and voluntariness -- all endorsed by the reasonable man) also buttressed regulatory myopia. This too destroyed lives for failing to keep the unsophisticated and under-qualified borrower out of the market altogether. But the consequences, tragic at the local level, also had world-wide repercussions. In short, the view that people should be punished for their emotions helped to bring down global financial markets.

Footnotes

[1] MARK ZANDI, FINANCIAL SHOCK: A 360 DEGREE LOOK AT THE SUBPRIME MORTGAGE IMPLOSION AND HOW TO AVOID THE NEXT FINANCIAL CRISIS 9 (2009). A letter from the Federal Reserve Bank of Chicago identifies three types of mortgage markets: Prime, Subprime and Alt-A (see Sumit Agarwal and Calvin T. Ho, *Comparing the prime and subprime mortgage markets*, CHICAGO FED LETTER (August 2007),: http://www.chicagofed.org/publications/fedletter/cflaugust2007_241.pdf (last visited Feb. 8, 2009) According to the letter, "[t]he main difference between prime and subprime mortgages lies in the risk profile of the borrower; subprime mortgages are offered to higher risk borrowers." The letter goes on to explain that risk grades are determined by past mortgage or rent payment history, previous bankruptcy, debt-to-income ratios, and documentation supplied by the applicant to verify financial status. It notes that subprime mortgages tend to pay 200-300 basis points above the prevailing prime rate as well as higher loan origination fees and prepayment penalties.

[2] Zandi at 9.

[3] ROBERT J. SHILLER, THE SUBPRIME SOLUTION 1 (2008).

[4] *Id.* at 8, Shiller notes, that in Germany the crisis brought down IKB Deutsche Industriebank AG, SachsenLB, West LB, and BayernLB; in France, funds sponsored by BNP Paribas failed; and in the UK, there was a run on the Northern Rock Building Society – just to name a few examples.

[5] For example, six of Canada's biggest lenders (excluding TD Bank) have absorbed write-downs of about C$4.7 billion due to losses on investments related to U.S. subprime mortgages. See John Kiphoff, *Canadian Stocks Fall Most Since 2004 After CIBC's Share Sale*, Bloomberg.com (Jan. 5, 2008), *available at* http://www.bloomberg.com/apps/news?pid=20601082&sid=aDU0Yw976Sq0&refer=canada (last visited Feb. 8, 2009). And investors who bought auction rate securities associated with subprime loans which then became unsellable have begun class actions against those whom they believe are responsible, including several Canadian companies: Oppenheimer Holdings, the Royal Bank of Canada and two of its subsidiaries. See Donalee *Moulton, Subprime litigation hits Canada* LAWYERS WEEKLY 28:6 (June 6, 2008) at 14. Beyond this, "US-style lending practices" infected Canada for a time, including placing 40 year mortgages and zero down mortgages. These risky lending practices have since been banned. See Jacquie McNish and Greg McArthur, *How high-risk mortgages crept north,* THE GLOBE AND MAIL (Dec. 13, 2008) at A1 and *Explainer: Subprime Mortgages in B.C. and Alberta* (March 13, 2009) at http://www.theglobeandmail.com/servlet/story/RTGAM.20090313.wsubprimefactbox14/BNStory/Front (last visited March 19, 2009). In this latter story, the authors note:

Despite having just a share of about 7 per cent of the national market, subprime lenders in Alberta accounted for 56 per cent of the foreclosures in 2008. In British Columbia, the tiny subprime market laid claim to 42 per cent of the province's 2008 foreclosures. In comparison, Canada's five largest banks accounted for 33 per cent of the foreclosures in Alberta in 2008, even though the country's chartered banks account for about two-thirds of Canada's total outstanding mortgages.

[6] NYSSCPA.org E-Zine Staff, *Bank Failures and Fed Bailouts Stun Wall Street, World Markets* NYSSCPA.org E-Zine 8:38 (18 September 2008), *available at* http://www.nysscpa.org/ezine/ETPArticles/ML91808.htm (last visited Feb. 8, 2009).

[7] *Id.*

[8] Katalina Bianco, *The Subprime Lending Crisis: Causes and Effects of the Mortgage Meltdown*, (2008), CCH *available at* http://business.cch.com/bankingfinance/focus/news/Subprime_WP_rev.pdf at 19 (last visited Feb. 8, 2009).

[9] *Id.* at 20.

[10] *Government Bails Out Fannie Mae and Freddie Mac*, WALL STREET JOURNAL (Sept. 8, 2008), *available at* http://blogs.wsj.com/developments/2008/09/08/government-bails-out-fannie-mae-and-freddie-mac/ (last visited Feb. 8, 2009).

"Fannie Mae" refers to Federal National Mortgage Association and is the United States's largest mortgage buyer. Its home page (Fannie Mae http://www.fanniemae.com/aboutfm/index.jhtml) describes Fannie Mae as "a government-sponsored enterprise (GSE) chartered by Congress with a mission to provide liquidity and stability to the U.S. housing and mortgage markets." "Freddie Mac" refers to Federal Home Loan Mortgage Association and is the United States second largest mortgage buyer. As described by the *New York Times*, Freddie Mac and Fannie Mae purchase mortgages from lending institutions. They then either hold the mortgage "in investment portfolios" or resell them as "mortgage-backed securities to investors." The two companies are essential providers of home financing. See Freddie Mac: FRE: NYSE; Financials/Consumer Financial Services NEW YORK TIMES, *available at* http://topics.nytimes.com/top/news/business/companies/freddie_mac/index.html?inline=nyt-org, (last visited Feb. 8, 2009).

[11] As noted by Oren Bar-Gill, Federal Reserve Board Rule, *Truth in Lending Act*, 6 Federal Reserve Board, Truth in Lending, 73 Fed. Reg. 44,522, 44,524-25 (July 30, 2008) (to be codified at 12 C.F.R. pt. 226) provides: "The consequences of default are severe for homeowners, who face the possibility of foreclosure, the loss of accumulated home equity, higher rates for other credit transactions, and reduced access to credit." See Oren Bar-Gill, *The Law, Economics and Psychology of Subprime Mortgage Contracts* (2009) NYU Law and Economics Research Paper No. 08-59; 94 CORNELL LAW REVIEW, at footnote 217 (cited to SSRN: http://ssrn.com/abstract=1304744,), (last visited Feb. 8, 2009).

[12] The HOPE for Homeowners Act, Pub. L. No. 110-289, 122 Stat. 2800 (codified as amended in scattered section of 12 U.S.C.) passed by Congress in October, 2008, was intended to assist approximately 400,000 distressed borrowers. After two months, however, HUD received only 312 applications for assistance. *See* Dina ElBoghdady, THE WASHINGTON POST (Dec. 17, 2008), *available a*t: http://www.washingtonpost.com/wpdyn/content/article/2008/12/16/AR2008121603177.html (last visited Feb. 8, 2009). Among the reasons cited for the dismal failure of this legislation are: an unwillingness in lenders to participate when less than 100 % of the loan is insured; high borrower fees and the requirement that when the home is sold, any increased value will be shared with the government; and requirements that borrowers provide verification of income for 2 years, a statement that they did not give false or misleading information when they applied for their loans, and a threshold that the payment exceed 31% of borrowers' incomes.

