RE 320: MY RE FINANCE TEXTBOOK (SHULL)

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CHAPTER OVERVIEW

1: Functions of Money and Money Supply

1.1: The Functions of Money

Learning Objective

1. Identify the functions of money and describe the three government measures of the money supply.

Finance is about money. So our first question is, what is money? If you happen to have one on you, take a look at a $5 bill. What you'll see is a piece of paper with a picture of Abraham Lincoln on one side and the Lincoln Memorial on the other. Though this piece of paper—indeed, money itself—has no intrinsic value, it's certainly in demand. Why? Because money serves three basic functions. Money is the following:

1. A medium of exchange
2. A measure of value
3. A store of value

Figure 13.1. Money itself has no intrinsic value. 401(K) 2012 – Money – CC BY-SA 2.0.

To get a better idea of the role of money in a modern economy, let's imagine a system in which there is no money. In this system, goods and services are *bartered*—traded directly for one another. Now, if you're living and trading under such a system, for each barter exchange that you make, you'll have to have something that another trader wants. For example, say you're a farmer who needs help clearing his fields. Because you have plenty of food, you might enter into a barter transaction with a laborer who has time to clear fields but not enough food: he'll clear your fields in return for three square meals a day.

This system will work as long as two people have exchangeable assets, but needless to say, it can be inefficient. If we identify the functions of money, we'll see how it improves the exchange for all the parties in our hypothetical set of transactions.

Medium of Exchange

Money serves as a medium of exchange because people will accept it in exchange for goods and services. Because people can use money to buy the goods and services that they want, everyone's willing to trade something for money. The laborer will take money for clearing your fields because he can use it to buy food. You'll take money as payment for his food because you can use it not only to pay him but also to buy something else you need (perhaps seeds for planting crops).

For money to be used in this way, it must possess a few crucial properties:

1. It must be *divisible*—easily divided into usable quantities or fractions. A $5 bill, for example, is equal to five $1 bills. If something costs $3, you don't have to rip up a $5 bill; you can pay with three $1 bills.
2. It must be *portable*—easy to carry; it can't be too heavy or bulky.
3. It must be *durable*. It must be strong enough to resist tearing and the print can't wash off if it winds up in the washing machine.

4. It must be *difficult to counterfeit*; it won't have much value if people can make their own.

Measure of Value

Money simplifies exchanges because it serves as a measure of value. We state the price of a good or service in monetary units so that potential exchange partners know exactly how much value we want in return for it. This practice is a lot better than bartering because it's much more precise than an ad hoc agreement that a day's work in the field has the same value as three meals.

Store of Value

Money serves as a store of value. Because people are confident that money keeps its value over time, they're willing to save it for future exchanges. Under a bartering arrangement, the laborer earned three meals a day in exchange for his work. But what if, on a given day, he skipped a meal? Could he "save" that meal for another day? Maybe, but if he were paid in money, he could decide whether to spend it on food each day or save some of it for the future. If he wanted to collect on his "unpaid" meal two or three days later, the farmer might not be able to "pay" it; unlike money, food could go bad.

The Money Supply

Now that we know what money does, let's tackle another question: How much money is there? How would you go about "counting" all the money held by individuals, businesses, and government agencies in this country? You could start by counting the money that's held to pay for things on a daily basis. This category includes *cash* (paper bills and coins) and funds held in **demand deposits**—checking accounts, which pay given sums to "payees" when they demand them.

Then, you might count the money that's being "saved" for future use. This category includes *interest-bearing accounts, time deposits* (such as *certificates of deposit*, which pay interest after a designated period of time), and **money market mutual funds**, which pay interest to investors who pool funds to make short-term loans to businesses and the government.

M-1 and M-2

Counting all this money would be a daunting task (in fact, it would be impossible). Fortunately, there's an easier way—namely, by examining two measures that the government compiles for the purpose of tracking the money supply: M-1 and M-2.

- The narrowest measure, **M-1**, includes the most *liquid* forms of money—the forms, such as cash and checking-accounts funds, that are spent immediately.
- **M-2** includes everything in M-1 plus *near-cash items* invested for the short term—savings accounts, time deposits below $100,000, and money market mutual funds.

So what's the bottom line? How much money *is* out there? To find the answer, you can go to the Federal Reserve Board Web site. The Federal Reserve reports that in September 2011, M-1 was about $2.1 trillion and M-2 was $9.6 trillion (Federal Reserve, 2011). Figure 13.2 "The U.S. Money Supply, 1980–2010" shows the increase in the two money-supply measures since 1980.

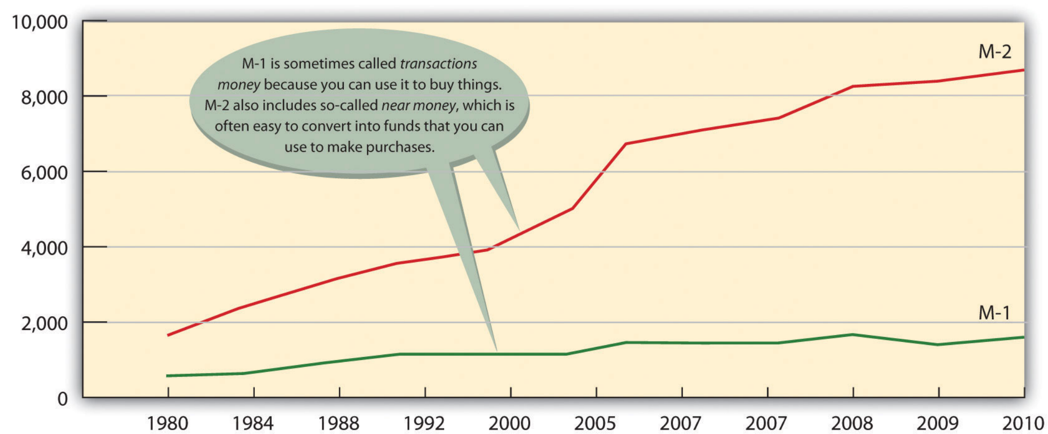

Figure 13.2. The U.S. Money Supply, 1980–2010

If you're thinking that these numbers are too big to make much sense, you're not alone. One way to bring them into perspective is to figure out how much money *you'd* get if all the money in the United States were redistributed equally. According to the U.S.

Census Population Clock (U.S. Census Bureau, 2011), there are more than three hundred million people in the United States. Your share of M-1, therefore, would be about $6,700 and your share of M-2 would be about $31,000.

What, Exactly, Is "Plastic Money"?

Are credit cards a form of money? If not, why do we call them plastic money? Actually, when you buy something with a credit card, you're not spending money. The principle of the credit card is buy-now-pay-later. In other words, when you use plastic, you're taking out a loan that you intend to pay off when you get your bill. And the loan itself is not money. Why not? Basically because the credit card company can't use the asset to buy anything. The loan is merely a promise of repayment. The asset doesn't become money until the bill is paid (with interest). That's why credit cards aren't included in the calculation of M-1 and M-2.

Key Takeaways

- Money serves three basic functions:
  1. *Medium of exchange*: because you can use it to buy the goods and services you want, everyone's willing to trade things for money.
  2. *Measure of value*: it simplifies the exchange process because it's a means of indicating how much something costs.
  3. *Store of value*: people are willing to hold onto it because they're confident that it will keep its value over time.
- The government uses two measures to track the money supply: **M-1** includes the most liquid forms of money, such as cash and checking-account funds. **M-2** includes everything in M-1 plus near-cash items, such as savings accounts and time deposits below $100,000.

Exercise

(AACSB) Analysis

Instead of coins jingling in your pocket, how would you like to have a pocketful of cowrie shells? These smooth, shiny snail shells, which are abundant in the Indian Ocean, have been used for currency for more than four thousand years. At one point, they were the most widely used currency in the world. Search "cowrie shells" on Google and learn as much as you can about them. Then answer the following questions:

1. How effectively did they serve as a medium of exchange in ancient times?
2. What characteristics made them similar to today's currencies?
3. How effective would they be as a medium of exchange today?

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1.2: Financial Institutions

Learning Objectives

1. Distinguish among different types of financial institutions.
2. Discuss the services that financial institutions provide and explain their role in expanding the money supply.

For financial transactions to happen, money must change hands. How do such exchanges occur? At any given point in time, some individuals, businesses, and government agencies have more money than they need for current activities; some have less than they need. Thus, we need a mechanism to match up savers (those with surplus money that they're willing to lend out) with borrowers (those with deficits who want to borrow money). We could just let borrowers search out savers and negotiate loans, but the system would be both inefficient and risky. Even if you had a few extra dollars, would you lend money to a total stranger? If you needed money, would you want to walk around town looking for someone with a little to spare?

Depository and Nondepository Institutions

Now you know why we have financial institutions: they act as intermediaries between savers and borrowers and they direct the flow of funds between them. With funds deposited by savers in checking, savings, and money market accounts, they make loans to individual and commercial borrowers. In the next section, we'll discuss the most common types of depository institutions (banks that accept deposits), including *commercial banks*, *savings banks*, and *credit unions*. We'll also discuss several nondepository institutions (which provide financial services but don't accept deposits), including finance companies, insurance companies, brokerage firms, and pension funds.

Commercial Banks

Commercial banks are the most common financial institutions in the United States, with total financial assets of about $13.5 trillion (85 percent of the total assets of the banking institutions) (Insurance Information Institute, 2011). They generate profit not only by charging borrowers higher interest rates than they pay to savers but also by providing such services as check processing, trust- and retirement-account management, and electronic banking. The country's 7,000 commercial banks range in size from very large (Bank of America, J.P. Morgan Chase) to very small (local community banks). Because of mergers and financial problems, the number of banks has declined significantly in recent years, but, by the same token, surviving banks have grown quite large. If you've been with one bank over the past ten years or so, you've probably seen the name change at least once or twice.

Savings Banks

Savings banks (also called *thrift institutions* and *savings and loan associations*, or *S&Ls*) were originally set up to encourage personal saving and provide mortgages to local home buyers. Today, however, they provide a range of services similar to those offered by commercial banks. Though not as dominant as commercial banks, they're an important component of the industry, holding total financial assets of almost $1.5 trillion (10 percent of the total assets of the banking institutions) (Insurance Information Institute, 2010). The largest S&L, Sovereign Bancorp, has close to 750 branches in nine Northeastern states. Savings banks can be owned by their depositors (mutual ownership) or by shareholders (stock ownership).

Credit Unions

To bank at a **credit union**, you must be linked to a particular group, such as employees of United Airlines, employees of the state of North Carolina, teachers in Pasadena, California, or current and former members of the U.S. Navy. Credit unions are owned by their members, who receive shares of their profits. They offer almost anything that a commercial bank or savings and loan does, including savings accounts, checking accounts, home and car loans, credit cards, and even some commercial loans (Pennsylvania Association of Community Bankers, 2011). Collectively, they hold about $812 billion in financial assets (around 5 percent of the total assets of the financial institutions).

Figure 13.3 "Where Our Money Is Deposited" summarizes the distribution of assets among the nation's depository institutions.

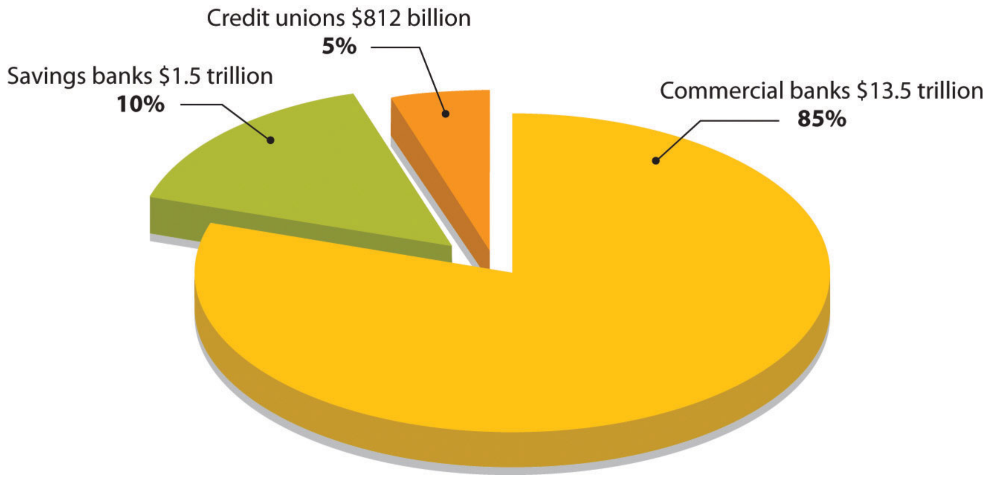

Figure 13.3 Where Our Money Is Deposited

Finance Companies

Finance companies are nondeposit institutions because they don't accept deposits from individuals or provide traditional banking services, such as checking accounts. They do, however, make loans to individuals and businesses, using funds acquired by selling securities or borrowed from commercial banks. They hold about $1.9 trillion in assets (Insurance Information Institute, 2010). Those that lend money to businesses, such as General Electric Capital Corporation, are *commercial finance companies*, and those that make loans to individuals or issue credit cards, such a Citgroup, are *consumer finance companies*. Some, such as General Motors Acceptance Corporation, provide loans to both consumers (car buyers) and businesses (GM dealers).

Insurance Companies

Insurance companies sell protection against losses incurred by illness, disability, death, and property damage. To finance claims payments, they collect premiums from policyholders, which they invest in stocks, bonds, and other assets. They also use a portion of their funds to make loans to individuals, businesses, and government agencies.

Brokerage Firms

Companies like A.G. Edwards & Sons and T. Rowe Price, which buy and sell stocks, bonds, and other investments for clients, are **brokerage firms** (also called *securities investment dealers*). A **mutual fund** invests money from a pool of investors in stocks, bonds, and other securities. Investors become part owners of the fund. Mutual funds reduce risk by diversifying investment: because assets are invested in dozens of companies in a variety of industries, poor performance by some firms is usually offset by good performance by others. Mutual funds may be stock funds, bond funds, and **money market funds**, which invest in safe, highly liquid securities. (Recall our definition of *liquidity* in Chapter 12 "The Role of Accounting in Business" as the speed with which an asset can be converted into cash.)

Finally, **pension funds**, which manage contributions made by participating employees and employers and provide members with retirement income, are also nondeposit institutions.

Financial Services

You can appreciate the diversity of the services offered by commercial banks, savings banks, and credit unions by visiting their Web sites. For example, Wells Fargo promotes services to four categories of customers: individuals, small businesses, corporate and institutional clients, and affluent clients seeking "wealth management." In addition to traditional checking and savings accounts, the bank offers automated teller machine (ATM) services, credit cards, and debit cards. It lends money for homes, cars, college, and other personal and business needs. It provides financial advice and sells securities and other financial products, including **individual retirement account (IRA)**, by which investors can save money that's tax free until they retire. Wells Fargo even offers life, auto, disability, and homeowners insurance. It also provides electronic banking for customers who want to check balances, transfer funds, and pay bills online (Wells Fargo, 2011).

Bank Regulation

How would you react if you put your life savings in a bank and then, when you went to withdraw it, learned that the bank had failed—that your money no longer existed? This is exactly what happened to many people during the Great Depression. In response to the crisis, the federal government established the **Federal Depository Insurance Corporation (FDIC)** in 1933 to restore confidence in the banking system. The FDIC insures deposits in commercial banks and savings banks up to $250,000. So today if your bank failed, the government would give you back your money (up to $250,000). The money comes from fees charged member banks.

To decrease the likelihood of failure, various government agencies conduct periodic examinations to ensure that institutions are in compliance with regulations. Commercial banks are regulated by the FDIC, savings banks by the Office of Thrift Supervision, and credit unions by the National Credit Union Administration. As we'll see later in the chapter, the Federal Reserve System also has a strong influence on the banking industry.

Crisis in the Financial Industry (and the Economy)

What follows is an interesting, but scary, story about the current financial crisis in the banking industry and its effect on the economy. In the years between 2001 and 2005, lenders made billions of dollars in subprime adjustable-rate mortgages (ARMs) to American home buyers. Subprime loans are made to home buyers who don't qualify for market-set interest rates because of one or more risk factors—income level, employment status, credit history, ability to make only a very low down payment. In 2006 and 2007, however, housing prices started to go down. Many homeowners with subprime loans, including those with ARMs whose rates had gone up, were able neither to refinance (to lower their interest rates) nor to borrow against their homes. Many of these homeowners got behind in mortgage payments, and foreclosures became commonplace—1.3 million in 2007 alone (Lahart, 2011). By April 2008, 1 in every 519 American households had received a foreclosure notice (RealtyTrac Inc., 2011). By August, 9.2 percent of the $12 trillion in U.S. mortgage loans was delinquent or in foreclosure (Mortgage Bankers Association, 2008; Duhigg, 2011).

