



Notre Dame Journal of Law, Ethics & Public Policy

Volume 27 | Issue 2

Article 9

6-1-2013

Treading in High Tide: Examining Moral Hazard within Foreclosure Reform

Laura P. Pollard

Follow this and additional works at: <http://scholarship.law.nd.edu/ndjlepp>

Recommended Citation

Laura P. Pollard, *Treading in High Tide: Examining Moral Hazard within Foreclosure Reform*, 27 NOTRE DAME J.L. ETHICS & PUB. POL'Y 585 (2013).

Available at: <http://scholarship.law.nd.edu/ndjlepp/vol27/iss2/9>

This Note is brought to you for free and open access by the Notre Dame Journal of Law, Ethics & Public Policy at NDLScholarship. It has been accepted for inclusion in Notre Dame Journal of Law, Ethics & Public Policy by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.

TREADING IN HIGH TIDE: EXAMINING MORAL HAZARD WITHIN FORECLOSURE REFORM

LAURA P. POLLARD*

INTRODUCTION

A major debate within the areas of mortgage and foreclosure law is that of “moral hazard.” As specifically applied within the context of financing in the housing industry, moral hazard carries a two-part ethical concern. The first ethical concern is that legislative refinancing and assistance programs, designed to assist borrowers who “behaved responsibly” but nevertheless fell upon difficult economic times and became unable to repay their mortgage loan obligations, will also permit borrowers who behaved irresponsibly to receive assistance.¹ The second ethical concern is that, by granting relief to homeowners who have defaulted on their mortgages, the law cultivates an acceptance of loan default, which encourages other borrowers to default purposefully if doing so will benefit them financially.² This application of the concept of “moral hazard” pits a subjective standard of moral and ethical obligations to repay debt owed on mortgage loans against an objective economic standard, where homeowners pay more in mortgage and interest than their homes are worth.³ As borrowers desperately turn to the law for guidance

* J.D. Candidate, Notre Dame Law School, 2013. I would like to thank Professor Judy Fox for the inspiration and guidance I received while writing this Note. I would also like to thank the members of the *Notre Dame Journal of Law, Ethics & Public Policy* for their hard work in editing and providing feedback.

1. Ruth Simon & Nick Timiraos, *Financing ‘Moral Hazard’ Is Tough in Housing Plan*, WALL ST. J., Feb. 21, 2009, <http://online.wsj.com/article/SB123517426207837283.html>; see also Elyse Cherry, Op-Ed., *A Realistic Fix for the Mortgage Crisis*, L.A. TIMES, Oct. 28, 2011, <http://articles.latimes.com/2011/oct/28/opinion/la-oe-cherry-foreclosure-20111028>.

2. See generally Richard H. Thaler, *Underwater, but Will They Leave the Pool*, N.Y. TIMES, Jan. 23, 2010, <http://www.nytimes.com/2010/01/24/business/economy/24view.html>.

3. Kathryn Hatter, *How to Define ‘Underwater Mortgage,’* S.F. GATE, <http://homeguides.sfgate.com/define-underwater-mortgage-9500.html> (last visited Feb. 16, 2013).

and aid to regain control of their financial situations and home ownership, lending institutions push back, citing moral hazard as a reason to oppose assistance programs, and ethical obligations as a reason that foreclosure should not be an acceptable solution.⁴ Although lending institutions have some valid reasons to fear the changing ethical climate regarding loan and debt obligations,⁵ there are greater concerns, both ethical and economic, involved in resisting corrective measures for borrowers facing default. The economy cannot be revived and returned to a pattern of growth when so many borrowers continue to swim upstream with their finances, making payments on a mortgage that will never be fully repaid. Furthermore, in their opposition to assistance programs for homeowners, lenders have solidified their role as the “enemy.” Many homeowners blame lending institutions for their mortgage and home ownership woes, wondering why these financial experts would approve loans that were later deemed inadvisable and risky.⁶ In failing to accept responsibility for their own role in the mortgage crisis, and in further opposing corrective measures, lenders have done even more damage to the ethical climate of the loan industry because borrowers have become angry and mistrustful of lending institutions.⁷ In light of the difficult economic climate and the emotionally-driven tension between borrowers and lenders, the law must view the situation from an objective perspective, and should take measures that will address and correct the situation

4. See Gregory Scott Crespi, *The Trillion Dollar Problem of Underwater Homeowners: Avoiding a New Surge of Foreclosures by Encouraging Principal-Reducing Loan Modifications*, 51 SANTA CLARA L. REV. 153, 182 (2011); see also Brent T. White, *Underwater and Not Walking Away: Shame, Fear and the Social Management of the Housing Crisis*, 45 WAKE FOREST L. REV. 971 (2010).

5. Carrie Bay, *Survey: More Underwater Homeowners Open to Strategic Default*, DSNEWS.COM (May 13, 2011), <http://www.dsnews.com/articles/survey-more-underwater-homeowners-open-to-strategic-default-2011-05-13>.

6. See generally Debra Poggrund Stark, *Unmasking the Predatory Loan in Sheep's Clothing: A Legislative Proposal*, 21 HARV. BLACKLETTER L.J. 129 (2005) (providing a definition and explanation of predatory lending and the subprime market, and articulating homeowners' confusion and frustration with lending institutions' practice of allowing, or even inducing borrowers into, bad loans).

7. Cf. Cecil J. Hunt, II, *The Price of Trust: An Examination of Fiduciary Duty and the Lender-Borrower Relationship*, 29 WAKE FOREST L. REV. 719 (1994). In his article, Hunt provides a detailed explanation of the unique relationship that is formed between borrowers and lenders, and the various elements of the relationship that can involve a special trust on the part of the borrower, and which give rise to special, fiduciary duties on the part of the lender. Because the relationship often involves an exchange of confidential information, and because both parties have vested financial interests in the transaction, violations of the fiduciary duty to the borrower can be especially damaging to the relationship, or to future relationships of a similar nature.

of underwater mortgages for the greater economic good, without concerning itself with the moral hazard or ethical obligations surrounding loan repayment.

This Note will argue that the law should resist drawing ethical conclusions about the decisions of homeowners to default on mortgage loans and allow banks and lending institutions to foreclose on their homes. Imputing concern for an ethical obligation of borrowers to continue to make payments on an underwater mortgage onto proposals that would help these borrowers get back on track financially ignores the economic reality and financial ability of homeowners and places an undue strain upon the economy. The result is a situation that prevents borrowers and lenders alike from taking the necessary steps to clean up past mistakes and work towards improving the economy nationwide.

