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# NOTES

## HOOSIER INHOSPITALITY: EXAMINING EXCESSIVE FORECLOSURE RATES IN INDIANA

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### INTRODUCTION

When can dreams quickly become nightmares? The dream of homeownership has now become a reality for more Americans than at any point in history.[1] However, increased emphasis on flexible lending practices and recent national and regional economic slowdowns have turned opportunities for equity-building into recipes for foreclosures and disaster. While different states have been affected to varying degrees, Indiana has undoubtedly been one of the hardest hit by the recent wave of foreclosures.[2]

A foreclosure is a legal mechanism that a lender initiates after a borrower has defaulted on a mortgage.[3] Although the procedures vary depending on state statutory and common law, all foreclosures eventually eliminate all of the borrower-mortgagor's rights in the property. The two primary forms of foreclosure in the United States are judicial foreclosure, which all fifty states

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1. According to the U.S. Census Bureau, the national homeownership rate was 69.2%, the highest in United States history, in the fourth quarter of 2004. *See* Press Release, U.S. Dep't of Commerce, Census Bureau Reports on Residential Vacancies and Homeownership, Table 5 (Jan. 27, 2005), http://www.census.gov/hhes/www/housing/hvs/qtr404/q404tab5.html.

2. In the second quarter of 2002, Indiana's foreclosure rate was the highest in the nation at 2.22%, compared with the national average of 1.24%. *See* Indiana Mortgage Bankers Ass'n, Indiana Mortgage Foreclosure Rate 1 (Jan. 9, 2003), http://www.indianamba.org/Downloads/Indiana%20Mortgage%20Foreclosure%20Analysis%20-%20Jan%2015%2003.pdf (citing Mortgage Bankers Association, *National Delinquency Survey for 2nd Quarter* (June 30, 2002)). By the second quarter in 2004, Indiana's foreclosure rate, now second highest to Ohio, increased to 2.78% while the national average fell to 1.16%. Lesley Mitchell, *Foreclosure Rate Remains High in Utah*, SALT LAKE TRIB., Sept. 9, 2004, at E1.

3. A mortgage is "a conveyance of title to property that is given as security for the payment of a debt or the performance of a duty . . . ." BLACK'S LAW DICTIONARY 1031 (8th ed. 2004).

recognize, and nonjudicial foreclosure, which only some states permit by statute.[4] While foreclosures are a necessary tool for lender-mortgagees to protect their interests, they are always entered into reluctantly because of the excessive costs that they entail.[5]

While the prospect of some mortgages entering into foreclosure is inevitable, the exorbitant number of foreclosures in Indiana is cause for alarm, and its source must be addressed as soon as possible. Various causes of Indiana's poor mortgage performance include the weakened economy, Indiana's high homeownership rate, predatory lending, the lack of equity for borrowers, state foreclosure laws, and the influence of government subsidized loan agencies such as the Federal Housing Administration ("FHA").

Because of the downturn in the national economy, Indiana's job market has weakened considerably in recent years.[6] The collapse of the manufacturing sector, which hit Indiana particularly hard, induced this trend.[7] Nevertheless, Indiana's unemployment rates remain below those of states that have lower foreclosure rates. Implicitly, therefore, it is not the level of unemployment that affects foreclosure rates, but rather how the level of unemployment changes from one period to the next.[8] Nonetheless, when people lose their jobs, they will be less able to pay their monthly liabilities, including their mortgage payments.

Indiana has one of the highest state homeownership rates in the country, even at a time when national homeownership is on the rise.[9] Relatively low home prices and previously low unemployment rates have allowed Indiana citizens to have ownership opportunities that are not available elsewhere.[10] Because of the large number of homeowners in the state, negative developments in the housing market will have a disparate impact on Indiana residents.

One of the most hotly debated topics in lending is predatory lending. Predatory lending practices, such as charging excessive fees or interest rates and performing fraudulent appraisals, exploit the financial situation or lack of

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4. The differences between judicial and nonjudicial foreclosure will be examined in greater detail, *infra* Part I.

5. KAREN M. PENCE, FORECLOSING ON OPPORTUNITY: STATE LAWS AND MORTGAGE CREDIT 1 (2003), *available at* http://www.mbaa.org/industry/reports/03/FRB_Foreclosure_Study_0214.pdf ("[E]stimated losses on these foreclosures range from 30 to 60 percent of the outstanding loan balance because of legal fees, foregone interest, and property expenses.").

6. National Ass'n of REALTORS®, Rising Foreclosure Rates in Indiana: An Explanatory Analysis of Contributing Factors 5 (Mar. 2003), http://www.indianamba.org/Downloads/Realtors%20research.pdf [hereinafter Rising Foreclosure Rates in Indiana].

7. Indiana has one of the highest percentages of workforce participation in the manufacturing sector. Twenty-two percent of Indiana's workforce is based on manufacturing, compared to 14.5% nationally. *Id.*

8. *Id.* at 11.

9. Based on 2000 census data, Indiana's homeownership rate was 74.9%, compared to 67.4% nationally. *Id.* at 5.

10. *Id.*

knowledge of the borrower.[11] In response to concerns that lenders in Indiana are engaging in these practices, the Indiana General Assembly enacted the "Indiana Home Owner Protection Act"[12] in 2004. This bill, which became effective on January 1, 2005, aims at preventing and punishing lenders engaged in predatory lending schemes.

Another reason that Indiana residential mortgages have been more likely to foreclose is that mortgagors have a lack of equity in their homes. Indiana borrowers tend to initiate loans with greater loan-to-value ratios than borrowers in other states.[13] In addition to lower beginning equity, Indiana homes have not appreciated at a rate consistent with the national average.[14] Relatively high rates of new homebuilding activity, seen in most Midwestern states, contribute significantly to this lack of appreciation.[15] Based on basic economics principles, this increase in housing supply causes the average price of the homes to remain constant or decrease over time, as there has not been a proportionate increase in demand. Inevitably, when mortgagors with low equity face foreclosure, they are more likely to concede to the process than a person with a higher amount of equity because they would be less able to sell the property to satisfy the mortgage balance and could face a negative equity position.[16]

The Federal Housing Administration is a government agency that, along with other functions, insures private lenders against possible defaults by mortgagors.[17] Because the FHA has allowed lenders to provide mortgages with higher risk without the fear of losses from default, more people are able to qualify for mortgages. However, because of this added risk, FHA loans are nearly five times more likely to foreclose than conventional loans.[18] While the FHA program is national, Indiana has a higher share of FHA loans than most other states.[19] Because of this heightened presence, the FHA's negative impacts cause

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11. *See* Anna Beth Ferguson, Note, *Predatory Lending: Practices, Remedies and Lack of Adequate Protection for Ohio Consumers*, 48 CLEV. ST. L. REV. 607, 609-11 (2000).

12. 2004 Ind. House Enrolled Act 1229, (effective Jan. 1, 2005), *available at* http://www.state.in.us/legislative/bills/2004/PDF/HE/HE1229.1.pdf.

13. The loan-to-value ratio measures the proportion of debt to equity that a borrower incurs in a loan. According to the Federal Housing Finance Board, in 2002 Indiana mortgagors had five percent less equity in their homes than the national average. Only thirteen states had a higher ratio during that time. Rising Foreclosure Rates in Indiana, *supra* note 6, at 8.

14. According to the Office of Federal Housing Enterprise Oversight, Indiana recently ranked forty-ninth among states in one-year price growth and forty-fifth over a five-year span. *Id.* at 9.

15. *Id.*

16. Negative equity positions can occur when a buyer owes larger transaction fees, such as real estate agent fees, than the low amount of equity they have in the home. *Id.* at 8.

17. U.S. GEN. ACCOUNTING OFFICE, GAO NO. 02-7773, MORTGAGE FINANCING: CHANGES IN THE PERFORMANCE OF FHA-INSURED LOANS 4 (2002), *available at* http://www.gao.gov/new.items/d02773.pdf. [hereinafter CHANGES IN THE PERFORMANCE OF FHA-INSURED LOANS].

18. Rising Foreclosure Rates in Indiana, *supra* note 6, at 7.

19. In 2001, FHA loans comprised twenty-five percent of loans in Indiana, compared to seventeen percent nationally. *Id.*

disproportionate increases in Indiana's foreclosure rate.

