



THE JOHN MARSHALL LAW SCHOOL  
FAIR & AFFORDABLE HOUSING  
COMMENTARY

**Behavioral Economics in the Mortgage Lending  
and Mortgage Foreclosure Contexts**

By Kelli Dudley

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## **Behavioral Economics in the Mortgage Lending and Mortgage Foreclosure Contexts**

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### **I. Introduction**

Barry and Beth Borrower call seeking an appointment at your law office. Beth relates to your intake coordinator that the couple is in foreclosure, has two other mortgages on their home, and is at least three months behind on every mortgage. Beth provides a suburban address, in a nearby town that consists of both new development and older homes where most residents have owned their homes a long time. She shares with your sympathetic staff person that she has two children enrolled in elementary school, although your staff person does not gather her precise age. Your staff person forgets to ask about income, but as he is setting the appointment time, he gathers that both Barry and Beth are employed. Beth also shares with him that the default was caused by a brief bout of unemployment on Barry's part.

#### ***A. The Intake***

Reading the intake sheet, you tell your assistant you are happy to meet with Barry and Beth. "This looks like a case of predatory lending," you say, "I doubt they can afford to hire me, but I can explain their rights to them and provide them with the telephone numbers of some Clinics. Maybe someone at the John

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Kelli is the former supervisor of the Chancery Advice Desk located in the Daley Center courthouse in Chicago. The Advice Desk was founded as a collaboration between the Court, legal services agencies, and attorneys to help people with problems like mortgage foreclosure understand their rights. Kelli also worked as an attorney and as a law student to assist people with limited income as an attorney with the Chicago Legal Clinic. This enabled her to win judgments or settlements in cases involving civil rights, fair debt collection practices, fair housing, tenant's rights, fraud, and similar issues.

Marshall Law School can help.”<sup>1</sup> You ask your assistant to prepare the conference table with a brochure explaining to clients the types of problems that can lead to foreclosure and advising them to get help if they believe they are victims of predatory lending, a list of causes of action arising from home repair fraud, a checklist of disclosures and documents required at a real estate closing, a timetable explaining redemption and reinstatement rights, and your bulging referral list.

### ***B. The First Impression***

You are shocked when Barry and Beth arrive for their appointment. You see them pull into the parking lot in a brand-new Ford F-150 vehicle replete with carrying cases in the bed for various tools. The side of the truck is emblazoned with a logo for “B & B Home Repair.” The two people who exit the truck are in their late 30’s. Barry is wearing work clothes, but Beth has on a designer suit of recent vintage. You are well aware of the cost of the suit, because you have tried it on several times and, ultimately, decided against spending the large sum. Beth reaches behind her and extracts two children from the extended cab—a boy and a girl, each clad in designer clothing. Both children carry small electronic games that seem to absorb all of their attention.<sup>2</sup>

### ***C. The Problem***

Predatory lending has received well-deserved attention from lawyers and academia alike. Although predatory lending has not been precisely defined, it is a subset of sub-prime lending. Sub-prime loans carry higher interest rates and less favorable loan terms, but are believed by some to provide access to credit to people who could not afford prime loans. The loans classified as predatory include features designed to prevent the homeowner from ever building any equity in the home, or to strip any equity the homeowner has at the time he or she

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<sup>1</sup> While enough compliments cannot be heaped upon the Fair Housing Clinic at the John Marshall Law School and other legal service organizations, a referral does not ensure representation. Each organization is overburdened, has income and eligibility guidelines it must follow, and faces funding cuts when funding is most needed. Even clients who can afford private representation may decline to pay or may be unable to find a competent attorney who is willing to accept the complex mortgage foreclosure defense at any price. Referrals sometimes result in declinations and further referral, adding to the mortgage foreclosure defendant’s confusion and raising the time investment (from an economic perspective, a cost) required on the part of the defendant to assert his or her rights.

<sup>2</sup> Barry and Beth Borrower, who appear throughout this paper, are not typical borrowers. They represent one species of borrower. Typically, this does not include low-income, minority, elderly, or non-English speaking borrowers. This type of borrower is also usually distinct from those borrowers who have experienced redlining or reverse-redlining. Although the challenges faced by these other borrowers are many, and interesting, they are beyond the very narrow scope of this paper. This paper does not do anything more than open a dialogue about behavioral economics as applied to the challenges presented by mortgage foreclosure.



applies for the loan. These features include high upfront costs like broker's commissions or "bogus" charges listed on the HUD-1, high interest rate, negative amortization, high prepayment penalties, balloon payments—often undisclosed to the borrower, and similar terms unfavorable to the borrower.

However, not all mortgage defaults are caused solely by predatory behavior by the lender. Indeed, some people who become mortgage foreclosure defendants are sophisticated, enjoy moderate or high incomes, and—outwardly—enjoy all the trappings of economic success. Models that assume defaults are strictly due to unfavorable mortgage terms or lack of income do not account for the defaults on the part of Barry and Beth, the mortgage foreclosure defendants in the hypothetical above. Barry and Beth are not representatives of all mortgage foreclosure defendants. Although some of their circumstances may be common to many defendants, Barry and Beth are a conflation of several mortgage foreclosure defendants, created for illustrative purposes. Typically, the borrowers discussed in this paper are not low-income, minority, elderly, or non-English speaking borrowers. They also are not representative of people who are victims of redlining or reverse-redlining. In Barry and Beth's case, unlike most cases, the borrowers share some fault with the lender for the loan terms leading to default and foreclosure.

The reasons for default are complex and vary greatly among individuals. More study is needed to equip practitioners to recognize the sorts of behavior on the part of the borrower that may make the borrower more likely to experience default. While this may be distasteful to some practitioners as "blaming" the client, the demand for services in the defense of mortgage foreclosure is high. It is in the interest of clients, the courts, and practitioners to use resources wisely by understanding and recognizing the factors that may make one client more prone than another to particular kinds of imprudent financial behavior. Likewise, lenders may know about and exploit human frailties like those belonging to Barry and Beth, and some of this lender behavior could be unrecognized, as yet, as predatory lending. Lenders hoping to make a positive impact, and avoid the expense and inconvenience that mortgage foreclosure proceedings cause ethical lenders, must be equipped to recognize people who engage in fraud. Some of the motivation to engage in behavior such as falsification of loan applications may be explained, or even predicted by, behavioral economics.

