

RE 320: MY RE FINANCE TEXTBOOK



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RE 320: My RE Finance Textbook (Shull)

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TABLE OF CONTENTS

Licensing

1: Functions of Money and Money Supply

- 1.1: The Functions of Money
- 1.2: Financial Institutions
- 1.3: The Federal Reserve System

2: Primary Market

- 2.1: Explain Primary Market
- 2.2: What is a mortgage broker and when do you want to use one anyway?

3: Loan Programs

- 3.1: VA Home Loans
- 3.2: Calhfa
- 3.3: Understanding the Different Types of Loans
- 3.4: Types of Conventional Loans

4: Loan Products

4.1: Personal Finances

- 4.1.1: Financial Planning
- 4.1.2: Time Is Money
- 4.1.3: The Financial Planning Process
- 4.1.4: A House Is Not a Piggy Bank- A Few Lessons from the Subprime Crisis
- 4.1.5: Cases and Problems

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

- 4.3: Hard Money Loans
- 4.4: Second Trust Deeds
- 4.5: Wrap-around/ Land Contracts, Construction, As-is
- 4.6: Financing Small Investment Properties
- 4.7: Shared Equity
- 4.8: Residential Income Properties
- 4.9: Pricing Loans- Yields, Buy downs

5: Loan Qualification and Processing

- 5.1: Qualifying the Property
- 5.2: Qualifying the Buyer
- 5.3: Difference between Prequal and Preapproval
- 5.4: (Processing, Servicing, Closing the Loan) Items Included
- 5.5: RE Math

6: Ethics and Consumer Protection

6.1: Ethics- Fair Credit Reporting (Foreclosure)

6.1.1: Chapter Introduction

6.1.2: Uses, History, and Creation of Mortgages

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

6.2: Consumer Protection Laws

6.3: Fair Housing

6.3.1: Finding a Home- Inequities

6.3.2: Movement toward Equity

6.3.3: Video

6.3.4: Merlot Module on Fair Housing

6.4: Mechanics Liens

6.4.1: Nonconsensual Lien

Index

Glossary

Detailed Licensing

Licensing

A detailed breakdown of this resource's licensing can be found in **Back Matter/Detailed Licensing**.

1: FUNCTIONS OF MONEY AND MONEY SUPPLY

1.1: The Functions of Money

1.2: Financial Institutions

1.3: The Federal Reserve System

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.)

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1.2: Financial Institutions

Learning Objectives

- Distinguish among different types of financial institutions.
- 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 summarizes the distribution of assets among the nation's depository institutions.

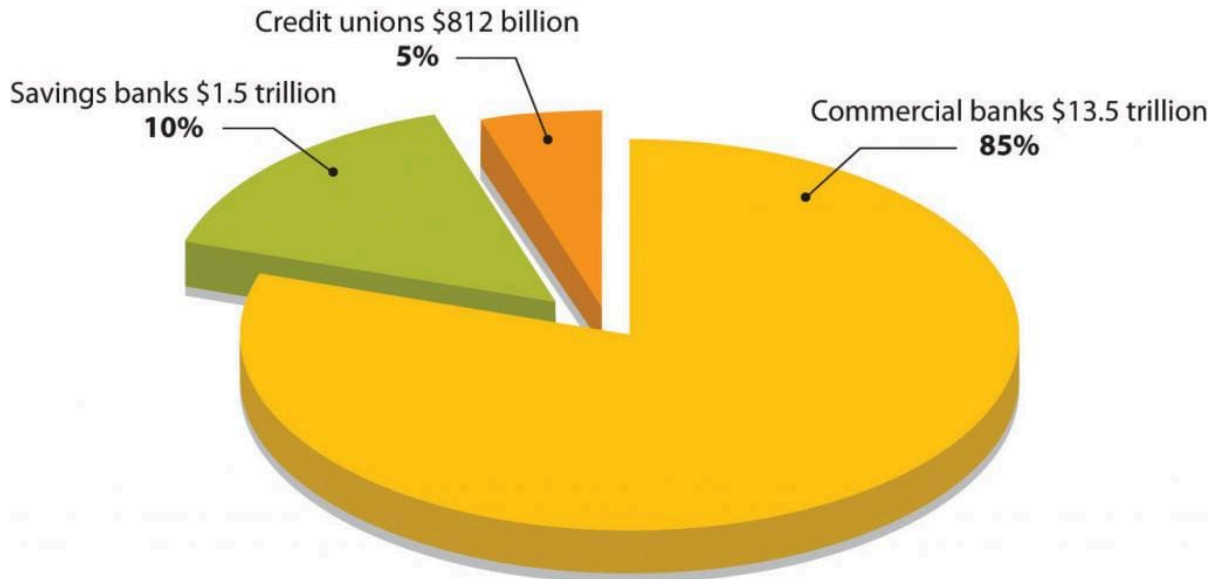


Figure 13.3 Where Our Money Is Deposited

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 as Citigroup, 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.

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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 – [Federal Reserve Building – eagle](#) – CC BY-SA 2.0.)

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2: PRIMARY MARKET

2.1: Explain Primary Market

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

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/>

3: LOAN PROGRAMS

3.1: VA Home Loans

3.2: Calhfa

3.3: Understanding the Different Types of Loans

3.4: Types of Conventional Loans

3.1: VA Home Loans

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

YouTube Video

This interactive element is not available in this format. Visit the link or scan the QR code to access it online.