Although all of these factors have some influence on the exorbitant foreclosure rates in Indiana, they affect the rate to varying degrees. Some experts consider unemployment to be the largest influence on foreclosures,[20] but policymakers cannot control unexpected changes in the economy. Therefore, analyzing the effect of the economy on foreclosures is futile. In addition, despite the recent actions by the Indiana General Assembly, there is no evidence of higher predatory lending practices in Indiana than in any other state that would cause Indiana's foreclosure rate to be excessively high.[21] On the contrary, according to a 2003 study, the share of FHA loans in a state had the greatest influence on the foreclosure rate and accounted for more than half of the difference between the Indiana rate and the national rate.[22] The way a state structures its foreclosure laws also has a direct correlation on whether it has high or low foreclosure rates.[23] Thus, the two most important, controllable factors that cause Indiana's high foreclosure rate are the state's interaction with the FHA and its statutory procedures for foreclosures.

Part I of this Note examines the varying landscape of state foreclosure laws in the United States. Part II provides background on the FHA, recent problems with high foreclosure rates, and steps that the agency is taking to remedy these problems. Finally, Part III will examine the competing policy concerns surrounding increased homeownership and make suggestions for changes in Indiana statutory foreclosure laws and FHA policies to reduce the number of foreclosures in the state.

## I. State Foreclosure Laws

Although foreclosure laws vary by state, there are certain basic elements included in every set of statutes.[24] There are two predominant foreclosure

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20. "The most important factor in foreclosures is always employment. And the structural change that we've seen affecting states with a high manufacturing component has been the biggest factor in their unemployment." Interview by Ceci Rodgers with Douglas Duncan, Mortgage Bankers Association of America, *Market Call* (CNN television broadcast Aug. 25, 2004), *available at* http://www-cgi.cnn.com/TRANSCRIPTS/0408/25/lad.03.html.

21. Rising Foreclosure Rates in Indiana, *supra* note 6, at 6. Furthermore, because HEA 1229 did not become effective until 2005, the true impact of predatory lending on Indiana cannot be adequately estimated this early in its implementation.

22. If Indiana had the same share of FHA loans as the average state, its foreclosure rate would be reduced by 0.44%. *Id.* at 7.

23. There is no mandatory national foreclosure law, which allows states to statutorily define their own process. Indiana defines its foreclosure procedures under Title 32 of the Indiana Code. *See, e.g.*, IND. CODE § 32-29-7-1 to -14 (2002). Because of this freedom, states have conflicting provisions that can have varying effects on the frequency and likelihood of foreclosures. These differences are explored later in this Note.

24. There has been widespread support on the benefits of uniform national foreclosure laws. *See, e.g.*, Grant S. Nelson, *Reforming Foreclosure: The Uniform Nonjudicial Foreclosure Act*, 53

methods in the United States, judicial foreclosure and nonjudicial (also known as "power-of-sale") foreclosure. Judicial foreclosure entails court adjudication of a lender-mortgagee initiated foreclosure action.[25] In contrast, nonjudicial foreclosure gives the mortgagee the power to sell the mortgaged property to the general public, without court supervision, by placing advertisements.[26] Currently, judicial foreclosure is available in every state, but only approximately sixty percent of states permit nonjudicial foreclosure.[27] A third type of foreclosure, strict foreclosure, is available in only three states.[28]

In addition, states differ in the notice required to mortgagors when they have defaulted or are facing foreclosure. While some states require notice to the mortgagor if they have defaulted on their mortgage or if it is being accelerated, others leave it up to the parties to include such notice requirements in the loan document itself. These notice provisions can reduce the number of foreclosures

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DUKE L.J. 1399 (2004). However, until such a law is passed, state statutes must be examined individually and Indiana should strive to have the most effective and inexpensive foreclosure laws it can.

25. Judicial foreclosure, while time consuming and costly, is the best way to ascertain the rights of the parties involved in the dispute. *See* JON W. BRUCE, REAL ESTATE FINANCE IN A NUTSHELL 199 (1997). However, rights are only finalized once the court confirms the sale of the property, which it will do unless fraud of some sort is shown. *Id.* at 202. Typically, proceeds from any sale cover the expenses of the foreclosure, satisfaction of the mortgage debt, and satisfaction of any junior liens on the property. Any excess proceeds go to the purchaser, and lenders may be able to seek a deficiency judgment to recover personally from the borrower if the proceeds from the sale are insufficient to satisfy the debt. *Id.* at 205. Each state specifically outlines the procedures for judicial foreclosure by statute or common law.

26. When available, lenders almost always use nonjudicial foreclosures because they are quicker and less expensive than judicial foreclosures. However, nonjudicial foreclosures do not have the benefit of being backed by a court order, and courts generally will set them aside for even a slight error in mechanics. Furthermore, some states do not allow lenders to pursue deficiency judgments when they proceed nonjudicially. *See* SIDNEY A. KEYLES, FORECLOSURE LAW & RELATED REMEDIES: A STATE-BY-STATE DIGEST 321 (1995).

27. Nelson, *supra* note 24, at 1403. States that allow either nonjudicial or judicial foreclosure include: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Georgia, Hawaii, Idaho, Iowa, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New York, North Carolina, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. All other states, including Indiana, require judicial foreclosure. PENCE, *supra* note 5, at 3.

28. Strict foreclosure gives a mortgagor in default a period of time to repay the debt, or their right to redeem the property is extinguished. This result is often viewed as too harsh and unfair, especially when the value of the mortgaged land exceeded the debt owed by the mortgagor. Georgina W. Kwan, Comment, *Mortgagor Protection Laws: A Proposal for Mortgage Foreclosure Reform in Hawai'i*, 24 U. HAW. L. REV. 245, 248-49 (2001). Currently, only Connecticut, Illinois, and Vermont allow strict foreclosure, and the requirements for each state differ. *See generally* CONN. GEN. STAT. § 49-15 (1998); 735 ILL. COMP. STAT. 5/15-1403 (2004); VT. STAT. ANN. tit. 12, § 4531 (2002).

because many homeowners are not aware they are in default until they receive such notice, allowing them to cure the default at that time.

Finally, some states grant homeowners a right of redemption, while others limit or remove the right.[29] Statutory rights of redemption grant mortgagors a period of time after a foreclosure in which they may reclaim the property through payment of the foreclosure sale price or delinquent amount.[30] These different combinations shift the balance between being considered a creditor-friendly or a lender-friendly state and affect the number and efficiency of foreclosures in the state.

### *A. Indiana Foreclosure Law*

Indiana's statutory framework for the foreclosure process affects its abnormally high foreclosure rates. Before drawing comparisons between Indiana's laws and those of other states and finding possible nexuses between certain rules and higher occurrences of foreclosures, it is important to understand how Indiana deals with these events. Surprisingly, even though Indiana consistently has high foreclosure rates, its foreclosure laws tend to favor borrower-mortgagors over lender-mortgagees.

As with all other states, Indiana allows judicial foreclosure, but Indiana does not permit power-of-sale foreclosure.[31] If the court finds in favor of the mortgagee, Indiana Code section 32-29-7 governs the sale of the property through judicial foreclosure in the state.[32] Because mortgagees are not able to sell

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29. All states give borrowers an equity right of redemption, which developed from common law. However, this equitable right expires at the time of foreclosure. Therefore, some states offer additional statutory rights of redemption to a varying extent after foreclosure is completed. Currently, the following states grant a statutory right of redemption in some form: Alabama, Alaska, Arkansas, California, Colorado, Idaho, Illinois, Iowa, Kansas, Kentucky, Maine, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Oregon, Rhode Island, South Dakota, Tennessee, Vermont, Virginia, Washington, West Virginia, Wisconsin, and Wyoming. PENCE, *supra* note 5, at 3.

30. These redemption laws are designed to protect against sales of the property in question at a price far below its actual value and give more time to allow the mortgagor to obtain necessary funds to retain the land. These statutes often vary in the time period allowed for redemption and whether they even apply to nonjudicial foreclosures. Redemption statutes often come under fire because many believe they do not protect against underbidding. The purchaser must wait for the statutory time to ensure they actually own the property, so it reduces the price they are willing to pay. *See* BRUCE, *supra* note 25, at 215. Currently, there are only eight states that absolutely disallow redemption rights: Arizona, Hawaii, Louisiana, Montana, New York, Pennsylvania, South Carolina, and Texas.

31. Pursuant to Indiana statute, "[t]he sale of mortgaged property by the mortgagee may only be made under a judicial proceeding." IND. CODE § 32-29-1-3 (2002).