To support the assertion that the law should favor remedies that will help revive the economic efficiency of the housing market over the ethical concern that a “moral hazard” will develop that encourages borrowers to default, this Note will examine several important elements of the mortgage loan process as it currently stands, as well as emerging proposals to assist homeowners who are underwater on their mortgages and homes. Part I will provide a general background of the recent housing crisis, and will define key terms, such as “underwater” and “moral hazard,” as they pertain to mortgages and proposed homeowner assistance programs. Part II will identify and explain the opposition that lending institutions have put forth with regards to the proposed assistance and refinancing programs, and will also identify and assess lending institutions’ concerns for the perpetuation of moral hazard. Particular focus will be given to the reality of this concern, and an assessment of available statistics regarding strategic default within recent years will serve to support the assertion that strategic default is not as prevalent as lending institutions often claim it to be. Part III will address the manner in which moral hazard has influenced legislative proposals and procedures regarding mortgage loan refinancing and repayment assistance programs. Part III will also address potential damage to the United States economy as a whole if the law does not set aside the concern for ethical obligations in the course of the discussion of economic remedies to underwater mortgages. Finally, Part IV will suggest methods that will more effectively assist homeowners, and that will shift the lending industry’s excessive focus on moral hazard toward more constructive measures of reform.

I. BACKGROUND ON THE HOUSING AND FINANCIAL CRISIS

Explaining the cause and progression of events that led to what is now often called the “Financial and Housing Crisis,” has been a challenge for even the most educated and experienced analysts and scholars. Providing a plain-language synopsis to the general public has been even more difficult, and people of all backgrounds, educational levels, and experiences have struggled to understand the economic situation that has unfolded over the course of the past few years. This barrier to explanation and comprehension has likely contributed to the frustration of many who have sought to offer their insight and ideas as to how to remedy this crisis, and has almost certainly exacerbated been the outrage and devastation that borrowers and homeowners have experienced. Without background information and a basic understanding of how the mortgage crisis arose, it is not possible to fully understand its economic and ethical elements, and the role that these considerations play in determining policy measures that affect borrowers and lenders alike, as well as the economy as a whole.

A. *The Mortgage Crisis: A Short History of a Long Road to Recovery*

To overcome the hurdles to comprehension that are posed by the incredible amount of information and events that have contributed to the Financial Crisis, the best summaries have chosen to focus on specific aspects, usually those that are most pertinent to their proposal, objective, or theory, and have “trimmed the fat,” discarding information that is not entirely relevant or that could increase confusion. For a streamlined explanation of the crisis, it is informative to consult speeches given by Professors William T. Allen and Steven L. Schwarcz at the 2009 *New York University Journal of Law and Business* Annual Symposium.⁸ In summary, Professors Allen and Schwarcz assert that, “securitization markets collapsed due to a systemic cascade of failures initially triggered by the historically unanticipated depth of the fall in housing prices.”⁹ Nevertheless, financial institutions continued to regularly approve mortgage loans to “risky borrowers,” with the expectation of refinancing these loans, and thereby

8. William T. Allen & Steven L. Schwarcz, *Proceedings of the 2009 Annual Symposium: Modernizing the Financial Regulatory Structure: Introductory Remarks*, 5 N.Y.U. J. L. & Bus. 339 (2009) (explaining the series of events within the financial market that ultimately led to the credit crunch and current financial crisis, and identifying subprime mortgage loans to risky borrowers as the initial trigger).

9. *Id.* at 347.

negating risk factors, through home appreciation.¹⁰ These high-risk borrowers were unable to refinance when home prices ceased to appreciate, and many defaulted on their mortgage loans, which in turn caused mortgage-backed securities, and the financial institutions that issued them, to be downgraded in their investment grade.¹¹ The loss of credibility as an investment institution cinched the cash flow to these lenders, which abruptly caused market prices to “plummet” and, in several cases, led to the bankruptcy of institutions that had previously reigned as industry giants for many years.¹²

B. *Mortgage and Foreclosure: A New Language for American Homeowners*

An ancillary effect of the recent economic and financial crisis has been the introduction of a new vocabulary. A variety of buzzwords and catchphrases arise regularly in newspaper articles, and terms previously only used within boardrooms of investment banks and finance corporations have become a part of the everyday language of many Americans. Particularly in the context of mortgages and foreclosures, many of these frequently used terms carry specific meanings that are unclear on their face. To understand an analysis of moral hazard in the arena of mortgage and foreclosure law, one must be familiar with a concise, and generally accepted, meaning of certain terms in particular. While there may not be universal consensus, even among experts and academics in the field, as to the meaning of these terms, for purposes of this Note, definitions and meanings for certain important and commonly used terms will remain consistent throughout the piece. The words and phrases used herein will reflect the meaning most widely recognized by financial and loan industry experts and academics.

C. *The Concept of “Moral Hazard”*

The concept of “moral hazard” has become a controversial and oft-discussed issue in the area of mortgage and foreclosure law.¹³ Many discussions and proposals regarding the mortgage reconfiguration or refinancing process include some mention of the concern that struggling borrowers and homeowners will abuse assistance programs by purposefully and strategically

10. *Id.*

11. *Id.*

12. *Id.* at 348.

13. *See, e.g.,* White, *supra* note 4.

defaulting on their mortgages.¹⁴ This “moral hazard,” lending institutions and critics of the refinancing and assistance programs say, allows irresponsible borrowers to take the easy way out by foreclosing on their house rather than struggling through the repayment and interest requirements that have bankrupted and devastated so many.¹⁵ While it is undeniable that strategic default is a reality, and is a move that some homeowners who could feasibly repay their mortgages have decided to make, “moral hazard” has become a catchphrase used by lending institutions in protest against refinancing programs and loan modifications.

Although “moral hazard” has perhaps only recently become a household phrase in American society, rising to common usage in the wake of the controversial Bear Stearns bailout,¹⁶ it has been used since the eighteenth century.¹⁷ The term has predominantly been used since the nineteenth century in scenarios involving insurance or finance, to categorize the risk that individuals will purposefully behave in an immoral or dishonest way in order to gain a benefit only available under specific circumstances.¹⁸ While many authorities in these fields maintain that the term carries a neutral connotation,¹⁹ there is little opposition to the assertion that the term has a highly pejorative meaning as used in modern media, literature, and discussion. It is difficult to imagine modern usage of a phrase containing the word “hazard” meeting the standard for even a neutral connotation, and this is certainly the case for use of the phrase within the sphere of mortgage loans and foreclosures.

The concern for moral hazard with regards to mortgage loan refinancing and assistance policies involves the possibility that, while helping homeowners who “behaved responsibly but wound up in trouble,” some borrowers who did, in fact, behave

14. *Id.*

15. James R. Hagerty, *Is Walking Away from Your Mortgage Immoral?*, WALL ST. DEV. BLOG (Dec. 17, 2009, 12:31 PM), <http://blogs.wsj.com/developments/2009/12/17/is-walking-away-from-your-mortgage-immoral/>.