[13] Kathleen M. Howley, *Mortgage Delinquencies, Foreclosures Rise to Record*, Bloomberg.com (Dec. 5, 2008), *at* http://www.bloomberg.com/apps/news?pid=20601087&refer=home&sid=a37uyBrX6dvY (last visited Feb. 8, 2009).

[14] Dawn Kopecki & Rebecca Christie Fannie, *Freddie Boost Effort to Minimize Foreclosures*, Bloomberg.com (Nov. 11, 2008), *at* http://www.bloomberg.com/apps/news?pid=20601087&sid=agXldWXbC1DM&refer=home (Last visited Feb. 3, 2009).

[15] Bar-Gill, s*upra* note 11 at 8.

[16] Robert J. Shiller, *Infectious Exuberance*, THE ATLANTIC (July/August 2008) 19.

[17] For an insider's view of the tactics used by mortgage brokers in the subprime market, see RICHARD BITNER, CONFESSIONS OF A SUBPRIME LENDER: AN INSIDER'S TALE OF GREED, FRAUD, AND IGNORANCE (2008).

[18] Bianco, *supra* note 8 at 8 notes that mortgage underwriters determine "if the risk of lending to a borrower under certain parameters is acceptable. Most of the risk and terms considered by underwriters fall under three categories – credit, capacity, and collateral…." She also notes, at 8, that 40% of all subprime loans were generated by automated underwriting with approval coming "as soon as within 30 seconds as opposed to the week it would take for an underwriter to generate a decision." Bianco goes on to state, at 8, that many experts believe "that lax controls and a willingness to rely on shortcuts led to approval of buyers that under a less-automated system would not have been approved." See too LAURIE GOODMAN ET AL., SUBPRIME MORTGAGE CREDIT DERIVATIVES 304 (2008) who refers to Standard & Poor's view that traditional loan and borrower attributes "lost all relevance" because indicators – such as FICO credit scores and loan to value ratios – "were all corrupted, either by the borrowers who deliberately committed fraud, or by a general corruption of the underwriting process that lead to exaggerated incomes and appraisals, and new techniques that allowed borrowers to inflate their FICO scores." A FICO (Fair Isaac Corporation) score refers to an individual's credit score.

[19] Shiller, *supra* note 3 at 7.

[20] See Vikas Bajaj, *A Cross Country Blame Game*, NEW YORK TIMES (May 8, 2007) who reports on stated-income loans – also called "liar's loans." These are loans made with no external verification of the borrower's true income. They thereby became very convenient vehicles of fraud. According to Bajaj, the Mortgage Asset Research Institute reports a sampling of loan applications taken by one lender. This lender determined that the incomes listed on 60 percent of the applications "were, on average, 50 percent higher than those on the borrowers' tax returns." As Baja notes, lenders liked the stated income loans because they were more profitable– borrowers were charged a higher rate of interest. For the full story, see http://query.nytimes.com/gst/fullpage.html?res=9D02E2D71631F93BA35756C0A9619C8B63&sec=&spon=&pagewanted=2 (last visited Feb. 8, 2009). Bianco, *supra* note 8 notes that as much as "70 percent of recent early payment defaults had fraudulent misrepresentations on their original loan applications, according to BasePoint analytics, a company that assists lenders and banks to identify fraudulent transactions." Another study cited by Bianco shows that "borrowers simply lied about their incomes, reporting up to five times their actual earnings. Other borrowers used false income documents created on their computers" at 10. For fuller discussion of borrower fraud, see Allen Ferrell, Jennifer Bethel & Gang Hu, *Legal and Economic Issues in Litigation Arising from the 2007-2008 Credit Crisis* (Nov. 17, 2008) Harvard Law and Economics Discussion Paper No. 612; Harvard Law School Program on Risk Regulation Research Paper No. 08-5, *at*: SSRN: http://ssrn.com/abstract=1096582. See too Shiller, *supra* note 16 at 19.

[21] Bianco, *supra* note 8 at 10 notes that members of the Senate Banking Committee blamed federal regulators for not doing their jobs. Senator Christopher Dodd, Chairman of that committee, referred to a "chronology of regulatory neglect" in relation to mortgage standards by banks and other lenders, at 10.

[22] Bar-Gill, *supra* note 11 at 23-24.

[23] Shiller, *supra* note 3 at 6.

[24] *Id.* at 50-51.

[25] See Gretchen Morgenson, *Debt Watchdogs, Tamed or Caught Napping*, THE NEW YORK TIMES (Dec. 7, 2008) 1, *available at*: http://www.nytimes.com/2008/12/07/business/07rating.html (last visited Feb. 8. 2009). As reported by Morgenson, three of the top credit-rating agencies (Moody's, Standard & Poor's, and Fitch Ratings) have faced a "firestorm of criticism about whether their rosy ratings of mortgage securities generated billions of dollars in losses to investors who relied on them" at 1. One concern identified by Morgenson was that while a firm like Moody's, for example, historically generated revenue from investors who bought its research, it "ended up working closely with the companies it rated, and being paid by them" at 1. See too Bianco, *supra* note 8 at 9.

[26] Zandi, s*upra* note 1 at 114 and following; Shiller, *supra* note 3 at 4 and 6. See too Steven Schwarcz *Protecting Financial Markets: Lessons from the Subprime Mortgage Meltdown* (2007) Duke Law School Legal Studies Paper No. 175 who identifies the complexity of subprime structured finance products and a related failure to disclose as "a central culprit" at 32, *at*: SSRN http://ssrn.com/abstract=1056241.

[27] Nicolas Retsinas, *Building Sandcastles: The Subprime Adventure*, Harvard Business School Working Knowledge (12 September 2007) *at*: Working Knowledge http://hbswk.hbs.edu/item/5771.html (last visited Feb. 8, 2009)

[28] *Supra* note 8 at 4.

[29] *Supra* note 3 at 4.

[30] *Supra* note 16 at 22. Shiller also cites Araon M. Sakolski's 1932 work, THE GREAT AMERICAN LAND BUBBLE (1932), which he sees as having ominous similarities to the current landscape. Alan Greenspan refers to the same kind of phenomenon when he talks about the "irrational exuberance" of the stock market climb in the mid 1999's. See ALAN GREENSPAN, THE AGE OF TURBULENCE176-177 (2007).

[31] *Supra* note 3 at 5. Shiller notes that from 1997 to 2005, homeownership increased 11.5%, with increases being largest "in the West, for those under the age of 35, for those with below-median incomes, and for Hispanics and blacks" at 5. According to Mara Lee, African American mortgages showed the highest rate of subprimes at 49.3%; Hispanics at 33.8%, and non-Hispanic whites at 21% See Mara Lee, *Subprime Mortgages: A Primer* NPR (March 23, 2007), *at* http://www.npr.org/templates/story/story.php?storyId=9085408 (last visited Feb. 8, 2009). See too Chris Mayer & Karen Pence, *Subprime Mortgages: What, Where, and to Whom?* Finance and Economics Discussion Series Divisions of Federal & Statistics and Money Affairs, Washington D.C. (2008) Federal Reserve Board. They note that subprime mortgages are focused in neighbourhoods with "high proportions of black and Hispanic residents, even controlling for the income and credit scores of these Zip codes" at 3. According to Francine Lipman in *The Graying of Poverty: The Rollercoaster Ride of Increasing Debt, Decreasing Savings and Lack of Financial Education*, (Presentation at The Law, Poverty & Inequality Conference, Valparpaiso Univ. April 2008), senior citizens (i.e. those 65 years or over) are five times more likely to be a subprime borrower than those under 35 years of age. Abstract *available at* http://taxprof.typepad.com/taxprof_blog/2008/04/tax-profs-at-la.html (last visited March 18, 2009).