32. Court orders to file a sheriff's sale must wait three months after filing of the foreclosure complaint. *Id.* § 32-29-7-3(a). There are exceptions to this lag period when the property has been abandoned, in which case a writ of sale may be executed on the date of the judgment according to

property without supervision, the statute provides mortgagors more protection against potential fraudulent or inequitable actions taken by mortgagees. Furthermore, Indiana's judicial foreclosure process also protects homeowners by allowing them to remain in their homes, rent free, until the process is completed.[33]

Once a homeowner neglects to make a payment to the mortgagee or perform some other obligation pursuant to the terms of the mortgage, he or she is in default on the mortgage.[34] At that point, the mortgagee may accelerate the loan to make it immediately payable in full.[35] Indiana's foreclosure statutes draw a distinction between these events, as it does not require notice of default to delinquent property owners, but the lender must give notice of acceleration of the loan.[36] While this provision does not fully protect mortgagors, it is more borrower-friendly than many states that do not require the lender to notify the borrower at any point in the process.[37]

Another component of Indiana's statutory scheme partially grants power to borrowers involved in a foreclosure proceeding. Prior to a court authorized foreclosure sale, a mortgagor may redeem the property from the judgment by paying the amount of the judgment, plus interest, and the costs of procuring the judgment.[38] However, unlike in some other states, once a foreclosure sale has been completed, there is no statutory right of redemption.[39] This limited protection benefits homeowners in some regards, but the pre-sale right of redemption likely has little impact or practical use.[40]

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section 32-29-7-3(a)(2), or when the owner has waived the time limit under section 32-29-7-5. Because of these time limits, even in an uncontested case, the time to complete the foreclosure process will average about six months, including three months until the writ is permitted, six to eight weeks to date of sale, and two to four months for judgment on the sale. *See* KEYLES, *supra* note 26, at 168. There are many other particularities of the Indiana Code dealing with judicial foreclosure, but they are not relevant for purposes of this Note.

33. This protection does have some limitations to protect against abuse by mortgagors. The mortgaged property must be occupied by the mortgagor, the mortgagor must not damage the premises in any way, and the mortgagor must continue to pay taxes and assessments while they remain in the home. IND. CODE § 32-29-7-11(b) (2002).

34. Michael Guisto, Note, *Mortgage Foreclosure for Secondary Breaches: A Practitioner's Guide to Defining "Security Impairment,"* 26 CARDOZO L. REV. 2563, 2565 (2005).

35. *Id.* at 2564.

36. This difference in notice requirements is due to the severity of acceleration compared to default. Notice is required for acceleration because it is the triggering mechanism that begins the foreclosure process, whereas a lender may not begin foreclosure merely upon default. *See* KEYLES, *supra* note 26, at 167.

37. *See, e.g.*, OHIO REV. CODE ANN. § 2329.23 (LexisNexis 2002).

38. IND. CODE § 32-29-7-7 (2002).

39. *In re* M & L Farms, Inc., No. 96-10012, 1996 Bankr. LEXIS 1921, at *9-10 (Bankr. N.D. Ind. Apr. 1, 1996) (interpreting Indiana Code section 32-29-7-13 to forbid post-sale right of redemption).

40. Typically, common law rights of redemption are not exercised. Borrowers have no

### *B. Foreclosure Law in States with High Foreclosure Rates*

In the past few years, many other states in addition to Indiana have suffered high foreclosure rates. Four states that have consistently had the highest foreclosure rates in recent times are Ohio, South Carolina, Pennsylvania, and Mississippi. Although these states are geographically diverse, there are consistencies in their statutes that raise possible correlations between their impact on the mortgage market and higher occurrences of foreclosure.

Although Ohio has consistently had high foreclosure rates in the past few years, it recently reached the dubious distinction of having the highest foreclosure rate in the country at 3.33%.[41] Not surprisingly, many of Ohio's foreclosure laws are similar to the laws in Indiana. All foreclosures in Ohio utilize judicial foreclosure.[42] Similarly, the mortgagor only has redemption rights until confirmation of the foreclosure sale.[43] One difference between Ohio and Indiana is that, unless enumerated and required in the loan documents, Ohio does not require notice of default or acceleration.[44] Nonetheless, the basic legal framework in Ohio and Indiana is similar and is a contributing factor in each state's recent high foreclosure rates.

South Carolina, which recently had the third highest foreclosure rate of 2.46%,[45] also has laws similar to those in Indiana. South Carolina only permits judicial foreclosure in the state.[46] Furthermore, while Indiana only allows redemption before the foreclosure sale, South Carolina completely forbids a mortgagor's statutory right of redemption.[47] South Carolina's rules regarding notice are similar to those in Ohio, because they only require notice of acceleration if the mortgage explicitly provides for it.[48]

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incentive to redeem the property when its value is lower than the amount owed on the loan, which is what most often leads to foreclosure. PENCE, *supra* note 5, at 6. Nonetheless, even if the value of the property is higher than the amount on the loan, there is likely nothing that has changed in the short-term that would enable the borrower to financially support the redemption of the property.

41. Mitchell, *supra* note 2, at E1.

42. Nonjudicial foreclosures are permitted if they are by a trustee pursuant to a deed of trust. However, this exception is never used because there is no judicial determination of title. Therefore, Ohio is exclusively a judicial foreclosure state. *See* KEYLES, *supra* note 26, at 443.

43. OHIO REV. CODE ANN. § 2329.33 (LexisNexis 2002).

44. In Ohio and states where no notice of default or acceleration is required, the filing of a foreclosure action with the court, which will entail service upon the party involved, will serve as sufficient notice. *See id.* § 2329.23.

45. Mitchell, *supra* note 2, at E1.

46. *See* S.C. CODE ANN. § 15-7-10 (2004).

47. *See* KEYLES, *supra* note 26, at 495.

48. Because judicial foreclosure is the only method in South Carolina, the service of a court summons and complaint for foreclosure is an adequate notice of acceleration when it is not enumerated in the mortgage. Hendrix v. Franklin, 355 S.E.2d 273, 274 (S.C. Ct. App. 1986).

Pennsylvania, another state with a high foreclosure rate,[49] continues the trend, with laws parallel to Indiana's statutory scheme. Pennsylvania is an exclusively judicial foreclosure state and ends a mortgagor's right of redemption after the completion of a sheriff's sale of the foreclosed property.[50] Conversely, Pennsylvania does not require default and acceleration notices where the principal on the loan exceeds $50,000, but requires thirty days notice before acceleration or the commencement of legal action for residential mortgages that are below that amount.[51] Pennsylvania's notice provision is evidence of the infinite statutory variations that exist among states.

Mississippi has shared similar problems with high foreclosure rates in the past few years, where 2.27% of mortgages in the state foreclosed in the second quarter of 2004.[52] However, unlike most other states with high rates, Mississippi is a nonjudicial (or power-of-sale) foreclosure state.[53] Because the state permits nonjudicial foreclosures, lenders rarely use judicial foreclosures unless there is an error in the deed that prevents a nonjudicial foreclosure.[54] In fact, most of Mississippi's laws make the state more pro-lender than other states with high foreclosure rates. Except in some cases where there was course of dealing between the mortgagor and mortgagee, Mississippi does not require written notice of either default or acceleration.[55] Furthermore, redemption rights are only available before a valid foreclosure sale.[56]

### *C. Foreclosure Law in States with Low Foreclosure Rates*

At the same time that the national foreclosure rate has been on the rise and at all-time highs, some states have managed to keep foreclosures to a minimum. Although some uncontrollable factors such as geographic location can affect a state's ability to limit foreclosures,[57] the structure of the laws of these states also

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49. Pennsylvania's foreclosure rate for the second quarter in 2004 was 1.94%. Mitchell, *supra* note 2, at E1.

50. PA. R. CIV. P. 1141 (2004).

51. 41 PA. CONS. STAT. § 101 (2004). The likely justification for this distinction is that borrowers are more likely to be able to pay off the balance of their mortgage when it is below a certain amount, and the state may see it unjust to strip a homeowner of their property without time to react when they are close to having full equity in the property. In addition, low-income mortgagors are more likely to have lower mortgage amounts and be in need of extra protection from the state.

52. Mitchell, *supra* note 2, at E1.

53. *See* MISS. CODE ANN. § 89-1-55 (1999).