16. Frank Ahrens, ‘Moral Hazard’: *Why Risk Is Good*, WASH. POST, Mar. 19, 2008, <http://www.washingtonpost.com/wp-dyn/content/article/2008/03/18/AR2008031802873.html>.

17. Allard E. Dembe & Leslie I. Boden, *Moral Hazard: A Question of Morality?*, 10 J. ENVTL. & OCCUPATIONAL HEALTH POL’Y, 257, 258 (2000).

18. *Id.* at 261 (identifying the emergence of the term within the growing insurance industry to categorize individuals who insurance companies believed would concoct and execute schemes by which they would qualify to collect insurance payments, after having observed others who were able to collect due to real experiences and necessity).

19. *Id.* at 258.

irresponsibly will also receive assistance.²⁰ In this sense of the term, the hazard lies with the borrower – that they will disregard the moral or ethical obligation to repay their mortgage, in light of the more attractive or more convenient option of seeking and accepting assistance, refinancing, or modifications.²¹ There is widespread fear (primarily among lending institutions, but one that is shared by critics in other arenas as well) that, as assistance becomes an increasingly available option to borrowers, those borrowers who are facing mere financial difficulty, rather than complete financial destitution, in mortgage repayment will attempt to take advantage of these programs.²² Lenders worry that borrowers will become jaded to the seriousness of the promise implicit in a mortgage agreement. Borrowers, however, are not the experts in the loan and finance industry. Lenders themselves, in a different but equally dangerous manner, engage in moral hazard by counseling and approving loans to unqualified, or underqualified, applicants,²³ and by using the premise of ethical concerns to prohibit measures that will objectively improve the economic situation.

D. *Underwater Mortgages*

One of the most common terms that is not always fully or correctly understood by those who use it is the description of a homeowner as “underwater” on his or her mortgage. When discussing secured loans, such as mortgages, home equity, or auto loans, a borrower is “underwater” when he or she owes more debt on a particular asset than the asset is worth.²⁴ Within the mortgage loan industry, and as discussed within the context of the mortgage and housing crisis, this would mean that the homeowner owes more money on his or her mortgage than his or her home is worth, and is therefore paying amounts each month to the lending institution that would, if completely paid off over the

20. Simon & Timiraos, *supra* note 1; *see also* Cherry, *supra* note 1 (explaining moral hazard as the fear that providing help to homeowners who are facing default due to their true inability to repay their mortgage obligations will incentivize other homeowners to default as well, due to their desire to receive the same assistance).

21. *Id.*

22. Simon & Timiraos, *supra* note 1.

23. Stark, *supra* note 6.

24. For purposes of this Note, this will be the meaning of the term “underwater” as used throughout the discussion. For further discussion on the origin and significance of “underwater” status on mortgage loans, or secured loans more generally, see Evan Bedard, *Definition of Underwater Mortgage*, MORTGAGE NEWS DAILY (Nov. 19, 2009), <http://www.loansafe.org/definition-of-underwater-mortgage>.

period of time specified in the mortgage contract, exceed the value at which the homeowner could sell the house on the market. Some homeowners or others unfamiliar with the mortgage or loan industry confuse being “underwater” with merely being in debt on a mortgage, or unable to afford and pay mortgage repayments, but these are very different situations.²⁵ When a homeowner simply owes payments on their mortgage, these payments still represent the value of the home, as configured in the loan agreement.²⁶ When a homeowner has become “underwater” on a mortgage, his or her debt has exceeded the value of the home in question.²⁷

Even if the homeowner were able to afford the mortgage payments, he or she would be paying in excess of the market price of the home.²⁸ Underwater mortgages are often the focus of mortgage repayment assistance programs, and home mortgages that are underwater can create situations in which homeowners consider default to be their best option for personal financial recovery.²⁹

A homeowner may come to be underwater on his loan in several situations.³⁰ One scenario that leads to underwater mortgage loan status occurs when the homeowner refinances his mortgage after having accrued equity in the home.³¹ Once equity is accrued, lenders may approve additional loans to the borrower, which are based upon the home equity.³² Trouble arises for the homeowner in this situation when the homeowner no longer has a significant amount of equity to support the additional loan.³³ The homeowner will be responsible for paying an additional amount each month for the home loan, when the home is not valued at the same total amount which the homeowner must pay.³⁴ A second situation that may cause a homeowner to go underwater on his or her mortgage loan occurs when home values drop.³⁵ Homeowners continue to pay the amount on their mortgage as originally calculated by the home’s

25. *Id.*

26. Hatter, *supra* note 3.

27. *Id.*

28. *Id.*

29. Tim Rood, *Strategic Default: Inconceivable Assumptions Suddenly Conceivable*, MORTGAGE NEWS DAILY (May 12, 2011, 12:09 PM), <http://www.mortgagenewsdaily.com/channels/voiceofhousing/211245.aspx>.

30. *See* Hatter, *supra* note 3.

31. *Id.*

32. *Id.*

33. *Id.*

34. *Id.*

35. *Id.*

higher value, and then must continue paying this higher amount for a home that is no longer worth that price on the market.³⁶

In understanding the definition of underwater mortgage loans, the significance also becomes apparent. Borrowers are clearly reluctant to pay more for their homes than the house is worth. It is a generally recognized economic (and common sense) principle that it is rarely in one's best interest to pay more for an asset than the amount for which it could be sold on the open market at any given time. Even taking into consideration that homeowners are likely willing to pay more to keep their homes due to sentimental value, pride, and a desire to avoid the inconveniences of seeking a new home,³⁷ this additional price must always have some limit. Though this above-market price value of a home will vary from one homeowner to another, regardless of how high a homeowner is willing to set its ceiling, the resources available to the homeowner to repay are prohibitive. Default becomes an attractive, and not unreasonable, option for many homeowners in this situation.³⁸

II. THE REALITY OF MORAL HAZARD AND STRATEGIC DEFAULT

The reality of strategic default, and whether borrowers and homeowners willfully seek to disregard any moral obligation related to the promise of repaying a mortgage has been extensively explored. What has not been examined as closely, or at least has not been asserted as forcefully, is whether this concern has a place in the process of drafting legislation designed to assist struggling homeowners and to help revive the housing market and economy. Before examining this issue, it is helpful to assess the facts and figures of strategic default among American homeowners in order to develop a basis for judging whether moral hazard is a valid and pervasive concern.

36. See Hatter, *supra* note 3; see also Rood, *supra* note 29 (providing statistics regarding the sudden and severe decline in home values nationwide, which dropped between thirty and fifty percent from their peak in 2006, and wiped out approximately \$7 million of home equity in the process).

37. Cherry, *supra* note 1.

38. Thaler, *supra* note 2 (taking the argument further, and in the reverse, to propose that once homeowners are no longer underwater, they will have little or no incentive to default, and that loan refinancing should seek to match home values with mortgage payments to negate underwater status, keep homeowners in their homes, and avoid moral hazard).