The repercussions? Banks and other institutions that made mortgage loans were the first sector of the financial industry to be hit. Largely because of mortgage-loan defaults, profits at more than 8,500 U.S. banks dropped from $35 billion in the fourth quarter of 2006 to $650 million in the corresponding quarter of 2007 (a decrease of 89 percent). Bank earnings for the year 2007 declined 31 percent and dropped another 46 percent in the first quarter of 2008 (Federal Deposit Insurance Corporation, 2008; FDIC, 2008).

Losses in this sector were soon felt by two publicly traded government-sponsored organizations, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Both of these institutions are authorized to make loans and provide loan guarantees to banks, mortgage companies, and other mortgage lenders; their function is to make sure that these lenders have enough money to lend to prospective home buyers. Between them, Fannie Mae and Freddie Mac backed approximately half of that $12 trillion in outstanding mortgage loans, and when the mortgage crisis hit, the stock prices of the two corporations began to drop steadily. In September 2008, amid fears that both organizations would run out of capital, the U.S. government took over their management.

Freddie Mac also had another function: to increase the supply of money available in the country for mortgage loans and new home purchases, Freddie Mac bought mortgages from banks, bundled these mortgages, and sold the bundles to investors (as mortgage-backed securities). The investors earned a return because they received cash from the monthly mortgage payments. The banks that originally sold the mortgages to Freddie Mac used the cash they got from the sale to make other loans. So investors earned a return, banks got a new influx of cash to make more loans, and individuals were able to get mortgages to buy the homes they wanted. This seemed like a good deal for everyone, so many major investment firms started doing the same thing: they bought individual subprime mortgages from original lenders (such as small banks), then pooled the mortgages and sold them to investors.

But then the bubble burst. When many home buyers couldn't make their mortgage payments (and investors began to get less money and consequently their return on their investment went down), these mortgage-backed securities plummeted in value. Institutions that had invested in them—including investment banks—suffered significant losses (Tully, 2007). In September 2008, one of these investment banks, Lehman Brothers, filed for bankruptcy protection; another, Merrill Lynch, agreed to sell itself for $50 billion. Next came American International Group (AIG), a giant insurance company that insured financial institutions against the risks they took in lending and investing money. As its policyholders buckled under the weight of defaulted loans and failed investments, AIG, too, was on the brink of bankruptcy, and when private efforts to bail it out failed, the U.S. government stepped in with a loan of $85 billion (Robb, et. al., 2008). The U.S. government also agreed to buy up risky mortgage-backed securities from teetering financial institutions at an estimated cost of "hundreds of billions" (Mortgage Bankers Association, 2008). And the banks started to fail—beginning with the country's largest savings and loan, Washington Mutual, which had 2,600 locations throughout the country. The list of failed banks kept getting longer: by November of 2008, it had grown to nineteen.

The economic troubles that began in the banking industry as a result of the subprime crisis spread to the rest of the economy. Credit markets froze up and it became difficult for individuals and businesses to borrow money. Consumer confidence dropped, people stopped spending, businesses cut production, sales dropped, company profits fell, and many lost their jobs. It would be nice if this story had an ending (and even nicer if it was positive), but it might take us years before we know the ending. At this point in time, all we do know is that the economy is going through some very difficult times and no one is certain about the outcome. As we head into 2012, one in three Americans believe the United States is headed in the wrong direction. Our debt has been downgraded by Moody's, a major credit rating agency. Unemployment seems stuck at around 9 percent, with the long-term unemployed making up the biggest portion of the jobless since records began in 1948. "As the superpower's clout seems to ebb towards Asia, the world's most consistently inventive and optimistic country has lost its mojo" (The Economist, 2011).

How Banks Expand the Money Supply

When you deposit money, your bank doesn't set aside a special pile of cash with your name on it. It merely records the fact that you made a deposit and increases the balance in your account. Depending on the type of account, you can withdraw your share whenever you want, but until then, it's added to all the other money held by the bank. Because the bank can be pretty sure that all its depositors won't withdraw their money at the same time, it holds on to only a fraction of the money that it takes in—its *reserves*. It lends out the rest to individuals, businesses, and the government, earning interest income and expanding the money supply.

The Money Multiplier

Precisely how do banks expand the money supply? To find out, let's pretend you win $10,000 at the blackjack tables of your local casino. You put your winnings into your savings account immediately. The bank will keep a fraction of your $10,000 in reserve; to keep matters simple, we'll use 10 percent. The bank's reserves, therefore, will increase by $1,000 ($10,000 × 0.10). It will then lend out the remaining $9,000. The borrowers (or the parties to whom they pay it out) will then deposit the $9,000 in their own banks. Like your bank, these banks will hold onto 10 percent of the money ($900) and lend out the remainder ($8,100). Now let's go through the process one more time. The borrowers of the $8,100 (or, again, the parties to whom they pay it out) will put this amount into their banks, which will hold onto $810 and lend the remaining $7,290. As you can see in Figure 13.4 "The Effect of the Money Multiplier", total bank deposits would now be $27,100. Eventually, bank deposits would increase to $100,000, bank reserves to $10,000, and loans to $90,000. A shortcut for arriving at these numbers depends on the concept of the **money multiplier**, which is determined using the following formula:

Money multiplier = 1/Reserve requirement

In our example, the money multiplier is 1/0.10 = 10. So your initial deposit of $10,000 expands into total deposits of $100,000 ($10,000 × 10), additional loans of $90,000 ($9,000 × 10), and increased bank reserves of $10,000 ($1,000 × 10). In reality, the multiplier will actually be less than 10. Why? Because some of the money loaned out will be held as currency and won't make it back into the banks.

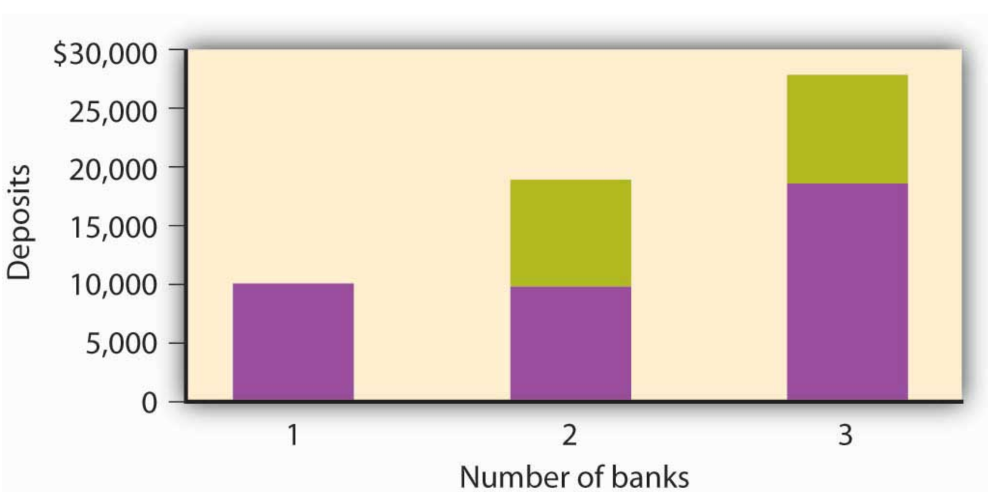

Figure 13.4 The Effect of the Money Multiplier

Key Takeaways

- Financial institutions serve as financial intermediaries between savers and borrowers and direct the flow of funds between the two groups.
- Those that accept deposits from customers—depository institutions—include **commercial banks**, **savings banks**, and **credit unions**; those that don't—nondepository institutions—include **finance companies**, **insurance companies**, and **brokerage firms**.
- Financial institutions offer a wide range of services, including checking and savings accounts, ATM services, and credit and debit cards. They also sell securities and provide financial advice.
- A bank holds onto only a fraction of the money that it takes in—an amount called its **reserves**—and lends the rest out to individuals, businesses, and governments. In turn, borrowers put some of these funds back into the banking system, where they become available to other borrowers. The **money multiplier** effect ensures that the cycle expands the money supply.

Exercises

1. **(AACSB) Analysis**

   Does the phrase "The First National Bank of Wal-Mart" strike a positive or negative chord? Wal-Mart isn't a bank, but it does provide some financial services: it offers a no-fee Wal-Mart Discovery credit card with a 1 percent cash-back feature, cashes checks and sells money orders through an alliance with MoneyGram International, and houses bank branches in more than a thousand of its superstores. Through a partnering arrangement with SunTrust Banks, the retailer has also set up in-store bank operations at a number of outlets under the cobranded name of "Wal-Mart Money Center by SunTrust." A few years ago, Wal-Mart made a bold attempt to buy several banks but dropped the idea when it encountered stiff opposition. Even so, some experts say that it's not a matter of *whether* Wal-Mart will become a bank, but a matter of *when*. What's your opinion? Should Wal-Mart be allowed to enter the financial-services industry and offer checking and savings accounts, mortgages, and personal and business loans? Who would benefit if Wal-Mart became a key player in the financial-services arena? Who would be harmed?

2. **(AACSB) Analysis**

   Congratulations! You just won $10 million in the lottery. But instead of squandering your newfound wealth on luxury goods and a life of ease, you've decided to stay in town and be a financial friend to your neighbors, who are hardworking but never seem to have enough money to fix up their homes or buy decent cars. The best way, you decide, is to start a bank that will make home and car loans at attractive rates. On the day that you open your doors, the reserve requirement set by the Federal Reserve System is 10 percent. What's the maximum amount of money you can lend to residents of the town? What if the Fed raises the reserve requirement to 12 percent? Then how much could you lend? In changing the reserve requirement from 10 percent to 12 percent, what's the Fed trying to do—curb inflation or lessen the likelihood of a recession? Explain how the Fed's action will contribute to this goal.

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1.3: The Federal Reserve System

Learning Objective

1. Identify the goals of the Federal Reserve System and explain how it uses monetary policy to control the money supply and influence interest rates.

Figure 13.5. The Federal Reserve Building in Washington, DC. Tim Evanson – Federl Reserve Building – eagle – CC BY-SA 2.0.

Who decides how much banks should keep in reserve? The decision is made by the Federal Reserve System (popularly known as “the Fed”), a central banking system established in 1913. Most large banks belong to the Federal Reserve System, which divides the country into twelve districts, each with a member-owned Federal Reserve Bank. The twelve banks are coordinated by a board of governors.

The Tools of the Fed

The Fed has three major goals:

1. Price stability
2. Sustainable economic growth
3. Full employment (Federal Reserve System, 2011)

Recall our definition of *monetary policy* in Chapter 1 “The Foundations of Business” as the efforts of the Federal Reserve System to regulate the nation’s money supply. We also defined *price stability* as conditions under which the prices for products remain fairly constant. Now, we can put the two concepts together: the Fed seeks to stabilize prices by regulating the money supply and interest rates. In turn, stable prices promote economic growth and full employment—at least in theory. To conduct monetary policy, the Fed relies on three tools: *reserve requirements*, the *discount rate*, and *open market operations*.

Reserve Requirements

Under what circumstances would the Fed want to change the reserve requirement for banks? The purpose of controlling the money supply is primarily to lessen the threat of *inflation* (a rise in the overall price level) or *recession* (an economic slowdown gauged by a decline in gross domestic product). Here’s how it works (again, in theory). If the Fed *raises* the reserve requirement (for example, from 10 percent to 11 percent), banks must set aside more money. Consequently, they have *less to lend* and so raise their interest rates. Under these conditions, it's harder and more expensive for people to borrow money, and if they can't borrow as much, they can't spend as much, and if people don't spend as much, prices don't go up. Thus, the Fed has lessened the likelihood of inflation.

Conversely, when the Fed *lowers* the reserve requirement (for example, from 10 percent to 9 percent), banks need to set aside less money. Because they have *more money to lend*, they keep interest rates down. Borrowers find it easier and cheaper to get money for buying things, and the more consumers buy, the higher prices go. In this case, the Fed has reduced the likelihood of a recession.

A 1 percent change in the reserve requirement, whether up to 11 percent or down to 9 percent, may not seem like much, but remember our earlier discussion of the *money multiplier*: because of the money-multiplier effect, a small change in the reserve requirement has a dramatic effect on the money supply. (For the same reason, the Fed changes reserve requirements only rarely.)

The Discount Rate

To understand how the Fed uses the discount rate to control the money supply, let's return to our earlier discussion of reserves. Recall that banks must keep a certain fraction of their deposits as reserves. The bank can hold these reserve funds or deposit them into a Federal Reserve Bank account. Recall, too, that the bank can lend out any funds that it doesn't have to put on reserve. What happens if a bank's reserves fall below the required level? The Fed steps in, permitting the bank to "borrow" reserve funds from the Federal Reserve Bank and add them to its reserve account at the Bank. There's a catch: the bank must pay interest on the borrowed money. The rate of interest that the Fed charges member banks is called the **discount rate**. By manipulating this rate, the Fed can make it appealing or unappealing to borrow funds. If the rate is high enough, banks will be reluctant to borrow. Because they don't want to drain their reserves, they cut back on lending. The money supply, therefore, decreases. By contrast, when the discount rate is low, banks are more willing to borrow because they're less concerned about draining their reserves. Holding fewer excess reserves, they lend out a higher percentage of their funds, thereby increasing the money supply.

Even more important is the carryover effect of a change in the discount rate to the overall level of interest rates (Heilbroner & Thurow, 1998). When the Fed adjusts the discount rate, it's telling the financial community where it thinks the economy is headed—up or down. Wall Street, for example, generally reacts unfavorably to an increase in the discount rate. Why? Because the increase means that interest rates will probably rise, making future borrowing more expensive.

Open Market Operations

The Fed's main tool for controlling the money supply and influencing interest rates is called **open market operations**: the sale and purchase of U.S. government bonds by the Fed in the open market. To understand how this process works, we first need to know a few facts:

- The Fed's assets include a substantial dollar amount of government bonds.
- The Fed can buy or sell these bonds on the open market (consisting primarily of commercial banks).
- Because member banks use cash to buy these bonds, they decrease their reserve balances when they buy them.
- Because member banks receive cash from the sale of the bonds, they increase their reserve balances when they sell them.
- Banks must maintain a specified balance in reserves; if they dip below this balance, they have to make up the difference by borrowing money.

If the Fed wants to decrease the money supply, it can *sell* bonds, thereby reducing the reserves of the member banks that buy them. Because these banks would then have less money to lend, the money supply would decrease. If the Fed wants to increase the money supply, it will *buy* bonds, increasing the reserves of the banks that sell them. The money supply would increase because these banks would then have more money to lend.

The Federal Funds Rate

In conducting open market operations, the Fed is trying to do the same thing that it does in using its other tools—namely, to influence the money supply and, thereby, interest rates. But it also has something else in mind. To understand what that is, you need to know a few more things about banking. When a bank's reserve falls below its required level, it may, as we've seen, borrow from the Fed (at the discount rate). But it can also borrow from other member banks that have excess reserves. The rate that banks pay when they borrow through this channel is called the **federal funds rate** (Federal Reserve System, 2011).

How does the federal funds rate affect the money supply? As we've seen, when the Fed sells bonds in the open market, the reserve balances of many member banks go down. To get their reserves back to the required level, they must borrow, whether from the Fed or from other member banks. When Bank 1 borrows from Bank 2, Bank 2's supply of funds goes down; thus, it increases the interest rate that it charges. In short, the increased demand for funds drives up the federal funds rate.

All this interbank borrowing affects you, the average citizen and consumer. When the federal funds rate goes up, banks must pay more for their money, and they'll pass the cost along to their customers: banks all over the country will raise the interest rates charged on mortgages, car loans, and personal loans. Figure 13.6 "Key Interest Rates, 2002–2011" charts ten-year fluctuations in the discount rate, federal funds rate, and **prime rate**—the rate that banks charge their best customers. Because all three rates tend to move in the same direction, borrowers—individuals, as well as organizations—generally pay more to borrow money when banks have to pay more and less when banks have to pay less. Notice that the prime rate (which banks charge their customers) is higher than both the federal funds and discount rates (which banks must pay when they need to borrow). That's why banks make profits when they make loans. Note, too, that the Fed lowered the discount rate and federal funds rate drastically in 2008 in an attempt to stimulate a weakening economy. Despite continued low rates through 2011, the economy is still very weak.