54. KEYLES, *supra* note 26, at 319.

55. *Id.*

56. MISS. CODE ANN. § 89-1-59 (1999).

57. The foreclosure rate among regions of the United States can vary drastically, even though economic conditions and foreclosure laws may be the same. In the fourth quarter of 2004, the foreclosure rate in the North Central region of the United States was 1.75%, whereas the foreclosure rate in the West region was only 0.68%. Press Release, Mortgage Bankers Association, Residential

contributes to their relative success. Over the past few years, states such as California, Alaska, New Hampshire and Wyoming have enjoyed foreclosure rates well below the national average.[58]

California, like most states with low foreclosure rates, allows nonjudicial foreclosure.[59] Although nonjudicial foreclosures are completed without court intervention, they are still included in the calculation of state foreclosure rates.[60] Also, unless the loan agreement provides otherwise, California does not require notice of default, but does require notice of acceleration unless the agreement expressly states that the lender has the right to accelerate the debt.[61] This provision gives lenders the right to control their mortgages at the outset, a benefit not given to unknowledgeable borrowers. California permits redemption until the completion of a foreclosure sale, which does give some power to mortgagors.[62] Because of California's "unique" real estate market, it is likely that these foreclosure laws have less of an effect on its foreclosure rates than those in other states.[63]

Alaska similarly permits nonjudicial foreclosure, which is the primary foreclosure method in the state.[64] Like many power-of-sale foreclosure states with low foreclosure rates, statutory rules differ depending on whether the lender pursues the foreclosure judicially or nonjudicially. For example, Alaska does not require written notice of default and acceleration for judicial foreclosure, but does require notice of default for nonjudicial foreclosure.[65] Also, the mortgagor has redemption rights for nonjudicial foreclosure, but not for judicial foreclosure. These distinctions strike a balance between the power that nonjudicial foreclosure gives to lenders and the need to protect borrowers from this extra

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Mortgage Delinquencies Continue to Fall While Foreclosures Increase Slightly According to MBA's National Delinquency Survey (Mar. 11, 2004), *available at* http://www.mbaa.org/news/2004/pr0311a.html.

58. As of the third quarter in 2002, the national average was 1.15%, compared to California (0.5%), Alaska (0.4%), New Hampshire (0.4%), and Wyoming (0.5%). Rising Foreclosure Rates in Indiana, *supra* note 6, at 15-16.

59. *See* CAL. CIV. CODE § 2924 (West 2004).

60. Reports such as the Mortgage Bankers Association delinquency surveys cover all government-insured and conventional loans in their results.

61. KEYLES, *supra* note 26, at 37.

62. *Id.* at 42.

63. *Golden West Financial Corp.*, SAN FRAN. CHRON., Jan. 18, 2004, at I1. As opposed to Midwest states where farmland may easily be purchased and developed, California has limited residential space. This has led to appreciation of property values and a "seller's" market. "One big market driver is that housing demand is greater than supply." Alec Rosenberg, *Home Prices Creep Up: Bay Area Housing Market Stays Hot But Increases May Slow Down*, DAILY REV. (Hayward, Cal.), Sept. 17, 2004. Because property values largely remain above mortgage balances in California, fewer foreclosures occur, and those who do face financial difficulty are easily able to sell their homes to a willing buyer at an inflated price.

64. *See* ALASKA STAT. § 34.20.090 (2004).

65. *Id.* § 34.20.070.

power, which may lead to potential fraudulent actions by lenders.

In addition to its geographic difference, New Hampshire's statutory foreclosure scheme differs from these other states. Unless the loan explicitly provides otherwise, the state does not require notice of default or acceleration.[66] New Hampshire permits nonjudicial foreclosure, but it also permits three additional special methods of foreclosure: entry under process, entry and publication, and possession and publication.[67] New Hampshire, as with all states, allows a common law equitable right of redemption until a foreclosure sale, but does not offer statutory redemption rights under any foreclosure method after such a sale.[68]

Finally, Wyoming also allows nonjudicial foreclosure.[69] Despite this similarity with other low foreclosure rate states, Wyoming's other laws differ from the other low foreclosure states in many ways. For example, Wyoming requires both notice of default and acceleration by statute,[70] and redemption rights exist for mortgagors under both judicial and nonjudicial foreclosure for a period of three months from the date of the foreclosure sale.[71] These notice provisions and redemption rights are again mitigating protection against the broad power that nonjudicial foreclosure gives lenders.

Despite the subtle differences among the laws of states with high foreclosure rates, most are judicial foreclosure states that tend to favor the borrower. On the other hand, states with low foreclosure rates tend to favor the lender, or at least strike a better balance between the two parties. While it appears contradictory that there would be more foreclosures in a state where the borrower is at an advantage, Part III.B of this Note addresses the many reasons for this relationship.

## II. THE FEDERAL HOUSING ADMINISTRATION

### *A. Overview of the FHA*

The National Housing Act led to the establishment of the Federal Housing Administration in 1934.[72] Created in reaction to the Great Depression, the main goal of the FHA was to further homeownership, protect lenders, and increase

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66. KEYLES, *supra* note 26, at 373.

67. N.H. REV. STAT. ANN. § 479:19 (2004). Entry under process is valid by lawful entry and possession of the property in question for one year. Entry and publication entails "peaceable" entry onto the property, possession for one year, and publication for three consecutive weeks in a newspaper of general circulation in the property's county. Possession and publication is used when the lender already has possession of the property and similar publication is used as under "entry and publication."

68. *Id.*

69. *See* WYO. STAT. ANN. § 34-4-102 (2003).

70. *Id.* § 34-4-103.

71. *Id.* § 1-18-103(a).

72. 12 U.S.C. § 1701 (2000).

employment in the building industry. The program accomplishes these goals by insuring private lenders against losses on mortgages that finance purchases of property with one to four housing units, up to certain principal amounts.[73] Because the insurance subjects lenders to less risk, they are more willing to give mortgages to borrowers who otherwise would have been too financially unstable to qualify. The FHA became part of the Department of Housing and Urban Development's ("HUD") Office of Housing in 1965 and remains under the authority of that department today.[74] HUD also oversees the Fannie Mae and Freddie Mac corporations, both of which the FHA references in determining loan limits.[75]

The FHA is a self-sufficient agency with its own funding through the Mutual Mortgage Insurance Fund ("MMIF"). Insurance premiums and proceeds from the sale of foreclosed properties cover the payments of claims by lenders on foreclosed properties and other administrative expenses.[76] To ensure that this fund does not get depleted, the FHA's underwriting guidelines require lenders to evaluate and limit risk. Lenders evaluate a borrower's ability and willingness to pay by evaluating qualifying ratios, stability and adequacy of income, credit history, and funds to close on the sale.[77] Despite these protections, the FHA continues to have a detrimental impact on foreclosure rates across the nation.

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73. CHANGES IN THE PERFORMANCE OF FHA-INSURED LOANS, *supra* note 17, at 4. Borrowers pay insurance premiums, often as part of their monthly payment, to cover the cost of the FHA's insurance to lenders. According to HUD's website, insurance costs drop dramatically after the longer of five years or when the balance of the loan is less than seventy-eight percent of the property value. HUD Website, http://www.hud.gov/offices/hsg/fhahistory.cfm (last updated June 27, 2005).

74. *Id.*

75. Both Freddie Mac and Fannie Mae are stockholder-owned corporations that provide funding to lenders to ensure they continue to offer mortgages to high-risk borrowers. Both entities are far too complex to discuss in detail for purposes of this Note. To limit its potential losses, the FHA sets loan limits on the mortgages it insures based on a percentage of area home prices, which protects against regional discrepancies in home prices. Historically, limits were set at ninety-five percent of the median home sale price within a county and between thirty-eight and seventy-five percent of the loan limits for Freddie Mac or Fannie Mae purchased loans. These limits have recently increased, as discussed later in this Note.

76. CHANGES IN THE PERFORMANCE OF FHA-INSURED LOANS, *supra* note 17, at 5. The fund is increased by insurance premiums from borrowers at the beginning of the mortgage and periodically over its life and by proceeds from the sale of foreclosed properties insured by the FHA. Although the fund is backed by the U.S. Treasury, the FHA would only rely on treasury funding if and when it depleted the MMIF.

77. *Id.* at 7. For a full discussion of these factors, including the changes made to them in the 1990s, see *infra* notes 82-85 and accompanying text. The FHA has not recently changed the amount of funding required at the beginning of a mortgage, but the general trend in the mortgage market has been towards lower down payments to encourage higher levels of homeownership.

### B. *Impact of the FHA on Foreclosure Rates*

Throughout the 1990s, FHA loans grew increasingly more likely to foreclose.[78] When combined with the higher number of borrowers obtaining FHA loans, this had a profound negative impact on the national residential mortgage market. A number of factors contributed to increased FHA foreclosure rates, including changes in underwriting requirements by the FHA at a time when the conventional mortgage market was growing and there was price appreciation for residences.[79] These underwriting requirement changes aimed to "expand homeownership opportunities by eliminating unnecessary barriers to potential homebuyers," but instead, the FHA became overwhelmed with high-risk borrowers.[80] Part III.A of this Note fully examines this type of tradeoff, which is the topic of ongoing debates in the housing arena.