A. *Facts and Figures of Strategic Default Among American Homeowners*

At the end of the year in 2010, 11.1 million homeowners (23.1% of all homes that are mortgaged) were faced with decisions pertaining to their mortgage payments.³⁹ A survey conducted by Fannie Mae revealed that 27% of homeowners with negative equity would consider strategic default to be a viable option.⁴⁰ That statistic is based on a nationwide poll taken during the first three months of 2011, and that number was up from 15% who answered accordingly in the January 2010 survey.⁴¹ This statistic reveals that people may have begun to understand the appeal of strategic default.⁴² A significant percentage of homeowners have considered this option themselves, and a much larger number knows, or has known, someone facing the same situation. This certainly validates lenders' concern that the ethical norm for borrowers has shifted, with the social stigma associated with default disappearing at what might even be considered a rapid rate.

Despite statistics reflecting a shift in attitude among Americans that defaulting on a loan is a socially acceptable option, evidence also supports the assertion that, while this may be the personal opinion of more homeowners than in years or generations past, these homeowners do not always act in accord with their new beliefs. While nationwide, "millions of American homeowners are 'underwater,' meaning that they owe more on their mortgages than their homes are worth," these statistics can also be analyzed in specific locations to support the conclusion that, despite being underwater, homeowners generally choose to continue to make their mortgage payments regularly.⁴³ In one particular study conducted in Nevada, nearly two-thirds of homeowners fall within the category of being "underwater" on their mortgages, "yet most of them are dutifully continuing to pay their mortgages, despite substantial financial incentives for walking away from them."⁴⁴

39. Rood, *supra* note 29 (providing results from a National Housing Survey conducted by Fannie Mae, with analysis by CoreLogic, which illustrates the "alarming" increase in the number of homes that are underwater and the number of homeowners who are concerned about their current financial situation and ability to make their monthly mortgage payments).

40. Bay, *supra* note 5.

41. *Id.*

42. *See generally id.*

43. Thaler, *supra* note 2.

44. *Id.*

The Chicago Booth/Kellogg School Financial Trust Index “regularly assesses Americans’ trust in various aspects of the nation’s financial system,” and found that, in March 2011, there was a nationwide decrease in the number of strategic defaults.⁴⁵ The index found that strategic default rates were at 30% across all states, down from 37% in December of 2010.⁴⁶ This does not conclusively prove that lenders and financial institutions have an unrealistic fear as to the amount of strategic defaulters or potential strategic defaulters. However, it does support the assertion that the problem is not as pervasive as is often claimed. Additionally, it suggests that any nationwide problem with strategic default is actually in remission.

B. *Reconciling Motives with Actions: Will Strategic Default Be Another Way in Which American Homeowners Are “Keeping Up with the Joneses”?*

It can be difficult for the average individual to imagine that a person would knowingly choose to default on an obligation. It is even more difficult for those who have not had personal or firsthand experience with financial difficulties, whether in the form of income, credit, mortgages, or other loans, to imagine that a person would purposefully choose not to pay a debt he owed.⁴⁷ The moral obligation of debt repayment is a long-standing and deeply ingrained tenet of human nature.⁴⁸ Particularly in the financial realm in the United States, people are well aware of the consequences of debt and insolvency, as evidenced by the ever-present television and radio commercials for credit score and credit history reports, billboards and flyers advertising foreclosure counseling and attorneys, and background credit checks performed by virtually every apartment leasing office and employer.⁴⁹ The failure to repay what is owed is accompanied by a significant stigma, both socially and on one’s personal credit history, to be carried with that individual until reparations are made, and often times, even thereafter.⁵⁰ Despite the seemingly obvious and glaring negatives, many authorities and experts within the lending and financial fields insist that borrowers will opt to purposefully default on mortgage loans in an attempt to ease their way out of increasing interest rates and financial obli-

45. Bay, *supra* note 5.

46. *Id.*

47. White, *supra* note 4, at 986; *see also* Rood, *supra* note 29.

48. *See* Rood, *supra* note 29.

49. Curtis Bridgeman, *The Morality of Jingle Mail: Moral Myths About Strategic Default*, 46 WAKE FOREST L. REV. 123, 125 (2011).

50. *Id.*

gations that they can, in fact, afford.⁵¹ Nevertheless, even where homeowners may not be concerned with any moral or ethical obligation to repay their mortgage loans, other factors work to deter strategic default, including the “economic and emotional costs of giving up one’s home and moving, the perceived social stigma of defaulting, and a serious hit to a borrower’s credit rating.”⁵² Mortgage loan default and foreclosure are far from desirable to homeowners and borrowers. The repercussions to those who default on mortgage loans are severe and long lasting, and affect almost every aspect of borrowers’ lives, and the lives of their families.⁵³

Concern for moral hazard among lending institutions and other critics of mortgage assistance programs and reforms is not entirely unfounded. The social stigma associated with defaulting on one’s mortgage, foreclosing on one’s home, or other evidence indicating that a person has made irresponsible financial decisions or defaulted on a contractual obligation of debt has been largely cited as a major factor compelling struggling homeowners to continue to pay their mortgages, even when they are underwater.⁵⁴ As with any observable pattern of human behavior within a society, when an increasing number of people engage in a particular behavior, that behavior gains social acceptance, and eventually the stigma is eradicated.⁵⁵ It is not difficult to see the logic behind a belief that, as unemployment affects more and more Americans, and economic conditions impose greater restraints on saving and spending habits, defaulting on one’s mortgage and foreclosing on one’s home are not only absolved of the social stigma of financial failure, but actually garner a certain degree of sympathy. Many have come to view default and foreclosure as an unavoidable tragedy, an inevitable function of a failing market and the missteps of financial institutions.

51. Rood, *supra* note 29.

52. Thaler, *supra* note 2.

53. Cherry, *supra* note 1 (analyzing a case study of Boston Community Capital and how moral hazard has not been evident; asserting the argument that homeowners would not choose foreclosure if there was a way for them to avoid it, as it destroys their credit score and, in many states, foreclosure can preclude borrowers who have defaulted from a variety of opportunities, including education, loan approval, rental, or even employment).

54. White, *supra* note 4, at 972 (suggesting that most homeowners choose not to strategically default as a result of emotional forces, including a strong desire to avoid shame and guilt associated with foreclosure, and an exaggerated anxiety over what they believe to be the consequences of foreclosure, when they often misunderstand or lack information about the process and result of foreclosure); *see also* Thaler, *supra* note 2.