[View this YouTube Video online](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/>

4: LOAN PRODUCTS

4.1: Personal Finances

4.1.1: Financial Planning

4.1.2: Time Is Money

4.1.3: The Financial Planning Process

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

4.1.5: Cases and Problems

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

4.3: Hard Money Loans

4.4: Second Trust Deeds

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

4.6: Financing Small Investment Properties

4.7: Shared Equity

4.8: Residential Income Properties

4.9: Pricing Loans- Yields, Buy downs

4.1: PERSONAL FINANCES

4.1.1: Financial Planning

4.1.2: Time Is Money

4.1.3: The Financial Planning Process

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

4.1.5: Cases and Problems

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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:

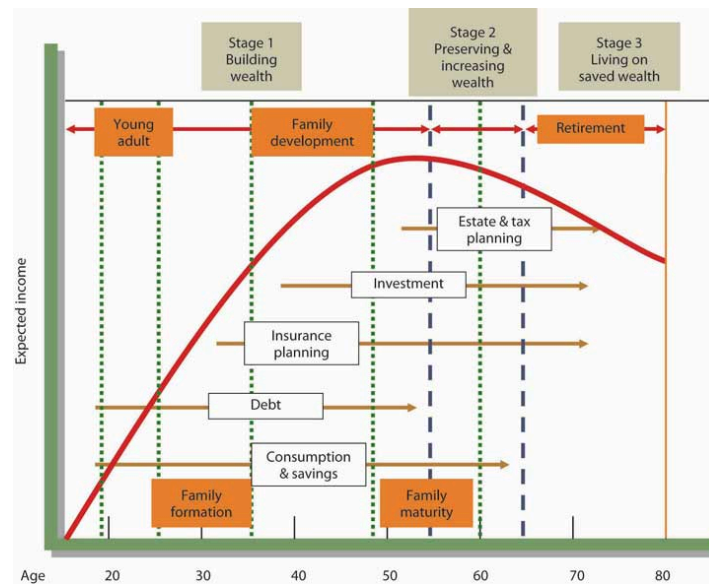


Figure 14.3 Financial Life Cycle

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%
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 diverse¹.

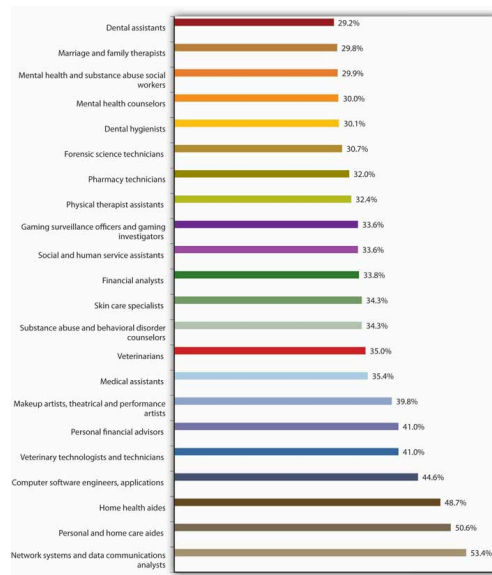


Figure 14.4 Top 25 Fastest-Growing Jobs, 2006–2016

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
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.

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4.1.2: Time Is Money

Learning Objectives

- Explain *compound interest* and *the time value of money*.
- 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.

Compound Interest

In your efforts to appreciate the potential of your \$10,000 to multiply itself, you have acquainted yourself with two of the most important concepts in finance. As we've already indicated, one is the principle of compound interest, which refers to the effect of earning interest on your interest.

Let's say, for example, that you take your grandfather's advice and invest your \$10,000 (your *principal*) in a savings account at an annual interest rate of 5 percent. Over the course of the first year, your investment will earn \$512 in interest and grow to \$10,512. If you now reinvest the entire \$10,512 at the same 5 percent annual rate, you'll earn another \$537 in interest, giving you a total investment at the end of year 2 of \$11,049. And so forth. And that's how you can end up with \$104,345 at age sixty-five.

Time Value of Money

You've also encountered the principle of the time value of money—the principle whereby a dollar received in the present is worth more than a dollar received in the future. If there's one thing that we've stressed throughout this chapter so far, it's the fact that, for better or for worse, most people prefer to consume now rather than in the future. This is true for both borrowers and lenders. If you borrow money from me, it's because you can't otherwise buy something that you want at the present time. If I lend it to you, it's because I'm willing to postpone the opportunity to purchase something I want at the present time—perhaps a risk-free, ten-year U.S. Treasury bond with a present yield rate of 3 percent.

I'm willing to forego my opportunity, however, only if I can get some compensation for its loss, and that's why I'm going to charge you interest. And you're going to pay the interest because you need the money to buy what you want to buy. How much interest should we agree on? In theory, it could be just enough to cover the cost of my lost opportunity, but there are, of course, other factors. Inflation, for example, will have eroded the value of my money by the time I get it back from you. In addition, while I would be taking no risk in loaning money to the U.S. government (as I would be doing if I bought that Treasury bond), I am taking a risk in loaning it to you. Our agreed-on rate will reflect such factors (Gallagher & Andrews Jr., 2003).