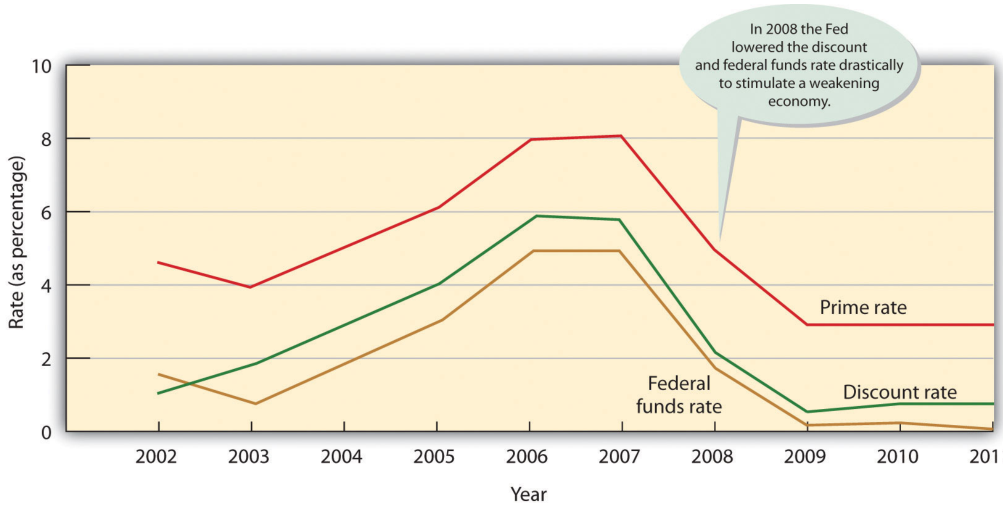


Figure 13.6 Key Interest Rates, 2002–2011

The Banker's Bank and the Government's Banker

The Fed performs another important function: it serves its member banks in much the same way as your bank serves you. When you get a check, you deposit it in your checking account, thereby increasing your balance. When you pay someone by check, the dollar amount of the check is charged to your account, and your balance goes down. The Fed works in much the same way, except that its customers are member banks. Just as your bank clears your check, the Fed clears the checks that pass through its member banks. The monumental task of clearing more than fifteen billion checks a year is complicated by the fact that there are twelve district banks. If someone in one district (for example, Boston) writes a check to a payee in another district (say, San Francisco), the check must be processed through both districts (Federal Reserve System, 2011).

Prior to 2004, clearing checks took days because the checks themselves needed to be physically moved through the system. But thanks to the passage of Check 21 (a U.S. federal law), things now move much more quickly. Instead of physically transporting checks, banks are allowed to make an image of the front and back of a check and send the digital version of the original check, called a "substitute" check, through the system electronically (Privacy Rights Clearinghouse, 2011). The good news is that Check 21 shortened the time it takes to clear a check, often down to one day. The bad news is that Check 21 shortened the time it takes to clear a check, which increases the risk that a check you write will bounce. So be careful: don't write a check unless you have money in the bank to cover it.

In performing the following functions, the Fed is also the U.S. government's banker:

- Holding the U.S. Treasury's checking account
- Processing the paperwork involved in buying and selling government securities
- Collecting federal tax payments
- Lending money to the government by purchasing government bonds from the Treasury

The Fed also prints, stores, and distributes currency and destroys it when it's damaged or worn out. Finally, the Fed, in conjunction with other governmental agencies, supervises and regulates financial institutions to ensure that they operate soundly and treat customers fairly and equitably (Federal Reserve System, 2011).

Key Takeaways

- Most large banks are members of the central banking system called the **Federal Reserve System** (commonly known as "the Fed").
- The Fed's goals include price stability, sustainable economic growth, and full employment. It uses *monetary policy* to regulate the money supply and the level of interest rates.
- To achieve these goals, the Fed has three tools:
  1. it can raise or lower reserve requirements—the percentage of its funds that banks must set aside and can't lend out;
  2. it can raise or lower the **discount rate**—the rate of interest that the Fed charges member banks to borrow "reserve" funds;
  3. it can conduct **open market operations**—buying or selling government securities on the open market.

Exercise

(AACSB) Analysis

Answer this three-part question on the Federal Reserve:

1. What is the Federal Reserve?
2. What is the purpose of the Federal Reserve? What are its goals?
3. How does the Federal Reserve affect the U.S. economy?

References

Federal Reserve System, "Banking Supervision," http://federalreserveeducation.org/about%2Dthe%2Dfed/structure%2Dand%2Dfunctions/banking%2Dsupervision/ (accessed November 7, 2011).

Federal Reserve System, "Financial Services," http://federalreserveeducation.org/about%2Dthe%2Dfed/structure%2Dand%2Dfunctions/financial%2Dservices/ (accessed November 7, 2011).

Federal Reserve System, "Monetary Policy Basics," http://federalreserveeducation.org/about%2Dthe%2Dfed/structure%2Dand%2Dfunctions/monetary%2Dpolicy/ (accessed November 7, 2011).

Heilbroner, R., and Lester Thurow, *Economics Explained* (New York: Simon & Schuster, 1998), 134.

Privacy Rights Clearinghouse, "Fact Sheet 30: Check 21: Paperless Banking," Privacy Rights Clearinghouse, https://www.privacyrights.org/fs/fs30-check21.htm (accessed November 7, 2011).

CHAPTER OVERVIEW

2: Primary Market

2.1: Explain Primary Market

https://www.sofi.com/learn/content/primary-vs-secondary-mortgage-markets/

2.2: What is a mortgage broker and when do you want to use one anyway?

https://www.sofi.com/learn/content/what-does-a-mortgage-broker-do/

CHAPTER OVERVIEW

3: Loan Programs

3.1: VA Home Loans

https://www.youtube.com/watch?v=QwchuWczB_s

3.2: Calhfa

https://www.calhfa.ca.gov/homebuyer/programs/index.htm

3.3: Understanding the Different Types of Loans

https://www.sofi.com/learn/content/different-types-of-mortgage-loans

3.4: Types of Conventional Loans

Types of Conventional Loans (Fixed vs. Adjustable) and Conventional vs. FHA:

https://www.sofi.com/learn/content/conventional-home-loan/

CHAPTER OVERVIEW

4: Loan Products

SECTION OVERVIEW

4.1: Personal Finances

4.1.1: Financial Planning

Learning Objectives

1. Define *personal finances* and *financial planning*.
2. Explain the *financial planning life cycle*.
3. Discuss the advantages of a college education in meeting short- and long-term financial goals.
4. Describe the steps you'd take to get a job offer and evaluate alternative job offers, taking benefits into account.
5. Understand the ways to finance a college education.

Before we go any further, we need to nail down a couple of key concepts. First, just what, exactly, do we mean by personal finances? *Finance* itself concerns the flow of money from one place to another, and your personal finances concern your money and what you plan to do with it as it flows in and out of your possession. Essentially, then, personal finance is the application of financial principles to the monetary decisions that you make either for your individual benefit or for that of your family.

Second, as we suggested in Section 14—and as we'll insist in the rest of it—monetary decisions work out much more beneficially when they're planned rather than improvised. Thus our emphasis on financial planning—the ongoing process of managing your personal finances in order to meet goals that you've set for yourself or your family.

Financial planning requires you to address several questions, some of them relatively simple:

- What's my annual income?
- How much debt do I have, and what are my monthly payments on that debt?

Others will require some investigation and calculation:

- What's the value of my assets?
- How can I best budget my annual income?

Still others will require some forethought and forecasting:

- How much wealth can I expect to accumulate during my working lifetime?
- How much money will I need when I retire?

The Financial Planning Life Cycle

Another question that you might ask yourself—and certainly would do if you were a professional in financial planning—is something like, "How will my financial plans change over the course of my life?" Figure 14.3 "Financial Life Cycle" illustrates the financial life cycle of a typical individual—one whose financial outlook and likely outcomes are probably a lot like yours (Keown, 2007). As you can see, our diagram divides this individual's life into three stages, each of which is characterized by different life events (such as beginning a family, buying a home, planning an estate, retiring). At each stage, too, there are recommended changes in the focus of the individual's financial planning:

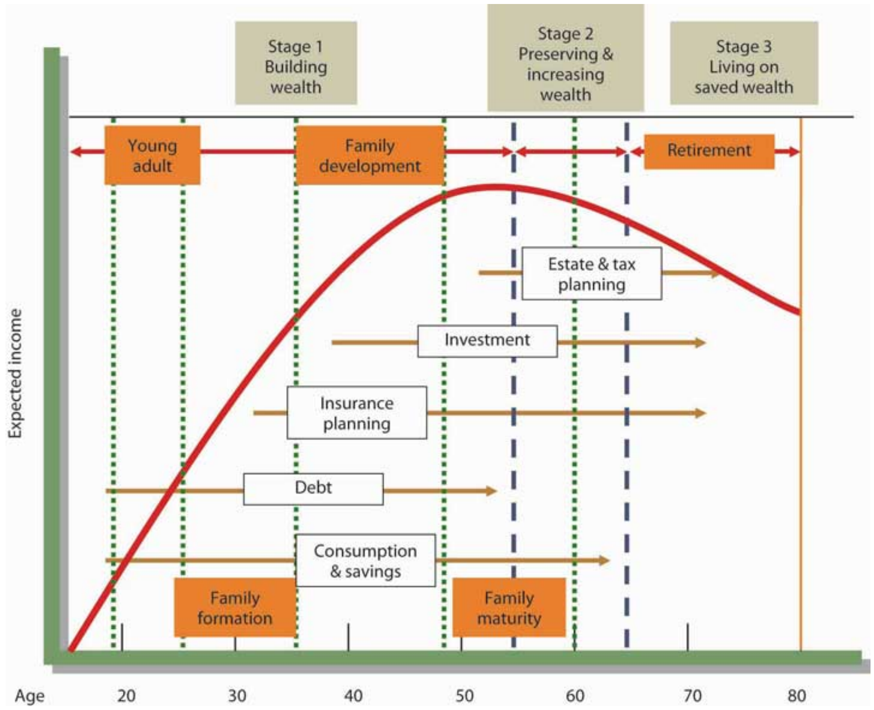


Figure 14.3 Financial Life Cycle

At each stage, of course, complications can set in—say, changes in such conditions as marital or employment status or in the overall economic outlook. Finally, as you can also see, your financial needs will probably peak somewhere in stage 2, at approximately age fifty-five, or ten years before typical retirement age.

- In stage 1, the focus is on building wealth.
- In stage 2, the focus shifts to the process of preserving and increasing the wealth that one has accumulated and continues to accumulate.
- In stage 3, the focus turns to the process of living on (and, if possible, continuing to grow) one's saved wealth.

Choosing a Career

Until you're eighteen or so, you probably won't generate much income; for the most part, you'll be living off your parents' wealth. In our hypothetical life cycle, however, financial planning begins in the individual's early twenties. If that seems like rushing things, consider a basic fact of life: this is the age at which you'll be choosing your career—not only the sort of work you want to do during your prime income-generating years, but also the kind of lifestyle you want to live in the process (Keown, 2007).

What about college? Most readers of this book, of course, have decided to go to college. If you haven't yet decided, you need to know that college is an extremely good investment of both money and time.

Table 14.1 "Education and Average Income", for example, summarizes the findings of a study conducted by the U.S. Census Bureau (U.S. Census Bureau, 2008). A quick review shows that people who graduate from high school can expect to increase their average annual earnings by about 49 percent over those of people who don't, and those who go on to finish college can expect to generate 82 percent more annual income than that. Over the course of the financial life cycle, families headed by those college graduates will earn about $1.6 million more than families headed by high school graduates who didn't attend college. (With better access to health care—and, studies show, with better dietary and health practices—college graduates will also live longer. And so will their children.) (U.S. Census Bureau, 2008)

Table 14.1 Education and Average Income

Education	Average income	Percentage increase over next-highest level
High school dropout	$20,873	—
High school diploma	$31,071	48.9%

Education	Average income	Percentage increase over next-highest level
College degree	$56,788	82.8%
Advanced higher-education degree	$82,320	45.0%

And what about the debt that so many people accumulate to finish college? For every $1 that you spend on your college education, you can expect to earn about $35 during the course of your financial life cycle (Hansen, 2008). At that rate of return, you should be able to pay off your student loans (unless, of course, you fail to practice reasonable financial planning).

Naturally, there are exceptions to these average outcomes. You'll find English-lit majors stocking shelves at 7-Eleven, and you'll find college dropouts running multibillion-dollar enterprises. Microsoft cofounder Bill Gates dropped out of college after two years, as did his founding partner, Paul Allen. Current Microsoft CEO Steve Ballmer finished his undergraduate degree but quit his MBA program to join Microsoft (where he apparently fit in among the other dropouts in top management). It's always good to remember, however, that though exceptions to rules (and average outcomes) occasionally modify the rules, they invariably fall far short of disproving them: in entrepreneurship as in most other walks of adult life, the better your education, the more promising your financial future. One expert in the field puts the case for the average person bluntly: educational credentials "are about being employable, becoming a legitimate candidate for a job with a future. They are about climbing out of the dead-end job market" (Ramsay, 2008).

Finally, does it make any difference *what* you study in college? To a perhaps surprising extent, not necessarily. Some career areas, such as engineering, architecture, teaching, and law, require targeted degrees, but the area of study designated on your degree often doesn't matter much when you're applying for a job. If, for instance, a job ad says, "Business, communications, or other degree required," most applicants and hires will have those "other" degrees. When poring over résumés for a lot of jobs, potential employers look for the degree and simply note that a candidate has one; they often don't need to focus on the particulars (Roth, 2008).

This is not to say, however, that all degrees promise equal job prospects. Figure 14.4 "Top 25 Fastest-Growing Jobs, 2006–2016", for example, summarizes a U.S. Bureau of Labor Statistics projection of the thirty fast-growing occupations for the years 2006–2016. Veterinary technicians and makeup artists will be in demand as never before, but as you can see, occupational prospects are fairly diverse[1].

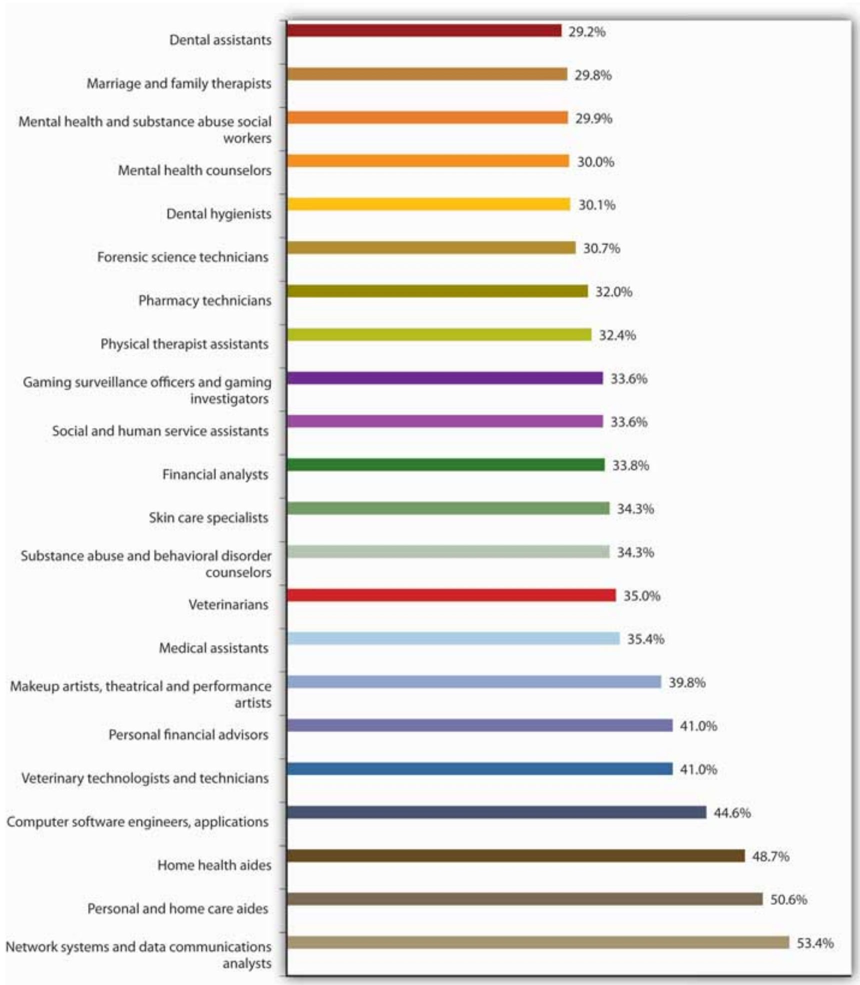


Figure 14.4 Top 25 Fastest-Growing Jobs, 2006–2016

Nor, of course, do all degrees pay off equally. In Table 14.2 "College Majors and Average Annual Earnings", we've extracted the findings of a study conducted by the National Science Foundation on the earnings of individuals with degrees in various undergraduate fields (Penrice, 1999; Harrington & Sum, 2011). Clearly, some degrees—notably in the engineering fields—promise much higher average earnings than others. Chemical engineers, for instance, can earn nearly twice as much as elementary school teachers, but there's a catch: if you graduate with a degree in chemical engineering, your average annual salary will be about $67,000 *if you can find a job related to that degree*; if you can't, you may have to settle for as much as 40 percent less (Penrice, 1999). (Supermodel Cindy Crawford cut short her studies in chemical engineering because there was more money to be made on the runway.)