#### *D. The Interview*

"I am glad you came in," you tell Barry and Beth as they spoon sugar and cream into their coffee cups at your conference table. "This mortgage foreclosure complaint appears to have only been filed three weeks ago. It looks like you sought legal help right away, and that can be one of the most important things to enable us to help you."

Beth sobs. “But that isn’t the only one. We saw the Sheriff coming up the lane as we left today. We think we are getting two more, because we are behind on all our mortgages.”

You take a minute to scan the complaint. “That just can’t be. This complaint asks for over \$300,000. You mean you have additional mortgages not included in that?”

Beth sniffs. “Yes, we are behind on both of our other mortgages. They are both from investors we met through our business. We couldn’t qualify for any more loans from a bank, and we needed another \$150,000 to close.”

You quickly do the math. Barry and Beth seem to owe about \$450,000. “So you bought your house a little over a year ago for about \$450,000?”

“No, it was \$475,000. We wiped out our savings to do this,” Barry adds. “We thought we would pay it all back with money from the business, but I got hurt and missed two weeks.”

You ask the couple how much they make. They toss around figures. Finally, you place your pen firmly on a lined pad. “Barry, your job selling truck parts?”

“\$40,000, plus commission.”

“How much is the commission?”

“Well the last two years, only \$5,000 a year, but—”

“Fine, and the business—how much do you clear each year?”

“Well, the accountant kinda took our papers to do our taxes and took off.”

“Ok, but how much did you pay yourselves out of the business?”

“Well, we didn’t really clear anything.”

“Now, Beth, how about your job as a secretary?”

“\$30,000, but I’ve been hoping for a raise. I missed some days when Barry got hurt, so I think that’s why I didn’t get my raise. But I think it will come through any day now, and I was hoping to bring the mortgages current with that.”

You look at the figures in dismay. Barry and Beth earn \$75,000 per year. You quickly calculate that they could easily afford a mortgage of \$225,000—maybe even \$250,000. But, instead, you have just discovered they purchased a \$475,000 house and owe \$450,000.

### *E. Conclusion*

The Barry and Beth scenario above is an extreme example. As the truth comes out about Barry and Beth, they have never been current on all their mortgages at once, and they have experienced far more than the one default they attribute to Barry’s short illness. They reluctantly admit that they may have made some “mistakes” in the figures they presented to the bank and investors when they applied for their loans. A last-ditch Chapter 13 bankruptcy fails to save the house because Barry and Beth have credit card balances and other unsecured debts that make it impossible for them to make the monthly payments required as part of a Chapter 13 bankruptcy plan. They fail to accurately describe their financial

situation to a well-respected, diligent bankruptcy attorney. In the end, Barry, Beth, and their two children lose their home and experience difficulty finding an apartment to rent because of their poor credit rating.

If Barry and Beth were hypothetical clients, their virtual homelessness would not be so troubling. Unfortunately, their story is an amalgamation of several actual mortgage foreclosure cases in which I have been involved. If lawyers are going to be able to help people like Barry and Beth, then it will be necessary to understand their financial behavior pattern to avoid time wasted treating their cases like any predatory lending case, and, ultimately, to become able to counsel such clients to avoid a cycle of repeated mistakes.

Although cases come into law offices one at a time and most evidence about clients whose primary legal problems arise from their improvident use of money or debt is anecdotal, it may be possible to define some common characteristics for the purpose of study. The following is intended to begin the discussion. More study is needed, and this article is intended only to open a discussion that may prove helpful to practitioners.

Clients whose legal problems arise primarily from their behavior concerning money are people with:

- Income above the median for their geographical location
- Some savings or home equity, or who have had savings or home equity in the past
- Employment
- Multiple debts that have become a problem (collections, foreclosures, judgments, etc.)
- Debts that are so high relative to income the client cannot reasonably<sup>3</sup> expect to repay the debts

As the list above reflects, clients in this category have income that is above the median, employment, and some savings or home equity. However, these factors, which seem to be positive, may work against the client because he or she is more likely to qualify for loans—leading to problems with multiple debts and a total indebtedness so high that the client cannot reasonably expect to ever repay the debts.

## **II. A New Paradigm for Evaluating the Relationship Between Economic Choices and Legal Outcomes**

Fortunately, the question of whether people behave rationally with regard to money is not a new one. Anecdotal evidence tells us that they do not, but, as

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<sup>3</sup> The client may insist that she is repaying the debt, will repay the debt, or even has repaid the debt. The relevant question is whether a reasonable person in the client's circumstance would reasonably expect to repay the debt.

discussed above, has little or no predictive value. The relatively new field of behavioral economics may provide a basis for understanding debtors like Barry and Beth. Behavioral economics has value for lawyers because it may enable the legal community to have a discussion that is not tied to the legal relevance of the facts of a particular case for purposes of preparing a pleading. This discussion may lead to an increase in some attorneys' abilities to recognize new forms of predatory lending or to counsel clients to avoid the consequences of improvident financial behavior. These consequences often include home loss.

While understanding the behavioral factors that contribute to the accumulation of debts that cannot reasonably be repaid may not lead to the immediate collection of a legal fee, it may serve an important policy goal of preventing the distress associated with loss of a home to mortgage foreclosure. Such an understanding may also help lawyers serve clients more efficiently, an achievement that would particularly benefit attorneys practicing in the legal services area or in small neighborhood law offices where few clients have the money to fully pay the attorney for time spent on complex mortgage foreclosure defense work.