Finally, the time value of money principle also states that a dollar received today starts earning interest sooner than one received tomorrow. Let's say, for example, that you receive \$2,000 in cash gifts when you graduate from college. At age twenty-three, with your college degree in hand, you get a decent job and don't have an immediate need for that \$2,000. So you put it into an

account that pays 10 percent compounded *and* you add another \$2,000 (\$167 per month) to your account every year for the next eleven years¹. The left panel of Table 14.3 “Why to Start Saving Early (I)” shows how much your account will earn each year and how much money you’ll have at certain ages between twenty-three and sixty-seven. As you can see, you’d have nearly \$52,000 at age thirty-six and a little more than \$196,000 at age fifty; at age sixty-seven, you’d be just a bit short of \$1 million. The right panel of the same table shows what you’d have if you hadn’t started saving \$2,000 a year until you were age thirty-six. As you can also see, you’d have a respectable sum at age sixty-seven—but less than half of what you would have accumulated by starting at age twenty-three. More important, even to accumulate that much, *you’d have to add \$2,000 per year for a total of thirty-two years, not just twelve*.

Table 1.3 Why to Start Saving Early (I)

Savings accumulated from age 23, with deposits of \$2,000 annually until age 67				Savings accumulated from age 36, with deposits of \$2,000 annually until age 67		
Age	Annual deposit	Annual interest earned	Total saved at the end of the year	Annual deposit	Annual interest earned	Total saved at the end of the year
23	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
24	\$2,000	\$200.00	\$2,200	\$0.00	\$0.00	\$0.00
25	\$2,000	\$420.00	\$4,620	\$0.00	\$0.00	\$0.00
30	\$2,000	\$1,897.43	\$20,871.78	\$0.00	\$0.00	\$0.00
35	\$2,000	\$4,276.86	\$47,045.42	\$0.00	\$0.00	\$0.00
36	\$0.00	\$4,704.54	\$51,749.97	\$2,000	\$200.00	\$2,200.00
40	\$0.00	\$6,887.92	\$75,767.13	\$2,000	\$1,221.02	\$13,431.22
45	\$0.00	\$11,093.06	\$122,023.71	\$2,000	\$3,187.48	\$35,062.33
50	\$0.00	\$17,865.49	\$196,520.41	\$2,000	\$6,354.50	\$69,899.46
55	\$0.00	\$28,772.55	\$316,498.09	\$2,000	\$11,455.00	\$126,005.00
60	\$0.00	\$46,338.49	\$509,723.34	\$2,000	\$19,669.41	\$216,363.53
65	\$0.00	\$74,628.59	\$820,914.53	\$2,000	\$32,898.80	\$361,886.65
67	\$0.00	\$90,300.60	\$993,306.53	\$2,000	\$40,277.55	\$442,503.09

Source: Data from Consumer Credit Counseling Service of Maryland and Delaware Inc., “Power of Saving Early” (2008), www.cccs-inc.org/tools/tools_saving_early.php (accessed November 15, 2008).

Here’s another way of looking at the same principle. Suppose that you’re twenty years old, don’t have \$2,000, and don’t want to attend college full-time. You are, however, a hard worker and a conscientious saver, and one of your (very general) financial goals is to accumulate a \$1 million retirement nest egg. As a matter of fact, if you can put \$33 a month into an account that pays 12 percent interest compounded¹, you can have your \$1 million by age sixty-seven. That is, *if you start at age twenty*. As you can see from Table 14.4 “Why to Start Saving Early (II)”, if you wait until you’re twenty-one to start saving, you’ll need \$37 a month. If you wait until you’re thirty, you’ll have to save \$109 a month, and if you procrastinate until you’re forty, the ante goes up to \$366 a month (Keown, 2007).

Table 1.4 Why to Start Saving Early (II)

First Payment When You Turn	Required Monthly Payment	First Payment When You Turn	Required Monthly Payment
20	\$33	30	\$109
21	\$37	31	\$123
22	\$42	32	\$138
23	\$47	33	\$156
24	\$53	34	\$176

First Payment When You Turn	Required Monthly Payment	First Payment When You Turn	Required Monthly Payment
25	\$60	35	\$199
26	\$67	40	\$366
27	\$76	50	\$1,319
28	\$85	60	\$6,253
29	\$96		

Source: Arthur J. Keown, *Personal Finance: Turning Money into Wealth*, 4th ed. (Upper Saddle River, NJ: Pearson Education, 2007), 23.

The moral here should be fairly obvious: a dollar saved today not only starts earning interest sooner than one saved tomorrow (or ten years from now) but also can ultimately earn a lot more money in the long run. Starting early means in your twenties—early in stage 1 of your financial life cycle. As one well-known financial advisor puts it, “If you’re in your 20s and you haven’t yet learned how to delay gratification, your life is likely to be a constant financial struggle” (Clements, 2006).

Key Takeaways

- The principle of **compound interest** refers to the effect of earning interest on your interest.
- The principle of the **time value of money** is the principle whereby a dollar received in the present is worth more than a dollar received in the future.
- The principle of the time value of money also states that a dollar received today starts earning interest sooner than one received tomorrow.
- Together, these two principles give a significant financial advantage to individuals who begin saving early during the financial-planning life cycle.

Exercise

(AACSB) Analysis

Everyone wants to be a millionaire (except those who are already billionaires). To find out how old you’ll be when you become a millionaire, go to www.youngmoney.com/calculator...ire_calculator and input these assumptions:

Age: your actual age

Amount currently invested: \$10,000

Expected rate of return (interest rate): 5 percent

Millionaire target age: 65

Savings per month: \$500

Expected inflation rate: 3 percent

Click “calculate” and you’ll learn when you’ll become a millionaire (given the previous assumptions).

Now, let’s change things. We’ll go through this process three times. Change only the items described. Keep all other assumptions the same as those listed previously.