In 1995, the FHA made a number of changes that allowed more people to acquire funding for homes through FHA programs for the first time and increased the amount for which these borrowers could qualify. The underwriting requirements changed in four key areas, each increasing the loan amount for which individuals could qualify.[81] The FHA restricted the definition of "long-term debt," which often reduced the amount of debt included in qualifying ratios.[82] The FHA also expanded the definition of "effective income," so that previously unusable forms of income are now relevant for purposes of the FHA's qualifying payment-to-income ratio.[83] Aside from the qualifying ratios, the FHA

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78. *Id.* at 2. A sign of the problems in the program, even FHA adjustable-rate mortgages had increasing foreclosure rates at a time in the 1990s when mortgage interest rates were either stable or declining. *Id.* at 10. Adjustable-rate mortgages tie the interest paid for the mortgage to a market index. Therefore, even though mortgage payments would theoretically fall during this time, more people were defaulting and losing their homes.

79. *Id.* at 3.

80. *Id.* at 22. FHA loans are more likely to be issued to low-income, minority, or first-time homeowners who would otherwise not qualify for a loan due to possible poor credit records or the fact that they live in an underserved neighborhood. *See* U.S. DEP'T OF HOUS. AND URBAN DEV., ISSUE BRIEF NO. IV, FHA'S IMPACT ON INCREASING HOMEOWNERSHIP OPPORTUNITIES FOR LOW-INCOME AND MINORITY FAMILIES DURING THE 1990S 3 (2000), *available at* http://www.huduser.org/publications/pdf/fha.pdf [hereinafter FHA'S IMPACT ON INCREASING HOMEOWNERSHIP OPPORTUNITIES].

81. CHANGES IN THE PERFORMANCE OF FHA-INSURED LOANS, *supra* note 17, at 22.

82. *Id.* at 23. The qualifying ratio is the debt-to-income ratio, which must not be higher than forty-one percent to qualify for an FHA-insured loan. Items such as childcare expenses, which previously were required additions to debt calculations, no longer must be included. In addition, long-term debts previously included debts extending sixth months or longer, but the new guidelines only include debts extending ten months or more. Thus, for many borrowers, less debt was included in their debt-to-income ratio, and they were able to meet the forty-one percent threshold for the first time.

83. *Id.* at 24. Mortgage payments under the payment-to-income ratio may not exceed twenty-nine percent of a borrower's monthly income. Thus, additional income items enable more people

also increased the number of compensating factors that may nonetheless approve a borrower for a loan amount.[84] Finally, the FHA relaxed the standards for evaluation of past credit history, allowing some people with previously poor credit to qualify for new mortgages.[85]

At the same time the FHA relaxed these underwriting requirements, Congress raised loan limits for FHA loans to forty-eight and eighty-seven percent of the conforming loan limit.[86] This change came at HUD's request, again in line with its goal to give more families the ability to use the FHA for their mortgages.[87] While this change did allow more people to obtain FHA-insured loans, these loans carried higher principal values than the FHA had dealt with previously,[88] which can lead to larger losses for the MMIF if borrowers are unable to fulfill the terms of their mortgages.

Finally, competition from the private mortgage insurance market also increased while the FHA was changing its requirements.[89] These private insurers serve essentially the same purpose as the FHA, offering mortgages with low down payments to borrowers who may not be otherwise qualified, but whom the insurer sees as a low-risk borrower.[90] Borrowers often prefer private mortgage insurance, if attainable, because it is less expensive than FHA insurance.[91] In the

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to qualify for loans and for higher loan amounts. When calculating income, lenders balance the amount of anticipated income with the likelihood the income will continue. The underwriting changes now allow certain types of income that were previously considered too volatile to be included, such as overtime and bonuses. In addition, income must now only be expected to continue for three years, when in the past it must have met a five-year mark.

84. *Id.* While the qualifying ratios discussed above serve as guidelines for lenders to follow, borrowers are not completely barred from FHA-insured protection if they do not meet the stated percentages. The new underwriting standards included several new compensating factors that lenders may weigh in determining solvency. Lenders may now include public benefits, such as food stamps or welfare, in the borrower's ability to pay. In addition, if a borrower has shown an ability to pay housing expenses greater than those allowed in the past, lenders may allow the increased amount.

85. *Id.* at 25. Before the underwriting changes, borrowers were unable to qualify for FHA-insured loans if they were delinquent on any federal debt or liens on any property. However, the FHA will now qualify such individuals. In addition to traditional credit reports, lenders were previously only permitted to use rent or utilities as a nontraditional way of showing good credit. The underwriting changes now allow other nontraditional credit reports as well, which consider periodic payments such as tuition, insurance, and medical bills. These changes essentially allow lenders to choose what credit history casts the borrower in the best light and then approve them for mortgages to be insured by the FHA.

86. FHA'S IMPACT ON INCREASING HOMEOWNERSHIP OPPORTUNITIES, *supra* note 80, at 6. At these levels, the FHA insures homes with prices between $132,000 and $239,250.

87. *Id.*

88. CHANGES IN THE PERFORMANCE OF FHA-INSURED LOANS, *supra* note 17, at 3.

89. *Id.* at 26.

90. *Id.* at 22.

91. *Id.* at 26.

past, the FHA had an advantage over these private insurers because it was able to identify low-risk borrowers more effectively. However, as the competencies of the private market have increased, private mortgage insurance companies have been able to identify and select the lower risk would-be mortgagors. The would-be mortgagors that remain for the FHA are higher-risk insureds, leading to higher foreclosure rates for the program.[92]

In the end, the FHA's internal changes conflicted with the changing external mortgage market, which forced the FHA to reevaluate its goals and policies. While the dream of homeownership for all had been, and continues to be, a noble ideal of the FHA, its achievability was called into question in the 1990s and the agency took action to reduce the growing number of foreclosures it faced.

### *C. Steps Taken by FHA to Reduce Foreclosure*

In November 1996, the FHA finally reacted to its foreclosure problems. Recognizing that foreclosure is often unavoidable, the FHA instead implemented a program aimed at loss mitigation. This program provided a variety of alternatives, each seeking to help borrowers avoid foreclosure or dispose of their property in cost-effective ways for the FHA and the borrower.[93] The FHA supports three types of loss mitigation that enable borrowers to remain in their homes: special forbearance, loan modification, and partial claims.[94] If none of these options is available or feasible, the FHA encourages the borrower to either perform a pre-foreclosure sale or deed-in-lieu of foreclosure.[95] The FHA expects

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92. *Id.* In addition, the competition has raised concerns over the future funding of the MMIF. As the "FHA's claims rate . . . continues to rise each year and with fewer FHA mortgage applicants there is less premium income to cover the claims." *Mortgage Fraud and Its Impact on Mortgage Lenders: Before the Subcomm. on Housing and Community Opportunity of the H. Comm. on Financial Services*, 108th Cong. 1 (2004) (prepared testimony of Hon. Kenneth M. Donohue, Sr., Inspector General, Department of Housing and Urban Development), http://financialservices.house.gov/media/pdf/100704kd.pdf.

93. CHANGES IN THE PERFORMANCE OF FHA-INSURED LOANS, *supra* note 17, at 22 n.15.

94. Special forbearance allows borrowers a period of suspended or reduced payments and an additional grace period to repay the arrearage of the delinquent mortgage. *See* 24 C.F.R. § 203.614. This option is typically only offered when there is a reasonable chance the borrower can resume normal payments in the future. Loan modification changes the mortgage to lower interest rates or extended mortgage terms in order to lower payment amounts. *See id.* § 203.616. Partial claims involve one-time payments from the FHA to the borrower to make the mortgage balance current. *See id.* § 203.371. Partial claims are offered when borrowers have long-term financial stability to cover their mortgage but are not able to cure the outstanding delinquency. U.S. DEP'T OF HOUS. AND URBAN DEV. MORTGAGEE LETTER 96-25, EXISTING ALTERNATIVES TO FORECLOSURE-LOSS MITIGATION (1996), *available at* http://www.hudclips.org/sub_nonhud/html/ shortcut.htm (follow "1996" hyperlink under Letters: Mortgage then locate letter 96-25) [hereinafter MORTGAGE LETTER 96-25].