### ***A. Behavioral Economics***

Behavioral economics describes and attempts to explain areas where human behavior does not comport with economic predictions. For example, economists have traditionally based their models on assumptions that market actors are "rational."<sup>4</sup> In the area of finance, this might mean that an investor who receives new information about the market will update his or her beliefs, and will make market choices that are normatively acceptable, or another investor will make normatively acceptable choices and profit for doing so.<sup>5</sup> Behavioral economics explores instances where market actors do not appear rational.<sup>6</sup>

Traditional economics placed great faith in the ability of the market to correct itself.<sup>7</sup> In other words, a stock might be underpriced because "noise," or misinformed, traders suddenly dumped many shares of that stock onto the

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<sup>4</sup> Richard H. Thaler. (1992). *The Winner's Curse: Paradoxes and Anomalies of Economic Life*. Princeton: Princeton University Press, 2.

<sup>5</sup> "Normatively acceptable" means that the choices made by the investor will make choices that maximize profits. This is an overgeneralization, and description of complex economic theories is beyond the scope of this paper. For more information see Richard H. Thaler. (2005). Preface, in *Advances in Behavioral Finance: Volume II*. Princeton: Princeton University Press, xii.

<sup>6</sup> Belsky, Gary and Thomas Gilovich. (1999). *Why Smart People Make Big Money Mistakes and How to Correct Them: Lessons from the New Science of Behavioral Economics*. New York: Simon & Schuster, 20.

<sup>7</sup> The entire passage following summarizes material from several sources; most notably see Nicholas Barberis and Richard H. Thaler (2005). A Survey of Behavioral Finance, in *Advances in Behavioral Finance, Volume II*. Princeton: Princeton University Press, 2-3.

market.<sup>8</sup> This “mistake” would be corrected because “arbitrageurs,” rational traders, would quickly buy up the stock.<sup>9</sup> The demand created by the arbitrageurs would correct the price of the stock, bringing it to the higher cost it enjoyed before it was spurned by the noise traders.<sup>10</sup>

Behavioral economists recognize that not all mistakes can be corrected.<sup>11</sup> One reason that mistakes, or irrationality, persist in some markets is that there is no corrective mechanism like that described above.<sup>12</sup> The absence of a corrective mechanism is described by behavioral economists as a “limit to arbitrage.”<sup>13</sup> This is eloquently explained by Richard Thaler, who uses a quaint example and brings this complex subject much closer to the realm of consumer-level decision making:

It has long been known by researchers in behavioral economics that the importance of less than fully rational behavior depends on the extent to which rational actors can profit from the sub optimal choices of others, especially if in the tact of profiting, rational individuals push the quasi-rational agents to behave more rationally [citation omitted]. In many important economic choices (e.g., career choice, marriage, saving for retirement), if one agent makes a poor choice (picks the wrong career or spouse, saves too little) no profit opportunity is created. You may think that my wife will soon realize what a mistake she has made in marrying me, but (as far as I know) there is no way for you to sell my marriage prospects short, and even if you could, it might not alter the behavior of me or my unlucky wife. Missing markets prevent arbitrage, thus allowing irrationality to persist.<sup>14</sup>

The absence of arbitrage should be no surprise to lawyers, simply a new term. Poor decision-making by clients is the basis, in many cases, for the need for an attorney’s advice. This is indicated in the statistics concerning foreclosure and bankruptcy. Foreclosure has increased precipitously in Cook County, Illinois, alone. In this large, urban county, home to the largest unified court system in the United States, the number of foreclosures increased from under 6,000 in 1993 to

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<sup>8</sup> Fischer Black. (1993). Noise, in *Advances in Behavioral Finance*. New York: Russell Sage Foundation, 7.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.*

<sup>11</sup> Andrei Schleifer and Robert W. Vishny. The Limits of Arbitrage, in *Advances in Behavioral Finance: Volume II*. Princeton: Princeton University Press, 81.

<sup>12</sup> Limitations can arise from factors such as lack of incentive to take advantage of profitable opportunities or unavailability of a profit margin for arbiters. *See Id.*, 81-99 and Richard H. Thaler, Preface, in *Advances in Behavioral Finance: Volume II*. Princeton: Princeton University Press, xii.

<sup>13</sup> Nicholas Barberis and Richard H. Thaler. (2005). A Survey of Behavioral Finance, in *Advances in Behavioral Finance, Volume II*. Princeton: Princeton University Press, 2.

<sup>14</sup> Richard H. Thaler. (2005). Preface, in *Advances in Behavioral Finance: Volume II*. Princeton: Princeton University Press, xi-xii.

more than 12,000 in 2001.<sup>15</sup> Approximately 20,000 foreclosures were filed in 2002.<sup>16</sup> Similarly, the number of people who filed for bankruptcy protection has increased greatly, with some scholars placing the increase as high as 600 percent during the past decade.<sup>17</sup> While attorneys do not always know for certain whether clients have previously experienced financial problems, lawmakers are certainly convinced. The Illinois Mortgage Foreclosure law provides for only one reinstatement<sup>18</sup> every five years.<sup>19</sup> Similarly, the recently-enacted bankruptcy provisions set limits on the number of petitions for bankruptcy protection that may be filed by an individual in a given time.<sup>20</sup> The presence of such provisions suggests that there is a public policy concern that some people repeatedly fail to meet their financial obligations.

### ***B. Irrational Borrower Behavior***

“You could sell the house,” you advise Barry and Beth after reviewing their paperwork. “You don’t have any equity, but you could move and get a fresh start without doing any more harm to your credit record.”

“We can’t sell!” Beth wails. “The kids really like the house. I have it all decorated.”

“Well, then, for the meantime, you will have to refinance the loan that is in default,” you begin—doubtful your clients will ever find a lender willing to loan such a large amount on Barry and Beth’s income, which is small relative to the size of the indebtedness.

“We’ll never refinance,” says Barry. “They’ve smeared us with all the credit bureaus. This is all over our credit reports,” he snorts.

You begin to see there is little that can be done for Barry and Beth. You quickly explain the rights of reinstatement, redemption, and so on to them—each time hearing why each option will never work for them due to one creditor-driven vendetta or another. Finally, you explain that some of the loans may have been improvidently made, giving rise to possible defenses, and you offer to enter your appearance in the lawsuit. However, Barry and Beth assert they have no money to pay. You watch them leave the office with the materials you have provided, saddened by the realization that, despite their relatively good income, they are

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<sup>15</sup> Cook County Clerk of Court at [www.cookcountyclerkofcourt.org](http://www.cookcountyclerkofcourt.org).