Table 14.2 College Majors and Average Annual Earnings

Major	Average Earnings with Bachelor's Degree	Major	Average Earnings with Bachelor's Degree
Chemical engineering	$67,425	History	$45,926
Aerospace engineering	$65,649	Biology	$45,532
Computer engineering	$62,527	Nursing	$45,538
Physics	$62,104	Psychology	$43,963
Electrical engineering	$61,534	English	$43,614
Mechanical engineering	$61,382	Health technology	$42,524

Major	Average Earnings with Bachelor’s Degree	Major	Average Earnings with Bachelor’s Degree
Industrial engineering	$61,030	Criminal justice	$41,129
Civil engineering	$58,993	Physical education	$40,207
Accounting	$56,637	Secondary education	$39,976
Finance	$55,104	Fine arts	$38,857
Computer science	$52,615	Philosophy	$38,239
Business management	$52,321	Dramatic arts	$37,091
Marketing	$51,107	Music	$36,811
Journalism	$46,835	Elementary education	$34,564
Information systems	$46,519	Special education	$34,196

In short, when you’re planning what to do with the rest of your life, it’s a good idea to check into the fine points and realities, as well as the statistical data. If you talk to career counselors and people in the workforce, you might be surprised by what you learn about the relationship between certain college majors and various occupations. Onetime Hewlett-Packard CEO Carly Fiorina majored in medieval history and philosophy.

4.1.2: Time Is Money

Learning Objectives

1. Explain *compound interest* and *the time value of money*.
2. Discuss the value of getting an early start on your plans for saving.

The fact that you have to choose a career at an early stage in your financial life cycle isn't the only reason that you need to start early on your financial planning. Let's assume, for instance, that it's your eighteenth birthday and that on this day you take possession of $10,000 that your grandparents put in trust for you. You could, of course, spend it; in particular, it would probably cover the cost of flight training for a private pilot's license—something you've always wanted but were convinced that you couldn't afford for another ten or fifteen years. Your grandfather, of course, suggests that you put it into some kind of savings account. If you just wait until you finish college, he says, and if you can find a savings plan that pays 5 percent interest, you'll have the $10,000 plus another $2,209 to buy a pretty good used car.

The total amount you'll have— $12,209—piques your interest. If that $10,000 could turn itself into $12,209 after sitting around for four years, what would it be worth if you actually held on to it until you did retire—say, at age sixty-five? A quick trip to the Internet to find a compound-interest calculator informs you that, forty-seven years later, your $10,000 will have grown to $104,345 (assuming a 5 percent interest rate). That's not really enough to retire on, but after all, you'd at least have some cash, even if you hadn't saved another dime for nearly half a century. On the other hand, what if that four years in college had paid off the way you planned, so that (once you get a good job) you're able to add, say, another $10,000 to your retirement savings account every year until age sixty-five? At that rate, you'll have amassed a nice little nest egg of slightly more than $1.6 million.

4.1.3: The Financial Planning Process

Learning Objectives

1. Identify the three stages of the *personal-finances planning process*.
2. Explain how to draw up a personal *net-worth statement*, a personal *cash-flow statement*, and a personal *budget*.

We've divided the financial planning process into three steps:

1. Evaluate your current financial status by creating a net worth statement and a cash flow analysis.
2. Set short-term, intermediate-term, and long-term financial goals.
3. Use a budget to plan your future cash inflows and outflows and to assess your financial performance by comparing budgeted figures with actual amounts.

4.1.4: A House Is Not a Piggy Bank- A Few Lessons from the Subprime Crisis

Learning Objectives

1. Discuss the trend in the U.S. savings rate.
2. Define a *subprime loan* and explain the difference between a *fixed-rate mortgage* and an *adjustable-rate mortgage*.
3. Discuss what can go wrong with a subprime loan at an adjustable rate. Discuss what can go wrong with hundreds of thousands of subprime loans at adjustable rates.
4. Define *risk* and explain some of the risks entailed by personal financial transactions.

Joe isn't old enough to qualify, but if his grandfather had deposited $1,000 in an account paying 7 percent interest in 1945, it would now be worth $64,000. That's because money invested at 7 percent compounded will double every ten years. Now, $64,000 may or may not seem like a significant return over fifty years, but after all, the money did all the heavy lifting, and given the miracle of compound interest, it's surprising that Americans don't take greater advantage of the opportunity to multiply their wealth by saving more of it, even in modest, interest-bearing accounts. Ironically, with $790 billion in credit card debt, it's obvious that a lot of American families are experiencing the effects of compound interest—but in reverse (Frank, 2005).

As a matter of fact, though Joe College appears to be on the right track when it comes to saving, many people aren't. A lot of Americans, it seems, do indeed set savings goals, but in one recent survey, nearly 70 percent of the respondents reported that they fell short of their monthly goals because their money was needed elsewhere. About one-third of Americans say that they're putting away something but not enough, and another third aren't saving anything at all. Almost one-fifth of all Americans have net worth of zero—or less (Taylor, 2007; Frank, 2005).

As we indicated in the opening section of this chapter, this shortage of savings goes hand in hand with a surplus in spending. "My parents," says one otherwise gainfully employed American knowledge worker, "are appalled at the way I justify my spending. I think, 'Why work and make money unless you're going to enjoy it?' That's a fine theory," she adds, "until you're sixty, homeless, and with no money in the bank" (Gardner, 2008). And indeed, if she doesn't intend to alter her personal-finances philosophy, she has good reason to worry about her "older adult" years. Sixty percent of Americans over the age of sixty-five have less than $100,000 in savings, and only 30 percent of this group have more than $25,000; 45 percent have less than $15,000. As for income, 75 percent of people over age sixty-five generate less than $35,000 annually, and 30 percent are in the "poverty to near-poverty" range of $10,000 to $20,000 (as compared to 12 percent of the under-sixty-five population) (Rubin, et. al., 2000).

4.1.5: Cases and Problems

Learning on the Web (AACSB)

Go to https://www.quizzle.com[1] and request a free copy of your credit report. Review the report. If you identify any errors, get them fixed. Write a brief report explaining the value of good credit.

Ethics Angle (AACSB)

Go online and read this article at Forbes.com: "Most Common Resume Lies," by Kate DuBose Tomassi at www.forbes.com/workspecial/2006/05/20/resume-lies-work_cx_kdt_06work_0523lies.html. View the slide show of common résumé lies. Answer these questions: What are the most common lies made in résumés? Why is it a bad idea to lie on such a document? What are the potential consequences of misstating facts on your résumé?

Team-Building Skills (AACSB)

It's becoming more difficult for individuals to buy homes. This has meant that many people who would have bought a home have remained in apartments. In big cities, such as New York, sharing an apartment with roommates is a good way to save money. Yet it has some disadvantages. Get together as a team and identify the pros and cons of sharing housing. Pretend that each member of the group has agreed to share one apartment. Create a document that details each member's rights and responsibilities. Decide as a group whether the lease should be in one person's name or in all your names. Explain the pros and cons of both approaches.

The Global View (AACSB)

You're looking forward to taking a month-long vacation to Australia when you graduate from college in two years. Create a budget for this trip after researching likely costs. Determine how much you'll need for the trip and calculate how much you'd have to save each month to afford the trip.

4.2: Loan Products (All including Seconds / Reverse / Balloon)

https://www.merlot.org/merlot/viewMaterial.htm?id=771655997

4.3: Hard Money Loans

https://socotracapital.com/hard-money-loan-types/

https://www.thenorrisgroup.com/

4.4: Second Trust Deeds

https://www.northcoastfinancialinc.com/hard-money-2nd-mortgages-trust-deeds/

4.5: Wrap-around/ Land Contracts, Construction, As-is

https://www.rocketmortgage.com/learn/land-contract

https://www.rocketmortgage.com/learn/construction-loans

https://www.rocketmortgage.com/learn/sold-as-is

4.6: Financing Small Investment Properties

https://www.investopedia.com/articles/investing/021016/complete-guide-financing-investment-property.asp

4.7: Shared Equity

https://www.investopedia.com/terms/s/sharedequityfinanceagreements.asp

4.8: Residential Income Properties

https://www.investopedia.com/terms/i/income-property-mortgage.asp

4.9: Pricing Loans- Yields, Buy downs

https://www.rocketmortgage.com/learn/buydown-mortgage

CHAPTER OVERVIEW

5: Loan Qualification and Processing

5.1: Qualifying the Property

https://www.quickenloans.com/learn/understanding-property-classification

5.2: Qualifying the Buyer

https://www.rocketmortgage.com/learn/mortgage-qualification

5.3: Difference between Prequal and Preapproval

https://www.rocketmortgage.com/learn/preapproval-vs-prequalification

5.4: (Processing, Servicing, Closing the Loan) Items Included

https://www.merlot.org/merlot/viewMaterial.htm?id=771655997

5.5: RE Math

CHAPTER OVERVIEW

6: Ethics and Consumer Protection

6.1: Ethics- Fair Credit Reporting (Foreclosure)

6.1.1: Chapter Introduction

> **Learning Objectives**
>
> After reading this chapter, you should understand the following:
>
> 1. The basic concepts of mortgages
> 2. How the mortgage is created
> 3. Priorities with mortgages as security devices
> 4. Termination of the mortgage
> 5. Other methods of using real estate as security
> 6. Nonconsensual liens

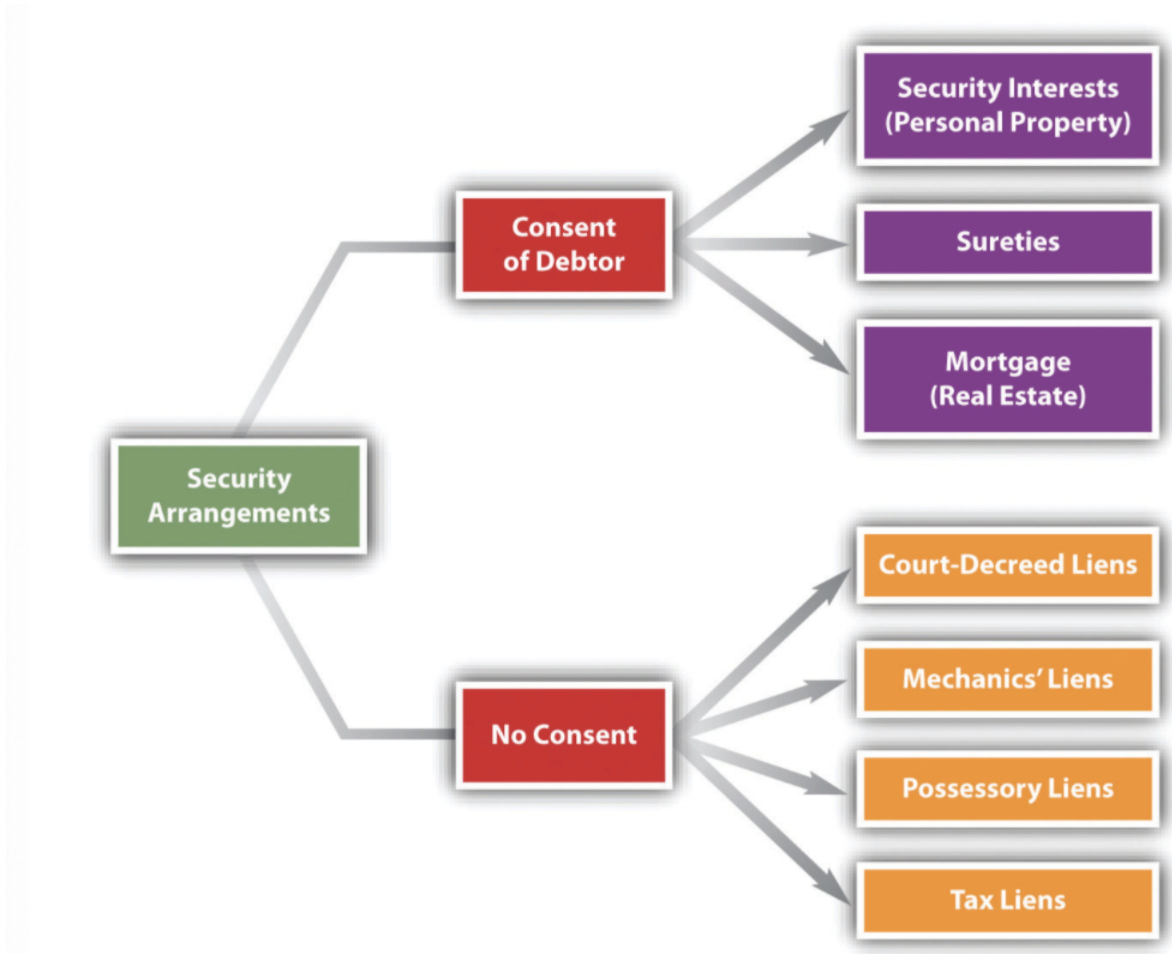
6.1.2: Uses, History, and Creation of Mortgages

Learning Objectives

1. Understand the terminology used in mortgage transactions, and how mortgages are used as security devices.
2. Know a bit about the history of mortgages.
3. Understand how the mortgage is created.

Having discussed in Chapter 33 "Secured Transactions and Suretyship" security interests in personal property and suretyship—two of the three common types of consensual security arrangements—we turn now to the third type of consensual security arrangement, the mortgage. We also discuss briefly various forms of nonconsensual liens (see Figure 34.1 "Security Arrangements").

Figure 34.1 Security Arrangements



Definitions

A **mortgage** is a means of securing a debt with real estate. A long time ago, the mortgage was considered an actual transfer of title, to become void if the debt was paid off. The modern view, held in most states, is that the mortgage is but a lien, giving the holder, in the event of default, the right to sell the property and repay the debt from the proceeds. The person giving the mortgage is the **mortgagor**, or borrower. In the typical home purchase, that's the buyer. The buyer needs to borrow to finance the purchase; in exchange for the money with which to pay the seller, the buyer "takes out a mortgage" with, say, a bank. The lender is the **mortgagee**, the person or institution holding the mortgage, with the right to foreclose on the property if the debt is not timely paid. Although the law of real estate mortgages is different from the set of rules in Article 9 of the Uniform Commercial Code (UCC) that we examined in Chapter 33 "Secured Transactions and Suretyship", the circumstances are the same, except that the security is real estate rather than personal property (secured transactions) or the promise of another (suretyship).

The Uses of Mortgages

Most frequently, we think of a mortgage as a device to fund a real estate purchase: for a homeowner to buy her house, or for a commercial entity to buy real estate (e.g., an office building), or for a person to purchase farmland. But the value in real estate can be mortgaged for almost any purpose (a home equity loan): a person can take out a mortgage on land to fund a vacation. Indeed, during the period leading up to the recession in 2007–08, a lot of people borrowed money on their houses to buy things: boats, new cars, furniture, and so on. Unfortunately, it turned out that some of the real estate used as collateral was overvalued: when the economy weakened and people lost income or their jobs, they couldn't make the mortgage payments. And, to make things worse, the value of the real estate sometimes sank too, so that the debtors owed more on the property than it was worth (that's called being underwater). They couldn't sell without taking a loss, and they couldn't make the payments. Some debtors just walked away, leaving the banks with a large number of houses, commercial buildings, and even shopping centers on their hands.

Short History of Mortgage Law

The mortgage has ancient roots, but the form we know evolved from the English land law in the Middle Ages. Understanding that law helps to understand modern mortgage law. In the fourteenth century, the mortgage was a deed that actually transferred title to the mortgagee. If desired, the mortgagee could move into the house, occupy the property, or rent it out. But because the mortgage obligated him to apply to the mortgage debt whatever rents he collected, he seldom ousted the mortgagor. Moreover, the mortgage set a specific date (the "law day") on which the debt was to be repaid. If the mortgagor did so, the mortgage became void and the mortgagor was entitled to recover the property. If the mortgagor failed to pay the debt, the property automatically vested in the mortgagee. No further proceedings were necessary.