55. Bridgeman, *supra* note 49; *see also* Thaler, *supra* note 2.

C. *An Objective Assessment and Analysis of Mortgage Loan Default*

It is true that borrowers who apply for and obtain mortgage loans sign a promissory note.⁵⁶ The operative word, “promissory,” specifies a promise on the part of the borrower to pay the agreed upon monthly amount, along with applicable interest.⁵⁷ However, the contractual penalty for failure to do so is that the borrower will lose the property.⁵⁸ If these are the terms agreed upon by both parties, lenders and borrowers, from where do any additional problems arise if the borrower chooses not to pay?⁵⁹

Two reasons have been given to support the assertion that defaulting on one’s home mortgage loan is in fact immoral, or at least more immoral than defaulting on other types of personal loans.⁶⁰ The first reason cited is that foreclosures depress the economy and drive down market value in a community, and therefore adversely affect other homeowners who have dutifully paid their monthly mortgage payments and deserve to enjoy the full value of their homes and communities.⁶¹ The second reason is that default allegedly degrades the character of the borrower, and perpetuates a general disregard for the sanctity of promises and contractual agreements.⁶² Academics and experts in the field of business ethics argue that the loan agreement is a promise on the part of the borrower to repay the loan amount, but is

56. Roger Lowenstein, *Just Walk Away: Why Should Underwater Homeowners Behave Any Different from Banks?*, N.Y. TIMES MAG., Jan. 10, 2010, at 15.

57. *Id.*

58. *Id.*

59. *See id.* (contrasting corporations, who routinely choose to default on mortgages, yet are much better equipped to handle the financial obligations incurred with these loans and are rarely admonished for their strategic default, with the average mortgaged homeowner, who is expected to dutifully pay more than he is capable to avoid the stigma of being “unethical” and the credit and social consequences that accompany such default). For an in-depth discussion and analysis of the importance of understanding and applying contract law as the key to resolving dilemmas in the home mortgage arena, see Bridgeman, *supra* note 49. The author argues that contract law contains inherently moral principles, and that to allow strategic default on home loans will effectively shift the manner in which people regard contractual duties and obligations in a way that is most likely detrimental to the legal and ethical climate of contract law. Bridgeman largely seeks to evaluate and provide an opposing viewpoint to the arguments set forth by Brent T. White, author of *The Morality of Strategic Default* and *Take This House and Shove It: The Emotional Drivers of Strategic Default*, both of which set forth extensive arguments as to why strategic default is not immoral, and should be permissible where it makes financial sense for the homeowner to purposefully choose to cease monthly mortgage payments and allow his or her home to be foreclosed upon.

60. Lowenstein, *supra* note 56, at 16.

61. *Id.*

62. *Id.*

also a promise to repay interest accrued on the loan.⁶³ In defaulting on the mortgage, these borrowers are breaking the promise to pay the additional amount owed in interest.⁶⁴ Furthermore, because foreclosure proceedings and the actual eviction process generally do not conclude for a year, or sometimes more, after the homeowner stops making his or her monthly payments, the homeowner is able to remain in the home rent-free until legal proceedings have been resolved.⁶⁵ This arguably provides at the very least a convenience, and at most a benefit, to a borrower who has defaulted on a promise made. It is this aspect of the argument upon which lending institutions have focused their battle behind the shield of moral hazard. However, both of these arguments ignore many unforeseeable elements that factor into a homeowner's inability to repay his mortgage or a borrower's decision to default on his mortgage loan. When viewed in light of the currently dismal economic and employment climates in the United States, these factors suddenly lose much of the muster they may have had in previous times, where borrowers enjoyed a more prosperous economic setting. Borrowers do have obligations to lending institutions, but they have obligations to a host of other parties as well, including other lenders, their families, and themselves.⁶⁶

The reality of the situation is that there is and should be no real problem with allowing these contracts to be enforced according to the terms that they contain. Where a homeowner has failed to make monthly mortgage payments, for whatever reason, foreclosure is the legally enforceable contractual consequence. The argument that homeowners have an ethical obligation to repay mortgages is used as a defensive tool on the part of the lending institutions to resist legislative and policy proposals that would require them to work with homeowners to refinance or reconfigure mortgages, or with government assistance programs that would provide struggling homeowners with the

63. Hagerty, *supra* note 15.

64. *Id.*

65. Paul Krugman, *One to the Left*, N.Y. TIMES OP. PAGES: THE CONSCIENCE OF A LIBERAL (Feb. 12, 2008, 2:13 PM), <http://krugman.blogs.nytimes.com/2008/02/12/one-to-the-left/> (The author explains how the current situation allows homeowners to strategically default and remain in their homes because the bank often delays or fails to take action to foreclose and evict. These homeowners then simply purchase another foreclosed-upon house "one door to the left" and thus perpetuate a cycle of default.); *see also* Hagerty, *supra* note 15 (referencing the lapse in time between the stopped mortgage payments and action taken against the homeowner who has defaulted, during which time the homeowner may remain in the home "rent-free").

66. Hagerty, *supra* note 15.

necessary assistance to allow them to take steps to pull their heads above water and salvage their financial futures. Furthermore, to make a general assertion that homeowners have an ethical obligation to repay mortgages ignores the reality of many foreclosure situations, specifically where banks themselves behaved unethically in granting subprime loans under fraudulent circumstances to homeowners who may otherwise not have been granted a mortgage in the first place.⁶⁷

III. THE MANNER IN WHICH CONCERN FOR MORAL HAZARD INFLUENCES MORTGAGE REFINANCING POLICY FORMATION

There is evidence that moral hazard is a real factor, and one to which at least some homeowners will succumb, but lending and financial institutions have chosen to rely on this concern to an unfounded degree when asserting their opposition to assistance programs.⁶⁸ The argument likely perpetuates within the financial industry as a means of self-preservation, and is used as a sword against proposed policy and legislation that would compel financial and lending institutions to acquiesce to loan modification and mortgage reconfiguration assistance programs seeking to help those at risk of default.⁶⁹

Lending institutions are outspoken opponents to mortgage reconfiguration and repayment assistance programs, and they are supported by critics of the proposals from academic and business fields as well.⁷⁰ This position is backed by lenders' claims that they will suffer from granting financial assistance to homeowners. In many scenarios, lending institutions have little to lose in granting loans to borrowing homeowners, even where it is highly likely that the borrower will be unable to make payments on the loan within ten years, or even fewer, because lending institutions usually sell the loan to a mortgage loan pool.⁷¹ This sale of the loan to the mortgage loan pool shields the original lender

67. Stark, *supra* note 6, at 134.

68. Crespi, *supra* note 4, at 182.

69. MANUEL ADELINO ET AL., FED. RESERVE OF BOS., WHY DON'T LENDERS RENEGOTIATE MORE HOME MORTGAGES? REDEFAULTS, SELF-CURES, AND SECURITIZATION, PUBLIC POLICY DISCUSSION PAPER NO. 09-4 (2009).

70. Bridgeman, *supra* note 49 (providing a detailed and in-depth argument from a law professor as to why strategic default is immoral and damaging to the legal climate in the United States).

71. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1261-65 (2002); Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 512-13 (2002).

from the consequences of the default.⁷² As a result, lending institutions' primary concern with proposals that will allow borrowers to default on their mortgage loans is not rooted in finances. Lenders argue that the most extensive damage will occur not in immediate situations where borrowers are facing default, but rather by what lenders believe will be the influx of borrowers who will strategically default to receive the same treatment.⁷³

"Large lenders have long resisted debt forgiveness because of fears that it creates a moral hazard, meaning it could encourage borrowers to take out risky loans in the future because the consequences would not be so bad, or to default to qualify for principal reduction."⁷⁴ Lenders instead "argue that other types of loan modifications achieve the same goal" without the fear of raising widespread ethical implications.⁷⁵

A. *Perception Is Reality: Or Is It?*

It cannot be denied that some homeowners do make an informed decision to strategically default on their mortgages. However, it is unacceptable to characterize an entire population based upon the behavior of some of its members, even though that behavior may be recognized as unethical, unfair, or even reprehensible. Furthermore, it is difficult, if not impossible, to make accurate generalized assumptions about homeowners and strategic default, as each homeowner has a unique situation. Homeowners, like any cross-section of the population, come from varied backgrounds, have any number of personal obligations to uphold, and adhere to a broad spectrum of ethical beliefs and value systems.⁷⁶ All of these factors contribute to a borrower's attitude toward loans and debt well before even the initial decision to take out a mortgage loan.

The personal and lifestyle characteristics of mortgagors continue to factor into every stage of the mortgage process, weighing

72. See Eggert, *supra* note 71, at 538, 541.

73. Krugman, *supra* note 65.

74. Sheila Dewan, *Freddie and Fannie Reject Debt Relief*, N.Y. TIMES, Oct. 6, 2011, at B1.

75. *Id.*

76. See Hagerty, *supra* note 15 (discussing the fact that borrowers and homeowners owe a variety of duties to various parties, including multiple lending institutions, their businesses, their families, and themselves, and that these duties include both the legal and contractual obligation to repay on debts owed, but also include the obligation to take care of dependents and to behave in a manner that perpetuates the borrowers' own personal moral code—one that he wishes to pass along to his children and neighbors).

into the amount of loan with which the borrower feels comfortable borrowing, the promptness with which monthly payments are made, the remedies and assistance sought upon first signs of trouble with repayments, and the decision to default and foreclose.⁷⁷ Some homeowners may prioritize making payments on the debt incurred on their homes, but are also willing to max out credit card after credit card. Others may have no qualms about walking away from their homes, but are very concerned about their inability to repay educational loans or credit card debt, and may take extremely frugal and scrupulous measures to keep on top of these payments. As a result of the many external factors involved in the decision-making process, it is inaccurate for lending institutions to generalize borrowers as a group of people who are likely to behave in a particular manner, namely by strategically defaulting or seeking and accepting unwarranted assistance from government programs designed to help those in true need. Accordingly, this concern should not be a serious factor in policy formation for mortgage refinancing and assistance programs.

B. *Recent and Current Legislative and Policy Proposals Designed to Assist Homeowners Facing Default and Foreclosure and Evidence of Moral Hazard's Role in the Formation of These Plans*

Currently, under the Home Affordable Modification Program (HAMP), which is a subset of the Making Home Affordable Act, homeowners who are determined to be eligible for a reduction in their monthly mortgage payments are subject to a trial period of three or four months to show that they are able to make the reduced payments.⁷⁸ While those who support this plan argue that it helps to reduce the risk of moral hazard, it can also be argued that it has no effect, as it still provides the benefit of reduced payments, and may achieve the same goal of those homeowners who would choose to strategically default, namely to improve their financial situation rather than continue with their agreed upon mortgage contract.

Another program under the umbrella of the government's initiative to "Make Home Affordable," the Home Affordable Refinance Program (HARP),⁷⁹ has struggled to achieve the success

77. University of Alabama at Birmingham, *Consumer Behavior and Lifestyle Traits Influence Foreclosure Rates*, SCIENCE DAILY (January 14, 2010), <http://www.sciencedaily.com/releases/2010/01/100114143511.htm>.

78. *Making Home Affordable*, MAKINGHOMEAFFORDABLE.GOV, <http://www.makinghomeaffordable.gov/pages/default.aspx> (last visited Feb. 16, 2013).

79. *Home Affordable Refinance Program (HARP)*, MAKINGHOMEAFFORDABLE.GOV, <http://www.makinghomeaffordable.gov/programs/lower-rates/Pages/harp.aspx> (last visited Feb. 16, 2013).

rate for which it was designed. The HARP program originated in 2008, and stated a goal of assisting five million borrowers.⁸⁰ As of August, fewer than 895,000 borrowers have been helped by the HARP program.⁸¹ The hope is that these numbers will double by 2013,⁸² but for this to come to fruition, lending institutions will have to comply with the initiative. Legislation under the Obama Administration has provided some improvement in the mortgage situation nationwide, particularly when compared to the essential failure of previous legislation.⁸³ Despite this improvement, however, the programs have not achieved their original goals, and also fail to quell the fears of lending institutions as to the expected flood of homeowners seeking to utilize assistance programs and the changes in societal attitudes toward mortgage loan obligations that lending institutions believe will stem from these programs.⁸⁴

There have been suggestions made which propose that homeowners seeking to obtain mortgage refinancing or seeking to receive other forms of government-provided assistance provide some type of non-monetary or service-based compensation. This proposal would further egalitarian purposes and act as a deterrent to those who may seek to obtain financial assistance for strategic default “free of charge.” These proposals have been compared to other government assistance programs, such as unemployment, which demands that recipients make certain active efforts in exchange for monetary support. One scholar has proposed, as a means to reduce the risk of moral hazard, a requirement of 200 hours of community service performed by homeowners in exchange for a mortgage bailout.⁸⁵ This arguably serves as both a deterrent and a source of retribution with respect to those who seek to be approved for such an assistance program. The question remains, however, whether these functions would be appropriate for homeowners who are underwater as the result of legitimate financial and economic hardship, and whether these functions would be effective for those who make the active and informed choice to default.

80. Lorraine Woellert, *U.S. Mortgage Plan Expands to Refinance Underwater Borrowers*, BUS. WK. (Nov. 4, 2011), <http://www.businessweek.com/news/2011-11-04/u-s-mortgage-plan-expands-to-refinance-underwater-borrowers.html>.

81. *Id.*

82. *Id.*

83. Crespi, *supra* note 4, at 182.

84. *Id.* at 182–83.

85. Michael H. LeRoy, *The Inequality of Sacrifice—Reducing Moral Hazard for Bailed-Out Homeowners: The Case for Compulsory Community Service*, ILL. PUB. L. & LEGAL THEORY RES. PAPERS SERIES NO. 09-18 (Nov. 30, 2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1515983.