<sup>16</sup> *Id.*

<sup>17</sup> See e.g., Richard M. Hynes. Bankruptcy and State Collections: The case of the missing garnishments. [http://organizations.lawschool.cornell.edu/clr/91\\_3/Hynes\\_91\\_3.pdf](http://organizations.lawschool.cornell.edu/clr/91_3/Hynes_91_3.pdf). Last accessed July 19, 2006.

<sup>18</sup> Reinstatement is the process by which a borrower brings a mortgage loan current, including costs associated with collection, and is able to resume making his or her regular mortgage payment.

<sup>19</sup> 735 ILCS Section 5/15-1602.

<sup>20</sup> For example, debtors are limited to using Chapter 7 bankruptcy once every eight years. 11 U.S.C. Section 727.

likely to experience the same outcome as your severely economically-disadvantaged clients—the loss of their home.<sup>21</sup>

The following are some of the behavioral phenomena observed by behavioral economists that may explain some of the irrational behavioral observed among debtors, particularly those in mortgage foreclosure. This is in no way an exhaustive discussion, and other behavioral factors may better explain some of the problems experienced by debtors. The following is an opening discussion based on a brief literature review.

### 1. *Endowment Effect, Status Quo Bias, or Loss Aversion*

In the scenario above, the lawyer offers Barry and Beth Borrower the chance to sell the home and pay off the mortgage. Even though they have no equity to speak of, Beth stridently insists this is “her” home. The evidence in the hypothetical suggests that Beth is not relying upon having clear title as the indicia of ownership; in fact, there has never been a time that all the mortgages were current. She verbally offers the following as reasons why it is “her” home: the kids like the house, and she has decorated it. The borrower’s definition of ownership seems to be based upon possession, improvement, and comfort. These factors mean very little in the legal context, where a lawyer or judge would examine deeds and other documents to determine ownership.

Debtors like Beth and Barry are stuck in the gap that separates the vernacular and legal definitions of ownership. The result is that their emotional attachment to the home is greater than their economic stake in it. This is a phenomenon similar to that described by behavioral economists as endowment effect, status quo bias, or loss aversion.<sup>22</sup> There are differences in how each phenomenon is described,<sup>23</sup> but, in general, each refers to the attachment to a

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<sup>21</sup> Barry and Beth are among the few fortunate borrowers who have the opportunity to consult with competent counsel. Legal services that are free or based on a sliding-scale fee are rare compared to the overwhelming demand for the services. Many such services would not accept clients with Barry and Beth’s income. Even for clients who can pay and who are eager to pay, there is a lack of competent professionals willing to accept the cases. An effective defense, asserting affirmative defenses and counterclaims, can be so time-consuming that many private lawyers do not even consider accepting the cases. In my law office, only about three in ten telephone calls culminates in an offer of representation from me; of these three offers, at most one results in a signed contract.

<sup>22</sup> Richard H. Thaler, Daniel Kahneman, and Jack L. Knetsch. (1992). *The Endowment Effect, Loss Aversion, and Status Quo Bias*, in *The Winner’s Curse: Paradoxes and Anomalies of Economic Life*. Princeton: Princeton University Press, 63.

<sup>23</sup> Thaler sets forth a hypothetical in which a wine-loving investor both refuses to buy more of a wine in his collection at the going price, yet simultaneously refuses to sell the bottles he owns of the same wine at any price. He explains the concepts of endowment effect, loss aversion, and status quo bias as follows: “This pattern—the fact that people often demand much more to give up an object that they would be willing to pay to acquire it is called the endowment effect . . . . The example also illustrates . . . a status quo bias, a preference for the current state that biases the [investor] against both buying and selling his wine. These anomalies are a manifestation of an

good that causes one to be reluctant to give up that good—more reluctant than one objectively should be given the value of the good. For example, one may demand more to sell the object than one would be willing to pay to have acquired it.

In Barry and Beth’s case, they are unwilling to part with their house even though they cannot possibly pay for it, or, in this case, prevent its loss. In the absence of some action on the part of Beth and Barry, mere legal formalities lie between them and eviction from their home. They are unwilling to sell, presumably at a price that would at least be sufficient to relieve them of their legal problems, yet they claim to be incapable of paying anything—even a legal fee—to keep the right to stay in the home. The quandary created when a borrower is unable to pay, unwilling or unable to invest anything to retain the property, and unwilling to sell is a sinkhole for the legal practitioner and for the borrower. The legal practitioner will urge some sort of solution sanctioned by the legal system—paying the debt, refinancing, selling, or pleading appropriate defenses. All of these require some monetary or emotional investment<sup>24</sup> on the part of the borrower. If the borrower has decided that he “owns” the house even if he cannot pay for it, the practitioner will be left confronting irrationality with reason, often to no avail.

#### a. Endowment Effect

Endowment effect is described as the phenomenon that may be observed when people demand more to give up an object than they would be willing to pay to acquire it.<sup>25</sup> As discussed above, borrowers are loathe to sell a property at any price, even when they have no equity and are unwilling or unable to invest any money in saving it. Studies conducted by behavioral economists suggest that this behavior is motivated by the pain of giving up the good one owns more than by the benefit one derives from owning the good.<sup>26</sup>

#### b. Status Quo Bias

Status quo bias is the tendency of individual to remain at the status quo, because the disadvantages of other options seem more compelling than the advantages. As set forth above, one who refuses to move out of the discomfort of mortgage foreclosure by selling his or her home or investing money to in some way move past the economic challenges of owning a home one cannot afford,

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asymmetry of value [called] loss aversion—the disutility of giving up an object is greater than the utility associated with acquiring it.” *Id.*

<sup>24</sup> Selling requires giving up the emotional commitment to the idea that the house is the borrower’s regardless of the legal status, and even pro bono legal services require time commitment and acceptance of legal advice by the borrower.