[32] *Supra* note 3 at 50. The *New York Times* reported in September 2007 that foreclosures had reached record rates in each of the last previous three quarters. *Rate of Home Foreclosure Rates Hits Record*, NEW YORK TIMES (Sept. 7, 2007), *available at:* http://www.nytimes.com/2007/09/07/business/07mortgage.html?_r=1&scp=1&sq=rate%20of%20home%20foreclosure%20r

ates%20hit%20record&st=cse (last visited Feb. 8, 2009). From March 2007 through January 2009 the Mortgage Bankers Association also reported increasing foreclosure rates. See Mortgage Bankers Association website at: http://www.mortgagebankers.org/ResearchandForecasts/ProductsandSurveys/NationalDelinquencySurvey.htm (last visited Feb. 8, 2009).

[34]Kristopher Gerardi, Adam Shapiro, & Paul Willen, *Subprime Outcomes: Risky Mortgages, Homeownership Experiences, and Foreclosures*, (Dec. 3, 2007) FRB of Boston Working Paper No. 07-15 at 1, *at:* SSRN http://ssrn.com/abstract=1073182. These authors note that first time subprime homeowners are foreclosed upon nearly 20% of the time – that is, six times more often than the prime mortgage purchaser. See too Michelle Danis & Anthony Pennington-Cross, *The Delinquency of Subprime Mortgages* (March 2005) FRB of St. Louis Working Paper No. 2005-022A at 5-6 for similar analysis, *at*: SSRN http://ssrn.com/abstract=761804.

[35] Subject, of course, to such doctrines as undue influence and unconscionability as well as predatory lending statutes. See *infra* notes 81 - 88 and surrounding text.

[36] *Supra* note 11 at 5.

[37] *Id.* at 2.

[38] Schwarcz, *supra* note 26, offers this partial solution as a way to protect financial markets going forward, at 15-16. We apply this solution in order to protect the borrower.

[39] Lawrence Vale, *The Ideological Origins of Affordable Homeownership Efforts, in* CHASING THE AMERICAN DREAM 18-19 (William Rohe & Harry Watson, eds. 2007).

[40] *Id.* at 18. Accord Nicolas Retsinas and Eric Belsky who state: "From its agrarian roots in medieval England, the concept of landholding as a precondition of liberty has evolved into a yearning for ownership" [footnote omitted] at 1. See *Examining the Unexamined Goal* in LOW-INCOME HOMEOWNERSHIP at 1 (Nicolas Resinas & Eric Belsky, eds. 2002).

[41] *Supra* note 40 at 18.

[42] J. Riis, A TEN YEARS' WAR (1900) quoted by Vale, *supra* note 40, at 18.

[43] *Supra* note 40 at 19.

[44] *Id.* at 32.

[45] *Id.* at 39.

[46]Nick Timiraos, *Homeownership Push is Rethought*, WALL STREET JOURNAL (Sept. 12, 2008) *at:* http://online.wsj.com/article/SB122118681151726565.html?mod=googlenews_wsj (last visited Feb. 8, 2009).

[47] Zandi, *supra* note 1 at 50-52. See too Edward Golding, Richard Green & Douglas McManus, *Imperfect Information and the Housing Finance Crisis* (2008) Joint Center for Housing Studies Harvard University, at 6 *at:* http://www.jchs.harvard.edu/publications/finance/understanding_consumer_credit/papers/ucc08-6_golding_green_mcmanus.pdf (last visited Feb. 8, 2009).

[48] J. Michael Collins, *Federal Policies Promoting Affordable Homeownership: Separating the Accidental from the Strategic*, in CHASING THE AMERICAN DREAM: MULTIDISCIPLINARY PERSPECTIVES ON AFFORDABLE HOMEOWNERSHIP (William Rohe & Harry Watson, eds. 2007) at 69 and following.

[49]42 U.S.C.S. § 12701 (2003).

[50]White House, Press Release *President Bush Signs American Dream Downpayment Act of 2003 at:* http://www.whitehouse.gov/news/releases/2003/12/print/20031216-9.html (last visited Feb. 8, 2009).

[51] *Supra* note 3 at 5.

[52] Hazel Christie, Susan Smith & Moira Munro, *The emotional economy of housing*, 40 ENVIRONMENT AND PLANNING 2296, 2299 (*footnotes omitted*) (2008). As Wharton Professor Grace Wong Bucchianeri notes in *The American Dream or The American Delusion? The Private and External Benefits of Homeownership*, (2009) *at:* http://real.wharton.upenn.edu/~wongg/research/The%20American%20Dream.pdf (last visited March 5, 2009): "Home ownership is central to the American Dream in the public imagination. In a national survey, 65 percent of the respondents cited the 'dream' as a major reason to buy a home (Fannie Mae, 2003)" (at 1). She also notes at 18-19 as follows: "In the 2003 Fannie Mae National Survey, 74 percent of the respondents believe that homeownership provides the feeling of "owning something of your very own", alluding to what economists call 'the pride of ownership'. 81 percent of homeowners report homeownership being a very positive experience, while only 31% of renters report renting being so." That said, Bucchianeri goes on to question assumptions regarding what home ownership delivers emotionally, concluding: "after controlling for household income, housing quality, and health, homeowners are no happier than renters by any of the following definitions: life satisfaction, overall mood, overall feeling, general moment-to-moment emotions (i.e. affect) and affect at home but instead derive more pain from their house and home" at 4. Her findings bring into question the very foundation of public policies that promote home ownership. Moreover, these observations further underscore the insidiousness of the manipulation of first time borrowers: not only were they manipulated into ill advised mortgages, the very promise of the benefits those mortgages were to provide was, itself, a false promise.

[53] Christie, *id.* at 2299.

[54] *Id.* at 2305.