This law was severe. A day's delay in paying the debt, for any reason, forfeited the land, and the courts strictly enforced the mortgage. The only possible relief was a petition to the king, who over time referred these and other kinds of petitions to the courts of equity. At first fitfully, and then as a matter of course (by the seventeenth century), the equity courts would order the mortgagee to return the land when the mortgagor stood ready to pay the debt plus interest. Thus a new right developed: the *equitable right of redemption*, known for short as the equity of redemption. In time, the courts held that this equity of redemption was a form of property right; it could be sold and inherited. This was a powerful right: no matter how many years later, the mortgagor could always recover his land by proffering a sum of money.

Understandably, mortgagees did not warm to this interpretation of the law, because their property rights were rendered insecure. They tried to defeat the equity of redemption by having mortgagors waive and surrender it to the mortgagees, but the courts voided waiver clauses as a violation of public policy. Hence a mortgage, once a transfer of title, became a security for debt. A mortgage as such can never be converted into a deed of title.

The law did not rest there. Mortgagees won a measure of relief in the development of the **foreclosure**. On default, the mortgagee would seek a court order giving the mortgagor a fixed time—perhaps six months or a year—within which to pay off the debt; under the court decree, failure meant that the mortgagor was forever foreclosed from asserting his right of redemption. This **strict foreclosure** gave the mortgagee outright title at the end of the time period.

In the United States today, most jurisdictions follow a somewhat different approach: the mortgagee forecloses by forcing a public sale at auction. Proceeds up to the amount of the debt are the mortgagee's to keep; surplus is paid over to the mortgagor. **Foreclosure by sale** is the usual procedure in the United States. At bottom, its theory is that a mortgage is a lien on land. (Foreclosure issues are further discussed in Section 34.2 "Priority, Termination of the Mortgage, and Other Methods of Using Real Estate as Security".)

Under statutes enacted in many states, the mortgagor has one last chance to recover his property, even after foreclosure. This statutory **right of redemption** extends the period to repay, often by one year.

Creation of the Mortgage

Statutory Regulation

The decision whether to lend money and take a mortgage is affected by several federal and state regulations.

Consumer Credit Statutes Apply

Statutes dealing with consumer credit transactions (as discussed in Chapter 32 "Consumer Credit Transactions") have a bearing on the mortgage, including state usury statutes, and the federal Truth in Lending Act and Equal Credit Opportunity Act.

Real Estate Settlement Procedures Act

Other federal statutes are directed more specifically at mortgage lending. One, enacted in 1974, is the Real Estate Settlement Procedures Act (RESPA), aimed at abuses in the settlement process—the process of obtaining the mortgage and purchasing a residence. The act covers all federally related first mortgage loans secured by residential properties for one to four families. It requires the lender to disclose information about settlement costs in advance of the closing day: it prohibits the lender from "springing" unexpected or hidden costs onto the borrower. The RESPA is a US Department of Housing and Urban Development (HUD) consumer protection statute designed to help home buyers be better shoppers in the home-buying process, and it is enforced by HUD. It also outlaws what had been a common practice of giving and accepting kickbacks and referral fees. The act prohibits lenders from requiring mortgagors to use a particular company to obtain insurance, and it limits add-on fees the lender can demand to cover future insurance and tax charges.

Redlining. Several statutes are directed to the practice of **redlining**—the refusal of lenders to make loans on property in low-income neighborhoods or impose stricter mortgage terms when they do make loans there. (The term derives from the supposition that lenders draw red lines on maps around ostensibly marginal neighborhoods.) The most important of these is the Community Reinvestment Act (CRA) of 1977.12 United States Code, Section 2901. The act requires the appropriate federal financial supervisory agencies to encourage regulated financial institutions to meet the credit needs of the local communities in which they are chartered, consistent with safe and sound operation. To enforce the statute, federal regulatory agencies examine banking institutions for CRA compliance and take this information into consideration when approving applications for new bank branches or for mergers or acquisitions. The information is compiled under the authority of the Home Mortgage Disclosure Act of 1975, which requires financial institutions within its purview to report annually by transmitting information from their loan application registers to a federal agency.

The Note and the Mortgage Documents

The note and the mortgage documents are the contracts that set up the deal: the mortgagor gets credit, and the mortgagee gets the right to repossess the property in case of default.

The Note

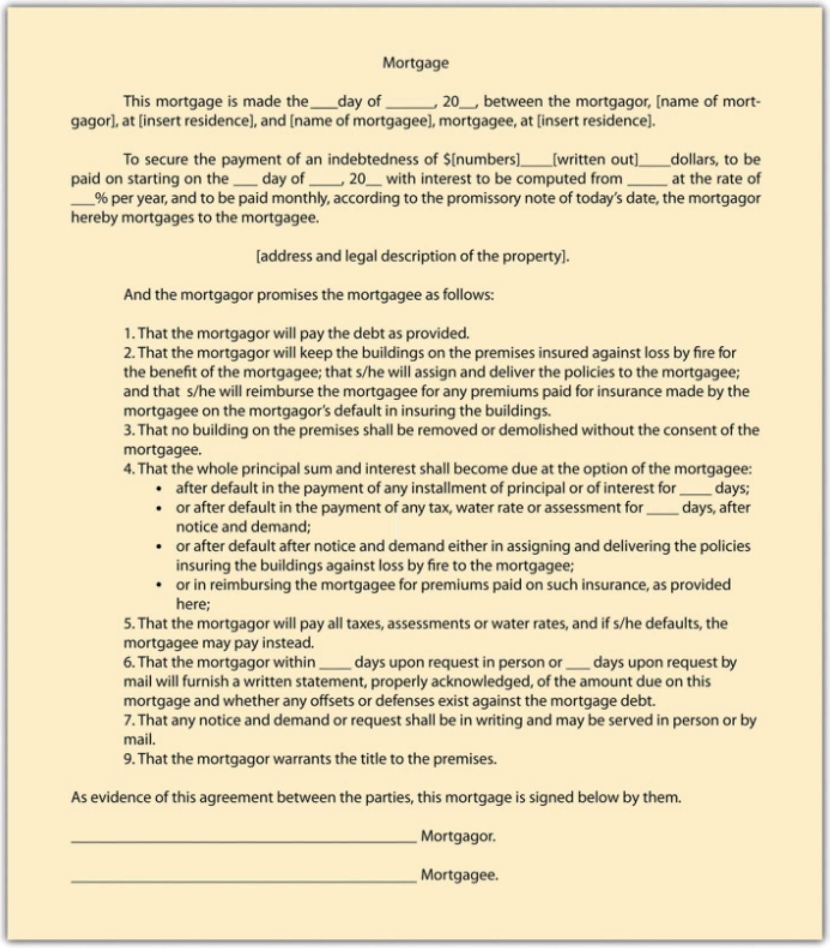
If the lender decides to grant a mortgage, the mortgagor signs two critical documents at the closing: the note and the mortgage. It is enough here to recall that in a note (really a type of IOU), the mortgagor promises to pay a specified principal sum, plus interest, by a certain date or dates. The note is the underlying obligation for which the mortgage serves as security. Without the note, the mortgagee would have an empty document, since the mortgage would secure nothing. Without a mortgage, a note is still quite valid, evidencing the debtor's personal obligation.

One particular provision that usually appears in both mortgages and the underlying notes is the **acceleration clause**. This provides that if a debtor should default on any particular payment, the entire principal and interest will become due immediately at the lender's option. Why an acceleration clause? Without it, the lender would be powerless to foreclose the entire mortgage when the mortgagor defaulted but would have to wait until the expiration of the note's term. Although the acceleration clause is routine, it will not be enforced unless the mortgagee acts in an equitable and fair manner. The problem arises where the mortgagor's default was the result of some unconscionable conduct of the mortgagee, such as representing to the mortgagee that she might take a sixty-day "holiday" from having to make payments. In *Paul H. Cherry v. Chase Manhattan Mortgage Group* (Section 34.4 "Cases"), the equitable powers of the court were invoked to prevent acceleration.

The Mortgage

Under the statute of frauds, the mortgage itself must be evidenced by some writing to be enforceable. The mortgagor will usually make certain promises and warranties to the mortgagee and state the amount and terms of the debt and the mortgagor's duties concerning taxes, insurance, and repairs. A sample mortgage form is presented in Figure 34.2 "Sample Mortgage Form".

Figure 34.2 Sample Mortgage Form



Mortgage

This mortgage is made the___day of ______, 20__, between the mortgagor, [name of mortgagor], at [insert residence], and [name of mortgagee], mortgagee, at [insert residence].

To secure the payment of an indebtedness of $[numbers]____[written out]____dollars, to be paid on starting on the ___ day of ____, 20__ with interest to be computed from _____ at the rate of ___% per year, and to be paid monthly, according to the promissory note of today's date, the mortgagor hereby mortgages to the mortgagee.

[address and legal description of the property].

And the mortgagor promises the mortgagee as follows:

1. That the mortgagor will pay the debt as provided.
2. That the mortgagor will keep the buildings on the premises insured against loss by fire for the benefit of the mortgagee; that s/he will assign and deliver the policies to the mortgagee; and that s/he will reimburse the mortgagee for any premiums paid for insurance made by the mortgagee on the mortgagor's default in insuring the buildings.
3. That no building on the premises shall be removed or demolished without the consent of the mortgagee.
4. That the whole principal sum and interest shall become due at the option of the mortgagee:
   - after default in the payment of any installment of principal or of interest for ____ days;
   - or after default in the payment of any tax, water rate or assessment for ____ days, after notice and demand;
   - or after default after notice and demand either in assigning and delivering the policies insuring the buildings against loss by fire to the mortgagee;
   - or in reimbursing the mortgagee for premiums paid on such insurance, as provided here;
5. That the mortgagor will pay all taxes, assessments or water rates, and if s/he defaults, the mortgagee may pay instead.
6. That the mortgagor within ____ days upon request in person or ___ days upon request by mail will furnish a written statement, properly acknowledged, of the amount due on this mortgage and whether any offsets or defenses exist against the mortgage debt.
7. That any notice and demand or request shall be in writing and may be served in person or by mail.
9. That the mortgagor warrants the title to the premises.

As evidence of this agreement between the parties, this mortgage is signed below by them.

____ Mortgagor.

____ Mortgagee.

Key Takeaway

As a mechanism of security, a mortgage is a promise by the debtor (mortgagor) to repay the creditor (mortgagee) for the amount borrowed or credit extended, with real estate put up as security. If the mortgagor doesn't pay as promised, the mortgagee may repossess the real estate. Mortgage law has ancient roots and brings with it various permutations on the theme that even if the mortgagor defaults, she may nevertheless have the right to get the property back or at least be reimbursed for any value above that necessary to pay the debt and the expenses of foreclosure. Mortgage law is regulated by state and federal statute.

Exercises

1. What role did the right of redemption play in courts of equity changing the substance of a mortgage from an actual transfer of title to the mortgagee to a mere lien on the property?
2. What abuses did the federal RESPA address?
3. What are the two documents most commonly associated with mortgage transactions?

6.1.3: Priority, Termination of the Mortgage, and Other Methods of Using Real Estate as Security

Learning Objectives

1. Understand why it is important that the mortgagee (creditor) record her interest in the debtor's real estate.
2. Know the basic rule of priority—who gets an interest in the property first in case of default—and the exceptions to the rule.
3. Recognize the three ways mortgages can be terminated: payment, assumption, and foreclosure.
4. Be familiar with other methods (besides mortgages) by which real property can be used as security for a creditor.

Priorities in Real Property Security

You may recall from Chapter 33 "Secured Transactions and Suretyship" how important it is for a creditor to perfect its secured interest in the goods put up as collateral. Absent perfection, the creditor stands a chance of losing out to another creditor who took its interest in the goods subsequent to the first creditor. The same problem is presented in real property security: the mortgagee wants to make sure it has first claim on the property in case the mortgagor (debtor) defaults.

The General Rule of Priorities

The general rule of priority is the same for real property security as for personal property security: the first in time to give notice of the secured interest is first in right. For real property, the notice is by **recording** the mortgage. Recording is the act of giving public notice of changes in interests in real estate. Recording was created by statute; it did not exist at common law. The typical recording statute calls for a transfer of title or mortgage to be placed in a particular county office, usually the auditor, recorder, or register of deeds.

A mortgage is valid between the parties whether or not it is recorded, but a mortgagee might lose to a third party—another mortgagee or a good-faith purchaser of the property—unless the mortgage is recorded.

Exceptions to the General Rule

There are exceptions to the general rule; two are taken up here.

Fixture Filing

The fixture-filing provision in Article 9 of the UCC is one exception to the general rule. As noted in Chapter 33 "Secured Transactions and Suretyship", the UCC gives priority to purchase-money security interests in fixtures if certain requirements are met.

Future Advances

A bank might make advances to the debtor after accepting the mortgage. If the future advances are obligatory, then the first-in-time rule applies. For example: Bank accepts Debtor's mortgage (and records it) and extends a line of credit on which Debtor draws, up to a certain limit. (Or, as in the construction industry, Bank might make periodic advances to the contractors as work progresses, backed by the mortgage.) Second Creditor loans Debtor money—secured by the same property—before Debtor began to draw against the first line of credit. Bank has priority: by searching the mortgage records, Second Creditor should have been on notice that the first mortgage was intended as security for the entire line of credit, although the line was doled out over time.

However, if the future advances are not obligatory, then priority is determined by notice. For example, a bank might take a mortgage as security for an original loan and for any future loans that the bank chooses to make. A later creditor can achieve priority by notifying the bank with the first mortgage that it is making an advance. Suppose Jimmy mortgages his property to a wealthy dowager, Mrs. Calabash, in return for an immediate loan of $20,000 and they agree that the mortgage will serve as security for future loans to be arranged. The mortgage is recorded. A month later, before Mrs. Calabash loans him any more money, Jimmy gives a second mortgage to Louella in return for a loan of $10,000. Louella notifies Mrs. Calabash that she is loaning Jimmy the money. A month later, Mrs. Calabash loans Jimmy another $20,000. Jimmy then defaults, and the property turns out to be worth only $40,000. Whose claims will be honored and in what order? Mrs. Calabash will collect her original $20,000, because it was recited in the mortgage and the mortgage was recorded. Louella will collect her $10,000 next, because she notified the first mortgage holder of the advance. That leaves Mrs. Calabash in third position to collect what she can of her second advance. Mrs. Calabash could have protected herself by refusing the second loan.

Termination of the Mortgage

The mortgagor’s liability can terminate in three ways: payment, assumption (with a novation), or foreclosure.

Payment

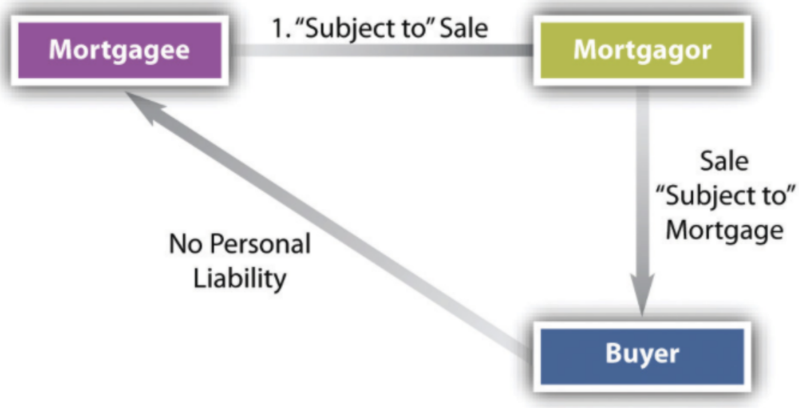
Unless they live in the home for twenty-five or thirty years, the mortgagors usually pay off the mortgage when the property is sold. Occasionally, mortgages are paid off in order to refinance. If the mortgage was taken out at a time of high interest rates and rates later drop, the homeowner might want to obtain a new mortgage at the lower rates. In many mortgages, however, this entails extra closing costs and penalties for prepaying the original mortgage. Whatever the reason, when a mortgage is paid off, the discharge should be recorded. This is accomplished by giving the mortgagor a copy of, and filing a copy of, a Satisfaction of Mortgage document. In the *Paul H. Cherry v. Chase Manhattan Mortgage Group* case (Section 34.4 "Cases"), the bank *mistakenly* filed the Satisfaction of Mortgage document, later discovered its mistake, retracted the satisfaction, accelerated the loan because the mortgagor stopped making payments (the bank, seeing no record of an outstanding mortgage, refused to accept payments), and then tried to foreclose on the mortgage, meanwhile having lost the note and mortgage besides.