- Change the interest rate to 3 percent and then to 6 percent.
- Change the savings amount to \$200 and then to \$800.
- Change your age from “your age” to “your age plus 5” and then to “your age minus 5.”

Write a brief report describing the sensitivity of becoming a millionaire, based on changing interest rates, monthly savings

amount, and age at which you begin to invest.

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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.

Step 1: Evaluating Your Current Financial Situation

Just how are you doing, financially speaking? You should ask yourself this question every now and then, and it should certainly be your starting point when you decide to initiate a more or less formal financial plan. The first step in addressing this question is collecting and analyzing the records of what you *own* and what you *owe* and then applying a few accounting terms to the results:

- Your personal *assets* consist of what you *own*.
- Your personal *liabilities* are what you *owe*—your obligations to various creditors, big and small.

Preparing Your Net-Worth Statement

Your net worth (accounting term for your *wealth*) is the difference between your assets and your liabilities. Thus the formula for determining net worth is:

$$\text{Assets} - \text{Liabilities} = \text{Net worth}$$

If you own more than you owe, your net worth will be *positive*; if you owe more than you own, it will be *negative*. To find out whether your net worth is on the plus or minus side, you can prepare a personal net worth statement like the one in Figure 14.6, which we've drawn up for a fictional student named Joe College. (Note that we've included lines for items that may be relevant to some people's net worth statements but left them blank when they don't apply to Joe.)

Joe College's Personal Net Worth Statement as of August 31, 2012	
ASSETS (what you own)	Value
Cash	\$ 200
Checking accounts	1,000
Savings accounts/CDs/money market accounts	400
Market value of investments (stocks, bonds, mutual funds)	—
Retirement accounts	—
Market value of real estate	—
Cars	8,000
Furniture and appliances	1,500
Computers	900
Stereo/video equipment/cell phones	400
Jewelry	—
Clothing	300
Other assets	—
Total Assets	12,700
LIABILITIES (what you owe)	Amount
Credit card balances	1,200
Charge account balances	200
Student loans	7,000
Car loans	2,300
Home mortgage	—
Other liabilities	—
Total Liabilities	10,700
Assets – Liabilities = Net worth	
Total Net Worth	\$ 2,000

Figure 14.6 Net Worth Statement

Assets

Joe has two types of assets:

- First are his *monetary* or *liquid assets*—his cash, the money in his checking accounts, and the value of any savings, CDs, and money market accounts. They're called *liquid* because either they're cash or they can readily be turned into cash.
- Everything else is a *tangible asset*—something that Joe can use, as opposed to an investment. (We haven't given Joe any *investments*—such financial assets as stocks, bonds, or mutual funds—because people usually purchase these instruments to meet such long-term goals as buying a house or sending a child to college.)

Note that we've been careful to calculate Joe's assets in terms of their fair market value—the price he could get by selling them at present, not the price he paid for them or the price that he could get at some future time.

Liabilities

Joe's net worth statement also divides his liabilities into two categories:

- Anything that Joe owes on such items as his furniture and computer are *current liabilities*—debts that must be paid within one year. Much of this indebtedness no doubt ends up on Joe's credit card balance, which is regarded as a current liability because he *should* pay it off within a year.
- By contrast, his car payments and student-loan payments are *noncurrent liabilities*—debt payments that extend for a period of more than one year. Joe is in no position to buy a house, but for most people, their mortgage is their most significant noncurrent liability.

Finally, note that Joe has positive net worth. At this point in the life of the average college student, positive net worth may be a little unusual. If you happen to have negative net worth right now, you're technically *insolvent*, but remember that a major goal of getting a college degree is to enter the workforce with the best possible opportunity for generating enough wealth to reverse that situation.

Preparing Your Cash-Flow Statement

Now that you know something about your financial status *on a given date*, you need to know more about it *over a period of time*. This is the function of a cash-flow or income statement, which shows where your money has come from and where it's slated to go.

Figure 14.7 is Joe College's cash-flow statement. As you can see, Joe's *income* (his cash *inflows*—money coming in) is derived from two sources: student loans and income from a part-time job. His expenditures (cash *outflows*—money going out) fall into several categories: housing, food, transportation, personal and health care, recreation/entertainment, education, insurance, savings, and other expenses. To find out Joe's *net cash flow*, we subtract his expenditures from his income:

$$\$25,700 - \$25,300 = \$400$$

Joe College's Personal Cash-Flow Statement as of August 31, 2012	
CASH INFLOWS (cash coming in)	
Wages (full time in summer/part time during semester)	\$ 18,700
Student loan	7,000
Total inflow of cash	25,700
CASH OUTFLOWS (cash going out)	
Housing	
Rent	5,400
Utilities (electricity, heat, water, cable)	700
Communication (phone and internet access)	900
Food	
Groceries	2,300
Eating out	1,200
Transportation	
Gas and maintenance	1,400
Car loan payments	1,400
Personal and healthcare	
Medical co-payments and dental	200
Clothing	200
Laundry/cleaning supplies/miscellaneous	100
Recreation/Entertainment	
Night life/movies/concerts	900
Magazines/music/miscellaneous	200
Education	
Tuition	5,500
Books	1,000
Student loan payments	—
Insurance	
Car, health, renter's	1,900
Savings	1,200
Other expenses	800
Total outflow of cash	25,300
Cash inflow - Cash outflow = Net cash flow	
Net Cash Flow	\$ 400

Figure 14.7 Cash-Flow Statement

Joe has been able to maintain a positive cash flow for the year ending August 31, 2012, but he's cutting it close. Moreover, he's in the black only because of the inflow from student loans—income that, as you'll recall from his net worth statement, is also a noncurrent liability. We are, however, willing to give Joe the benefit of the doubt: Though he's incurring the high costs of an education, he's willing to commit himself to the debt (and, we'll assume, to careful spending) because he regards education as an investment that will pay off in the future.