[55] *Id.* at 2305-06.
[56] *Id.* at 2305.
[57] *Id.*
[58] *Id.* at 2307.
[59] *Id.*
[60] *Id.*
[61] William M. Rohe, Roberto Quercia & Shannon Van Zandt, *The Social-Psychological Effects of Affordable Homeownership* in CHASING THE AMERICAN DREAM: NEW PERSPECTIVES ON AFFORDABLE HOMEOWNERSHIP (William Rohe & Harry Watson, eds., 2007) at 215 and 230-231.
[62] Kim Manturuk, Mark Lindblad & Robert Quercia, *Contextual Factors Moderating the Relationship between Homeownership and Political Participation* (April 2008) Working Paper, *at* http://www.ccc.unc.edu/?id=publications&t=Publications (last visited Feb. 8, 2009). But see Bucchianeri, *supra* note 52, whose study finds that homeowners are "not significantly different in terms of civic participation or social connectedness" at 5.
[63] *Supra* note 40 at 40. See too *supra*, note 3 at 6.
[64] *Supra* note 40 at 40.
[65] *Supra* note 27.
[66] Lee, *supra* note 31.
[67] Zandi, *supra* note 1 at 55.
[68] *Id.* at 59.
[69] *Id.* at 52.
[70] *Id.* at 53-54. See too Golding, Green & McManus, *supra* note 48 at 7: "with loan products that allowed borrowers to become owners with little or no equity, the prospect of being a homeowner was surely irresistible to many families who never thought they would be able to become homeowners".
[71] As noted by its website, the Federal Reserve is the Central Bank of the United States. It was founded by Congress in 1913 to provide the nation with a "a safer, more flexible, and more stable monetary and financial system." See http://www.federalreserve.gov/pf/pdf/pf_1.pdf. (last visited Feb. 8, 2009) According to the *New York Times*, the Federal Reserve has "exercises more influence over economic growth and the level of employment than any other government entity" through its power to set interest rates at http://topics.nytimes.com/top/reference/timestopics/organizations/f/federal_reserve_system/index.html (last visited Feb. 8, 2009).
[72] Zandi, *supra* note 1 at 54.
[73] *Id.* at 55.
[74] Danielle DiMartino & John Duca, in *The Rise and Fall of Subprime Mortgages*, Economic Letter, Federal Reserve Bank of Dallas 2;11 (November 2007) observe that the escape valve of selling was initially viable due to rapidly increasing house values, *at* Federal Reserve Bank of Dallas http://dallasfed.org/research/eclett/2007/el0711.html (last visited Feb. 8, 2009).
[75] *Supra* note 3 at 50. See too Retsinas, *supra* note 27 who states: "The subprime empire began with a tangible structure: a house. For the buyer, the house was a home. It represented upward mobility, a hedge against inflation, a stake in the community. As home prices rose, millions of renters, particularly those with less than stellar credit, yearned to seize the American dream."
[76] Abby Aguirre, *The Wrong Mortgage Derails a Mother's Plans*, THE NEW YORK TIMES, Nov. 8 2008 at 47.
[77] *Id.*
[78] *Id.*
[79] *Id.*
[80] Restatement 2d of Contracts §177 gives examples of the kinds of relationships that typically give rise to claims of undue influence: parent and child, husband and wife, clergyman and parishioner, and physician and patient. While other relationships may also support such a claim, they must, at a minimum, include an element of trust and confidence that are not present in the broker-borrower relationship.
[81] *Williams v Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C. Cir. 1965) at 449.
[82]The concept of unconscionability was introduced in Article 2 of the Uniform Commercial Code which applies to the sale of goods. See U.C.C.§1-102 (2003). However, some courts have applied the concept to other transactions including mortgages. See, for example, *Iamartino v. Avallone*, 2 Conn. App. 119 (1984).
[83] See Harry G. Prince, *Unconscionability in California: A Need for Restraint and Consistency* 46 HASTINGS L.J. 459 at 484-486 (*footnotes omitted*) (1995) and Frank Lopez, *Using the Fair Housing Act to Combat Predatory Lending*, 6 GEO. J. POVERTY LAW & POL'Y 73 at 88 (1999).

[84] See the National Conference of State Legislatures website *Subprime and Predatory Mortgage Lending, at*: http://www.ncsl.org/programs/banking/predlend_intro.htm (last visited Feb. 8, 2009) for a complete list of state statute citations for anti-predatory lending laws.

[85] *Id.*

[86] HOEPA (Home Ownership and Equity Protection Act) 15 U.S.C. §1601 (2008) eliminates holder-in-due-course status for purchasers of HOEPA-covered loans. The FTC has authority under HOEPA and other statutes to bring enforcement actions against predatory lenders.

[87] Note that Illinois and California, among other states, have commenced action against home loan provider Countrywide Financial Corp, alleging breach of their predatory lending statutes. As noted by Gretchen Mortgenson, *Illinois sues Countrywide Financial*, INTERNATIONAL HERALD TRIBUNE (June 25, 2008), the

> Illinois complaint accuses Countrywide and [its principal] Mozilo of relaxing underwriting standards, structuring loans with risky features and misleading consumers with hidden fees and fake marketing claims, like its heavily advertised "no closing costs loan." Countrywide also created incentives for its employees and brokers to sell questionable loans by paying them more on such sales, the complaint said.

At: International Herald Tribune http://www.iht.com/articles/2008/06/25/business/25mortgage.php (last visited Feb. 8, 2009). The Bank of America, which acquired Countrywide, has since announced a settlement, "with the bank unveiling an $8.4 billion program to modify 400,000 Countrywide-originated mortgages nationwide." See Paul Jackson, *BofA Rolls Out $8.4 Billion Loan Mod Program*, Housingwire.com (Oct. 6, 2008) *at:* Housingwire.com http://www.housingwire.com/2008/10/06/bofa-rolls-out-84-billion-loan-mod-program/ (last visited Feb. 8, 2009).

[88] *Supra* note 11 at 2.

[89] *Id.*

[90] For discussion of aspects of this phenomenon, see, for example, Genevieve Lloyd, *Maleness, Metaphor, and the 'Crisis 'of Reason* in., A MIND OF ONE'S OWN: FEMINIST ESSAYS ON REASON AND OBJECTIVITY, 2D ED. (Louise Antony & Charlotte Witt, eds ,2001); GENEVIEVE LLOYD, THE MAN OF REASON: "MALE" AND "FEMALE" IN WESTERN PHILOSOPHY 2D ED. (1993); MOIRA GATENS, FEMINISM AND PHILOSOPHY: PERSPECTIVES ON DIFFERENCE AND EQUALITY (1991); and Alison Jaggar, *Love and Knowledge: Emotion in Feminist Epistemology* in. WOMEN, KNOWLEDGE, AND REALITY: EXPLORATIONS IN FEMINIST PHILOSOPHY, 2D ED., (Ann Gary & Marilyn Purcell, eds , 1996). See too analysis offered by the law and emotions movement including in a survey article by Terry Maroney, *Law and Emotion: A Proposed Taxonomy of an Emerging Field* 30 LAW HUM BEHAV 119 (2006).

[91] Ellen L. Bassuk, *The Rest Cure: Repetition or Resolution of Victorian Women's Conflicts*, 6 POETICS TODAY 245 at 249 (1985).

[92] For further analysis, see Shannon O'Byrne, *Giving Emotions their Due: Justice Bertha Wilson's Response to Intangible Loss in Contract*, in. JUSTICE BERTHA WILSON: ONE WOMAN'S DIFFERENCE (Kim Brooks, ed., 2009).

[93] See Beverly Brown, *Contracting Out/Contracting In: Some Feminist Considerations*, in FEMINIST PERSPECTIVES ON THE FOUNDATION SUBJECTS OF LAW (Anne Bottomley, ed. 1996) at 5. Such essentialist characterization (ie. that abstraction is male) is subject to criticism by anti-essentialist scholars, notes Martha Ertman, Book Review: *Legal Tenderness: Feminist Perspectives on Contract Law* 18 YALE JOURNAL OF LAW AND FEMINISM 545 at her footnote 26 and surrounding text (2006). See too Mindy Chen –Wishart's discussion of 'Super-Detached Man' in *Undue Influence: Vindicating Relationships of Influence*, 59 CURRENT LEGAL PROBLEMS 231 at 240 and following (2006). Chen-Wishart shows how the law is framed through conceptions of a fictional individualist, devoid of all that is meaningful within relationships -- particularly, trust dependency, and commitment.