<sup>25</sup> Richard H. Thaler, Daniel Kahneman, and Jack L. Knetsch. (1992). The Endowment Effect, Loss Aversion, and Status Quo Bias, in *The Winner’s Curse: Paradoxes and Anomalies of Economic Life*. Princeton: Princeton University Press, 63.

<sup>26</sup> *Id.* at 68.

may be motivated in part by the idea that the house is “mine” regardless of the legal definition of ownership. At the same time, staying in the home, even with the attendant discomfort of an impending foreclosure, maintains the status quo. Resolving the foreclosure will mean change—resumed mortgage payments if one stays in the home, relocation if one moves. The second scenario, relocation, brings with it many other changes that may increase the preference for the status quo. For example, school-aged children may have to attend new schools, the commute to work may be longer, and friends from the neighborhood may be lost.

Status quo preference may contribute to financial hardship in ways other than failing to resolve a mortgage foreclosure. For example, a person in a disadvantageous loan may become aware that her payments are too high. She may come to regret taking out the loan, even discovering that she has grounds to rescind the loan.<sup>27</sup> Despite the discomfort generated by making the monthly mortgage payment required by the disadvantageous loan, the borrower may be loathe to visit a lawyer to exercise her rights or approach another lender about receiving a loan that is more fair. Each of these options will require an extra effort, and bears the risk that the borrower is wrong about her rights or mistaken in believing that another lender might offer better terms—in other words, it might be better to stick with the devil (or, in this case, banker) one knows rather than risk rejection by another lender or otherwise invest effort to no avail.

Lawrence M. Ausubel describes the effort required to find a better loan as the “search/switch” cost.<sup>28</sup> Ausubel explores the possibility that consumers who continue to use credit cards with high interest rates or fees may do so because of the costs of finding and obtaining a different credit card.<sup>29</sup> According to Ausubel, these costs include:

... (a) the information cost of discovering which banks are offering lower interest rates; (b) the cost in time, effort, and emotional energy in filling out an application for a new card (and possibly getting rejected); (c) the fact that the card is usually billed on an annual basis, so that if one switches banks at the wrong time, one foregoes some money; (d) the perception that one acquires a better credit rating or higher credit limit by holding the same bank’s card for a long time; and (e) the time lag between applying for a card and receiving one.<sup>30</sup>

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<sup>27</sup> For example, laws like the Truth in Lending Act have provisions that allow homeowners to rescind a loan transaction if certain violations have taken place, such as if the creditor failed to make certain required disclosure. *See* 15 U.S.C. Section 1635.

<sup>28</sup> Lawrence M. Ausubel. (1993). *The Failure of Competition in the Credit Card Market*, in *Advances in Behavioral Finance*. New York: Russell Sage Foundation, 557-560.

<sup>29</sup> *Id.*

<sup>30</sup> *Id.* at 558.

Although Ausubel is not convinced that search/switch costs fully explain the failure of credit card rates to decline with competition, search/switch costs such as those set forth above would certainly await any borrower seeking to refinance a mortgage loan. This may explain why borrowers remain in disadvantageous loans, even when they realize that better loans may be available.

Finally, status quo bias is evident at virtually every real estate closing.<sup>31</sup> As lawyers review documents including surveys, disclosures, contracts, mortgages, and notes with their clients, it is rare for a buyer or seller to fail to consummate the purchase or sale of property due to defects discovered at the closing table. In fact, the escrow agent for the mortgage company is the only party likely to “kill” a deal. Borrowers often receive the note and mortgage for the first time at the real estate closing. Careful review with the attorney may disclose terms different from those understood by the borrower, often greatly to the disadvantage of the borrower. However, sound legal advice at the closing table competes with countervailing forces—the agreement to close on a particular day, with possible costs for failing to do so, eagerness to acquire the home, and the fact that the position of the mortgage broker represents a sort of status quo. The borrower may feel it is hardly fair to require the mortgage broker to “change” terms at the last minute—even when it is the broker who has already changed the terms previously negotiated. Were the homebuyer to reject the mortgage offered, all of the search/switch costs discussed above would apply. Finally, mortgages and notes are contracts of adhesion—the borrower typically has little negotiating power, and feels happy to be able to borrow the money needed to buy something as important as a home. Borrowers rarely, if ever, actively negotiate mortgage terms.<sup>32</sup> Perhaps this is the ultimate status quo.

### c. Loss Aversion

Loss aversion is similar to status quo bias and endowment effect insofar as it explains the tendency of people not to make a change, even for the better, when it comes to financial decisions. Loss aversion, according to behavioral economists, is the phenomenon whereby the pain of losing something surpasses the pleasure of receiving it. This may explain the tendency, as set forth above, for mortgage foreclosure litigants to remain steadfastly attached to their property, even when there is no equity in the home.

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<sup>31</sup> This section is written from the perspective of a lawyer practicing in Illinois, where lawyers routinely review documents alongside buyers and sellers. If anything, the status quo bias discussed here might be even stronger where no lawyers were present to review documents and explain rights to a new mortgage borrower.

<sup>32</sup> This may vary with economic status and educational status. Although it is beyond the scope of this paper, most people are unaware of their true credit worthiness, and most believe their credit is worse than it is. Therefore, they are likely to regard the offer of mortgage financing as a privilege, rather than as an optional product that they might decide to buy from another vendor.

Thaler<sup>33</sup> and other behavioral economists recognize “enhanced loss aversion” that occurs when highly-charged emotional issues are involved in decision making. For example, a focus group is asked what price decrease in the cost of insecticide would justify a very small increase in the risks of injury associated with the product. A control group is asked how much more they would be willing to pay in addition to the current price for insecticide with a very small increase in safety. Although consumers indicate they are willing to pay a few dollars to increase safety, they refuse to take a corresponding decrease in safety for any price.