Remember that when constructing a cash-flow statement, you must record only income and expenditures that pertain to a given period, whether it be a month, a semester, or (as in Joe's case) a year. Remember, too, that you must figure both inflows and outflows *on a cash basis*: you record income only when you receive money, and you record expenditures only when you pay out money. When, for example, Joe used his credit card to purchase his computer, he didn't actually pay out any money. Each monthly payment on his credit card balance, however, is an outflow that must be recorded on his cash-flow statement (according to the type of expense—say, recreation/entertainment, food, transportation, and so on).

Your cash-flow statement, then, provides another perspective on your *solvency*: if you're *insolvent*, it's because you're spending more than you're earning. Ultimately, your net worth and cash-flow statements are most valuable when you use them together. While your net worth statement lets you know what you're worth—how much wealth you have—your cash-flow statement lets you know precisely what effect your spending and saving habits are having on your wealth.

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

Learning Objectives

- Discuss the trend in the U.S. savings rate.
- Define a *subprime loan* and explain the difference between a *fixed-rate mortgage* and an *adjustable-rate mortgage*.
- 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.
- Define *risk* and explain some of the risks entailed by personal financial transactions.

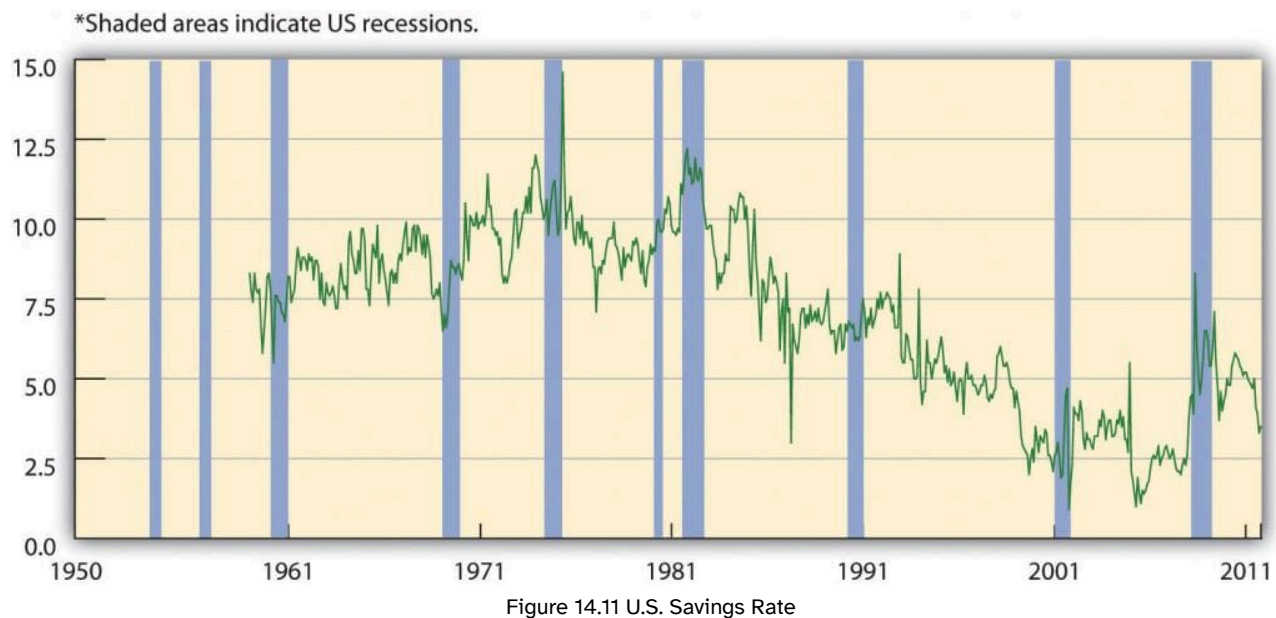
Joe isn't old enough to qualify, but if his grandfather had deposited \$1,000 in an account paying 7 percent interest in 1945, it would now be worth \$64,000. That's because money invested at 7 percent compounded will double every ten years. Now, \$64,000 may or may not seem like a significant return 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).

Disposing of Savings

Figure 14.11 shows the U.S. *savings rate*—which measures the percentage of disposable income devoted to savings for the period 1960 to 2010. As you can see, it suffered a steep decline from 1980 to 2005 and remained at this negligible savings rate until it started moving up in 2008. The recent increase in the savings rate, however, is still below the long-term average of 7 percent (Economic Research, 2008; Dickson, 2007).



Now, a widespread tendency on the part of Americans to spend rather than save doesn't account entirely for the downward shift in the savings rate. In late 2005, the Federal Reserve cited at least two other (closely related) factors in the decline of savings (Federal Reserve Bank of San Francisco, 2005):

- An increase in the ratio of stock-market wealth to disposable income
- An increase in the ratio of residential-property wealth to disposable income

Assume, for example, that, in addition to your personal savings, you own some stock and have a mortgage on a home. Both your stock and your home are (supposedly) *appreciable assets*—their value used to go up over time. (In fact, if you had taken out your mortgage in 2000, by the end of 2005 your home would have appreciated at double the rate of your disposable personal income.) The decline in the personal savings rate during the mid-2000s, suggested the Fed, resulted in part from people's response to "long-lived bull markets in stocks and housing"; in other words, a lot of people had come to rely on the appreciation of such assets as stocks and residential property as "a substitute for the practice of saving out of wage income."