[94] LAWRENCE FRIEDMAN, CONTRACT LAW IN AMERICA 20 (1965).

[95] *Id.* at 20

[96] Ertman, *supra* note 94 at 549-550.

[97] Brown, *supra* note 94 at 9.

[98] Ertman, *supra* note 94 at 549. In support of this proposition, Ertman cites E. ALLAN FARNSWORTH , FARNSWORTH ON CONTRACTS 20-21, (2d ed. 1990) and CHARLES FRIED, CONTRACT AS PROMISE: A THEORY OF CONTRACTUAL OBLIGATION (1981).

[99] Brown, *supra* note 94 at 9.

[100] *Id.*

[101] *Id.*

[102] *Id.* at 10. See too P.S. ATIYAH, THE RISE AND FALL OF FREEDOM OF CONTRACT 141 (1979): The parties are bound contractually obligated because they chose to be.

[103] HUGH COLLINS, THE LAW OF CONTRACT 6 (4th ed. 2003). This perspective is perfectly echoed in the 1875 assessment of Jessel MR in *Printing and Numerical Registering Company v. Sampson* (1875) LR 19 EQ 462 at 465:

> [i]f there is one thing which more than another public policy requires it is that men of full age and competent understanding shall have the utmost liberty of contracting, and that their contracts when entered freely and voluntarily shall be held sacred and shall be enforced by Courts of justice.

[104] PETER NYGH, AUTONOMY IN INTERNATIONAL CONTRACTS 8 (1999).
[105] In this way, law insists on keeping emotion out of its sphere. As Terry Maroney *supra* note 90 at 120 observes: "A core presumption underlying modern legality is that reason and emotion are different beasts entirely: they belong to separate spheres of human existence; the sphere of law admits only of reason; and vigilant policing is required to keep emotion from creeping in where it does not belong" [footnote omitted].
[106] Brown, *supra* note 94 at 9.
[107] *Id.*
[108] ROBERT HILLMAN, THE RICHNESS OF CONTRACT LAW 21 (1997) footnotes deleted, summarizing Grant Gilmore's understanding of this Holmesian perspective.
[109] Brown, *supra* note 94 at 9.
[110] This insight is embedded in Lord Bramwell's 1883 assessment in *B_ v. The Manchester, Sheffield & L. Rwy Co.* regarding freedom of contract and quoted in David Abraham, *Lord Bramwell and the Political Economy of Liberal Jurisprudence, Individualism, Freedom and Utility* 38 AMERICAN JOURNAL OF LEGAL HISTORY 288 AT 311 (1994) "the fact that it (a contract) has been voluntarily entered into is the strongest possible proof that it is a reasonable agreement."
[111] 743 F.2d 10 at 17 (D.C. Cir. 1984). In contrast, Gillian K. Hadfield proposes an "expressive theory of contracts" to replace the Bargain Theory of contracts that is based on the voluntary and rational choice made by the contracting parties. Hatfield argues that in relational contracts such as those for surrogacy, marital separation agreements and spousal guarantees, choices are made under conditions of inequality, and therefore require a re-examination of 'whether and to what extent a contract should be enforced." Gilliam K. Hadfield, *An Expressive Theory of Contract: From Feminist Dilemmas to a Reconceptualization of Rational Choice in Contract Law* 146 U. PA. L. REV. 1235 at 1238 (1998).
[112] Economists also recognize that a purely rational decision maker is a fiction. The concept of "bounded rationality" attempts to explain decision making in light of the fact that individuals, for various reasons, including emotional ones, cannot take all factors and risks into account when making a decision. The theory of "bounded rationality asserts that decision makers are intendedly rational; that is, they are goal oriented and adaptive, but because of human cognitive and emotional architecture, they sometimes fail, occasionally in important decisions." Bryan D. Jones, *Bounded Rationality*, 2 ANNU. REV. POLIT. SCI. 297–32, (1999) *available at:* http://www.princeton.edu/~smeunier/JonesBounded1.pdf (last visited Feb. 8, 2009) Unlike economic theory, the law of contracts has taken no account of this limitation. See too Claire Hill, *Beyond Mistakes: The Next Wave of Behaviour Law and Economics* 29 QUEEN'S L.J. 563 (2004) who critiques the Law and Economics model for failing to recognize that people make decisions on the basis of categorization, which is one of "the most basic psychological processes that help us organize our thinking and actions and make sense of the world" (abstract).
[113] For example, the law has historically misunderstood how to approach recovery for intangible loss in contract because it involves acknowledging emotions. See Shannon O'Byrne, *Damages for Mental Distress and Other Intangible Loss in a Breach of Contract Action* 28 DAL. L. 11 (2005) and Ronnie Cohen & Shannon O'Byrne, *Cry Me a River: Recovery of Mental Distress Damages in a Breach of Contract Action - A North American Perspective* 42 AM. BUS. L. J. 97 (2005). Both of these articles were cited with approval in *Fidler v. Sun Life Assurance Co. of Canada*, 2006 SCC 30, [2006] 2 S.C.R. 3.
[114] The globalization of mortgage backed derivatives was originally regarded as a positive development because it spread risk. But the very spreading of risk also spread the subprime contagion, helping to trigger the collapse of global markets. This phenomenon, whereby late modernity actually *creates* rather than *abates* risk, was forecast by ULRICH BECK IN HIS BOOK WORLD RISK SOCIETY (1999). Beck's focus was on science and technology, however, Professor D. Jarvis observes that globalization severs local links, depersonalizes economic relationships and renders risk impersonal and unobservable" D.S.L .Jarvis, *Ulrich Beck, Globalization and the Rise of the Risk Society: A Critical Exegetic Analysis* (July 18, 2008) *available at* SSRN: http://ssrn.com/abstract=1162662 (last visited Feb. 10, 2009). Securitization of mortgages did all of these things; it severed the link between borrower and lender; depersonalized the economic relationships through innovations in capital markets, and hid the risk by creating highly complex products that individual investors even investment banks could not decipher.
[115] *Supra* note 27. Bar-Gill, *supra* note 11, notes in his footnote 32 that, in 2001, 54 percent of subprime mortgages were securitized. However, by 2006, this amount had jumped to 75 percent. It is beyond the scope of this paper to account for why capital markets purchased such securities but one explanation is that the complexity of the products was essentially bamboozling.
[116] *Supra* note 11 at 5-6, Schwarcz, *supra* note 26 at footnote 53-53 and surrounding text and Zandi, *supra* note 1 at 11. As noted by Kathleen Engel & Patricia McCoy in *Turning a Blind Eye: Wall Street Finance of Predatory Lending*) 75 FORDHAM LAW REV 2039 at 2066, (2007) lenders did not always retain any of the risk in their securitized products:

> In the process of providing credit enhancements, the lender (through an affiliate) often buys securities in the subordinated tranches [of the financial product], which are rated double-or-single B or are simply unrated. While this makes it appear that the lender retains the riskiest securities, that was not necessarily the case. Instead outside investors buy many of these so-called 'residuals,' some at the time of offering and others through later secondary market resales. There is a strong demand by outside investors…for the double-and single-B tranches. In addition,

lenders can resell their subprime residuals to outside investors through bonds known as Collateralized Debt Obligations (CDOs). Essentially, CDOs securitize residuals from RMBS and other assets.)[footnotes omitted]

See too Lynn Turner (Chief Accountant to the SEC from 1998 to 2001) who observes that securitization brought out the worst in originators: "It was their job…to make sure they were making loans that had a high chance of repayment. Unfortunately, because they could make a lot of money doing these loans and then could sell them off and have no risk, they lined their pockets at the expense of the American public." quoted in Greg Giffin, *Homeownership push seen as top culprit in crisis* DENVER POST (Oct. 5 2008), *at:* http://www.denverpost.com/search/ci_10634680> (last visited Feb. 8, 2009). But see Goodman, *supra* note 18 at 314: OTD lenders often retained the risk on the "first loss piece on a securitization", meaning that the lender did not manage to transfer all the risk to the market. However, as even these authors acknowledge, the "bull market behaviour of investors", meant that there was, in fact, "very little penalty for producing ugly collateral." For discussion of the drop in lending standards the accompanied securitization, see *infra* notes 124-127 and surrounding text.

[117] Schwarcz, *supra* note 26 at 4.

[118] Treasury Secretary Henry Paulson in *Remarks on Current Housing and Mortgage Market Developments, Georgetown University Law Center* (Oct. 16, 2007) as cited by Bar-Gill, *supra* note 11 at footnote 40.

[119] Schwarcz, *supra* note 26 at 4-5.

[120] *Id.* at 15. As Engel & McCoy, *supra* note 117 at 2049, observe, securitization solved the lender's problem of 'lemon' loans. As Zandi, *supra* note 1 at 11, notes, under securitization, the originator "might still collect the cash and handle the paperwork, but it was otherwise out of the picture."

[121] Schwarcz, *supra* note 26 at 12. For their part, investors purchased structured finance products that were entirely too complex to evaluate but trusted in ratings provided by analysts, see Zandi, *supra* note 1 at 13. Of course, this trust was entirely misplaced.

[122] Because the brokers were paid a commission regardless of whether the loan ultimately defaulted, they had strong incentives to encourage the loan even it the borrower had no realistic chance of repaying it. Beyond this, as noted by Bianco, *supra* note 8, brokers had incentives to sell complex ARMS (which refers to adjustable rate mortgages) because they "earn higher commissions on them." As Bianco also notes, the Mortgage Bankers Association has taken the position that "brokers profited from the home loan boom but didn't do enough to determine whether the borrowers could repay the loans…." Furthermore, brokers had incentives to offer the loan at a higher interest rate than the borrower's circumstances would call for in order to access a "yield spread premium." In short, a yield spread premium is the fee which a broker gets "for selling a loan above the par rate, or the lowest interest rate a borrower qualifies for" per Les Chrisie, *Buying or refinancing a home? Watch out that the loan isn't more expensive than it looks* CNN (July 5, 2007), *at:* CNNMoney.com http://money.cnn.com/2007/07/02/real_estate/yield_spread_premium_demystified/index.htm (last visited Feb. 8, 2009). The yield spread fee may not even be disclosed to the borrower until the loan closing, as noted by Patricia A McCoy, *The Middle Class Crunch: Rethinking Disclosure in a World of Risk Based Pricing* 44 HARV. J. ON LEGIS. 123 (2007). McCoy observes that while sometimes the change in rate is due to legitimate underwriting concerns, other times it is simply a ploy to increase broker compensation. In any event, the broker is not required to disclose the rate change prior to closing and the premium itself need never be explicitly revealed to the borrower. The unsophisticated borrower, at the moment of closing on the loan that will admit the borrower to the exclusive world of homeowners, is unlikely to reconsider the transaction in light of this new information.

The legality of yield spread premiums was challenged in a series of cases leading to new guidelines from HUD for determining whether these payments to brokers were legal compensation or illegal kickbacks. In a memorandum opinion in a case challenging a yield spread premium, District Court Judge Moran stated: Under the HUD test, the burden is on the borrower to show that the broker's compensation was excessive. The presumption is that so long as brokers receive only reasonable market value for their services, they have no incentive to direct referrals. YSPs, by definition, are computed based on interest rates. Requiring brokers to show a direct nexus with particular services will make it nearly impossible for any YSP to pass muster. We do not believe Congress intended RESPA to specifically prescribe which formulae brokers and lenders can and cannot use to compute their compensation arrangements. And the reasonableness prong of HUD's two-step test ensures that total compensation is not excessive. Such a lenient standard certainly has its shortcomings… it ignores the parties' intent and permits *post hoc* explanations of fees. But HUD's interpretation is consistent with the statutory purpose and it is entitled to deference." *Dominguez v. Alliance Mortg. Co*., 226 F. Supp. 2d 907 at 914 (N.D. Ill., 2002).

[123] Bar-Gill, *supra* note 11 at footnote 158.

[124] See Bianco, *supra* note 8 at 8 who notes the view that lending standards became lax due to moral hazard: "each link in the mortgage chain collected profits while believing that it was passing on the risk." As evidence, she notes that in 1998, mortgage denial was 29 percent; in 2002-2003, the denial rate had dropped to 14 percent, at 8.

[125] As Schwarcz, *supra* note 26 at 27 notes, market discipline, at least as a means of handling systemic risk in financial markets "is inherently suspect because no firm has sufficient incentives to limit risk-taking in order to reduce the danger of systemic contagion for other firms." This comment applies equally to risk at the origination stage.

[126] See Schwarcz, *supra* note 26 at 15. As Danielle DiMartino and John V. Duca of the Ferderal Reserve Bank of Dallas observe:

> Part of the reason lenders eased credit standards was that… [originators] planned to sell, rather than hold, the mortgages. The earlier easing of standards may have partly owed to the potential moral hazard entailed when nonconforming loans are originated with the intent to fully sell them to investors.

The Rise and Fall of Subprime Mortgages, Economic Letter: Insights from the Federal Reserve Bank of Dallas, Vo. 2. No. 11 (November 2007) at footnote 2, summarizing in part Federal Reserve Chairman Ben Bernanke's remarks, "Housing, Housing Finance, and Monetary Policy" (Federal Reserve Bank of Kansas City's Economic Symposium, delivered at Jackson Hole, Wyoming, August 31, 2007). See too Shiller, *supra* note 3, who states at 6:

> Mortgage originators, who planned to sell off the mortgages to securitizers, stopped worrying about repayment risk. They typically made only perfunctory efforts to assess borrowers' ability to repay their loans—often failing to verify borrowers' income with the Internal Revenue Service, even if they possess signed authorization forms permitting them to do so. Sometimes these lenders enticed the naive with poor credit histories to borrow in the ballooning subprime mortgage market. These mortgages were packaged, sold, and resold in sophisticated but arcane ways to investors around the world, setting the stage for a crisis of truly global proportions. The housing bubble, combined with the incentive system implicit in the securitization process, amplified moral hazard, further emboldening some of the worst actors among mortgage lenders.