Similarly, mortgage foreclosure issues often involve a sense of injustice. Consumers are not willing, in some cases, to pay any amount of money to better their financial position, even to the point of saving their home from foreclosure. This may reflect an enhanced loss aversion tied to the outrage felt by many homeowners when a lender attempts to “take” property they feel is theirs. Similarly, consumers may be unwilling to pay for legal services or invest their own time to disengage from a predatory loan because of a sense that they should not be required to do so. While legally unfounded, this position prevents the consumer from opening a productive dialogue with the current lender, who might voluntarily offer more advantageous terms as the result of negotiations, or with prospective lenders who might offer a new loan with competitive terms.

Similar to a sense of injustice, shame is another emotion that may reinforce loss aversion. Home ownership, particularly if the home is large or located in a desirable neighborhood, is a source of pride. Homeowners may resist selling because it amounts to an announcement to the world that they no longer own the status-enhancing home. They may also avoid discussion with professionals such as attorneys or lenders because they are afraid of admitting they are not in control of their finances.

Popular financial advisor Suze Orman offers an illustration of the taboo associated with admitting loss of financial control:

In our culture it’s okay to talk about therapy we’ve been through, marital problems we’ve had, our deepest intimate secrets—but telling the truth about money, confessing our worries to our children, our parents, our friends, just isn’t done. Money is our secret both in private in public. Imagine going to a dinner party and telling a group of close acquaintances, “I just don’t know what to do. My credit card debt has gone up to \$17,000, and I don’t know how I’ll ever get out of it.” The room would fall into

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<sup>33</sup> Richard H. Thaler, Daniel Kahneman, and Jack L. Knetsch. (1992). The Endowment Effect, Loss Aversion, and Status Quo Bias, in *The Winner’s Curse: Paradoxes and Anomalies of Economic Life*. Princeton: Princeton University Press, 73-74.

embarrassed silence. (Most silent of all would be the others in the room weighed down by the secret of their own credit card debt.)<sup>34</sup>

Loss of social status enhances the aversion one would already experience on contemplating losing one's home, paying for the services of a professional to resolve the mortgage foreclosure problem, or investing time and money into applying for and receiving a new mortgage.

## 2. *Mental Accounting*

In the scenario above, Barry and Beth own an expensive vehicle. The entire family is well-heeled, and the children play electronic games. The vehicle, clothes, and games were acquired, presumably, at some cost to the family. The hypothetical makes it clear that the truck and clothes are of recent vintage. Since Barry and Beth have never been current on all three mortgages at once, they have purchased these items while defaulting on a mortgage.

One theory set forth by behavioral economists may be particularly helpful in explaining the phenomenon whereby people experiencing foreclosure, or other serious debt-related problems, spend money to pay unsecured debts or for luxury items rather than applying the money toward resolving the foreclosure.

While traditional economic—and legal—theories treat money as fungible, this is not consistent with how most individuals treat money. Instead, people categorize money by how it was received (i.e., money from gifts) and how they intend to use it (i.e., vacation money). Lest any law student or attorney scoff at the idea of “mental accounting” as an ill of those who do not understand money, consider the following:

1. You are a solo practitioner operating a sole proprietorship. You are buying a new fax machine. Are you willing to spend more money if you purchase the machine from your law office checking account than your personal checking account?
2. You are a student at the John Marshall Law School. You purchased all of your books for this semester from the library, but you were \$15.00 short of the money for Professor Caruso's Fair Housing book. You stop by Subway and enjoy a sandwich while you call your parents on your cell phone to ask for a loan, explaining you spent all the money you had saved from birthday and holiday gifts on books. You are too tired to wait for the classmate who offered you a ride home, so you hop aboard the Metra. You are anxious to get back to your apartment to watch your favorite show on cable.

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<sup>34</sup> Ormon, Suze. (1997). *The Nine Steps to Financial Freedom: Practical and Spiritual Steps So You Can Stop Worrying*. New York: Crown Publishers, Inc., 17.

As the above examples show, people do not always treat money like money. A sole proprietor likely has nothing to gain from treating money from her business checking differently than money from her personal checking account. At the end of the year, sole proprietors report their earnings and their expenses to the IRS for tax purposes, with no distinction made between whether the business or the individual received the money or spent the money.

The JMLS student above would have about broken even if he had foregone the meal at Subway, saved the cellular telephone minutes, waited on his friend for a ride home instead of buying a Metra ticket, and purchased the book. Simply canceling cable television for the duration of law school would save enough money to more than pay for all required textbooks.

The examples above do not involve expenditures most people would consider extravagant or reckless. All of the expenditures, with the exception of cable television, meet some basic business or human need—office supplies, transportation, food, and utilities. Therefore, these examples show how easily “mental accounting” can create problems, even for people who are not in financial distress.

It is likely that some mortgage defaults result from poor mental accounting. A failure to cancel the cable bill when financial trouble looms would be an easy mistake to make, yet skipping cable bills for two months might ease the financial strain of reimbursing a lawyer for appearance fees. An attorney friend of mine who has a reputable bankruptcy practice confided that he has never filed a bankruptcy that did not include a cable bill. This illustrates a complete failure on the part of debtors to adjust spending during times of financial distress. Nothing could be less necessary than television, yet some debtors choose to stay tuned in, even when their housing is threatened.

Larger financial mistakes, such as continuing to make a large vehicle payment while a foreclosure is pending, are likely far more common. If people running law offices and attending law school can fall victim to mental accounting, then it is reasonable that people with less formal education who are facing the severe emotional strain of foreclosure would make mistakes of greater magnitude.

Businesses that advance unsecured funds, such as installment loans or increases in credit card limits, to those who are in foreclosure do so at their peril. A borrower who loses his or her home nears “judgment proof” status—there is no possibility of placing a lien on the real estate to collect unpaid funds, even if the creditor receives a judgment in its favor. If the creditor tries other collection avenues, it will likely find itself in a lengthy line of creditors pursuing the same remedies.

These mistakes likely contribute both to default rates and to the unavailability of funds to hire attorneys, pay filing fees, and to exercise the rights of redemption and reinstatement.

### 3. *Over-confidence*

Behavioral economists have found that most people are over-confident about their abilities and their budgeting prowess. While Barry and Beth may be crying in the hypothetical, the problem tells us that they inflate the income earned from their business until pressed, Beth has already spent a raise she believes she will receive, and the couple took out three mortgages—based, in part, on untruthful statements to investors.