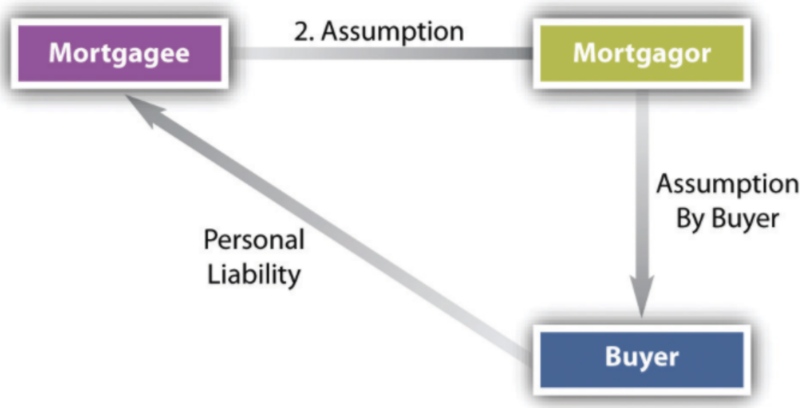
Assumption

The property can be sold without paying off the mortgage if the mortgage is assumed by the new buyer, who agrees to pay the seller’s (the original mortgagor’s) debt. This is a novation *if*, in approving the assumption, the bank releases the old mortgagor and substitutes the buyer as the new debtor.

The buyer need not assume the mortgage. If the buyer purchases the property without agreeing to be personally liable, this is a sale “subject to” the mortgage (see Figure 34.3 "“Subject to” Sales versus Assumption"). In the event of the seller’s subsequent default, the bank can foreclose the mortgage and sell the property that the buyer has purchased, but the buyer is not liable for any deficiency.

Figure 34.3 “Subject to” Sales versus Assumption





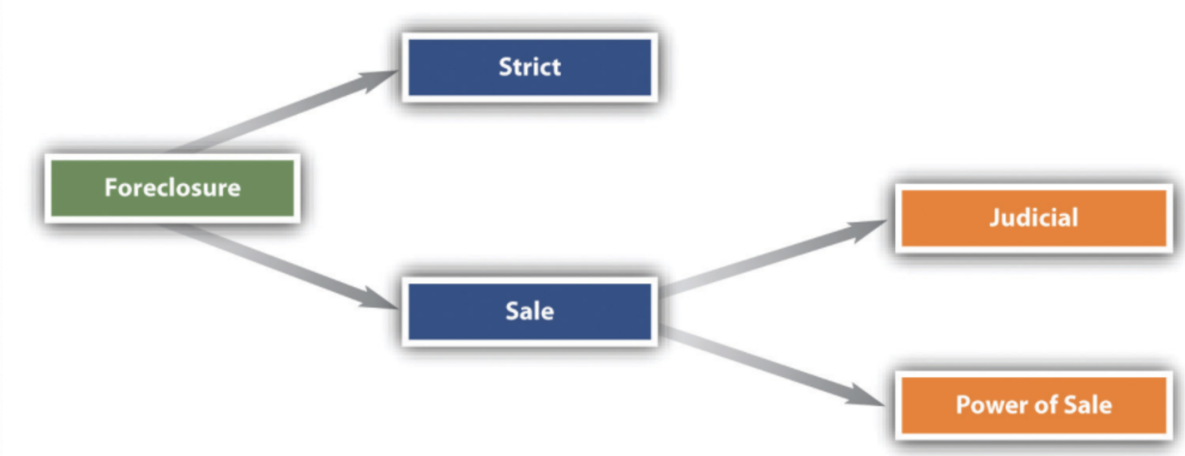
What if mortgage rates are high? Can buyers assume an existing low-rate mortgage from the seller rather than be forced to obtain a new mortgage at substantially higher rates? Banks, of course, would prefer not to allow that when interest rates are rising, so they often include in the mortgage a **due-on-sale clause**, by which the entire principal and interest become due when the property is sold, thus forcing the purchaser to get financing at the higher rates. The clause is a device for preventing subsequent purchasers from assuming loans with lower-than-market interest rates. Although many state courts at one time refused to enforce the due-on-sale clause, Congress reversed this trend when it enacted the Garn–St. Germain Depository Institutions Act in 1982.12 United States Code, Section 1701-j. The act preempts state laws and upholds the validity of due-on-sale clauses. When interest rates are low, banks have no interest in enforcing such clauses, and there are ways to work around the due-on-sale clause.

Foreclosure

The third method of terminating the mortgage is by foreclosure when a mortgagor defaults. Even after default, the mortgagor has the right to exercise his equity of redemption—that is, to redeem the property by paying the principal and interest in full. If he does not, the mortgagee may foreclose the equity of redemption. Although strict foreclosure is used occasionally, in most cases the mortgagee forecloses by one of two types of sale (see Figure 34.4 "Foreclosure").

The first type is **judicial sale**. The mortgagee seeks a court order authorizing the sale to be conducted by a public official, usually the sheriff. The mortgagor is entitled to be notified of the proceeding and to a hearing. The second type of sale is that conducted under a clause called a **power of sale**, which many lenders insist be contained in the mortgage. This clause permits the mortgagee to sell the property at public auction without first going to court—although by custom or law, the sale must be advertised, and typically a sheriff or other public official conducts the public sale or auction.

Figure 34.4 Foreclosure



Once the property has been sold, it is deeded to the new purchaser. In about half the states, the mortgagor still has the right to redeem the property by paying up within six months or a year—the statutory redemption period. Thereafter, the mortgagor has no further right to redeem. If the sale proceeds exceed the debt, the mortgagor is entitled to the excess unless he has given second and third mortgages, in which case the junior mortgagees are entitled to recover their claims before the mortgagor. If the proceeds are less than the debt, the mortgagee is entitled to recover the deficiency from the mortgagor. However, some states have statutorily abolished deficiency judgments.

Other Methods of Using Real Estate as Security

Besides the mortgage, there are other ways to use real estate as security. Here we take up two: the deed of trust and the installment or land contract.

Deed of Trust

The **deed of trust** is a device for securing a debt with real property; unlike the mortgage, it requires three parties: the borrower, the trustee, and the lender. Otherwise, it is at base identical to a mortgage. The borrower conveys the land to a third party, the trustee, to hold in trust for the lender until the borrower pays the debt. (The trustee's interest is really a kind of legal fiction: that person is expected to have no interest in the property.) The primary benefit to the deed of trust is that it simplifies the foreclosure process by containing a provision empowering the trustee to sell the property on default, thus doing away with the need for any court filings. The disinterested third party making sure things are done properly becomes the trustee, not a judge. In thirty states and the District of Columbia—more than half of US jurisdictions—the deed of trust is usually used in lieu of mortgages.The states using the deed of trust system are as follows: Alabama, Alaska, Arkansas, Arizona, California, Colorado, District of Columbia, Georgia, Hawaii, Idaho, Iowa, Michigan, Minnesota, Mississippi, Missouri, Montana, Nevada, New Hampshire, North Carolina, Oklahoma, Oregon, Rhode Island, South Dakota, Tennessee, Texas, Utah, Virginia, Washington, West Virginia, Wisconsin, and Wyoming.

But the deed of trust may have certain disadvantages as well. For example, when the debt has been fully paid, the trustee will not release the deed of trust until she sees that all notes secured by it have been marked canceled. Should the borrower have misplaced the canceled notes or failed to keep good records, he will need to procure a surety bond to protect the trustee in case of a mistake. This can be an expensive procedure. In many jurisdictions, the mortgage holder is prohibited from seeking a deficiency judgment if the holder chooses to sell the property through nonjudicial means.

Alpha Imperial Building, LLC v. Schnitzer Family Investment, LLC, Section 34.4 "Cases", discusses several issues involving deeds of trust.

Installment or Land Contract

Under the **installment contract or land contract**, the purchaser takes possession and agrees to pay the seller over a period of years. Until the final payment, title belongs to the seller. The contract will specify the type of deed to be conveyed at closing, the terms of payment, the buyer's duty to pay taxes and insure the premises, and the seller's right to accelerate on default. The buyer's particular concern in this type of sale is whether the seller in fact has title. The buyers can protect themselves by requiring proof of title and title insurance when the contract is signed. Moreover, the buyer should record the installment contract to protect against the seller's attempt to convey title to an innocent third-party purchaser while the contract is in effect.

The benefit to the land contract is that the borrower need not bank-qualify, so the pool of available buyers is larger, and buyers who have inadequate resources at the time of contracting but who have the expectation of a rising income in the future are good candidates for the land contract. Also, the seller gets all the interest paid by the buyer, instead of the bank getting it in the usual mortgage. The obvious disadvantage from the seller's point is that she will not get a big lump sum immediately: the payments trickle in over years (unless she can sell the contract to a third party, but that would be at a discount).

Key Takeaway

The general rule on priority in real property security is that the first creditor to record its interest prevails over subsequent creditors. There are some exceptions; the most familiar is that the seller of a fixture on a purchase-money security interest has priority over a previously recorded mortgagee. The mortgage will terminate by payment, assumption by a new buyer (with a novation releasing the old buyer), and foreclosure. In a judicial-sale foreclosure, a court authorizes the property's sale; in a power-of-sale foreclosure, no court approval is required. In most states, the mortgagor whose property was foreclosed is given some period of time—six months or a year—to redeem the property; otherwise, the sale is done, but the debtor may be liable for the deficiency, if any. The deed of trust avoids any judicial involvement by having the borrower convey the land to a disinterested trustee for the benefit of the lender; the trustee sells it upon default, with the proceeds (after expenses) going to the lender. Another method of real property security is a land contract: title shifts to the buyer only at the end of the term of payments.

Exercises

1. A debtor borrowed $350,000 to finance the purchase of a house, and the bank recorded its interest on July 1. On July 15, the debtor bought $10,000 worth of replacement windows from Window Co.; Window Co. recorded its purchase-money security interest that day, and the windows were installed. Four years later, the debtor, in hard financial times, declared bankruptcy. As between the bank and Windows Co., who will get paid first?
2. Under what interest rate circumstances would banks insist on a due-on-sale clause? Under what interest rate circumstance would banks not object to a new person assuming the mortgage?
3. What is the primary advantage of the deed of trust? What is the primary advantage of the land contract?
4. A debtor defaulted on her house payments. Under what circumstances might a court *not* allow the bank's foreclosure on the property?

6.2: Consumer Protection Laws

https://www.merlot.org/merlot/viewMaterial.htm?id=771655997

6.3: Fair Housing

6.3.1: Finding a Home- Inequities

Finding a place to call "home" is important. Living in a place that supports access to outdoor spaces, a feeling of security, effective schools, transportation, food and other resources and the potential for community are quality factors that affect a family's abilities to function effectively and efficiently. We might call these "livable environments".

Home ownership has been and is still the most basic and viable way to accrue wealth in the United States. Access to home ownership is important to families for both livability and financial investment purposes. Uncovering the inequities in access to home ownership is critical to understanding the well-being of families in the United States.

Power and the American Dream: Home Ownership

The government and financial organizations both hold substantial power in the United States. Together, they affect who and how homes are purchased. Although we know that race is a social construction, it is still used as an identifying feature for families, and has been used by these systems to control home purchases and to segregate living areas. We will discuss housing from the perspective of racial-ethnic groups affected by these regulations and practices.

As noted above, households that rent homes rather than buy are on the increase; more people are renting now than at any time in the last fifty years. This is not due to lack of desire to own a home; in a 2016 Pew Research Center Survey, 72% of renters said that they desire to own a home.[1] Denial rates for mortgages continue to be higher for Black and Hispanic applicants. When they are approved, they tend to have higher monthly payments, which increases the cost burden on families. This is typically due to having fewer financial resources with which to make a down payment.[2]

While it may be obvious that home ownership increases stability and enables individuals and families to accrue wealth, it is also true that home ownership has a significant effect on the life satisfaction of low-income people. Home buyers have been found to have higher levels of life satisfaction and may also have increased self-esteem and a sense of control compared to renters.[3] It is impossible to talk about lower rates of home ownership amongst minoritized groups without discussing the practices of intentional segregation and gouging enacted by the federal government, lending institutions, local governments and housing covenants enacted following the legal end of slavery in the United States.

Redlining

Figure 9.8. Segregated neighborhoods did not come about organically, but through deliberate planning of policies and practices.

Redlining is the discriminatory practice of refusing loans to creditworthy applicants in neighborhoods that banks deem undesirable or racially occupied. Although home ownership became an emblem of the American citizenship and the American dream during the 20th century, Blacks and other nationalities were specifically limited in their abilities to purchase homes. Both the federal government, which created the Home Owners' Loan Corporation in 1933 and the Federal Housing Association (FHA) in 1934, along with the real-estate industry, worked to segregate Whites from other groups in order to preserve property values.

Lending institutions and the federal government did this by creating maps in which the places where people of color and/or foreign-born lived were colored red. Then those areas were designated to be "dangerous" or "risky" in terms of loaning practices. Because families in these same groups were often denied access to the neighborhoods designated to be "good" or "the best" they were forced to take loans that required higher down payments and/or higher interest rates.

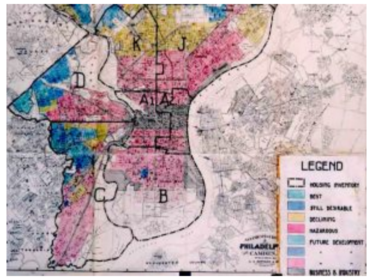


Figure 9.9. Lending institutions and the federal government created maps in which the places where people of color and/or foreign-born lived were colored red.

The Home Owners' Loan Corporation, which regulated home loans, created residential security maps divided into four different categories:

- Green: "the best" for businessmen
- Blue: "Good" for white-collar families
- Yellow: "Declining" for working-class families
- Red: "Detrimental" or "Dangerous" for foreign-born people, low-class Whites, and "negroes"

These ratings indicated to lending institutions how "risky" it was to provide loans by area. It was then less likely that loans could be secured in the red and yellow neighborhoods; interest and payments would be higher. Unscrupulous private lenders used this opportunity to create unfair practices such as unreasonably high payments with devastating consequences if one payment or partial payment was missed, such as the Black homeowner losing their home and all equity that had been earned.[4]

In 1968 these practices were outlawed by the Fair Housing Act which was part of the Civil Rights Act. The Fair Housing Act is an attempt at providing equitable housing to all. It makes discriminating against someone based on skin color, sex, religion, and disability illegal. Also banned is the practice of real estate lowballing, where banks underestimate the value of a home, in effect forcing a borrower to come up with a larger down payment to compensate for the lower loan value. The offering of higher interest rates, insurance, terms and conditions to minority loan applicants is illegal. Denying loans and services on the basis of an applicant's protected class is also illegal.

Still, much damage was done prior to its passage. For decades the federal government poured tax monies into home loans that almost exclusively favored White families. Home ownership is the most accessible way to build equity and wealth and it was denied to many minority families for decades. Once the Fair Housing Act passed, local governments, residential covenants, and deed modifications continued to discriminate well into the 2000s, and families in minoritized groups still had less success in achieving home loans.

The result of these institutionalized efforts resulted in residential segregation, the physical separation of two or more groups into different neighborhoods. Many times this is associated with race but can also be associated with income. Segregated neighborhoods did not come about organically, but through deliberate planning of policies and practices that have systematically denied equal opportunity to minority populations. Segregation has been present in the United States for many years and while now it is illegal to do so it has been institutionalized in neighborhood patterns. From information collected in the 2010 census we see that a typical White person lives in a neighborhood that is 75 percent White and 8 percent African American, while a typical African American person lives in a neighborhood that is 35 percent White and 45 percent African American.[5]

Play this six-minute video for a summary of housing segregation in the U.S.

As a recipient of federal funding the city of Portland is required to abide by the rules of the Fair Housing Act, but like many cities in the United States, Portland has a history of redlining and other discriminatory practices. In order to better understand Portland's practices, learning about Oregon's history is useful. The Oregon Encyclopedia contains a summary of Black exclusion laws in Oregon; these laws were put in place when the state was founded in order to discourage people of color from settling in Oregon.