C. *Policies and Initiatives Should Foster an Objective Mission of Education and Self-Regulation of the Lending Industry to Help Prevent Default and Foreclosure*

Borrowers are often uneducated, or undereducated, about the process and penalties of taking out mortgages, and rely on the advice of financial and lending experts.⁸⁶ When these experts fail to take the borrowers' situations and interests into account, this reliance creates a confusing and harmful financial situation for the borrower, which in turn creates problems for the lender and the economy on a larger scale.⁸⁷ Realistically, in failing to adhere to a fiduciary duty and standard of care with respect to borrowers, investment advisers also fall short of the fiduciary duty they owe to their firms.

As part of the hope to better unify the interests and needs of borrowers and lenders, recent government proposals have sought to increase accountability of lenders and to increase transparency in the lending and securitization process.⁸⁸ The Obama Administration has been developing rules that will require lenders and other financial advisers to keep greater "skin in the game" and to align incentives across the securitization chain.⁸⁹ One major step in this direction was codified by the Dodd-Frank Act, which included provisions that charged the Securities and Exchange Commission with the responsibility to set stricter disclosure requirements.⁹⁰ The purpose of this was two-fold: to enable investors to more easily understand the underlying risks of securities and loans, and to establish an Office of Credit Ratings to more effectively regulate credit rating agencies.⁹¹

Examination of management and regulatory behaviors within the financial sector has provided cause for legitimate concern as to the financial and lending industries' ability to self-regulate practices, procedures, and professionals within the industry. One of the emerging theories as to why there has been a notable shift in the attitudes of lending institutions, and the professionals that operate within them, that manifests as a lack of trust for borrowers is what has been dubbed the "Corporate Psy-

86. Hunt, *supra* note 7, at 746–49.

87. Stark, *supra* note 6, at 134.

88. Press Release, U.S. Dep't of Treasury, Obama Administration Plan Provides Path Forward for Reforming America's Housing Finance Market, Winding Down Fannie Mae and Freddie Mac (Feb. 11, 2011), *available at* <http://www.treasury.gov/press-center/press-releases/Pages/tg1059.aspx>.

89. *Id.*

90. *Id.*

91. *Id.*

chopath Theory.”⁹² Though this is a relatively new proposal, and one that will require more extensive research and analysis to gain acceptance, studies conducted thus far provide at least a foundation for this explanation.⁹³ In summary, the Corporate Psychopath Theory asserts that there is an identifiable propensity of the financial industry to attract, hire, and promote agents with particular personality traits.⁹⁴ The personality traits emerging as “desirable” within the culture of the financial industry are identified in individuals who “lack a conscience, have few emotions, and display an inability to have any feelings, sympathy, or empathy for other people.”⁹⁵ These individuals have, at best, wayward moral compasses, and, at worst, sociopathic tendencies.⁹⁶ It is likely that these types of personal characteristics allow individuals to succeed in the business and financial worlds because these are people that others often admire for their “thick skin” and ability to thrive in chaotic settings that would rattle and distract more emotionally attuned professionals.⁹⁷ Individuals who are less capable of understanding opposing points of view are often more direct and persistent in hostile situations, and are less likely to back down for fear of offending, insulting, or otherwise damaging, a relationship with another person.⁹⁸

As a result of recent changes in the “moral climate”⁹⁹ of the financial and loan industry, particularly of Wall Street financial institutions, these individuals have become the decision-makers of the finance industry, and have gained the power to influence an entire system that is an essential tenet of not only the American economy, but the international economy as well.¹⁰⁰ This climate of “heartless success” is self-perpetuating within the arena of financial institutions, but has a much broader (and much more devastating) economic effect on borrowers who lack the

92. Clive R. Boddy, *The Corporate Psychopaths Theory of the Global Financial Crisis*, 102 J. BUS. ETHICS 255 (2011); see also Brian Basham, *Beware Corporate Psychopaths—They Are Still Occupying Positions of Power*, THE INDEP. (Dec. 29, 2011), available at <http://www.independent.co.uk/news/business/comment/brian-basham-beware-corporate-psychopaths—they-are-still-occupying-positions-of-power-6282502.html>.

93. See Boddy, *supra* note 92.

94. *Id.*

95. William D. Cohan, *Did Psychopaths Take Over Wall Street Asylum?*, BLOOMBERG (Jan. 2, 2012, 7:01 PM), <http://www.bloomberg.com/news/2012-01-03/did-psychopaths-take-over-wall-street-asylum-commentary-by-william-cohan.html>; see Boddy, *supra* note 92.

96. See Boddy, *supra* note 92.

97. See *id.*

98. See *id.*

99. See Cohan, *supra* note 95; see also Boddy, *supra* note 92.

100. See Boddy, *supra* note 92.

power to influence or correct the ethical standards of the institutions from which they receive loans.¹⁰¹ To protect those most adversely affected by questionable actions of financial institutions, as well as the overall economic and ethical climate of the United States, the legal system should step in to regulate where there is no sense of ethical obligation or duty, or where attempts to institute corporate responsibility or to self-regulate the industry from within have failed.

VI. PROPOSAL

As a practical matter, ethical concerns should largely be removed from the discourse of legislative actions that will assist homeowners in resolving their mortgages and cleaning up their financial situations and credit. The harsh reality of the current economy requires the government to take necessary measures to correct the facts and figures of homeowners' finances as one step in a method to bust the economic slump. Lending institutions' persistent cries of moral hazard stand as one barrier to this goal. To move toward correcting the problems of the mortgage crisis, lending institutions can remove their focus on the potential for homeowners to behave unethically, and shift the focus to the ethics of their own industry. This can be accomplished through a continued emphasis on the fiduciary duty of the lender, through implementing measures to encourage self-regulation within the lending and financial industry, and by creating laws when self-regulation is unable to achieve the necessary goals. Additionally, proposed measures to assist struggling homeowners should clearly articulate the objective of resolving the mortgage and housing crises in the most economically efficient and practical manner possible, and should clearly set forth the means by which this goal may be accomplished.