95. MORTGAGE LETTER 96-25, *supra* note 94. These mitigation techniques do not allow the borrower to keep their property, but are still seen as cost-effective alternatives to foreclosure. Pre-

lenders to choose the appropriate mitigation tool on a case-by-case basis, depending on the extenuating circumstances and delinquency of payment (in terms of both time and amount), once a mortgagor has not made three full monthly payments.[96] While the FHA's loss mitigation program is not mandatory for lenders, the FHA does provide incentives for lenders to take part in the program, in addition to possible financial penalties for non-participation.[97] As of 2000, the loss mitigation program appeared to be a success, with more lenders participating in the program and the number of foreclosures falling.[98]

The FHA is also reacting to the increased competition from the private mortgage insurance sector. It has begun implementation of automated underwriting systems, designed to provide consistency and effectiveness in the FHA's underwriting practices.[99] These systems, designed to better distinguish between higher and lower credit risks, will attempt to lower the FHA's risk portfolio.[100]

However, these loss mitigation strategies and automated systems are not long-term solutions to the increasing foreclosure problems of the FHA. Pre-foreclosure sales and deeds-in-lieu of foreclosure prevent statistical foreclosures, but, undesirably, families are still stripped of their homes. The automated underwriting systems run against the goal of the FHA to provide housing to as

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foreclosure sales attempt to cover the outstanding mortgage amount for the lender much like the nonjudicial foreclosure process. *See* 24 C.F.R. § 203.370. Just as redemption rights are designed to prevent lenders from buying foreclosed properties for inadequate amounts, the FHA imposes a floor on the pre-foreclosure sale price, eighty-seven percent of the value of the property. If this bar is met, the FHA will reimburse the lender for the sale of the property. On the other hand, a deed-in-lieu of foreclosure does not involve the sale of property. *See id.* § 203.357. Instead, it offers incentives to the borrower to transfer the deed to their property to the lender rather than face foreclosure proceedings. These incentives include avoidance of costs and litigation involved in foreclosures and a payment of up to five hundred dollars. U.S. DEP'T OF HOUS. AND URBAN DEV., MORTGAGE LETTER 96-61, FHA LOSS MITIGATION PROCEDURES-SPECIAL INSTRUCTIONS (1996), *available at* http://www.hudclips.org/sub_nonhud/html/shortcut.htm (follow "1996" hyperlink under Letters: Mortgage then locate letter 96-61).

96. 24 C.F.R. § 203.605.

97. CHANGES IN THE PERFORMANCE OF FHA-INSURED LOANS, *supra* note 17, at 28. The amount of incentives offered varies depending on the extent of the lender's participation in the loss mitigation program. Some incentives offered include higher reimbursements for foreclosure expenses, reimbursements for expenses incurred while mitigating losses, and cash payments. The amount of these payments depends on the type of mitigation strategy that was used most by the lender. ABT ASSOCIATES INC., AN ASSESSMENT OF FHA'S SINGLE-FAMILY MORTGAGE INSURANCE LOSS MITIGATION PROGRAM: FINAL REPORT 18-22 (2000), *available at* http://www.abtassoc.com/reports/20007197399621.pdf. On the other hand, lenders who do not comply with the procedures miss the opportunity to receive incentives and benefits and may face reduced reimbursement for foreclosure costs or lower interest rates when foreclosure is delayed. *Id.* at 10.

98. CHANGES IN THE PERFORMANCE OF FHA-INSURED LOANS, *supra* note 17, at 30.

99. *Id.* at 26.

100. *Id.*

many people as possible, so it will be difficult to balance its implementation with its previously established guidelines. The FHA must also focus on changes at the outset of its mortgages, which will reduce the need for these loss mitigation strategies and less risky borrowers in the future. Part III.C of this Note discusses some potential mitigation options for the FHA.

## III. Proposals to Reduce Foreclosure Rates

### *A. Policy Considerations*

At the heart of the recent rise in foreclosures is the struggle between those who want increased homeownership opportunities for all and those who encourage a limit to such endeavors. The private mortgage market, along with programs like the FHA, has made it increasingly easy for people who would not otherwise qualify for mortgages in the past to receive financing. Proponents of increasing homeownership for all citizens may see these changes as a good thing, while others focus on the additional costs of foreclosures and burdens on local communities and the economy. The benefits and disadvantages of homeownership are thus central to the debate about where the line should be drawn as to what constitutes permissible financing from lenders. Policymakers can "facilitate availability of low-priced mortgage credit, or they can provide protections to home-owners who experience financial difficulties, but they cannot do both."[101]

*1. Advantages of High Homeownership.*—"Housing is a necessary of life."[102] Housing can take many different forms, from huge mansions owned by individuals to small apartments rented on a monthly basis. However, the "American dream" is to own some type of property, and therefore many believe that increasing homeownership can improve the morale of society. While studies cannot readily quantify and measure this positive emotional response, some studies have focused on peripheral advantages of owning a home.

First, homeowners have more of a financial interest and investment in their neighborhood and therefore are likely to be more conscientious about improving the quality of their surroundings than renters, who typically stay in one location for a short period of time. This conscientiousness can include taking better care of property or being more likely to vote for proposals needed for the future, such as road improvements.[103] Thus, the entire community benefits by having more homeowners in the area who take responsibility for managing and improving their investment.[104]

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101. PENCE, *supra* note 5, at 3.

102. Jonathan Douglas Witten, *The Cost of Developing Affordable Housing: At What Price?*, 30 B.C. ENVTL. AFF. L. REV. 509, 509 (2003) (quoting Block v. Hirsch, 256 U.S. 135, 156 (1920)) (emphasis omitted).

103. Peter Coy, *When Home Buying by the Poor Backfires: For Many Families, a House Can Be a Bad Investment*, BUS. WEEK, Nov. 1, 2004, at 68.

104. Daniel Aaronson, *A Note on the Benefits of Homeownership* 2 (Fed. Reserve Bank of

Aside from the external benefits homeownership may bring, there are individual benefits for the owner and their family. For example, the stability of owning a home, as opposed to short-term renting, can benefit children. Studies have shown that moving can have significant negative impacts on student achievement.[105] Also, homeowners can build equity and receive returns from their ownership investment in the form of appreciation, while renters instead make monthly payments to their landlords that are never recoupable. In addition to the stability that a home provides, this additional wealth from homeownership returns can provide better opportunities for children as well.[106]

In an ideal world, every citizen would have a home that they could afford and in which they could be comfortable. In this utopian society, people would take pride in their homes and the overall quality of the community would improve. However, the housing market is not perfect, and there are many problems that people create when they enter the housing market with inadequate means.

2. *Disadvantages of High Homeownership.*—Although the benefits of homeownership all have merit, they can be too idealistic in a society where foreclosure rates are on the rise. The theory of community improvement could become a reality, but there is also a substantial risk that increased homeownership will create more community harm than good. Because cities across the country have already been built-up and many low-cost homeownership options have moved to outlying areas, suburban sprawl has created real problems, both environmental and social.[107] Suburban housing areas may improve community surroundings in these areas, but it comes at the expense of the urban housing community, which is often left to the poor.[108] In the communities where new homeownership is thriving, unmanageably high homeownership rates may also have negative impacts because of the threat of foreclosure. Foreclosures, whether judicial or nonjudicial, have the effect of decreasing surrounding property values. In addition, foreclosures may lead to abandoned properties during the lengthy foreclosure process, causing deterioration in the structural and aesthetic quality in the area.

From an individual perspective, owners have been increasingly unable to build equity in their homes, and studies have shown that homeownership is not the most reliable means of building wealth for low-income families. Instead,

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Chi., Research Dep't, Working Papers Series, WP 99-23, 1999), *available at* http://www.chicagofed.org/publications/workingpapers/papers/wp99_23.pdf.

105. *Id.* at 3.

106. *Id.* at 8.

107. Michael Lewyn, *Suburban Sprawl: Not Just an Environmental Issue*, 84 MARQ. L. REV. 301, 301-03 (2000). Suburban sprawl is "the movement of people . . . and jobs from older urban cores to newer, less densely populated . . . communities generally referred to as suburbs." *Id.* at 301.

108. *Id.* at 305-12. Congress has expressed concern over these trends through the Housing and Community Development Act of 1974, 42 U.S.C. § 5301 (2000), which aims to encourage investment in housing for blighted urban neighborhoods. People's Hous. Dev. Corp. v. City of Poughkeepsie, 425 F. Supp. 482, 484 (S.D.N.Y. 1976).

other assets such as stocks tend to increase wealth more safely and effectively, even when appreciation for homes is at its peak.[109] This inability to build equity is also a result of owners borrowing against their equity to pay the bills that homeownership has created for them.[110] Furthermore, the tax advantages that homeownership can provide do not always benefit low-income families as much as established homeowners.[111]

Even in the utopia where homeowners are able to maintain equity in their homes, generate wealth, and contribute to the community, there are concerns that homeownership still may not be ideal. The increased time and money that is given to improving the community may actually be less helpful than any direct payoff that is made to a homeowner's family, including children.[112] While the increase in homeownership rates is commendable, it is possible that we have reached a point of diminishing returns where the addition of more owners will only cause more problems in foreclosure and the abandonment of more homes.

### *B. Changes to Indiana Foreclosure Laws*

Foreclosure laws across the United States are fragmented. Although past proposals attempted to create uniform national foreclosure laws,[113] a system for which there are many proponents,[114] states remain free to make independent decisions in this area. While the continued pursuit of a universal system is noble, statutory reform by individual states is the immediate cure for increased foreclosure rates.

