

## Rortybomb

### Megan McArdle on Foreclosure Fraud Crisis

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Megan McArdle has a series of posts on the foreclosure crisis. [What's a 'Libertarian Solution' to the Foreclosure Mess?](#), [Reader response](#), [Foreclosure Options](#). It comes off the question [highlighted](#) at [Balloon Juice](#): Why aren't libertarian outlets discussing the foreclosure crisis?

Given that McArdle and I are likely to disagree on many points, I found it a solid read and hope more libertarians get engaged in this important conversation. I may have more later, but a few high-level points right now.

1) Contra Balloon Juice, some libertarians have responded, usually finding that homeowners are in the wrong to be challenging this and the sooner we liquidate the homeowners the better off the economy will be. [Arnold Kling](#), for instance: “However, the \*&#^ lawyers for the borrower come in and claim standing to challenge the foreclosure on the grounds that the foreclosure notice was sent by someone who has not properly documented that he is the noteholder. Legally, they may have standing to do this. Morally, they do not. The sensible policy would be for the government to step in and legislate that borrowers have no standing to sue unless they are claiming to have complied with the terms of the note.”

And [Mark Calabria of Cato](#) “The current efforts by states to use technical mistakes by lenders to allow borrowers to remain in homes without paying could ultimately undermine the very concept of a mortgage.”

Those were from some months ago, I'm not sure if that's where they still stands. I discuss these approaches in those posts. If libertarians were quick to argue that we need to strictly respect contract and thus not support mortgage cramdown, or fixing defects in our bankruptcy laws when it comes to homeowners, they now have to consider that respecting contracts might mean trustees have no standing to foreclose, something they don't seem all that keen on.

2) McArdle: *Already I have a number of readers who seem to think that there is some sort of option specified in the mortgage contract. There isn't....The advocates of jingle mail are essentially arguing that there's an embedded option, and nothing wrong with exercising it; not that there is an actual option.*

Let's be clear on what the claims are. If you live in a state where you have the right for judicial bankruptcy you pay extra for that. This has been well-proven by Karen M. Pence of the Board of Governors of the Federal Reserve System, in her paper, [Foreclosing on Opportunity: State Laws and Mortgage Credit](#) (“[D]efaulter-friendly foreclosure laws are

correlated with a four percent to six percent decrease in loan size. This result suggests that defaulter-friendly foreclosure laws impose costs on borrowers at the time of loan origination.”)

That’s why I find approaches by libertarians to essentially skip judicial foreclosure for a bank-friendly “rocket docket” quick approach (what the two suggestions above imply) to be improper. They were charged a fair rate in a competitive market for a judicial review, and they should take advantage of it if they find it appropriate.

Also, if you look at any of the economic literature around consumer lending all of it refers to a default option ([example](#): “The results in the column illustrate the effect of the prepay and default options, trigger events, and loan- level characteristics on default when we do not control for recourse”). People are certainly charged for this and a lot of thought goes into thinking it through state-by-state; modeling this option is a big industry. It’s not an explicit option, but embedded options are the most important to think through.

**3) McArdle:** *“Let’s turn it around,” I asked. “What if the bank decided that it wanted to exercise the same sort of option?... What if the bank foreclosed on your house, even though you made the payments, because it figured it could make more money taking the house and selling it?” (Not a likely scenario, I know, but a useful thought experiment.)*

Banks exercise the same sort of option all the time when they resell mortgages (and hopefully notes!) from one entity to another entity. That’s the problem we have right now, that this reselling option banks use was so sloppy it’s tearing up the economy.

This is why if you are the type of person who thinks markets self-regulate through consumer demand and reputation there’s a major problem, as consumers have no choice over their mortgage servicer. If you don’t like your servicer, and refinance your mortgage with another bank, that bank can still sell off your mortgage and you can still end up serviced by the same institution. Given that the servicers haven’t been functionally regulated ([Andy Kroll](#), [Mother Jones](#): “An OTS spokesman could name only one formal action the agency has taken against a servicer—Ocwen, in 2004. An OCC spokesman said his agency has never taken action against servicers.”) this was a disaster coming down the pipeline for a while.

There are many other problems with the foreclosure crisis other than the note problem, but the note problem clearly brings together the whole shoddy mess of the issuance and management of mass mortgage debt, a network that spun out of control over the past 20 years. McArdle’s post bring up a good point; there should be clarifications on what a proper Democratic response should be to this crisis. The short answer is that the servicing model has broken down, so there needs to be mechanisms that allow for circumventing that process in the negotiation of bad mortgage debt.

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