According to Amiyatosh K. Purnanandam a "lack of screening incentives" was one cause of the subprime crisis. See *Originate-to-Distribute Model and the Sub-prime Mortgage* (February 2009), *at:* SSRN: http://ssrn.com/abstract=1167786 (last visited Feb. 8 2008), per abstract.

[127] Schwarcz, note 26 at 27.

[128] *Supra* note 11 at 2 and following.

[129] *Id.* at 2.

[130] *Id.* at 2-3.

[131] *Id.* at 24.

[132] *Id.* at 2.

[133] *Id.*

[134] *Id.*

[135] *Id.*

[136] *Id.* at 22.

[137] *Id.* at 23.

[138] *Id.*

[139] As previously noted, not all did. See *supra* note 72-76 and surrounding text.

[140] *Supra* note 11 at 3.

[141] *Id.*

[142] *Id.*

[143] *Id.* at 4. See too Melvin Aron Eisenberg who observes that "[contr]actors are unrealistically optimistic as a systematic matter" and that "[contr]actors make decisions on the basis of data that is readily available to their memory, rather than on the basis of all the relevant data." He concludes that these two defects in decision making are closely related, and "if actors are unrealistically optimistic they will systematically underestimate risks. If actors systematically underestimate risks, they will be unrealistically optimistic." See Melvin Aron Eisenberg, *Symposium on Law in the Twentieth Century: The Emergence of Dynamic Contract Law* 88 CALIF. L. REV. 1743 at 1783 (2000). Eisenberg observes a movement towards a more dynamic contract law which he argues is better suited to modern commercial transactions.

[144] We are grateful to Professor Linda Reif, Faculty of Law, University of Alberta, for this insight. Note that in the U.S., millions of private investors' mutual fund accounts include mortgage backed securities. Some of these are part of managed 401K retirement accounts. Litigation in which plaintiffs are claiming that the funds were misrepresented as "safe investments" have been filed against several financial services providers, such as State Street Bank, Goldman Sachs and Charles Schwab. See Kathryn A Bruce and Richard R. Zabel, C.P. A., *Trapped with Toxic Assets: Addressing Mortgage-Backed Securities and Other Mortgage-Related Securities Losses* (Jan. 26, 2009) available at http://www.rkmc.com/Trapped-with-Toxic-Assets-Addressing-Mortgage-Backed-Securities-and-Other-Mortgage-Related-Securities-Losses.htm (last visited Feb. 10, 2009).

[145] A firm would not even necessarily concern itself with risks to reputation because, during the bubble, there was "very little penalty for producing ugly collateral" per Goodman *supra* note 18 at 314.. See too, *supra* footnote127 and surrounding text concerning the 'tragedy of the commons" aspect of the subprime crisis.

[146] Donald Morgan *Defining and Detecting Predatory Lending* (Federal Reserve Bank of New York Staff Reports; Staff Report no. 273, January 2007) at 2 (footnote omitted) *at:* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=962711 (last visited March 20, 2009).

[147] *Id.*
[148] *Id.*
[149] *Id.* (footnotes omitted.) See too Howard Lax, Michael Manti, Paul Raca, and Peter Zorn *Subprime Lending: an Investigation of Economic Efficiency* (2004) 15 HOUSING POLICY DEBATE 533 *at* http://www.mi.vt.edu/data/files/hpd%2015(3)/hpd%2015(3)_article_lax.pdf (last visited March 21, 2009) who observe (per abstract) that subprime borrowers "are disproportionately minority and lower income, older, less well educated, less financially sophisticated, and less likely to search for the best interest rate when applying for a mortgage" at http://www.mi.vt.edu/data/files/hpd%2015(3)/hpd%2015(3)_article_lax.pdf (last visited Feb. 9, 2009). See too Francine J. Lipman, *The Graying of Poverty: The Rollercoaster Ride of Increasing Debt, Decreasing Savings and Lack of Financial Education* abstract *available at* http://taxprof.typepad.com/taxprof_blog/2008/04/tax-profs-at-la.html who notes that borrowers who are senior citizens (i.e. 65 years of age or older) are five time more likely to be subprime borrowers than those under 35 years old (last visited March 20, 2009).
[150]Lax, *supra* note 150. Senator Charles Schumer, Chairman of the Joint Economic Committee, observes that 11 percent of subprime borrowers were first time homeowners in 2006. See *Schumer Addresses the Subprime Housing Crisis and Possible Recession at the Brookings Institution* (press release) *at:* http://jec.senate.gov/archive/Documents/Releases/12.19.07brookingsspeechrelease.pdf (last visited March 20, 2009).
[151] The Federal Trade Commission, Improving Consumer Mortgage Disclosures- *An Empirical Assessment of Current and Prototype Disclosure Forms*, available *at:* http://www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf (last visited Feb. 9 2009) (hereinafter the "FTC Study.")
[152] Morgan, *supra* note 146 at 2. Kathleen Keest, senior policy counsel at the research and policy group Center for Responsible Lending observes that while subprime borrowers risk going deeper and deeper into debt, "[n]one of that is obvious from the papers." She states: "If you look at the documentation for a payment option ARM, I defy 95% of people to understand what was going on." Elenor Laise, *Some Consumers Say Wall Street Failed Them* WALL STREET JOURNAL (Nov. 29, 2008) *available at:* http://online.wsj.com/article/SB122791328588265155.html?mod=googlenews_wsj (last visited Feb. 9, 2009).
[153] Bar-Gill *supra*, note 11 at 1-2 (footnotes omitted).
[154]*Id.* at 24 (footnotes omitted). See too Jack Guttentag who identifies several reasons why the home loan mortgage contract is so complex: "market nichification, price volatility, rebate pricing, price complexity, locking delays, and processing complexity." See JACK GUTTENTAG , ANOTHER VIEW OF PREDATORY LENDING 12 (2001).
[155] *Supra* note 11 at 40.
[156]*Id.* footnotes omitted.
[157] Congressional Budget Office (CBO) Testimony of Peter Orzag "The Current Economic Situation" before the Committee on the Budget, U.S House of Representatives (Dec. 5, 2007), quoted by Bar-Gill, *id.* at 37. Note that Orzag was recently appointed President Obama's budget director. See Huffington Post *at* http://www.huffingtonpost.com/2008/11/18/peter-orszag-obamas-budge_n_144704.html (last visited Feb. 5, 2009).
[158]Shiller, *supra* note 16 at 22. Interestingly, Schiller also argues for additional information to the sophisticated investors and financial professionals. He proposes a real estate futures market that would operate to temper optimism to a more realistic level.
[159] *Id.*
[160]*Id. See also* MARK WIRANOWSKI, "SUSTAINING HOME OWNERSHIP THROUGH EDUCATION AND COUNSELING (2003). On the flipside, an FTC study tested current disclosures against a prototype disclosure statement that was designed specifically for the complex types of loans prevalent in the subprime market. While all borrowers' understanding of their contractual obligations increased using the prototype, the increase was greatest for the subprime group. FTC study. *But see*, Susan Block-Lieb and Edward J. Janger, *The Myth of the Rational Borrower: Rationality, Behavioralism, and the Misguided 'Reform' of Bankruptcy Law*, 84 TEX. L. REV. 1481 (2006) conclude that incentives for lenders to manipulate borrowers are so strong, that improving disclosure is unlikely to resolve the problem. They argue that "disclosure regulations create incentives for lenders to draft contract terms that evade current disclosure regulation and continue to obscure the actual contract terms" at 1560 . Moreover, "a laundry list may overload consumers and render the notice counterproductive [and] lenders may simply amend contractual terms to keep one step ahead of regulatory requirements" At 1561.
[161] These are primarily the Truth and Lending Act, (TILA) 15 U.S.C. § 1601(2008) originally enacted in 1968 and Good Faith Estimate (GFE) disclosures that are required by the Real Estate Settlement Procedures Act , 12 U.S.C.§ 2601(2008) originally enacted in 1998.
[162]For the statement of Chairwoman Majoras, see "FTC Releases Staff Report on Improving Mortgage Disclosures" Federal Trade Commission, June 13, 2007 *at*: http://www.ftc.gov/opa/2007/06/mortgage.shtm (last visited March 20, 2009).
[163] FTC Study *supra* note 151.
[164] Michael I. Meyerson *The Efficient Consumer Form Contract: Law and Economics Meets the Real World*, 24 GA. L. REV. 583 at 605 (1990).