Between 1900 and 1930 Portland began zoning practices, the act of separating land based on what it will be used for, such as residential, industrial and commercial. In 1924, Portland approved its first zoning code, Zone 1–SingleFamily, Zone 2–Multi-Family, Zone 3–Business-Manufacturing, and Zone 4–Unrestricted. Most residential areas were designated Zone 2, except for 15 neighborhoods considered the "highest quality" that were designated Zone One.[6]

Table 9.1. Some of the 15 neighborhoods that were designated Zone One
Data from Mapping Inequality: Redlining in New Deal America[7]

Neighborhood	**Environment**	**Occupants**	**Building Zone**
Alameda	Convenience to schools, churches, shopping centers and transportation. Fully improved streets and sufficiency of utilities and conveniences.	Foreign born: Few to none Black: Few to none	5-7 rooms mansions
Arlington-Heights	Schools, churches, transportation, recreational and trading areas reasonably available.	Foreign born: Few to none Black: Few to none	7-10 rooms mansions
Eastmoreland	Convenience to grade schools, churches, transportation, recreational and trading centers. Presence of all utilities and conveniences.	Foreign born: Few to none Black: Few to none	5-7 rooms houses
Abernathy	A sheltered and secluded neighborhood of great natural appeal. Schools, churches and trading centers reasonably available.	Foreign born: Few to none Black: Few to none	Mansions and Farm houses

Figure 9.10. Portland City Council's rezoning in the 1930s-40s was used as a tool to further reinforce racial segregation.

Between the 1930s and '40s, Portland City Council rezoned large areas of multi-family zoning to single-family zoning. This was done to protect real estate values of single-family homes and make it easier for homeowners to obtain Federal Housing Administration loans in those areas. During this time roughly 14.25 square miles was rezoned from multi-family to single-family housing. This was used as a tool to further reinforce racial segregation by restricting federal and private lending. It made it really difficult, sometimes even impossible, for residents living in "redlined" neighborhoods to receive residential and commercial loans.

Neighborhood planning from 1960 to 1970 included the ideas of residents instead of only the real estate industry. In 1973 a Senate bill was passed which eventually led to the creation of the state's land use planning program. This program required cities to have a 20 year plan to accommodate growth. There was a strong interest from Portland residents in housing policies which would distribute low-income housing throughout the entire Portland area. Although many strong neighborhood associations formed, power continued to reside with the more affluent, mostly White neighborhoods and the 1980 Comprehensive Plan favored expanding and protecting single-family zones.

In 1994 the Community and Neighborhood Planning Program was adopted to address issues that sprouted after the Comprehensive plan. With this they did the opposite of what had been done for many years in the past, they expanded the multi-family zones. Central City, Albina, Outer Southeast, Southwest, Inner Southeast, Peninsula area, Northwest Portland, and Northeast Portland were identified as focus neighborhoods. The program involved staggering the plans and completing them periodically and systematically. The program sought to expand and intermix multi-family housing, but was met with resistance and controversy that led to uneven results.

VisionPDX came forward in 2005 as an effort to engage community members, especially those from underrepresented communities, in developing a shared vision of Portland. They wanted to focus on providing a space for other folks who previously had no say in the future of Portland to now have the opportunity to do so. The new way of thinking about equity in planning led to the development of new goals and policies in the most updated version of the Comprehensive Plan in 2016.

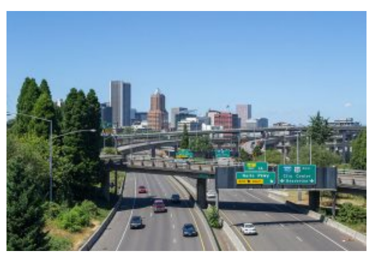


Figure 9.11. Portland has failed to create more mixed neighborhoods.

Today, single-family zoning accounts for approximately 74% of the total land area for housing in Portland. Since the 1920s, very little change has occurred with the original 15 single-family-zones. These neighborhoods have remained stable and demographically homogeneous with low levels of vulnerability to displacement and tend to be the zones for White households. Similarly, the zones originally designated as less desirable are homes for many families from marginalized groups, and contain fewer resources and amenities desired by families.

So what can we learn from this? Portland's land use planning history, intentional or not, has resulted in discrimination and segregation. These planning practices and the decisions made have predominantly benefited and privileged White homeowners while communities of color have been burdened, excluded, and displaced. Decision-making for collective improvement is often complicated when it affects individual outcomes. The same people who may believe in equity may also resist change when they perceive that it affects them individually. This is called the "Not in my Backyard" (NIMBY) phenomenon and likely affected Portland's failure to move toward creating more mixed neighborhoods. Portland and all cities can do better. Fair housing regulations can be achieved by understanding the history and then creating policy change which will lead to more equitable outcomes.

Bluelining

Blue Lining is a current banking and lending issue as a result of climate change. Real estate that is considered high risk due to low elevation may not qualify for loans. With the current rate of ocean warming, sea levels are expected to rise and warm water generate storms that displace millions of people in the US and worldwide. Flooding could displace 126 million people, or 40% of the US population, by 2021. Climigration is the act of people relocating to areas less devastated by flooding, storms, drought, lack of clean water or economic disaster due to the forces of climate change.

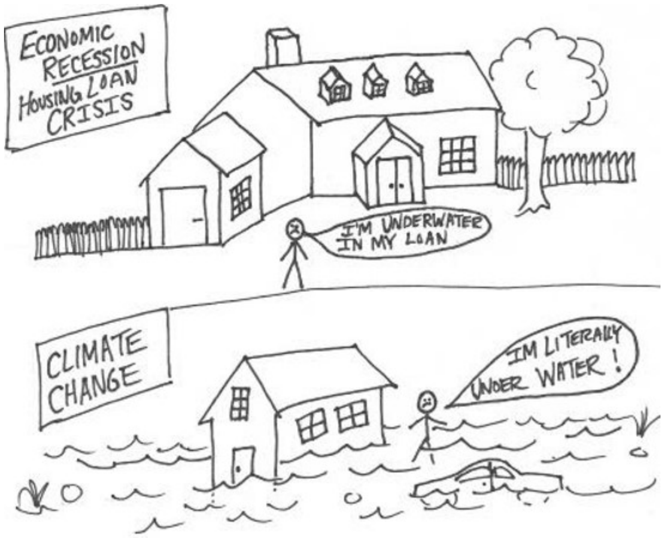


Figure 9.12. Flooding could displace 126 million people, or 40% of the US population, by 2021.

Many American families relocate as jobs disappear or land becomes flooded or arid. In response to immediate disaster, many families move to live with relatives or friends. Some families have nowhere to turn. “In January 2018, 3,900 people were staying in sheltered locations specifically for people displaced by presidentially declared national disasters. People in these locations were displaced from areas struck by Hurricanes Harvey, Irma, Maria, and Nate; western wildfires; and other storms and events.”[8]

Climate change has also changed the economic desirability of entire regions, creating a new divide between the poor and the privileged. In the Southern California region of Los Angeles, shade has become an increasingly precious commodity, giving respite from the searing heat that bakes the community during longer, hotter warm seasons.

Figure 9.13. People who live in less desirable neighborhoods and use public transportation suffer the highest heat index

In the 1950’s, the lure of the California sunshine attracted settlers from across the US to propel LA into a major metropolis. Now, shade provided by large tree-lined neighborhoods and areas of upscale urban design are enjoyed by the affluent but absent for those who need it the most. There is a public health benefit of trees, with studies showing benefits like lower asthma and improved mental health of those exposed to greenspaces.

People who live in less desirable neighborhoods and use public transportation, wait at the more than 750 bus stops where police ordered the removal or minimization of trees in an earlier era.

They spend more time outdoors traveling to jobs and needed resources and suffer the highest heat index.[9]

Figure 9.14. The accessibility of greenspaces is proving to have a direct impact on health.

The accessibility of greenspaces is proving to have a direct impact on health. This will be discussed more thoroughly in the Food, Water, and Air chapter.

Reservation Land and Home Ownership

There is another group of families unable to build capital via home ownership: Native American Indians who reside on reservations. When the United States government sequestered Native Americans to reservation lands, it also retained ownership of that land, creating a “ward: guardian relationship” between the government and the Indian Nations, as characterized by Supreme Court Chief Justice John Marshall in 1831.[10] The government holds reservation lands “in trust” for the tribe nations.

While there is much public debate about other aspects of tribal rights such as casinos, and the effects of using Native or Indian images and names for sport teams, there is little discussion about the ways the U.S. government has limited the abilities of Native Americans to own property within the communities where they live.[11] This most basic way of building equity in a country that values individualism and capitalism has been restricted for the people who have inhabited it the longest. Native Americans have the highest poverty rate of any racial-ethnic group (28% in 2015) and it is likely that the control the government has exerted over their living conditions contributes to this circumstance.[12]

Fair Housing Act

What legally constitutes as a family has influenced a multitude of the availability of resources and within that bubble of needs, housing is one of them. Housing distribution appears to have always been a necessity that was, historically discriminatory towards minority groups regarding social identities such as; people of color, sexual orientation, gender and sex, country of origin and disability. The Fair Housing Act passed in 1968 and originally banned the sale and rental of housing (and other housing practices) indicating preference or discrimination based on race, color, religion or national origin. In 1974 it was amended to include sex, and in 1988 people with disabilities and people with children. To date, it does not include gender identity or sexual orientation. Only a handful of states have it illegal to discriminate based on sexual orientation and gender identity and that creates a challenge for LGBTQ couples.

Socially constructed ideas of “normal” or “acceptable” identities are barriers to many people in accessing shelter, housing and many other services. Specifically in the case of homeless shelters, transgender women may be refused admittance by the women’s shelter and at risk of violence at the men’s shelter.[13] More progress must be made to provide security for all, regardless of identity.

Another barrier some women with children face in seeking shelter from domestic violence is the shelter rules themselves. Early curfews and overly strict rules can compromise the empowerment of residents. Many women fleeing domestic violence find themselves facing punitive and inflexible environments that mimic the patterns of control they are trying to escape. The Washington State Coalition Against Domestic Violence created a resource called Building Dignity, which “explores design strategies for domestic violence emergency housing. Thoughtful design dignifies survivors by meeting their needs for self-determination, security and connection. The idea here is to reflect a commitment to creating welcoming and accessible environments that help to empower survivors and their children.”[14]

Stigma

It is important to note the critical nature of stigma. When a characteristic or behavior is devalued in society, whether it be by legal status or by social construction of difference, individuals and families have a more difficult time accessing needs of survival, including housing. When negative labels are placed on people the consequences that the labels create can have lasting effects. Being called “homeless,” “drug-addict,” “unemployable,” can in fact cause the persons being called these things to self fulfill the negative labels that society has placed on them. Because people of color, the LGBTQ+ kinship groups, immigrant families and others have been stigmatized they are more likely to then be given other negative behavior-based labels. When someone feels as though they are seen as nothing, they can in turn feel as though they have nothing to offer. The Labeling Theory is a good example of how society can perpetuate things such as homelessness and criminality even though they might not necessarily realize that they are doing so. The Labeling Theory is a "sociological hypothesis that claims that by describing an individual in terms of particular behavioral characteristics may have a significant effect on his or her behavior, as a form of self-fulfilling prophecy."[15]

Families who Rent

Inherent with the owner role comes power. Decision-making about rental rates, whom to rent to, and upkeep of the home resides with the owner. People who rent, while receiving variable rights and responsibilities dependent on the municipality in which they reside, have less control over their living space than do owners. While many owner-renter relationships are mutually beneficial, renters who live at or below the poverty line have fewer choices and are more likely to encounter landlords who are inattentive or worse.

Slumlords

According to Wikipedia, a slumlord is: "a slang term for a landlord, generally an absentee landlord with more than one property, who attempts to maximize profit by minimizing spending on property maintenance, often in deteriorating neighborhoods."[16]

Typically these homes are found in low-income areas. People and families who cannot rent anywhere else utilize this type of housing. Usually because the rent is cheap and there are no background checks. Families who have had previous rental issues (evictions, late rent, etc.) frequently get sucked into this housing option. Also persons who have criminal records and have no other options rent from these types of owners.

Figure 9.15. Homes owned by "slum lords" are typically in low-income areas.

Section 8 Housing

The housing choice voucher program, more commonly known as Section 8 housing is the federal government's program for assisting low-income families, the elderly, and the disabled to afford housing. An important thing to notice is how since housing assistance is provided on behalf of the family or individual, participants themselves are able to find their own housing.

Housing choice vouchers are administered locally by public housing agencies (PHAs). The PHAs receive federal funds from the U.S. Department of Housing and Urban Development (HUD) to administer the voucher program. A housing subsidy is paid to the landlord directly by the PHA on behalf of the participating family. The family then pays the difference between the actual rent charged by the landlord and the amount subsidized by the program. Sometimes, a family could even use its voucher to purchase a home with a PHA's authorization.[17]

Qualifying for Section 8 housing is not a guarantee of moving into affordable housing. In 2020 the median wait time for people who have applied for a housing voucher in the United States is 1.5 years, with some waits as long as seven years. Currently in Oregon there are thirteen open waiting lists and at least seven counties where families cannot even get on a waiting list.[18]

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6.3.2: Movement toward Equity

Understanding and acknowledging past injustices is the first step toward making homes equitably available to all families. Efforts to make changes come from multiple directions. There are legislative changes (some which have passed and some that are proposed), and non-profit agencies and advocacy groups that work both legislative and with direct action. In addition, there are grassroots efforts to change neighborhood dynamics and to add resources.

Updating the Fair Housing Act

Housing distribution was historically discriminatory towards minority groups regarding social identities such as people of color, sexual orientation, gender and sex, country of origin and disability. The Fair Housing Act passed in 1968 and banned sale, rental and other housing practices that indicated preference or discrimination based on race, color, relgion or national origin. In 1974 it was amended to include sex, and in 1988 to include people with disabilities and people with children. While in 2016, a rule by the Housing and Urban Development Department (HUD) insured equal access to Community Planning and Development programs regardless of sexual orientation, gender identity or marriage status, non-conforming gender individuals may find it difficult to access services as this rule applies to one specific program (and not to other public or private programs).[1] To date, the Fair Housing Act does not include gender identity or sexual orientation. Only a handful of states have it illegal to discriminate based on sexual orientation and gender identity and that creates a challenge for LGBTQ+ families and couples.[2]

Figure 9.16 Many years of social activism, including protests, contributed to the creation and passage of the Fair Housing Act.

The 2019 Equality Act is an attempt to make all Americans equal. The Equality Act is a 2019 bill passed by the US House of Representatives that would amend the Civil Rights Act to "prohibit discrimination on the basis of the sex, sexual orientation, gender identity, or pregnancy, childbirth, or a related medical condition of an individual, as well as because of sex-based stereotypes." This Act was sent to the Senate in May 2019, but has not been taken up for consideration at this time (August 2020). [3]

Addressing Homelessness: Housing First

People who are homeless (aka "housing bereaved") can experience an overlap of social problems, such as poverty, untreated mental illness, unemployment, and/or addictions. Traditionally programs attempt to help people become "ready for housing" via support and criteria that may require multiple moves. For example the person must become sober or employed first. A relatively new and innovative approach, "Housing First" sprung from grassroots efforts as early as 1988 in California and 1992 in New York. Simply put, the idea is that if people have stable housing, solving other problems becomes more likely. Having a secure home, consistent access to schooling, transportation and support services means that people can be more successful in addressing overlapping issues such as mental health, addiction, and seeking employment.

Housing First: National Alliance to End Homelessness is a non-profit organization that exemplifies the approach to end homelessness. The United States Interagency Council on Homelessness has endorsed the Housing First approach. HUD estimates that homelessness costs the government between $30,000 and $60,000 per person annually, due to emergency room visits and jail time. A less expensive solution is to actually provide people with housing.

Various communities have adopted the Housing First approach and it looks different depending on the resources and principles of each location. Utah's Housing First approach is a model for how these services can be made available. Through the collaboration of many local organizations and donations from local churches, real permanent semi-communal housing is provided along with services such as counseling. A true success story, "Grace Mary Manor in Salt Lake City is a permanent affordable housing facility for 84 chronically homeless individuals with a disabling condition." (Clifford, NPR, 12/2015) Through programs like this, Utah was able to decrease their homeless population by 91%. [4]

At the time of this writing (July 2020) the state of Oregon hosts a web page dedicated to Permanent Supportive/Supported Housing Resources which contains some of the federal government's resources about Housing First. It is unclear how the COVID-19 pandemic will affect the future of this program. In addition, JOIN was founded in Portland in 1992 and reports that they supported 1,377 people leaving the street for permanent and stable housing in 2018. One year later, 83% of those families remain stable.[5]

Creating Standards

The United States Interagency Council on Homelessness has determined criteria and benchmarks for communities to achieve the goal of ending chronic homelessness. Standards are important because they help us identify what we are working toward. These criteria are summarized as follows:

1. The community has identified and provided outreach to all individuals experiencing or at risk for chronic homelessness and prevents chronic homelessness whenever possible.
2. The community provides access to shelter or other temporary accommodations immediately to any person experiencing unsheltered chronic homelessness who wants it.
3. The community has implemented a community-wide Housing First orientation and response that also considers the preferences of the individuals being served.
4. The community assists individuals experiencing chronic homelessness to move swiftly into permanent housing with the appropriate level of supportive services and effectively prioritizes people for permanent supportive housing.
5. The community has resources, plans, and system capacity in place to prevent chronic homelessness from occurring and to ensure that individuals who experienced chronic homelessness do not fall into homelessness again or, if they do, are quickly reconnected to permanent housing.