Subprime Rates and Adjustable Rate Mortgages

Let's assume that you weren't ready to take advantage of the boom in mortgage loans in 2000 but did set your sights on 2005. You may not have been ready to buy a house in 2005 either, but there's a good chance that you got a loan anyway. In particular, some lender might have offered you a so-called subprime mortgage loan. Subprime loans are made to borrowers 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. As of March 2007, U.S. lenders had written \$1.3 trillion in mortgages like yours (Associated Press, 2007).

Granted, your terms might not have been very good. For one thing, interest rates on subprime loans may run from 8 percent to 10 percent and higher (consumeraffairs.com, 2005). In addition, you probably had to settle for an adjustable-rate mortgage (ARM)—one that's pegged to the increase or decrease of certain interest rates that your lender has to pay. When you signed your mortgage papers, you knew that if those rates went up, your mortgage rate—and your monthly payments—would go up, too. Fortunately, however, you had a plan B: with the value of your new asset appreciating even as you enjoyed living in it, it wouldn't be long before you could refinance it at a more manageable and more predictable rate.

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4.1.5: Cases and Problems

Learning on the Web (AACSB)

Go to <https://www.quizzle.com> 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.

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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>

5: LOAN QUALIFICATION AND PROCESSING

5.1: Qualifying the Property

5.2: Qualifying the Buyer

5.3: Difference between Prequal and Preapproval

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

5.5: RE Math

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

6: ETHICS AND CONSUMER PROTECTION

6.1: Ethics- Fair Credit Reporting (Foreclosure)

6.1.1: Chapter Introduction

6.1.2: Uses, History, and Creation of Mortgages

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

6.2: Consumer Protection Laws

6.3: Fair Housing

6.3.1: Finding a Home- Inequities

6.3.2: Movement toward Equity

6.3.3: Video

6.3.4: Merlot Module on Fair Housing

6.4: Mechanics Liens

6.4.1: Nonconsensual Lien

6.1: ETHICS- FAIR CREDIT REPORTING (FORECLOSURE)

6.1.1: Chapter Introduction

6.1.2: Uses, History, and Creation of Mortgages

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

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

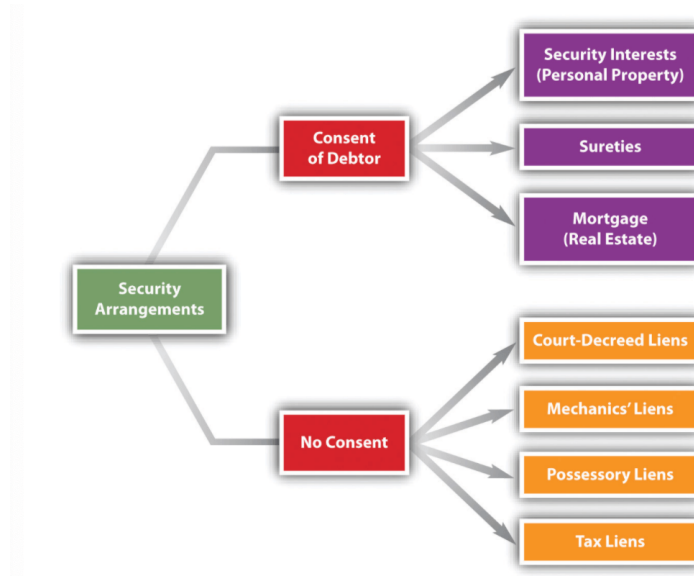
6.1.2: Uses, History, and Creation of Mortgages

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

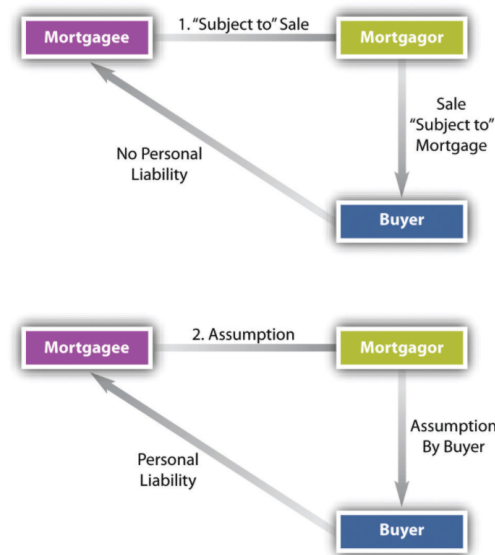
Unless they live in the home for twenty-five or thirty years, the mortgagors usually pay off the mortgage when the property is sold. Occasionally, mortgages are paid off in order to refinance. If the mortgage was taken out at a time of high interest rates and rates later drop, the homeowner might want 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