A. *The Continued Importance of Fiduciary Duties That Lending Institutions Owe to Borrowers*

To continue in the vein of a recent legal trend, continued emphasis should be placed upon the fiduciary duty of the lender and loan broker,¹⁰² including the duty to fully inform borrowers

101. *Id.*

102. Hunt, *supra* note 7, at 724–26; *see also* David Unseth, Note, *What Level of Fiduciary Duty Should Mortgage Brokers Owe Their Borrowers?*, 75 WASH. U. L. Q. 1737, 1738–51 (1997) (providing a concise summary and explanation of the fiduciary relationships that arise within the mortgage industry, and the varying degrees of legal requirements and consequences arising from these relationships).

and potential borrowers of the risks involved in taking out mortgages, and the realistic consequences of default and foreclosure, strategic or otherwise. Though this should go without saying, lenders must refuse to approve loans when presented with information that is incomplete or inaccurate.¹⁰³ The law should prohibit lending institutions from engaging in predatory lending tactics, and should encourage or mandate that lenders take measures to ensure that the terms of the loan, and the promises made between the lender and borrower, are accurately reflected in the loan documents.¹⁰⁴ Where the lender has concerns as to the borrowers' ability to repay the mortgage loan for which they have applied, the lender should advise clients accordingly as to these concerns.¹⁰⁵ Lenders should also work to include loan counseling wherever possible, as "counseling the borrower on issues relating to the affordability of the loan . . . rather than prohibiting lenders and borrowers from entering into such loans has the advantage of allowing the borrower to make an informed decision in light of his special circumstances."¹⁰⁶ Under a provision expounded in section 1404 "Additional Standards and Requirements" of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, lending institutions are required to provide "disclosure and counseling for first-time borrowers prior to consummation of loans with negative amortization secured by 'dwelling.'"¹⁰⁷ This is an excellent example of how the law has reformed the mortgage loan process from the front-end as a preventative method. It is also notable because it exemplifies the ability to remove the concern for borrowers' ethical considerations in dealing with their mortgages and focus on an objective means by which to resolve the problem. The law can also take this a step further, and can encourage, or perhaps even

103. Margot Saunders, *The Increase in Predatory Lending and Appropriate Remedial Actions*, 6 N.C. BANKING INST. 111 (2002); see also EDWARD VINCENT MURPHY, CONG. RESEARCH SERV., RL33930, SUBPRIME MORTGAGES: PRIMER ON CURRENT LENDING AND FORECLOSURE ISSUES (2007).

104. Stark, *supra* note 6, at 140; see also Jeanette Bradley & Peter Skilleern, *Predatory Lending: Banks Trick Poor into Expensive Loans*, 227 DOLLARS & SENSE (2000), available at <http://www.dollarsandsense.org/archives/2000/0100bradley.html>.

105. Stark, *supra* note 6, at 144.

106. *Id.* at 145.

107. MORTG. BANKERS ASS'N, SUMMARY OF MORTGAGE RELATED PROVISIONS OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT 10 (2010), available at http://www.mbaa.org/files/ResourceCenter/MIRA/MBA_SummaryofDoddFrank.pdf (providing plain language summaries of the sections and provisions of the Dodd-Frank Act that pertain to mortgages and to lending institutions); see also Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1414, 124 Stat. 1376 (2010).

require, that lending institutions provide loan counseling to borrowers who are not just first-timers, particularly where there may be potential “red flags” on the borrowers’ credit report or history.

Economic progress has already been evident through the implementation of homeowner assistance programs, and these programs should continue, and perhaps even increase, until the housing and mortgage market has been restored to a level where it can function without government assistance.¹⁰⁸ Lenders must not be permitted to resist assistance programs for fear of moral hazard on the part of homeowners.

B. *The Role That the Fear of Moral Hazard Has Played in Legislative and Policy Formation of Mortgage Refinancing and Assistance Programs*

Complicating the assessment of the best steps the law can take to help resolve issues of the mortgage crisis is the manipulative manner in which lending institutions have inflated moral hazard as a factor within the legislative and political discourse over proposed means by which the mortgage and housing crisis may be resolved.¹⁰⁹ Experts and academics have conducted research and analysis on the morality of homeowners’ behavior and the ethical considerations that guide the decision-making process of the mortgage repayment and foreclosure process.¹¹⁰ Significantly less attention has been paid to ethical considerations on the part of lenders. Even when they have been addressed and questioned as to their own ethical shortcomings in the mortgage crisis, lending institutions have been largely successful at turning the conversation on its head, citing moral hazard and the behavior of borrowers and homeowners as an inextricable cause of any decisions made, or positions taken, by lending institutions.¹¹¹ This “chicken and egg” explanatory tactic has allowed lending institutions to keep the focus of the media and the public on the ethical discussion of moral hazard, at times at the expense of discussing the more relevant economic elements of the situation.¹¹² The frequent mention of moral hazard and concern for strategic default has taken unwarranted precedent in the debate, and has caused the law and governing

108. See generally Crespi, *supra* note 4.

109. See Thaler, *supra* note 2.

110. See Cherry, *supra* note 1; see also Rood, *supra* note 29; White, *supra* note 4.

111. See Crespi, *supra* note 4, at 182.

112. *Id.*

bodies to include ethical concerns as a factor in their determinations as to how this crisis may best be resolved.¹¹³

Moral hazard is, and will continue to be, an area of concern and focus among experts, academics, and lay persons in the arena of mortgage and foreclosure law and policy. In light of recent debate over the prevalence of this factor, and lenders' often vehement opposition to new policies or proposals that may encourage, or at least accept, strategic default as a means of handling underwater mortgages, new research is emerging that can better assess the reality of this problem. In turn, there is hope that government assistance and other reforms can better address the most dire needs of those trapped underwater. In formulating these policies, it is essential that a balance be struck between the subjective standard of moral and ethical obligations to repay debt owed on mortgage loans and an objective economic standard of relieving struggling homeowners of the unmanageable burden of paying more in mortgage and interest than their homes are worth. Programs designed to match homeowners' monthly payments with the market value of their homes are arguably a manner in which this balance can be achieved, as they will not force borrowers out of their homes, but will also not relieve them of an excessive amount of their debt, such as to damage lending institutions. The risk that this solution will erode the ethical elements of loan obligations and cause default to become acceptable and commonplace is reduced because borrowers are still responsible for fulfilling monthly financial obligations to lenders, and will still be subject to penalties when they fail to meet their reconfigured mortgage obligations.

VII. CONCLUSION

Ultimately, borrowers and lenders do not, or at least should not, have such different goals. While each entity is concerned primarily with its own immediate interests and economic survival and prosperity, this is a micro-view. Looking at the big picture, both borrowers and lenders benefit from an efficiently functioning and growing economy. It then follows that both parties should be willing to work toward achieving that end goal. In the aftermath of the financial and housing crisis, pursuing what had previously been the status quo is the first step to economic and financial recovery. Borrowers must get their heads above water on their mortgage and debt obligations. Lenders must adapt to the current economic situation, which is significantly less sunny than it has been in some time, and must accept that they will be

113. Bridgeman, *supra* note 49, at 125.

required to work within the context of current conditions, and should adjust profit expectations accordingly. Lenders must cease to use the defense of “moral hazard” as a shield against progress toward economic recovery. Given their important role in ensuring the financial and economic health of individual borrowers, and the nation as a whole, lending institutions cannot afford to continue to be cast as the “enemy.”