These goals are considered met when the benchmark of maintaining these criteria has met for 90 days. Though likely not achievable, the goal of zero homeless individuals in a community is aspirational.[6]

Changing Opportunities

We've discussed at length redlining, and the continuing effects on people of color. How can the effects of so many years of institutionalized discrimination be undone? Analysis and action can contribute to change. Communities across the United States have been analyzed by The Opportunity Atlas, which identifies neighborhoods from which children are most likely to rise out of poverty. (Click on the link to assess your own community from a variety of social characteristics, including race, sex, and income). [7]

The Massachusetts Institute of Technology (MIT) Sloan School of Management partnered with the Seattle Public Housing Authority and King County (WA) Public Housing Authority and used The Opportunity Atlas to create a pilot program that offered families using housing vouchers to move into "high opportunity neighborhoods" as defined by the Atlas. Research shows that each year spent in a high opportunity neighborhood increases the likelihood of children going to college and and total lifetime earnings by at least $200,000.[8]

In this study, the Creating Moves to Opportunity (CMTO) project, families received additional basic services such as education on the location of opportunity neighborhoods, personalized rental application coaching, housing search assistance, and financial assistance. Fifty-four percent of the families receiving this assistance chose to move to opportunity neighborhoods compared to approximately 14 percent of families who received standard services. This demonstrates that families using housing vouchers are not choosing lower opportunity neighborhoods because of preference; when given education, means, and the choice to move to higher opportunity neighborhoods they are more likely to do so. This still in progress project offers hope that there are ways that federal housing voucher programs can change the course of intergenerational poverty via investments in families who use vouchers.[9] In 2019 the U.S. Housing and Urban Development Department (HUD) funded a larger version of this project.[10]

Community Efforts

Individuals and communities are taking initiative to improve their neighborhoods aesthetically and with increasing resources that benefit families, such as informal libraries, greenspaces, and art houses.

Figure 9.17. Theaster Gates organized multiple grassroots efforts that have used culture to transform the Greater Grand Crossing neighborhood in Chicago.

For example Theaster Gates, a University of Chicago professor who is also a potter and social activist, started by drawing attention to one run-down home that he refurbished, and gradually organized multiple grassroots efforts that have used culture to transform the Greater Grand Crossing neighborhood in Chicago.[11]

Gates founded the Rebuild Foundation in 2010, which is a non-profit organization that encompasses multiple neighborhood improvement projects. To read more about his community work, visit the “Projects” section of his website.

A TED element has been excluded from this version of the text. You can view it online here: https://openoregon.pressbooks.pub/families/?p=125

Another example combines an international organization, Firmeza Foundation based in the Netherlands works with local neighborhoods to create community artwork. Artists Jeroen Koolhaas and Dre Urhahn (aka Haas and and Hahn) work on the designs with community members, then hire and train local residents to complete the painting. Dre Urhahn describes the impact of the attention and love that community members pour into their neighborhoods as well as the resulting beauty as transformational aspects of the projects.[12] Two well known projects are the favela paintings in Rio de Janeiro, Brazil and Northern Philadelphia in the United States. To learn more about how their work is funded and organized, listen to their TED TALK here.

A TED element has been excluded from this version of the text. You can view it online here: https://openoregon.pressbooks.pub/families/?p=125

Conclusion: An Existence of Human Dignity

In prior chapters we have discussed models related to what human beings need. We shared this graphic that shows two versions of how needs are met.

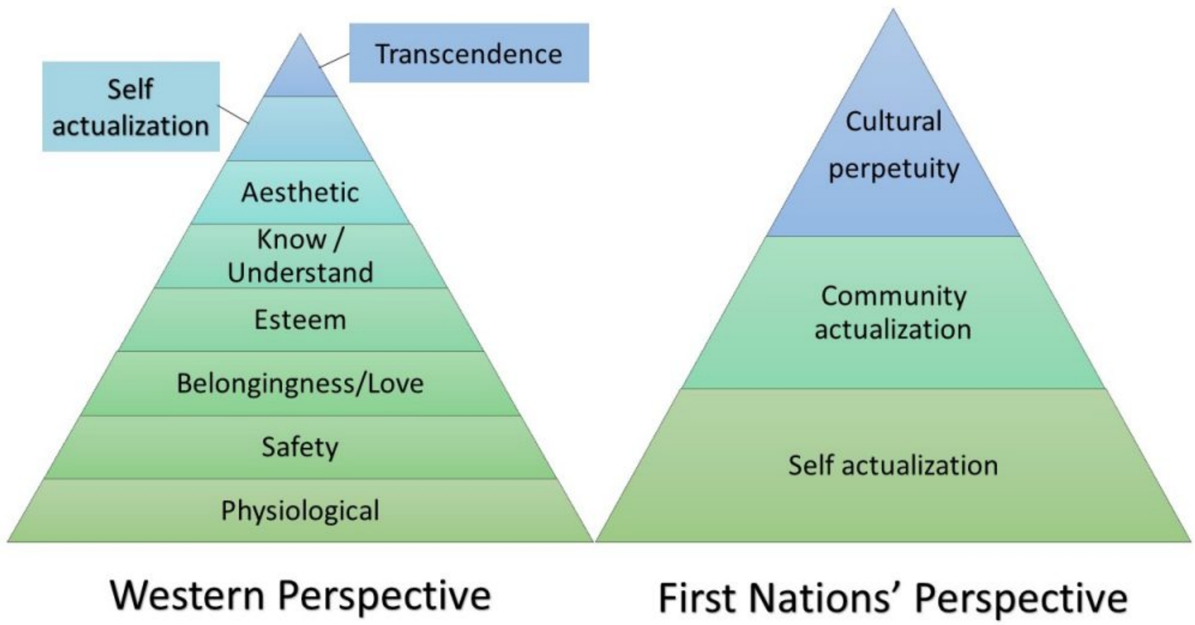

Figure 9.18. Maslow's hierarchy of needs compared to the First Nations' perspective. Maslow's scope of analysis is individual rights/privilege in one lifetime. The First Nations have an expansive concept of time and multiple dimensions of reality.

The models differ in perspective but they both emphasize the importance of basic needs, of which shelter is one. Maslow's model on the left places shelter as the foundation of the hierarchy of needs, meaning that it must be met first in order for other needs to be achieved. In the First Nations' Perspective on the right, the well-being of the community is prioritized; well-being includes basic needs for all being met.

The United Nations, a 193 nation member group founded in 1945, summarizes its mission as: Peace, Dignity and Equality on a Healthy Planet created a Universal Declaration of Human Rights in 1948 which includes

"Everyone who works has the right to just and favorable remuneration ensuring for himself and his family an existence worthy of human dignity, and supplemented, if necessary, by other means of social protection."

–Universal Declaration of Human Rights, United Nations. 1948. Article 23[13]

There is broad agreement that secure housing is a critical need for families to survive and thrive. While institutional biases that contribute to inequity and lack of secure housing for many families in the U.S. have decreased, they have not been completely eradicated. Nor have the effects of the prior centuries of discrimination been undone. We must continue to work to understand the past and the present in order to impact the future.

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Figure 9.17. "Theaster Gates" by Locust Projects. Public domain.

"How to revive a neighborhood: with imagination, beauty, and art" by Theaster Gates/TED Talks. License terms: CC BY-NC-ND 4.0.

“How painting can transform communities” by Jeroen Koolhaas and Dre Urhahn/TED Talks. License terms: CC BY-NC-ND 4.0.

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Figure 9.18. “Maslow’s hierarchy of needs compared to the First Nations’ perspective”. License: CC BY 4.0. Based on research from Rethinking Learning by Barbara Bray.

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6.3.3: Video

https://youtu.be/O5FBJyqfoLM

6.3.4: Merlot Module on Fair Housing

https://lawshelf.com/videocoursescontentview/fair-housing-act

6.4: Mechanics Liens

6.4.1: Nonconsensual Lien

Learning Objectives

1. Understand the nonconsensual liens issued by courts—attachment liens and judgment liens—and how they are created.
2. Recognize other types of nonconsensual liens: mechanic's lien, possessory lien, and tax lien.

The security arrangements discussed so far—security interests, suretyship, mortgages—are all obtained by the creditor with the debtor's consent. A creditor may obtain certain liens without the debtor's consent.

Court-Decreed Liens

Some nonconsensual liens are issued by courts.

Attachment Lien

An **attachment lien** is ordered against a person's property—real or personal—to prevent him from disposing of it during a lawsuit. To obtain an attachment lien, the plaintiff must show that the defendant likely will dispose of or hide his property; if the court agrees with the plaintiff, she must post a bond and the court will issue a writ of attachment to the sheriff, directing the sheriff to seize the property. Attachments of real property should be recorded. Should the plaintiff win her suit, the court issues a writ of execution, directing the sheriff to sell the property to satisfy the judgment.

Judgment Lien

A **judgment lien** may be issued when a plaintiff wins a judgment in court if an attachment lien has not already been issued. Like the attachment lien, it provides a method by which the defendant's property may be seized and sold.

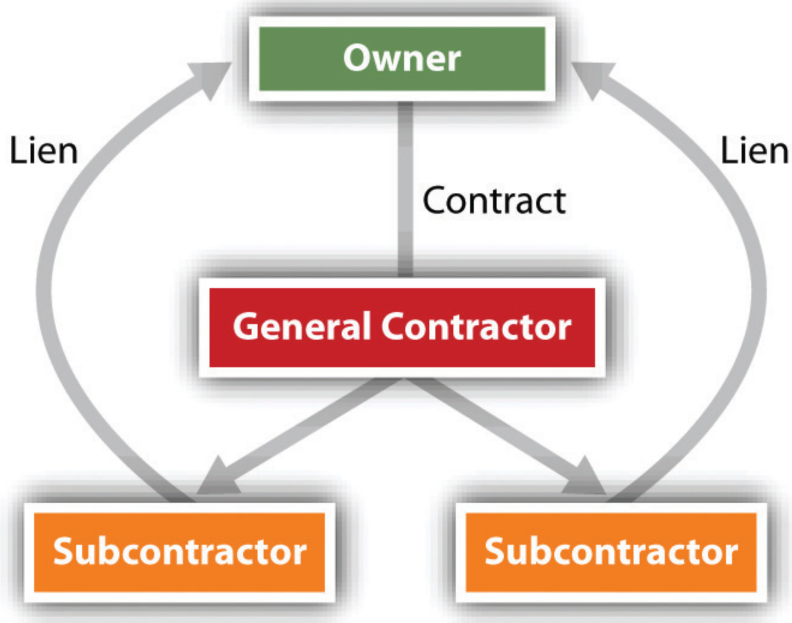
Mechanic's Lien

Overview

The most common nonconsensual lien on real estate is the **mechanic's lien**. A mechanic's lien can be obtained by one who furnishes labor, services, or materials to improve real estate: this is statutory, and the statute must be carefully followed. The "mechanic" here is one who works with his or her hands, not specifically one who works on machines. An automobile mechanic could not obtain a mechanic's lien on a customer's house to secure payment of work he did on her car. (The lien to which the automobile mechanic is entitled is a "possessory lien" or "artisan's lien," considered in Section 34.3.3 "Possessory Lien") To qualify for a mechanic's lien, the claimant must file a sworn statement describing the work done, the contract made, or the materials furnished that permanently improved the real estate.

A particularly difficult problem crops up when the owner has paid the contractor, who in turn fails to pay his subcontractors. In many states, the subcontractors can file a lien on the owner's property, thus forcing the owner to pay them (see Figure 34.5 "Subcontractors' Lien")—and maybe twice. To protect themselves, owners can demand a sworn statement from general contractors listing the subcontractors used on the job, and from them, owners can obtain a waiver of lien rights before paying the general contractor.

Figure 34.5 Subcontractors' Lien



Procedure for Obtaining a Mechanic's Lien

Anyone claiming a lien against real estate must record a lien statement stating the amount due and the nature of the improvement. The lienor has a specified period of time (e.g., ninety days) to file from the time the work is finished. Recording as such does not give the lienor an automatic right to the property if the debt remains unpaid. All states specify a limited period of time, usually one year, within which the claimant must file suit to enforce the lien. Only if the court decides the lien is valid may the property be sold to satisfy the debt. Difficult questions sometimes arise when a lien is filed against a landlord's property as a result of improvements and services provided to a tenant, as discussed in *F & D Elec. Contractors, Inc. v. Powder Coaters, Inc.*, Section 34.4 "Cases".

Mechanic's Liens Priorities

A mechanic's lien represents a special risk to the purchaser of real estate or to lenders who wish to take a mortgage. In most states, the mechanic's lien is given priority not from the date when the lien is recorded but from an earlier date—either the date the contractor was hired or the date construction began. Thus a purchaser or lender might lose priority to a creditor with a mechanic's lien who filed after the sale or mortgage. A practical solution to this problem is to hold back part of the funds (purchase price or loan) or place them in escrow until the period for recording liens has expired.

Possessory Lien

The most common nonconsensual lien on personal property (not real estate) is the **possessory lien**. This is the right to continue to keep the goods on which work has been performed or for which materials have been supplied until the owner pays for the labor or materials. The possessory lien arises both under common law and under a variety of statutes. Because it is nonconsensual, the possessory lien is not covered by Article 9 of the UCC, which is restricted to consensual security interests. Nor is it governed by the law of mechanic's liens, which are nonpossessory and relate only to work done to improve real property.

The common-law rule is that anyone who, under an express or implied contract, adds value to another's chattel (personal property) by labor, skill, or materials has a possessory lien for the value of the services. Moreover, the lienholder may keep the chattel until her services are paid. For example, the dry cleaner shop is not going to release the wool jacket that you took in for cleaning unless you make satisfactory arrangements to pay for it, and the chain saw store won't let you take the chain saw that you brought in for a tune-up until you pay for the labor and materials for the tune-up.

Tax Lien

An important statutory lien is the federal **tax lien**. Once the government assesses a tax, the amount due constitutes a lien on the owner's property, whether real or personal. Until it is filed in the appropriate state office, others take priority, including purchasers, mechanics' lienors, judgment lien creditors, and holders of security interests. But once filed, the tax lien takes priority over all subsequently arising liens. Federal law exempts some property from the tax lien; for example, unemployment benefits, books and tools of a trade, workers' compensation, judgments for support of minor children, minimum amounts of wages and salary, personal effects, furniture, fuel, and provisions are exempt.

Local governments also can assess liens against real estate for failure to pay real estate taxes. After some period of time, the real estate may be sold to satisfy the tax amounts owing.

Key Takeaway

There are four types of nonconsensual liens: (1) court-decreed liens are attachment liens, which prevent a person from disposing of assets pending a lawsuit, and judgment liens, which allow the prevailing party in a lawsuit to take property belonging to the debtor to satisfy the judgment; (2) mechanics' liens are authorized by statute, giving a person who has provided labor or material to a landowner the right to sell the property to get paid; (3) possessory liens on personal property allow one in possession of goods to keep them to satisfy a claim for work done or storage of them; and (4) tax liens are enforced by the government to satisfy outstanding tax liabilities and may be assessed against real or personal property.

Exercises

1. The mortgagor's interests are protected in a judicial foreclosure by a court's oversight of the process; how is the mortgagor's interest protected when a deed of trust is used?
2. Why is the deed of trust becoming increasingly popular?
3. What is the rationale for the common-law possessory lien?
4. Mike Mechanic repaired Alice Ace's automobile in his shop, but Alice didn't have enough money to pay for the repairs. May Mike have a mechanic's lien on the car? A possessory lien?
5. Why does federal law exempt unemployment benefits, books and tools of a trade, workers' compensation, minimum amounts of wages and salary, personal effects, furniture, fuel, and other such items from the sweep of a tax lien?

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Glossary

Sample Word 1 | Sample Definition 1

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