Belsky and Gilovich describe over-confidence not as the product of arrogance, but say that “. . . most people—those with healthy egos and those in the basement of self-esteem—consistently overrate their abilities, knowledge, and skill, at whatever level they place them.”<sup>35</sup>

Over-confidence has been documented, according to Belsky and Gilovich, as affecting personal finances:

Because people are over-confident, they’re likely to think they are in better financial shape than they are. Consider the results of a 1996 survey of American parents by the International Association of Financial Planning. Some 83 percent of respondents with children under the age of [18] said that they have a financial plan, while three-quarters of them expressed confidence about their long-term financial well-being. Yet less than half of the respondents said they were saving for their children’s education, and less than 10 percent described their financial plan as addressing basic issues such as investments, budgeting, insurance, savings, wills, and estates.<sup>36</sup>

If people are over-confident about saving and planning, it seems likely they are even less realistic about the state of their mortgage and other debts. Savings and planning are tasks that are powered by the consumer. Note that the study above did not explore whether people were getting the best possible value on savings and investments—simply whether they were engaging in these types of activities. Even using the very low threshold that would have recognized a passbook account at a local bank as savings, consumers were over-confident about their savings and planning. The result might have been more dismal had the quality of savings vehicles, for example, among those who chose to save been analyzed.

Unlike savings, a mortgage cannot be had simply by the actions of an individual consumer. In contrast, a person who decides to take out a mortgage must select among brokers, loan products, interest rates, and the like. Making good decisions about a mortgage means understanding the above terms and their

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<sup>35</sup> Belsky, Gary and Thomas Gilovich. (1999). *Why Smart People Make Big Money Mistakes and How to Correct Them: Lessons from the New Science of Behavioral Economics*. New York: Simon & Schuster, 154-155.

<sup>36</sup> *Id.* at 158-159.

consequences. Most consumers seem to have an undying belief that they can pay off higher and higher mortgages over longer and longer terms.<sup>37</sup> Yet, the high default and foreclosure rate may indicate that this belief is not realistic.

Ausubel suggests that not all credit-card borrowers intend to borrow on their accounts.<sup>38</sup> These customers find themselves borrowing in response to unforeseen expenses. Like Barry and Beth, these customers do not plan on paying finance charges. The hypothetical reveals that Barry and Beth believed they would pay off their heavy mortgage debt with pay raises, business profits, and bonuses that did not materialize. Like Ausubel's unintentional borrowers, homeowners like Barry and Beth are less inclined to diligently compare interest rates and loan terms because they do not believe they will be servicing the debt for a long term. I suggest that unrealistic expectations about debt repayment may be a form of over-confidence.

Understanding the phenomenon of over-confidence may help attorneys and advocates understand the mental processes of mortgage foreclosure defendants or buyers seeking to enter into a mortgage. It is likely that a person stating, for example, that he or she understands the cost of a high-interest loan over 30 years is over-confident about his or her information and understanding of the implications of that information. Likewise, a mortgage foreclosure defendant eager to sign a forbearance agreement with a lender may declare that he or she is aware of every jot of the agreement. Good advocacy requires sensitivity to the likelihood that the client believes he or she understands the agreement, and that he or she accurately estimates his or her ability to repay. Taking care not to unduly insult the client, the advocate must take care to explain documents before they are signed and to help the client understand the importance of not signing documents prior to review by an attorney.

### **III. Thaler's Rapidly-Expanding Household: Effects, From the Consumer Perspective, of the Absence of Arbitrage in the Mortgage Market**

As set forth above, Richard Thaler, a leading behavioral economist, explains the absence of arbitrage in his hypothetical wherein his wife makes a poor choice in her selection of a husband. Because there is no one who will profit from Mrs. Thaler's mistake, the market will not adjust if the Thaler household

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<sup>37</sup> Some banks in California have introduced 50-year mortgages, giving consumers little or no ability to build up equity in a home during the early years of a loan. If life expectancies are for one to live into one's 70's, one cannot expect to pay off a 50-year mortgage in one's lifetime if one is past one's mid-20's at the time the loan is originated. The 50-year mortgage is discussed at [http://mortgagenewsdaily.com/5162006\\_50\\_Year\\_Mortgage.asp](http://mortgagenewsdaily.com/5162006_50_Year_Mortgage.asp), last accessed July 18, 2006.

<sup>38</sup> Lawrence M. Ausubel. (1993). *The Failure of Competition in the Credit Card Market*, in *Advances in Behavioral Finance*. New York: Russell Sage Foundation, 560.

fails to experience domestic bliss. Because of this market failure, or limitation on arbitrage, irrationality (such as poor marriage choices) can continue to exist.<sup>39</sup>

Like choices in marriage partners, consumer choices about home buying and financing may be irrational. However, there is no arbitrage in the form of stock market correction. People who become over-mortgaged by taking out predatory loans or simply by over-estimating their ability to repay cannot repeat their experience in the short-term as traders in the stock market can. In the hypothetical, Barry and Beth's mortgages continue to exist, regardless of whether their decision was good or bad. The mortgage company is not "punished"—it continues to extract late fees, interest, and costs of collection. If Barry and Beth bring their mortgage current by refinancing, all of these expenses must be paid. The expenses must likewise be paid if Barry and Beth sell their property and pay off the mortgage in full. If a foreclosure is completed, the principal and expenses will be paid following a forced sale of the property. Therefore, there is no arbitrage to cause the lender not to make another such loan.

In fact, the lender may profit from offering a loan that could not be repaid by collecting expenses and fees in addition to the principal and interest agreed upon at the inception of the loan. It may also profit by offering Barry and Beth new financing at terms even more profitable than the first loan. The lender could purchase the property at a forced sale, and then sell it at fair market value. In other words, there is virtually no risk to encourage mortgage lenders to adjust their practices—in fact, bad practices such as charging exorbitant interest rates simply cause the mortgage companies to earn more money.