[165] FTC Study *supra* note 151.
[166] See the ETYMOLOGY DICTIONARY at http://www.etymonline.com/index.php?term=mortgage (last visited Feb. 5, 2009).
[167] This photograph by Fernando Morales accompanies a story by Paul Waldie, *Homeowners left to 'hope and pray' as foreclosure filings soar* (Oct. 1, 2008) GLOBE & MAIL at page 1.
[168] Zandi *supra* note 1 observes that since the 1970's, bonds "backed by residential mortgages" had already been invented by bankers and traders, at 10. That said, and as Zandi notes, in the period leading up to the subprime crisis, the "financial innovation machine went into high gear." at 10.
[169] It is beyond the scope of this paper to describe how regulatory failures contributed to the subprime crisis.. We observe, however, Bar-Gill's reference to the Federal Reserve Board's motivation in its new mortgage regulations. He quotes the Reserve as noting that "several riskier loans attributes," including "high loan-to-value ratio[s]" and "payment shock on adjustable-rate mortgages," "increased the risk of seriously delinquency and foreclosures for subprime loans originated in 2005 through early 2007." The new regulations are intended to address these deficits. See Bar-Gill, *supra* note 11 at footnote 208 and surrounding text.
[170] Various consumer protection statutes adopt the "least sophisticated consumer" standard. See, for example, *Smith v. Transworld Systems, Inc*., 953 F.2d 1025**,** 1028 (6th Cir. 1992) applying the least sophisticated consumer standard to determine whether a collection letter violated the Fair Debt Collection Practices Act, and *Jeter v. Credit Bureau*, 760 F.2d 1168, 1173 (11th Cir. 1985) quoting Federal Trade Commission v. Standard Education Soc., 302 U.S. 112, at 116 (1937) (the "fact that a false statement may be obviously false to those who are trained and experienced does not change its character, nor take away its power to deceive others less experienced.").
[171] As Dwight Jaffee and John Quigley note in *Housing Policy, Subprime Mortgage Policy and the Federal Housing Administration* (August 2007): "Government intervention … no doubt reflects some paternalism but…financial decisions by consumers often reflect framing and other behaviours with the results that an element of low-cost paternalism might be judged highly beneficial overall" at 36. See http://urbanpolicy.berkeley.edu/pdf/JQ_Housing_Policy_to_Lucas_080807.pdf On this basis, the authors propose an increased regulatory focus on predatory lending in the subprime mortgage market, at 35, including increased disclosures, at 38.
[172] Frank A. Hirsch, Jr., *The Evolution of a Suitability Standard in the Mortgage Lending Industry: The Subprime Meltdown Fuels the Fires of Change*, 12 N.C. BANKING INST. 21 (2008). See too Jaffee, *supra* note 171 at 27.
[173] Lloyd T. Wilson, *Effecting Responsibility In the Mortgage Broker Borrower Relationship: A Role for Agency Principles in Predatory Lending Regulation*, 72 U. CIN. L. REV. 1471(2005).
[174] Shiller, *supra* note 3 at 22.
[175]See Jaffee, *supra* note 171 (per abstract.) These authors propose an increased regulatory focus on predatory lending in the subprime mortgage market, at 35, including increased disclosure requirements, at 38.
[176]In fact, whether homeownership should be a public policy goal at all has been called into question by Bucchianeri's study, see note 53 *supra*. Citing that study, Richard Florida writes "If anything, our government policies should encourage renting, not buying. Homeownership occupies a central place in the American Dream primarily because decades of policy have put it there….. Instead of resisting foreclosures, the government should seek to facilitate them in ways that can minimize pain and disruption. Banks that take back homes, for instance, could be required to offer to rent each home to the previous homeowner, at market rates—which are typically lower than mortgage payments—for some number of years." Richard Florida, *How the Crash will Reshape America.* THE ATLANTIC. March 2009, *available at:* http://www.theatlantic.com/doc/200903/meltdown-geography
[177] Jeremy Blumenthal in *Emotional Paternalism* 35 FLA ST. U. L. REV 1 (2007) notes that legislative paternalism may, in fact, be especially appropriate in the context of "emotionally laden tasks" at 64. He argues, "[w]here lay perceptions of risk are biased due to emotional factors, more accurate third-party judgments of those risks should be substituted" at 64 - 65. While Blumental cites situations regarding physical dangers such as terrorism or smoking, his observation has broader implications for the mortgage contract context. According to Blumenthal: "the justification for this sort of substantive legislative paternalism may be not that such decisionmakers necessarily know individuals better than they do themselves, or necessarily make better decisions and judgments. Rather, the justification may simply be that they are more likely to be free of particular emotional biases. Thus, one implication is to suggest cooling-off periods for judgments or decisions that are likely to be biased by immediate or incidental affect, and the use of experts or other substitute decisionmakers for judgments about or involving emotionally-laden events" at 66. Note too that as government home-ownership policy resulted in people owning homes they could not actually afford, it is fitting that government seek to legislatively correct that problem going forward.
[178] President's Working Group on Financial Markets, *Policy Statement on Financial Market Developments* (March 13, 2008) (hereafter President) at 3 and 11 at: http://www.ustreas.gov/press/releases/reports/pwgpolicystatemktturmoil_03122008.pdf (last visited Feb. 5, 2009).
[179] For a discussion of the problem of information asymmetry in standard form consumer contracts, see Schmuel I. Becher, *Asymmetric Information in Consumer Contracts: The Challenge that is Yet to be Met*, 45 AM.BUS,L. J. 723 (2009).
[180] *Id.* at 3 and 12. See too Jaffee, *supra* note 171 at 27.

[181] Shiller, *supra* note 16 at 22.
[182] For discussion of these features, see Bar-Gill, *supra* note 11 at 2-3.
[183] President's Working Group on Financial Markets, *supra* note 173 at 3. Note that it is beyond the scope of this paper to access the extent to which regulators have or have not acted on these and related recommendations. For analysis of this question, see President's Working Group on Financial Markets, *Progress Update on March Policy Statement on Financial Market Developments* (October 2008) at 7 and following.
[184] Schwarcz, *supra* note 26 at 12.