Because mortgage and foreclosure law is established on the state level, Indiana has additional onus to create laws amicable to the welfare of its citizens. Currently, Indiana's foreclosure laws are structured in a way that keep the state's foreclosure rates among the highest in the nation.[115] To remedy this problem, Indiana should adopt a nonjudicial foreclosure system in addition to its common

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109. Coy, *supra* note 103, at 68. In states like Indiana where there has been a massive amount of new housing being built and widespread foreclosures have decreased property values, appreciation rates are nearly non-existent and in some cases people have seen their investment value decrease.

110. Many first-time homeowners are not aware of the increased bills that accompany homeownership, such as property taxes and home insurance, as they are used to these expenses being covered by their landlord wherever they rented.

111. The Internal Revenue Code allows for tax deductions for interest paid, including the large amount of interest on mortgages, under 26 U.S.C. § 163(h)(2)(D) (2000).

112. Aaronson, *supra* note 104, at 3.

113. As early as 1973, the ninety-third United States Congress considered a resolution that would establish standard foreclosure procedures. Frank S. Alexander, *Federal Intervention in Real Estate Finance: Preemption and Federal Common Law*, 71 N.C. L. REV. 293, 316 (1993).

114. *See, e.g.*, Nelson, *supra* note 24, at 1399; Patrick A. Randolph, Jr., *The Future of American Real Estate Law: Uniform Foreclosure Laws and Uniform Land Security Interest Act*, 20 NOVA L. REV. 1109 (1996).

115. *See supra* note 2.

law judicial foreclosure process.

Nonjudicial foreclosures, which expedite foreclosure proceedings because of the decreased time and expense required for lenders, are actually more prevalent in states with low foreclosure rates. Based on a 2003 report by the National Association of Realtors, fifteen states had a foreclosure rate less than 0.9%; of those fifteen states, thirteen permitted nonjudicial foreclosure.[116] Perhaps more significantly, seven of the nine states that had foreclosure rates of 1.6% or higher required judicial foreclosure.[117] Only Mississippi and Utah employ a nonjudicial foreclosure process while suffering poor foreclosure rate performance, but their performance can largely be attributed to extraneous circumstances.[118]

Although somewhat counterintuitive, several factors support the correlation between judicial foreclosure and high foreclosure rates. First, although judicial foreclosure is intended to protect borrowers, lenders could be passing the higher costs of court proceedings to homeowners in the form of higher interest rates and larger fees.[119] These additional costs make it more difficult for borrowers to increase equity in their homes, which makes them more susceptible to default. Because of the extra costs that judicial foreclosure entails, lenders attempt to avoid foreclosure and pursue alternative methods once default occurs,[120] but at that point the borrower is likely insolvent and even concessions may not prevent foreclosure. On the other hand, nonjudicial foreclosures allow lenders to be more flexible and forbearing with borrowers at the outset of the mortgage.

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116. These states included Alaska, Arizona, California, Colorado, Hawaii, Massachusetts, Minnesota, Montana, New Hampshire, North Dakota, Rhode Island, South Dakota, Vermont, Virginia, and Wyoming. Only North Dakota and Vermont were judicial foreclosure states that maintained a low foreclosure rate. Rising Foreclosure Rates in Indiana, *supra* note 6, at 15-16.

117. The nine states with the highest foreclosure rates included Indiana, Kentucky, Louisiana, Mississippi, New Mexico, Ohio, Pennsylvania, South Carolina, and Utah. *Id.*

118. Utah's "unique local culture" augments its foreclosure rates. *Local Culture and National Economy Cause Utah Bankruptcies*, 15 CONSUMER BANKR. NEWS 5, Feb. 17, 2005. The state amplifies the impact of national economic problems, because its citizens marry at earlier ages, have larger families, and buy homes earlier than national averages. Recent layoffs and additional children have forced many Utah citizens to fall behind on their mortgage payments, especially where both spouses were working to afford their monthly payments. *Id.* Mississippi's problems are not as readily apparent. The state has recently discovered a dramatic increase in the occurrence of predatory lending, especially "flipping." Kevin Walters, *Mortgage Fraud Probe Expands into New Week*, HATTIESBURG AM., May 25, 2003, at 1A. Flipping occurs when a lender encourages the borrower to repeatedly refinance his or her original mortgage, which adds higher interest and fees that reduce any equity the borrower originally had in the property. Ferguson, *supra* note 11, at 607, 609. Although the threat of predatory lending has extended beyond Mississippi's borders, new occurrences of fraud may artificially spike the foreclosure rate of an otherwise stable state.

119. Pence, *supra* note 5, at 1. This study found that the most plausible factor connecting foreclosure law and foreclosure rates was whether the state is a judicial or nonjudicial foreclosure state. *Id.* at 3.

120. *Id.* at 5.

Second, the extensive time requirements for judicial foreclosures create additional problems for the housing market.[121] The delay caused by judicial foreclosure finalization increases the likelihood of abandonment and deterioration of the property in question, which can have adverse effects on the surrounding area.[122] Indiana has seen this problem firsthand. Based on 2003 census data, one of every thirty homes in Indianapolis is abandoned, more than any other midwestern city.[123] Although proposals have been made to deal with these abandoned homes,[124] the continued existence of exclusively judicial foreclosure laws will only exacerbate the problem.

Finally, Indiana should also become a nonjudicial foreclosure state because it will allow more time to adjust to the change than if a new federal government regulation requires the state to use only nonjudicial foreclosure. If a universal foreclosure program is instituted, it will likely take the form of nonjudicial foreclosure because of its time and cost advantages. Congress followed this logic in enacting the Multi-Family Mortgage Foreclosure Act and Single-Family Mortgage Foreclosure Act in 1981 and 1994, respectively.[125] The Acts require that all mortgages held by HUD, which includes all FHA loans, be foreclosed using nonjudicial foreclosure even if the state prohibits the action.[126] Due to the widespread use of FHA programs, the Acts have had the ability to exert significant influence. However, other problems with the FHA's policies have prevented the agency from having a positive effect on foreclosure rates.

Additionally, during the transition from judicial to nonjudicial foreclosure laws, Indiana should implement loss mitigation strategies similar to those used by the FHA. These agency programs have had significant initial success and

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121. The average judicial foreclosure process takes approximately one year to complete, whereas the average nonjudicial foreclosure lasts only four months. Nelson A. Diaz, *HUD's New Foreclosure Act Cutting Losses and Improving Business Management*, 75 MICH. B.J. 532, 533 (1996). Furthermore, as the number of foreclosures increases in these judicial foreclosure states, courts will become increasingly delayed in adjudicating them. This will further compound the problems that delay can have on property values and conditions.

122. *Id.* The existence of abandoned homes in an area can "stifle [the] values of surrounding homes, . . . increase crime and cripple economic development." John Fritze, *Abandoned Homes Still a Problem; City Might Come Down Harder on Owners; Neighbors Uneasy With Crime, the Homeless*, INDIANAPOLIS STAR, Oct. 15, 2004, at 1A.

123. Not surprisingly, the Department of Housing and Urban Development, whose large presence in Indiana has been previously addressed, owns the largest share of these abandoned homes. *Id.*

124. The city of Indianapolis proposed increased fines for owners of abandoned homes, pass-through taxation for any repair costs, and appointment of receivers to take control of the property and resell it once repairs were made. *Id.*

125. *See* Diaz, *supra* note 121, at 532. The Multi-Family Mortgage Foreclosure Act is codified under 12 U.S.C. §§ 3701-3717 (2000). The Single-Family Mortgage Foreclosure Act, which applies to mortgages for one to four families, is codified under 12 U.S.C. §§ 3751-3768 (2000).

126. Diaz, *supra* note 121, at 532.

Indiana could easily adopt them. The money that Indiana pays in the form of judicial foreclosure court costs and fails to collect in property taxes because of depressed property values could be better applied toward rewarding lenders who provide alternatives to borrowers who have defaulted. The state would likely not be able to require lenders to pursue these mitigation strategies like the FHA, but offering attractive incentives could begin adequate participation to warrant the introduction of such a mandatory program.

### *C. Proposed Changes to the FHA Program*

Although the FHA has been in place for over seventy years, it still needs refinement. The most drastic change for the FHA would be its dissolution, an idea that has been considered in the past. "[M]any people (including many members of Congress) have questioned the usefulness of the FHA and suggest that its role would be better performed by the private sector," where financial markets are stronger and more sophisticated than they used to be.[127] Indeed, the strong competition of the private mortgage insurance market shows that it could be capable of providing inexpensive insurance for all borrowers. In addition to the numerous logistical difficulties of such a switch,[128] it is unlikely that the federal government will dissolve such a longstanding and historically significant agency. Therefore, the focus of changing the FHA should be on improving its practices.