The above article has set forth explanations for borrower behavior that may be found if behavioral economics is applied to the area of debtor behavior. As set forth above, a great deal of consumer behavior with respect to mortgages is irrational. One could argue that arbitrage could come through consumers who would learn from their experiences after selecting bad mortgage products or otherwise failing to pay, resulting in default or foreclosure. This would lead to consumers refusing to sign unfair loan documents or assume levels of debt they could not handle.

This possibility fails because the mortgage market is so vast that one "learner" cannot change the market. Unlike publicly-traded companies that issue limited shares of stock, allowing individual sales and purchases of stock to exert price pressure, mortgage companies market their products to a virtually unlimited universe of consumers. Each year, new potential customers enter the market as new homebuyers come of age, renters decide to buy, homeowners decide to refinance or to move, and the like.

The argument for consumer-driven arbitrage would also fail because, as mentioned above, the mortgage and note are the ultimate contracts of adhesion. The consumer needs the mortgage and note to buy or keep housing and, in the

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<sup>39</sup> Richard H. Thaler. (2005). Preface, in *Advances in Behavioral Finance, Volume II*. Princeton: Princeton University Press, xi-xii.

case of home purchases, to fill her obligations under a real estate contract. The mortgage and note are rarely presented before the scheduled closing date. Therefore, the consumer has no real opportunity to negotiate the costs and terms associated with the mortgage and note.

Like the hypothetical Thaler marriage discussed above, the irrationality in choice of mortgage products persists because there is no arbitrage. However, in this case, there is not only lack of arbitrage, but profits inherent in the irrational choices. This creates a situation in which people consume new mortgage products as quickly as they are offered, even when the mortgages are predatory. Applied to the Thaler hypothetical, the result is not only a long-suffering wife, but a line of women making the same irrational choice and begging admission to the unhappy household.

#### **IV. Practical Application**

Attorneys who seek to help those in mortgage foreclosure will do well to learn not to expect rational behavior from the client. Such an expectation will interfere with the attorney-client relationship. The attorney will be dismayed to hear cable television playing loudly in the background during a telephone call. The client may be half-listening to the attorney, paying the cable company while pleading inability to pay even a modest legal fee.

Some attorneys attempt to protect clients from economic mistakes by requiring the client to escrow an amount equal to the client's monthly mortgage amount with the attorney to be held in the attorney's client trust fund account. Since mortgage companies typically do not accept payment from borrowers who are in foreclosure, the payment amount will otherwise remain in the household, subject to being spent on items not related to housing. Once escrowed with the attorney, the money, by agreement between the attorney and client and subject to laws regarding attorney trust funds, may only be spent on funds to pay to bring the mortgage current or for expenses related to defending the mortgage foreclosure. The trust fund account makes good use of "mental accounting": it defeats the fungible nature of money. In this case, it does this to the good by reserving funds for the all-important expense of housing.

Other safeguards might include a clearly-written contract, drafted to inform the client of various options. The contract must inform the client of his or her rights and obligations. For example, mortgage foreclosure defendants, like any other client, are prone to disappear on elaborate vacations or to change their telephone numbers at important junctures in the case. A contract can place a clear requirement on the client to remain available, thus helping the attorney avoid a malpractice charge as a result of not timely solving the case of the vanishing client.

Written communication with clients is invaluable. The mortgage foreclosure client is immersed in a world of “redemption,”<sup>40</sup> “reinstatement,”<sup>41</sup> “workouts,”<sup>42</sup> and other terms. Written communication prevents the practitioner from claims that terms were not explained or that options were not offered. Clearly written communication lets the client know that he or she may attempt to shift blame for developments in the case any way he or she wishes, but the client will not succeed in embroiling the attorney in a malpractice claim.

An understanding of borrower behavior is a worthwhile endeavor for ongoing research and may lead to models that will help predict default, indicate outcomes likely to benefit each mortgage foreclosure defendant, and serve as a guide for borrower education to prevent default.

## V. Conclusion

Consumers of mortgage products do not always make rational decisions. This is especially true of the narrow set of borrowers described in this paper, those who are not particularly vulnerable to predatory lending but who overextend themselves financially or make other borrowing mistakes. As a result, they may end up with debt they cannot repay and ultimately default on the loan. The loan may end up in foreclosure.

Because of irrationality, with specific behavioral factors that are explored above, consumers are sometimes unable to cope with their debt or make good decisions even when facing the loss of their home. Awareness of these behavior factors may help attorneys and advocates better assist mortgage foreclosure defendants or those considering entering into a loan to make better decisions. Greater study is needed to understand the applications of behavioral economics to decision-making related to mortgages.

Economists describe a market correction that often occurs when rational actors profit from the choices of irrational actors as “arbitrage.” Arbitrage rewards the rational actors such that stock prices that decline due to bad decisions by a few irrational actors rebound as rational investors buy the stock and return the demand, and price, for it to equilibrium. In contrast, arbitrage does not work in the mortgage market because mortgage companies profit from irrationality. Irrational decisions result in higher interest rates, late fees, and other gains for mortgage companies. Mortgage companies are guaranteed to recoup their investment and costs, along with most or all of their anticipated profit, through forced sales of real estate. Therefore, mortgage companies have no incentive to exert market pressure toward rationality. Consumers are unable to exert enough market pressure to be arbiters because there is a virtually limitless pool of consumers who make irrational decisions because of bad information, bad

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<sup>40</sup> Paying off the entire loan, ending the foreclosure.

<sup>41</sup> Bringing the loan current, leading to the dismissal of the foreclosure case.

<sup>42</sup> Voluntary settlement arrangements with lenders designed to end the foreclosure; as in any settlement, terms are limited only by the willingness of the parties to discuss options.

decision-making, or lack of choice. Consumers are doubly unable to exert market pressure because mortgages and notes are typically contracts of adhesion—they are necessary for the consumer to procure or keep housing and are rarely offered to the consumer for review before they are signed. Because of this, irrationality not only persists, but also expands. Instead of market correction, the mortgage market becomes increasingly fraught with irrationality.