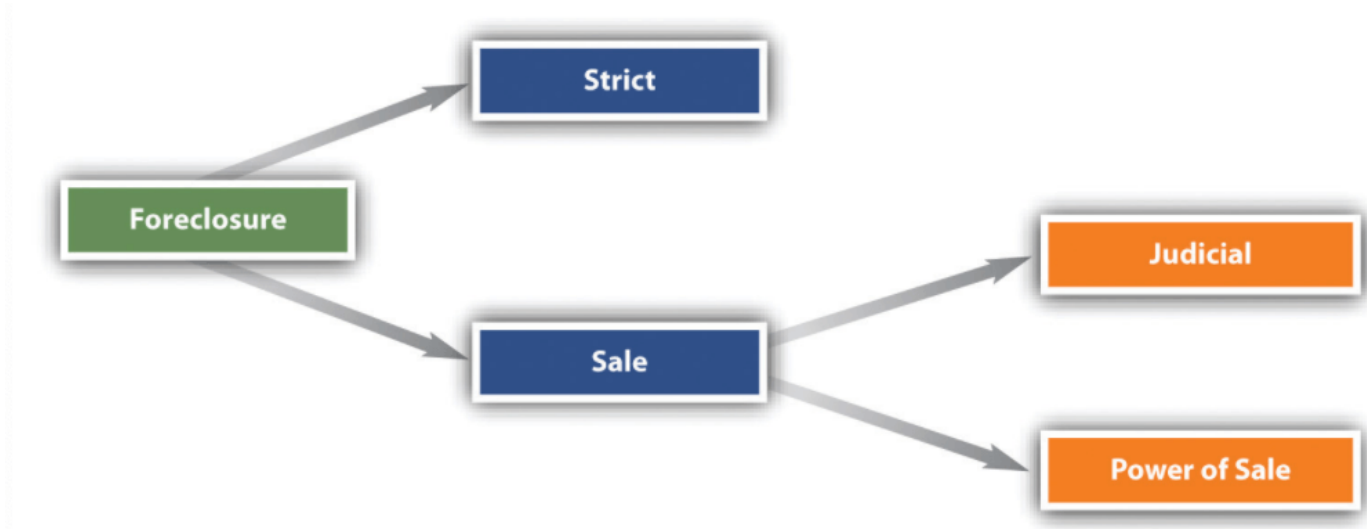
What if mortgage rates are high? Can buyers assume an existing low-rate mortgage from the seller rather than be forced to obtain a new mortgage at substantially higher rates? Banks, of course, would prefer not to allow that when interest rates are rising, so they often include in the mortgage a **due-on-sale 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

6.3.2: Movement toward Equity

6.3.3: Video

6.3.4: Merlot Module on 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.

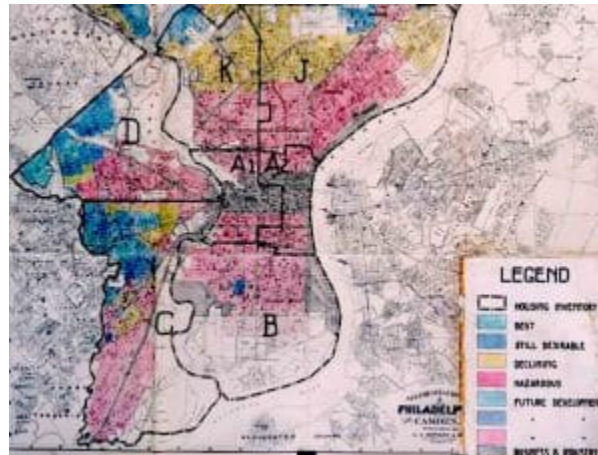


Figure 9.9. Lending institutions and the federal government created maps in which the places where people of color and/or foreign-born lived were colored red.

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]

YouTube Video

This interactive element is not available in this format. Visit the link or scan the QR code to access it online.

[View this YouTube Video online](#)



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.

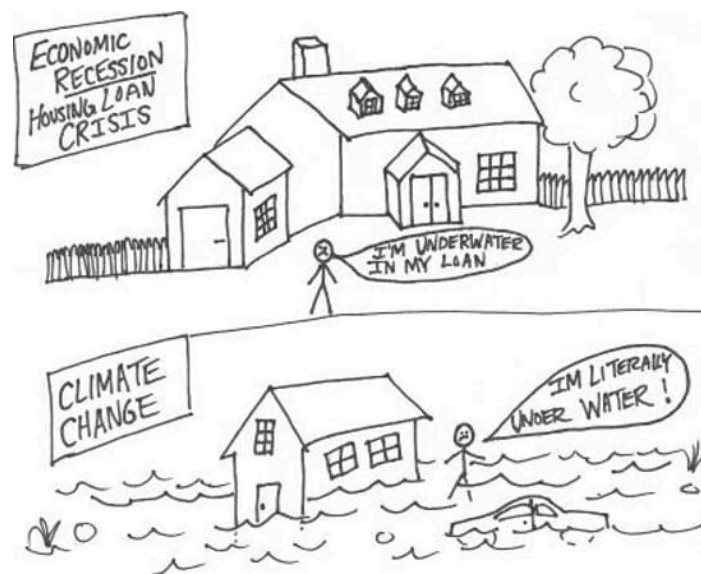


Figure 9.12. Flooding could displace 126 million people, or 40% of the US population, by 2021.

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, religion 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 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](https://theastergates.com/projects).



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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](#).



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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.