*1. Mandatory Mortgage Counseling.*—The first, and perhaps most significant, change that the FHA should implement is requiring homeowner counseling for all first-time borrowers. The FHA's insureds are largely comprised of first-time borrowers unfamiliar with the mortgage process.[129] There are currently few government and local consumer-education programs and, due to industry opposition and cost concerns, they may be slow to expand.[130] Thus, it is even more essential that these FHA borrowers receive adequate information before undertaking such a monumental investment.

As of 2003, only three states required pre-foreclosure counseling: Georgia,

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127. Albert Monroe, *How the Federal Housing Administration Affects Homeownership* 4 (Harvard University Joint Center for Housing Studies, Working Paper W02-4, 2001), *available at* http://www.jchs.harvard.edu/publications/governmentprograms/monroe_w02-4.pdf.

128. If the FHA ever dissolved, a decision would have to be made whether the program would simply stop issuing insurance to any new borrowers or whether insurance would immediately cease for all borrowers. In the earlier case, it would likely take an excessive amount of time to fully divest the FHA of all its mortgages. However, it would be equally difficult to require borrowers to seek new mortgage insurance from private sources to maintain the lower interest rates they were likely receiving as a result of the insurance. Private insurers would have a large amount of leverage at that time and could offer unfavorable terms.

129. *See supra* note 80.

130. Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1309 (2002).

New York, and North Carolina.[131] The Department of Housing and Urban Development currently requires counseling for the elderly under the Home Equity Conversion Mortgage program.[132] HUD provides grants to self-sufficient, non-profit counseling agencies that undergo certification from the Department and provide services to these elderly mortgagors.[133] Furthermore, on September 10, 2004, the federal government announced a national campaign to educate consumers on the threat of predatory lending.[134]

While these programs have merit and are likely helpful to outline the various loss mitigation techniques available and tactics used by predatory lenders, the ideal time for counseling is at the outset of the mortgage. Even the best pre-foreclosure counseling may not be able to fix problems with a mortgage that are created at its inception. Many times, the key problem with a mortgage is that the mortgagor, unaware of the extra costs and hidden fees that a mortgage may contain, borrows too much money and is unable to make payments. Both HUD and the FHA have recently increased the limits for loan values that they insure,[135] and therefore they have a responsibility to educate borrowers about increased housing expenditures.

Despite the inherent costs of providing counseling for all first-time borrowers, the FHA is logistically and financially able to provide such a program. By broadening its certification process to include more independent agencies, HUD could adequately satisfy the number of borrowers needing counseling. This expansion is essential, because studies have shown that individual counseling is the most effective and beneficial counseling method for borrowers.[136] Furthermore, the FHA appears to be financially solvent enough to incur the expenses of such a program.[137]

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131. Harold L. Levine, *A Real Estate Focus: A Day in the Life of a Residential Mortgage Defendant*, 36 J. MARSHALL L. REV. 687, 700 (2003).

132. *Id.*

133. Donna S. Harkness, *Predatory Lending Prevention Project: Prescribing a Cure for the Home Equity Loss Ailing the Elderly*, 10 B.U. PUB. INT. L.J. 1, 41 (2000).

134. HUD Website, http://www.hud.gov/local/in/news/2004-09-10.cfm (last updated July 1, 2005). The program will start in twenty United States cities, including Indianapolis, where HUD has a high concentration of insured homes and knows predatory lending exists.

135. *See supra* note 86 and accompanying text.

136. Counseling can reduce mortgage delinquency, but different approaches have had varying success. For example, classroom and home study counseling had some benefit for borrowers, but telephone counseling had no effect on mortgage success. Abdighani Hirad & Peter M. Zorn, A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling 2 (May 22, 2001), http://www.freddiemac.com/corporate/reports/pdf/homebuyers_study.pdf.

137. Even though the FHA has seen a large increase in the number of foreclosed properties that it insures, it has remained above its two percent insurance pool requirement for the MMIF during the same time period. Furthermore, the FHA could transfer some of the cost of the grants to the borrower through direct chargers or in the form of lower insurance premiums for borrowers who personally fund the counseling.

2. *Varying Insurance Premiums.*—Second, the FHA should vary its price of insurance according to a borrower's profile. As previously mentioned, the recent implementation of automated underwriting standards has enabled the FHA to identify borrowers who have a lower risk of default.[138] The FHA should leverage this technology to separate potential insureds into groups with varying insurance premiums. By rewarding borrowers who are a lower credit risk with reduced insurance premiums, the FHA will be able to more actively compete with the private mortgage insurance market. Under the current usage of the automated underwriting standards, the FHA is still losing quality insureds to the private market and the system's only purpose is to increase the speed with which lenders process the FHA loans.[139]

3. *Change Loss Mitigation Incentive Structure.*—Finally, the FHA should change the incentives and penalties for participation in its loss mitigation program. While the program has been a "powerful set of tools" for resolving mortgage delinquencies, it can and should make small changes to enhance the program's power.[140] In a 2000 study on the success of the loss mitigation program, the main recommendations for reform centered around more complete data collection and information sharing between lenders and HUD.[141] While these suggestions may have merit for HUD and the FHA in the future, its main concern should be ensuring continued involvement in the program. Under the loss mitigation program, the FHA provides incentives for program participation and penalties for lenders who do not participate.[142] While the FHA has, in the past, been able to impose these penalties against lenders without fear of recourse, they must now reevaluate the loss mitigation program's reward structure.

As stated previously, the private mortgage insurance market has created strong competition for the FHA. Lenders now have the option to encourage buyers to pursue either FHA or private insurance to obtain better interest rates. Because private mortgage insurers likely do not require loss mitigation before foreclosures and, even more likely, do not threaten penalties for non-compliance, many lenders may prefer to work with the private market. This will again flood the FHA's insurance portfolio with risky borrowers, because they will have fewer lenders with which to work. Thus, the FHA should focus on rewarding the lenders who use the loss mitigation system well with increased incentives and reduce or eliminate penalties for non-compliance. While this may increase the cost of the program, the FHA can likely afford the changes.[143] Furthermore, good relationships with lenders should reduce the risk of the FHA's insurance portfolio, leading to fewer foreclosures and less need for loss mitigation.

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138. CHANGES IN THE PERFORMANCE OF FHA-INSURED LOANS, *supra* note 17, at 26.

139. *Id.*

140. ABT ASSOCIATES INC., *supra* note 97, at 105.

141. *See id.* at 105-13.

142. *See supra* note 97.

143. *See supra* note 137.

## CONCLUSION

No matter whether states use judicial or nonjudicial foreclosure, or whether a home is worth fifty thousand or five million dollars, problems with high foreclosure rates are pervasive in Indiana and across the nation. Although different states may attribute this trend to varying economic and social factors, the impact of each state's foreclosure procedures and of federal agencies such as the Federal Housing Administration cannot be ignored.

State foreclosure laws differ in many ways. States that are considered more lender-friendly allow for nonjudicial foreclosure, do not require notice of default or acceleration to the borrower, and do not create an additional statutory right of redemption. Meanwhile, borrower-friendly states require judicial foreclosure proceedings, mandate notice to mortgagors, and offer redemption rights beyond those given by common law. These small differences can greatly impact the number of foreclosures in a state.

The Federal Housing Administration, despite its longstanding tradition, has also contributed to poor mortgage performance. The FHA's insurance portfolio has grown increasingly risky because of the agency's goal to permit more homeowners. This has forced the agency to undertake several measures to strike a balance between homeownership for all and mitigating costs.

The gentle balance between reasonableness and promoting homeownership opportunities for all citizens is at the heart of foreclosure law. There are many undeniable personal and external benefits that owning a home can have on a community, but at some point these benefits are outweighed by the additional costs of pursing such a goal.

Indiana, just like every other state, must address and confront its foreclosure problems because the federal government has not implemented universal changes in foreclosure standards. However, by creating a statutory nonjudicial foreclosure scheme and pursuing loss mitigation strategies, Indiana should be able to remove its stigma as an unstable real estate market.

At the same time that states are reexamining their procedures, the FHA should continue to reduce its increasingly negative impact on the housing market. Although it is unlikely the entire agency will terminate, it can reduce its impact and own risk by creating counseling opportunities for unknowledgeable borrowers, rewarding borrowers with less risk, and encouraging lenders to do their part to reduce foreclosures.

While there is no quick fix to the highest national foreclosure rate in history, with concerted efforts from many parties, the American housing market can turn the corner and homeownership can become a dream for all once again.