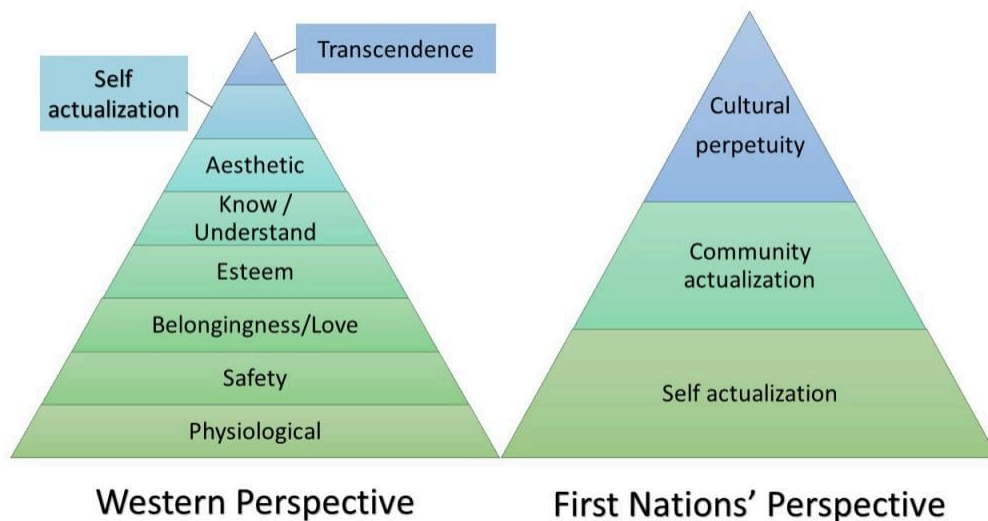


Figure 9.18. Maslow's hierarchy of needs compared to the First Nations' perspective. Maslow's scope of analysis is individual rights/privilege in one lifetime. The First Nations have an expansive concept of time and multiple dimensions of reality.

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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"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>

YouTube Video

This interactive element is not available in this format. Visit the link or scan the QR code to access it online.

[View this YouTube Video online](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

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.

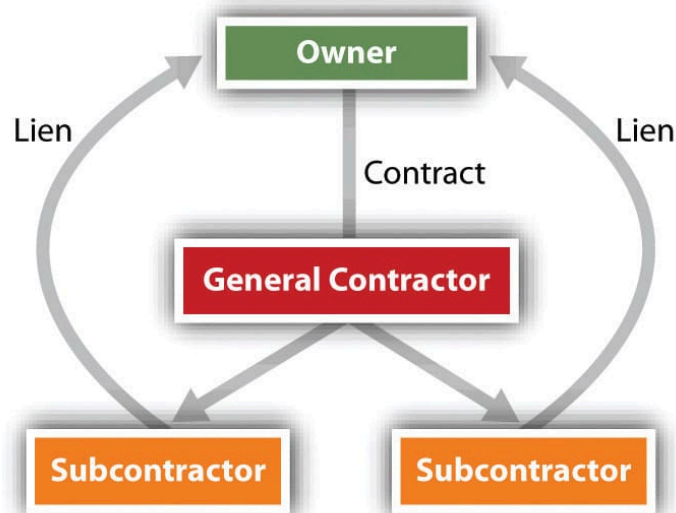
Mechanic's Lien

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?

INDEX

A

acceleration clause
6.1.2: Uses, History, and Creation of Mortgages

C

compound interest
4.1.2: Time Is Money

D

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

F

financial institutions
1.2: Financial Institutions

foreclosure
6.1.2: Uses, History, and Creation of Mortgages

foreclosure by sale
6.1.2: Uses, History, and Creation of Mortgages

I

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

J

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

M

mortgage
6.1.2: Uses, History, and Creation of Mortgages

mortgagee
6.1.2: Uses, History, and Creation of Mortgages

mortgagor
6.1.2: Uses, History, and Creation of Mortgages

P

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

R

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

redlining
6.1.2: Uses, History, and Creation of Mortgages

right of redemption
6.1.2: Uses, History, and Creation of Mortgages

S

strict foreclosure
6.1.2: Uses, History, and Creation of Mortgages

T

time value of money
4.1.2: Time Is Money

GLOSSARY

S

Sample Word 1 | Sample Definition 1

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 - 4.5: Wrap-around/ Land Contracts, Construction, As-is - *Undeclared*
 - 4.6: Financing Small Investment Properties - *Undeclared*
 - 4.7: Shared Equity - *Undeclared*
 - 4.8: Residential Income Properties - *Undeclared*
 - 4.9: Pricing Loans- Yields, Buy downs - *Undeclared*
 - 5: Loan Qualification and Processing - *Undeclared*
 - 5.1: Qualifying the Property - *Undeclared*
 - 5.2: Qualifying the Buyer - *Undeclared*
 - 5.3: Difference between Prequal and Preapproval - *Undeclared*
 - 5.4: (Processing, Servicing, Closing the Loan) Items Included - *Undeclared*
 - 5.5: RE Math - *Undeclared*
 - 6: Ethics and Consumer Protection - *Undeclared*
 - 6.1: Ethics- Fair Credit Reporting (Foreclosure) - *Undeclared*
 - 6.1.1: Chapter Introduction - *Undeclared*
 - 6.1.2: Uses, History, and Creation of Mortgages - *Undeclared*
 - 6.1.3: Priority, Termination of the Mortgage, and Other Methods of Using Real Estate as Security - *Undeclared*
 - 6.2: Consumer Protection Laws - *Undeclared*
 - 6.3: Fair Housing - *Undeclared*
 - 6.3.1: Finding a Home- Inequities - CC BY 4.0
 - 6.3.2: Movement toward Equity - CC BY 4.0
 - 6.3.3: Video - *Undeclared*
 - 6.3.4: Merlot Module on Fair Housing - *Undeclared*
 - 6.4: Mechanics Liens - *Undeclared*
 - 6.4.1: Nonconsensual Lien - *Undeclared*

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